CHAPTER 7

Market Structures

Advertisers try to persuade consumers to purchase their products.

Economics & You

Why are some products available at competitive prices? Why are other products priced higher? In **Chapter 7,** you will learn about the various effects competition and market structures have on the prices you pay. To learn more about competition in a free enterprise system, view the Chapter 8 video lesson:

Competition and Monopolies

Chapter Overview Visit the *Economics: Principles and Practices* Web site at epp.glencoe.com and click on ***Chapter 7—Chapter Overviews*** to preview chapter information.

CLICK HERE

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SECTION 1

Competition and Market Structures

Study Guide

Main Idea

Market structures include perfect competition, monopolistic competition, oligopoly, and monopoly.

Reading Strategy

Graphic Organizer As you read the section, complete a graphic organizer similar to the one below by identifying five conditions that characterize perfectly competitive markets.

Key Terms

laissez-faire, market structure, perfect competition, imperfect competition, monopolistic competition, product differentiation, nonprice competition, oligopoly, collusion, price-fixing, monopoly, natural monopoly, economies of scale, geographic monopoly, technological monopoly, government monopoly

Objectives

After studying this section, you will be able to:

1. **Explain** the characteristics of perfect competition.
2. **Understand** the nature of monopolistic competition.
3. **Describe** the behavior and characteristics of the oligopolist.
4. **Identify** several types of monopolies.

Applying Economic Concepts

Product Differentiation Think of a popular brand of shoes or clothing. Read to find out why sellers go to such lengths to differentiate their products.

Cover Story

Discount for *Times* Bestsellers Sparks On-line Book Price War

SEATTLE—A price war among the three biggest on-line booksellers broke out yesterday when Amazon.com announced 50 percent off all New York Times [best-selling books] and Barnesandnoble.com and Borders.com immediately matched the discount. The deep discounts will mean that the companies will make little or no profit on the books, but the offer could stimulate sales of other more lucrative products as customers browse through the Web sites. . . .

On-line discounts

—*The Boston Globe*, May 18, 1999

When Adam Smith published *An Inquiry into the Nature and Causes of the Wealth of Nations* in 1776, the average factory was small, and business was competitive. **Laissez-faire,** the philosophy that government should not interfere with commerce or trade, dominated Smith's writing. "Laissez-faire" is a French term that means "allow them to do." Under laissez-faire, the role of government is confined to protecting private property, enforcing contracts, settling disputes, and protecting businesses against increased competition from foreign goods.

By the late 1800s, however, competition was weakening. In some markets mergers and acquisitions had combined many small firms into a few very large businesses. As industries developed—*industry,* meaning the supply side of the market, or all producers collectively—the nature of competitive markets changed. Many modern markets, such as the one discussed in the cover story, are now dominated by a few very large firms.

Market Structures

Conditions A market is a place where buyers and sellers can exchange products. ***How do economists classify markets?***

Today, economists classify markets according to conditions that prevail in them. They ask questions such as: How many buyers and suppliers are there? How large are they? Does either have any influence over price? How much competition exists between firms? What kind of product is involved—is everyone trading the exact same product, or are they simply similar? Is it easy or difficult for new firms to enter the market?

The answers to these questions help determine **market structure,** or the nature and degree of competition among firms operating in the same industry. Economists group industries into four different market structures—perfect competition, monopolistic competition, oligopoly, and monopoly.

Perfect Competition

Perfect competition is characterized by a large number of well-informed independent buyers and sellers who exchange identical products. It represents a theoretically ideal situation that is used to evaluate other market structures. Five major conditions characterize perfectly competitive markets.

Necessary Conditions

The first condition is that there are a large number of buyers and sellers. No single buyer or seller is large enough or powerful enough to affect the price.

The second condition is that buyers and sellers deal in identical products. With no difference in quality, there is no need for brand names and no need to advertise. One seller's merchandise is just as good as another's. The market for table salt shares some of these features. Because salt is always the same chemical—sodium chloride—there is no logical reason to prefer one brand of salt over another.

The third condition is that each buyer and seller acts independently. This ensures that sellers compete against one another for the consumer's dollar, and that consumers compete against one another to obtain the best price. This competition is one of the forces that keeps prices low.

The fourth condition is that buyers and sellers are reasonably well-informed about products and prices. Well-informed buyers shop at the stores that have the lowest prices. Well-informed sellers match the lowest prices of their competitors to avoid losing customers.

The fifth condition is that buyers and sellers are free to enter into, conduct, or get out of business. This freedom makes it difficult for producers in any industry to keep the market to themselves. Producers have to keep prices competitive or new firms can take away some of their business.

Perfect Competition and Profit Maximization

Under perfect competition, each individual firm is too small to influence price. Therefore, the firm views demand differently than the market does. In a perfectly competitive market, supply and demand set

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the equilibrium price. Then, each firm selects a level of output that will maximize its profits at that price.

The relationship between an individual firm and the entire industry under perfect competition is shown graphically in **Figure 7.1.** In **Panel A,** the market forces of supply and demand set the equilibrium price at $15. This price, as shown in **Panel B,** now becomes a horizontal demand curve facing each perfectly competitive firm. Because the firm receives $15 for every additional unit it makes, the demand curve is the same as the marginal revenue (MR) curve.

Panel B also shows the cost and revenue information for the firm presented earlier, in **Figure 5.6** on page 128. This firm, as you may recall, also received $15 for every unit of output sold—which is why the price is the same as the marginal revenue shown in the second-to-last column. When the firm wanted to maximize its profits, it did so by finding the level of output that equated its marginal cost with its marginal revenue.

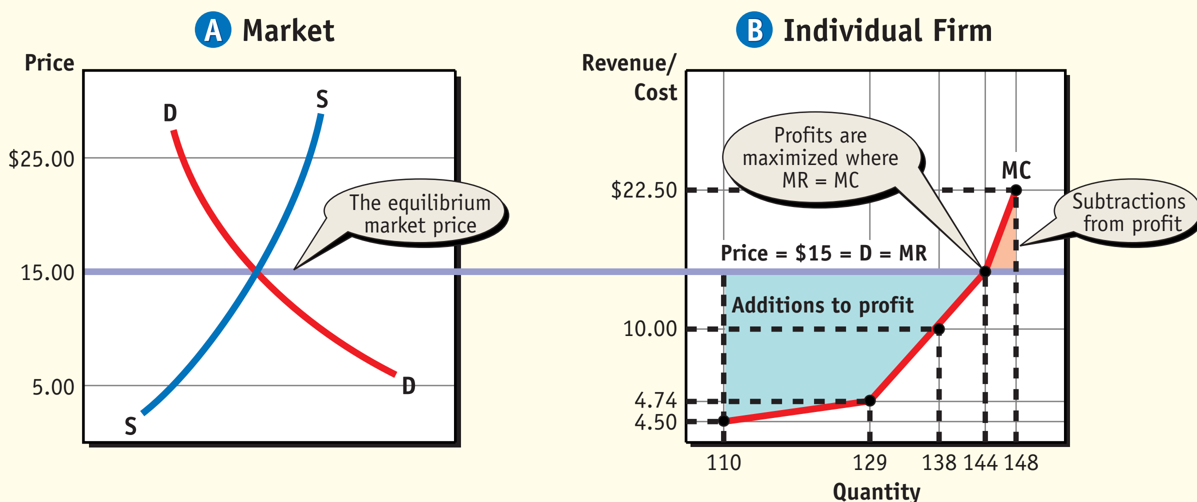
Panel B in **Figure 7.1** shows this same information graphically. For example, the firm's marginal cost (MC) for producing the 110th unit of output was $4.50. Because this unit could be sold in the market for $15, the firm made a profit of $10.50. When the firm added the seventh worker, total output rose to 129 units, and marginal costs rose to $4.74—thereby earning additional profits for the firm.

The eighth worker helped increase total output to 138 units. This was also profitable since the marginal cost of producing 138 units was less than the marginal revenue from the sale of those products. When the firm hired the ninth worker, however, marginal cost was exactly equal to marginal revenue, so at this point the firm would stop hiring labor and maintain production at 144 units. Had the firm hired the tenth variable input, increasing total output to 148 units, total profits would have gone down because the $22.50 marginal cost of production was larger than the $15 marginal revenue.

ECONOMICS AT A GLANCE

Figure 7.1

Perfect Competition: Market Price and Profit Maximization



Using Graphs Under perfect competition, the market forces of supply and demand establish the equilibrium price. The perfectly competitive firm treats this price as its demand curve and its marginal revenue (MR) because the firm will receive $15 for each and every unit it sells. **Is perfect competition always a theoretical situation? Explain.**

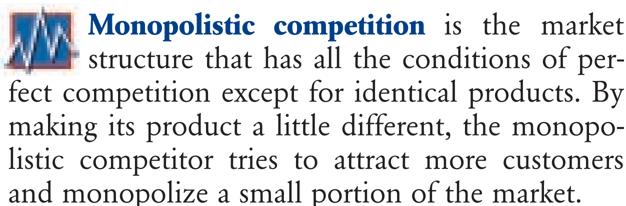
The profit maximizing quantity of output is found where the marginal cost of production is equal to the marginal revenue from sales, or where MC = MR. This occurs at 144 units of output, shown in both **Figure 5.6** and **Panel B** of **Figure 7.1.** Other levels of output may generate the same amount of profits, but none will generate more.

A Theoretical Situation

Few, if any, perfectly competitive markets exist, although local vegetable farming ("truck" farming) comes close to satisfying all five conditions. In these markets many sellers offer nearly identical products. Individual sellers are unable to control prices, and both buyers and sellers have reasonable knowledge of products and prices. Finally, anyone who wants to enter the business by growing tomatoes, corn, or other products can easily do so.

Although perfect competition is rare, it is important because economists use it to evaluate other market structures. **Imperfect competition** is the name given to a market structure that lacks one or more of the conditions of perfect competition. Most firms and industries in the United States today fall into this classification, which has three categories—monopolistic competition, oligopoly, and monopoly.

Monopolistic Competition



Monopolistic competition is the market structure that has all the conditions of perfect competition except for identical products. By making its product a little different, the monopolistic competitor tries to attract more customers and monopolize a small portion of the market.

Product Differentiation

In contrast to perfect competition, monopolistic competition utilizes **product differentiation**—real or imagined differences between competing products in the same industry. Most items produced today—from the many brands of athletic footwear to personal computers—are differentiated. The differentiation may even be extended to store location, store design, manner of payment, delivery, packaging, service, and other factors.

Sometimes differences between products are real. For example, some brands of athletic footwear have special shock-absorbing soles. Others have certain construction materials to reduce weight. Some are just designed to look more appealing, or are linked to star athletes.

Nonprice Competition

Monopolistic competitors want to make consumers aware of product differences. **Nonprice competition**—the use of advertising, giveaways, or other promotional campaigns to convince buyers that the product is somehow better than another brand—often takes the place of price competition. Therefore, monopolistic competitors usually advertise or promote heavily to make their products seem different from everyone else's.

Careers

Market Researcher

Can you organize and evaluate data? Can you be impartial when you compile your findings?

The Work

Market researchers gather, record, and analyze facts about products and sales. Information may be gathered from company or government records, published materials, statistical files, and other sources. Researchers often print and circulate questionnaires, or survey people over the phone or door-to-door. The information is used to prepare forecasts of future sales trends, offer recommendations on product design, and define the market toward which advertising should be directed.

Qualifications

Strong analytical and writing skills and experience with computerized data are essential. Courses in marketing, statistics, English composition, speech, psychology, and economics are required.

THE GLOBAL ECONOMY

Marketing in China

An important part of any product is its name. It must convey what the producers intend.

Potential exporters must understand cultural characteristics when considering brand management. Because the Chinese continue to favor names that convey goodness, luck, happiness, long life, prosperity or historical significance, it is sometimes difficult to translate a Western brand name into Chinese.

The Coca-Cola Company took 11 years to make a profit, in part due to an ill-advised brand name, after it came back to China in 1979. Today, Coke dominates the vast soft drink market across the Chinese continent after creating an improved name meaning "delicious, enjoyable and makes you happy."

PepsiCo, Inc., came up with "everything makes you happy" to capture market share for Pepsi. . . .

—Alcinda Hatfield, Foreign Agricultural Service, July 1999

Critical Thinking

1. **Making Generalizations** Why is it sometimes difficult to translate a brand name into a name acceptable to people in another country?
2. **Categorizing Information** What part does the brand name and labeling of a product play in product differentiation?

This explains why producers of designer jeans spend so much on advertising and promotion. If the seller can *differentiate* a product in the mind of the buyer, the firm may be able to raise the price above its competitors' prices.

Monopolistic Competition and Profit Maximization

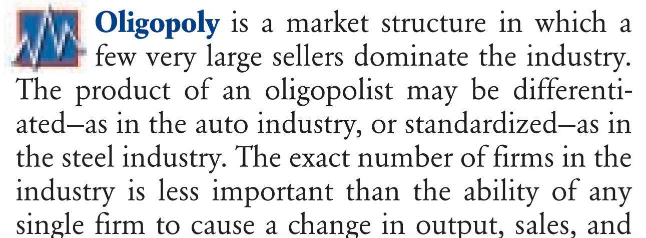
Under monopolistic competition, similar products generally sell within a narrow price range. The monopolistic aspect is the seller's ability to raise the price within this narrow range. The competitive aspect is that if sellers raise or lower the price enough, customers will forget minor differences and change brands.

The profit maximization behavior of the monopolistic competitor is no different from that of other firms. The firm produces the quantity of output where its marginal cost is equal to its marginal revenue. If the firm convinces consumers that its product is better, it can charge a higher price. If it cannot convince them, the firm cannot charge as much.

The monopolistic competitor can enter the market easily. The possibility of profits draws new firms, each of which produces a product only a little different from the ones already on the market. In time, both the number of firms in an industry and the supply of the product becomes fairly stable with no great profits or losses.

Oligopoly

Oligopoly is a market structure in which a few very large sellers dominate the industry. The product of an oligopolist may be differentiated—as in the auto industry, or standardized—as in the steel industry. The exact number of firms in the industry is less important than the ability of any single firm to cause a change in output, sales, and



Competing in the Market On an average shopping trip, a consumer's eye lingers on a product for only about 2.5 seconds. In order to stay competitive, companies experiment with new formulas, along with the color and size of the product's packaging. These research and development costs can range from $100,000 for adding a new color to an existing product line to millions of dollars for the creation of a new product.

prices in the industry as a whole. Because of these characteristics, oligopoly is further from perfect competition than is monopolistic competition.

In the United States, many markets are already oligopolistic, and many more are becoming so. Pepsi and Coke dominate the soft drink market. McDonald's, Burger King, and Wendy's dominate the fast-food industry. A few large corporations dominate other industries, such as the domestic airline, automobile, and long-distance telephone service industries. Oligopolists are even popping up on the Internet. The Internet bookstores discussed in the cover story—Amazon.com, Barnesandnoble.com, and Borders.com—are oligopolists in their industry.

Interdependent Behavior

Because oligopolists are so large, whenever one firm acts the other firms usually follow. For example, if one airline announces discount fares, the other airlines generally match the lower prices in a matter of days, if not hours. Each oligopolist knows that the other firms in the industry have considerable power and influence. Therefore, firms tend to act together.

Sometimes the interdependent behavior takes the form of **collusion,** a formal agreement to set prices or to otherwise behave in a cooperative manner. One form of collusion is **price-fixing**—agreeing to charge the same or similar prices for a product. In almost every case these prices are higher than those determined under competition. The firms also might agree to divide the market so that each is guaranteed to sell a certain amount. Because collusion usually restrains trade, it is against the law.

Pricing Behavior

While an oligopolist can lower the price of its product at any time, that firm knows that other oligopolists are likely to follow suit. When one firm lowers prices it can lead to a price war, or a series of price cuts that result in unusually low prices.

The cover story describes a typical oligopolistic price war. Amazon's two competitors matched its lower prices immediately, and prices were so low that none of the firms made a profit at the sale prices. Oligopolistic price wars are usually short but intense—and almost always provide welcome price breaks for consumers.

Raising prices is also risky, unless the firm knows for certain that its rivals will follow suit. Otherwise, the firm with higher prices will lose sales to its competitors. Because of the potential threat to profits when prices go up or down, oligopolists generally prefer to compete on a nonprice basis.

Nonprice competition has the advantage of making it more difficult for rivals to respond quickly. If an oligopolist finds a new advertising gimmick or a way to enhance a product, the other firms are at a disadvantage for a period of time. After all, it takes longer to develop a better advertising campaign or a new physical attribute for a product than it does to match a price cut.

Oligopoly and Profit Maximization

The oligopolist, like any other firm, maximizes its profits when it finds the quantity of output

Competition

Advertising Advertisers often use celebrities, such as star athletes, to increase the popularity of their products. ***What is the purpose of product differentiation?***

ECONOMICS AT A GLANCE

Figure 7.2

Characteristics of Market Structures

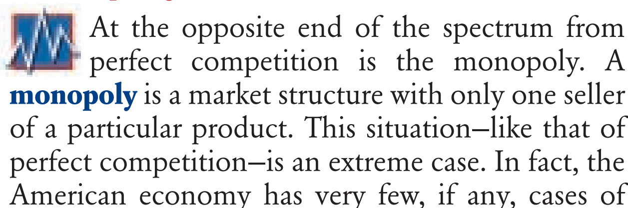
	Number of Firms in Industry	Influence Over Price	Product Differentiation	Advertising	Entry Into Market	Examples
Perfect Competition	Many	None	None	None	Easy	Perfect: None Near: Truck Farming
Monopolistic Competition	Many	Limited	Fair Amount	Fair Amount	Easy	Gas Stations Women's Clothing
Oligopoly	Few	Some	Fair Amount	Some	Difficult	Automobiles Aluminum
Pure Monopoly	One	Extensive	None	None	Almost Impossible	Perfect: None Near: Water

Using Tables The term market structure refers to the nature and degree of competition among firms operating in the same industry. Individual market structures—perfect competition, monopolistic competition, oligopoly, and monopoly—are determined by the five characteristics listed in the columns above. **In which market structure does nonprice competition play a major role?**

where its marginal cost is equal to its marginal revenue. Having found this level of production, the oligopolist will charge the price consistent with this level of sales.

The product's final price is likely to be higher than it would be under monopolistic competition, and much higher than it would be under perfect competition. Even when oligopolists do not collude formally, they still tend to act conservatively and seldom protest price hikes by their rivals.

Monopoly



At the opposite end of the spectrum from perfect competition is the monopoly. A **monopoly** is a market structure with only one seller of a particular product. This situation—like that of perfect competition—is an extreme case. In fact, the American economy has very few, if any, cases of pure monopoly—although the local telephone company or cable TV operator may come close.

Even the telephone company, however, faces competition from other communication companies, from the United States Postal Service, and from Internet providers that supply E-mail and voice-mail services. Local cable providers face competition from video rental stores, satellite cable systems, and the Internet. Consequently, when people talk about monopolies, they usually mean near monopolies.

One reason we have so few monopolies is that Americans traditionally have disliked and tried to outlaw them. Another reason is that new technologies often introduce products that compete with existing monopolies. The development of the fax machine allowed businesses to send electronic letters that compete with the United States Postal Service. Later, E-mail became even more popular than the fax.

Types of Monopolies

Sometimes the nature of a good or service dictates that society would be served best by a monopoly. One such case is a **natural monopoly**—a market situation where the costs of production are minimized by having a single firm produce the product.

Natural monopolies can provide services more cheaply as monopolies than could several competing firms. For example, two or more competing telephone companies serving the same area would be inefficient if they each needed their own telephone poles and lines. Public utility companies fall into this category because it would be wasteful to duplicate the networks of pipes and wires that distribute water, gas, and electricity throughout a city. To avoid these problems, the government often gives a public utility company a *franchise*, the exclusive right to do business in a certain area without competition. By accepting such franchises, the companies also accept a certain amount of government regulation.

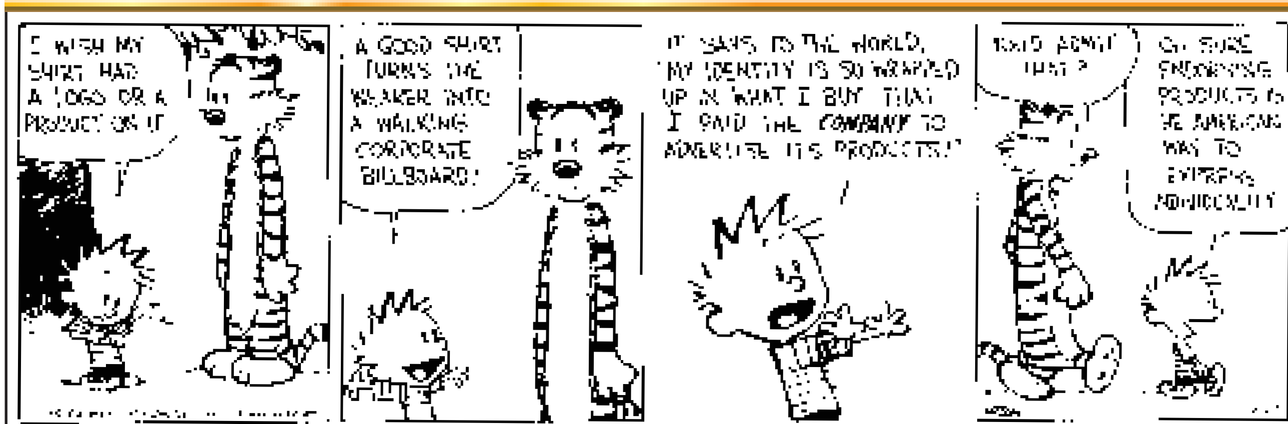
The justification for the natural monopoly is that a larger firm can often use its personnel, equipment, and plant more efficiently. This results in **economies of scale,** a situation in which the average cost of production falls as the firm gets larger. When this happens, it makes sense for the firm to be as large as is necessary to lower its production costs.

Sometimes a business has a monopoly because of its location. A drugstore operating in a town that is too small to support two or more such businesses becomes a **geographic monopoly,** a monopoly based on the absence of other sellers in a certain geographic area. Similarly, the owner of the only gas station on a lonely interstate highway exit also has a type of geographic monopoly.

A **technological monopoly** is a monopoly that is based on ownership or control of a manufacturing method, process, or other scientific advance. The government may grant a *patent*—an exclusive right to manufacture, use, or sell any new and useful invention for a specific period. Inventions are covered for 20 years; however, the product's designs can be patented for shorter periods, after which they become public property available for the benefit of all. Art and literary works are protected through a *copyright,* the exclusive right of authors or artists to publish, sell, or reproduce their work for their lifetime plus 50 years.

Still another kind of monopoly is the **government monopoly**—a monopoly the government owns and operates. Government monopolies are found at the national, state, and local levels. In most cases they involve products or services that private industry cannot adequately provide.

Competition



Nonprice Competition If advertisers can make you believe their product is better than others, you might pay more for it. ***How has nonprice competition affected your buying habits?***

Many towns and cities have monopolies that oversee water use. Some states control alcoholic beverages by requiring that they be sold only through state stores. The federal government controls the processing of weapons-grade uranium for military and natural security purposes.

Monopoly and Profit Maximization

Monopolies maximize profits the same way other firms do: they equate marginal cost with marginal revenue to find the profit-maximizing quantity of output. Even so, there are differences between the monopolist and other profit-maximizing firms—especially the perfect competitor.

First, the monopolist is very much larger than the perfect competitor. This is because there is only one firm—the monopolist—supplying the product, rather than thousands of smaller ones. Second, this large size, along with the lack of meaningful competition, allows the monopolist to behave as a *price maker*—as opposed to the perfect competitor who is a *price taker.*

Because there are no competing firms in the industry, there is no equilibrium price facing the monopolist. Instead, the monopolist determines the price that will equate its marginal revenue with its marginal cost, and then produces the quantity of output consistent with that price. In every case, the monopolist will charge more for its product—hence the term *price maker*—and then limit the quantity for sale in the market.

Monopoly

Geographic Monopoly A lone general store in an isolated area enjoys a geographic monopoly. ***How does a geographic monopoly differ from a natural monopoly?***

Section 1 Assessment

Checking for Understanding

1. **Main Idea** Describe the four basic market structures. Explain how they differ from one another.
2. **Key Terms** Define laissez-faire, market structure, perfect competition, imperfect competition, monopolistic competition, product differentiation, nonprice competition, oligopoly, collusion, price-fixing, monopoly, natural monopoly, economies of scale, geographic monopoly, technological monopoly, government monopoly.
3. **List** the five characteristics of perfect competition.
4. **Describe** monopolistic competition.
5. **Explain** why the actions of one oligopolist affect others in the same industry.
6. **Identify** the types of monopolies.

Applying Economic Concepts

7. **Product Differentiation** Make a list of as many clothing stores in your community as possible. Describe how each store tries to differentiate itself from the others.

Critical Thinking

8. **Synthesizing Information** Provide at least two examples of oligopolies in the United States today.

Practice and **assess** key social studies skills with the *Glencoe Skillbuilder Interactive Workbook, Level 2.*

Profiles in Economics

"I Love the Challenge": Charles Wang

(1944–)

"There are CEOs who brag about never having touched a PC," says Charles Wang, head of Computer Associates International. "I say to them, 'Get your head out of the sand, kid.'" Wang's aggressive approach has helped him grow his company from a four-person operation to one that earns more than $5 billion in computer software sales a year. Today, Computer Associates is the largest independent supplier of software for business computing.

A DIFFICULT START

Born in Shanghai, China, in 1944, Charles Wang and his family fled the communist regime in 1952 to settle in the United States. Wang attended Queens College in New York and then opened an American subsidiary of Swiss-owned Computer Associates in New York City in 1976. Wang began his operations with just one product.

STRATEGY FOR GROWTH

Wang believed that the best growth strategy for the fledgling company was to purchase existing software firms and market their products. This would spare his company the risk of developing its own products and enable it to get products to market sooner. The strategy paid off. Computer Associates purchased a number of firms throughout the 1980s, and increased its sales more than tenfold, from $85 million in 1984 to $1 billion in 1989.

The recession of 1990–1991 put a damper on business, but Wang remained optimistic about the future of his company and launched a campaign to purchase even more companies. His efforts were amply rewarded, and Computer Associates soon found itself back on the fast track.

PROGRESSIVE MANAGEMENT

Despite its enormous growth, the company still remains focused on its people. Wang supplies on-site fitness facilities and child development centers for employees. He brought together 2,000 members of Computer Associates' development staff for "Nerd Weekend"—a celebration for the people who fueled Computer Associates' growth. Wang also sponsors "Technology Boot Camps" to help chief executives get over their fear and ignorance of computers. In 1994, he wrote a book urging business people to start thinking like technology people, and vice versa.

How has Wang accomplished so much? "I love it when people say it can't be done," he says. "I love the challenge."

Examining the Profile

1. **Identifying Cause and Effect** What business strategy helped Wang's fledgling company become successful?
2. **Evaluating Information** How important do you think Wang's "Nerd Weekend" and similar activities are to his company's success?

SECTION 2

Market Failures

Study Guide

Main Idea

Inadequate competition, inadequate information, and immobile resources can result in market failures.

Reading Strategy

Graphic Organizer As you read the section, think about why maintaining adequate competition is a worthwhile goal. Use a graphic organizer like the one below to list effects of competition.

If markets are competitive . . . → Effects

Key Terms

market failure, externality, negative externality, positive externality, public goods

Objectives

After studying this section, you will be able to:

1. **Discuss** the problems caused by inadequate competition.
2. **Understand** the importance of having adequate information.
3. **Describe** the nature of resource immobility.
4. **Explain** the nature of positive and negative externalities.

Applying Economic Concepts

Market Failure Have you ever felt that the perfect part-time job is waiting for you—but you just can't seem to find it? If so, you are experiencing market failure. A market failure usually occurs when we don't have adequate information about the market. The result is that productive resources—including you—do not reach their maximum potential.

Cover Story

Mum's the Word

Woman on cell phone

We live in increasingly intolerant times. . . . Mobile telephones are the latest target: some trains, airline lounges, restaurants and even golf courses are being designated "no phone" areas.

The Economist would like to suggest restrictions on another source of noise pollution: children. . . . Smoking, driving and mobile phones all cause what economists call "negative externalities" . . . [the] costs of these activities to other people tend to exceed the costs to the individuals [who are doing it].

For children, just like cigarettes or mobile phones, clearly impose a negative externality on people who are near them. Anybody who has suffered a 12-hour flight with a bawling baby in the row immediately ahead or a bored youngster viciously kicking their seat from behind, will grasp this quickly. . . .

—*The Economist*, December 5, 1998

The writer of the article cited in the cover story went on to suggest that airlines should create "child-free zones" by seating children in the back of the aircraft—and by charging parents more. This "rare outbreak of humor at *The Economist*," according to London's *Daily Telegraph*, was a hit with readers, resulting in bulging mailbags and publicity.

The cover story, however, reminds us of another, more serious, fact of economic life—that markets sometimes fail. How they fail, and how the failures can be remedied, is a concern for economists. We now want to take a look at how markets fail. Ways to deal with these failures will be discussed in the next section of this chapter.

A competitive free enterprise economy works best when four conditions are met. Adequate competition must exist in all markets. Buyers and sellers must be reasonably well-informed about conditions and opportunities in these markets. Resources must be free to move from one industry to another. Finally, prices must reasonably

reflect the costs of production, including the rewards to entrepreneurs. Accordingly, a **market failure** can occur when any of these four conditions are significantly altered.

The most common market failures involve cases of inadequate competition, inadequate information, resource immobility, external economies, and public goods. These failures occur on both the demand and supply sides of the market.

Inadequate Competition

Over time, mergers and acquisitions have resulted in larger and fewer firms dominating various industries. The decrease in competition has several consequences.

Inefficient Resource Allocation

Inadequate competition tends to curb efficient use of scarce resources—resources that could be put to other, more productive uses if they were available. For example, why would a firm with few or no competitors have the incentive to use resources carefully? If a firm is free to do as it pleases, it likely will spend its profits on bonuses and extras like executive jets, lucrative salaries, and generous retirement benefits. This is one of the reasons that public utilities such as electricity are regulated by the government—to make sure that they do not use their monopoly status to waste or abuse resources.

Higher Prices and Reduced Output

An imperfect competitor such as a monopoly can use its position to prevent competition and restrict production. This situation brings about artificial shortages that cause higher prices than under other market structures.

Economic and Political Power

Inadequate competition may enable a business to influence politics by wielding its economic might. In the past, many firms have used their huge capital resources to further the political careers of owners and their relatives and friends.

A large corporation does not even have to be a monopoly for its economic power to translate to political power. A large corporation, for example, may demand tax breaks from the state or local government. If the government refuses, the corporation may threaten to move elsewhere, causing economic loss to the community. Because the community does not want to risk the loss, the corporation may get its way.

Both Sides of the Market

If we consider the supply side of the market, it is clear that perfectly competitive or monopolistically competitive markets usually have enough firms to ensure competition. When it comes to oligopoly, however, we know that the temptation to collude is strong. No competition exists if a monopolist dominates the supply side of the market.

Inadequate competition may occur on the demand side of the market as well. In most cases, such as in the consumer goods and services markets, many buyers can be found. How many buyers are there, though, for space shuttles, hydroelectric dams, super computers, M-1 tanks, and high technology fighter jets? While failures on the demand side of the market do occur, they are more difficult to correct than failures on the supply side.

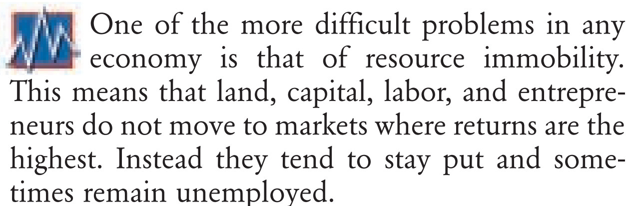
Inadequate Information

If resources are to be allocated efficiently, everyone—consumers, businesspeople, and government officials—must have adequate information about market conditions. A secretary or an accountant may receive a competitive wage in the automobile industry, but are wages for the same skills higher in the insurance industry, or in the banking industry? Even the treasurer of a small community needs to know if the town's surplus funds can earn a higher return if invested in Dallas, New York, Indianapolis, or Seattle. Information about conditions in many markets is needed before these questions can be answered.

Some information is easy to find, such as want-ads or sale prices found in the local newspaper. Other information is more difficult to obtain. If this

knowledge is important to buyers, and is difficult to obtain, then it is an example of a market failure.

Resource Immobility

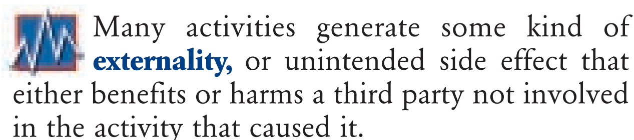


One of the more difficult problems in any economy is that of resource immobility. This means that land, capital, labor, and entrepreneurs do not move to markets where returns are the highest. Instead they tend to stay put and sometimes remain unemployed.

What happens, for example, when a large auto assembly plant, steel mill, or mine closes, leaving hundreds of workers without employment? Certainly some workers can find jobs in other industries, but not all can. Some of the newly unemployed may not be able to sell their homes. Others may not want to move away from friends and relatives to find new jobs in other cities.

Consider the problems caused when the federal government closed military bases to save taxpayers' dollars. Thousands of workers were laid off in communities that had no immediate means of employing them. Resource mobility, an ideal in the competitive free enterprise economy, is much more difficult to accomplish in the real world. When resources are immobile or refuse to move, markets do not always function efficiently.

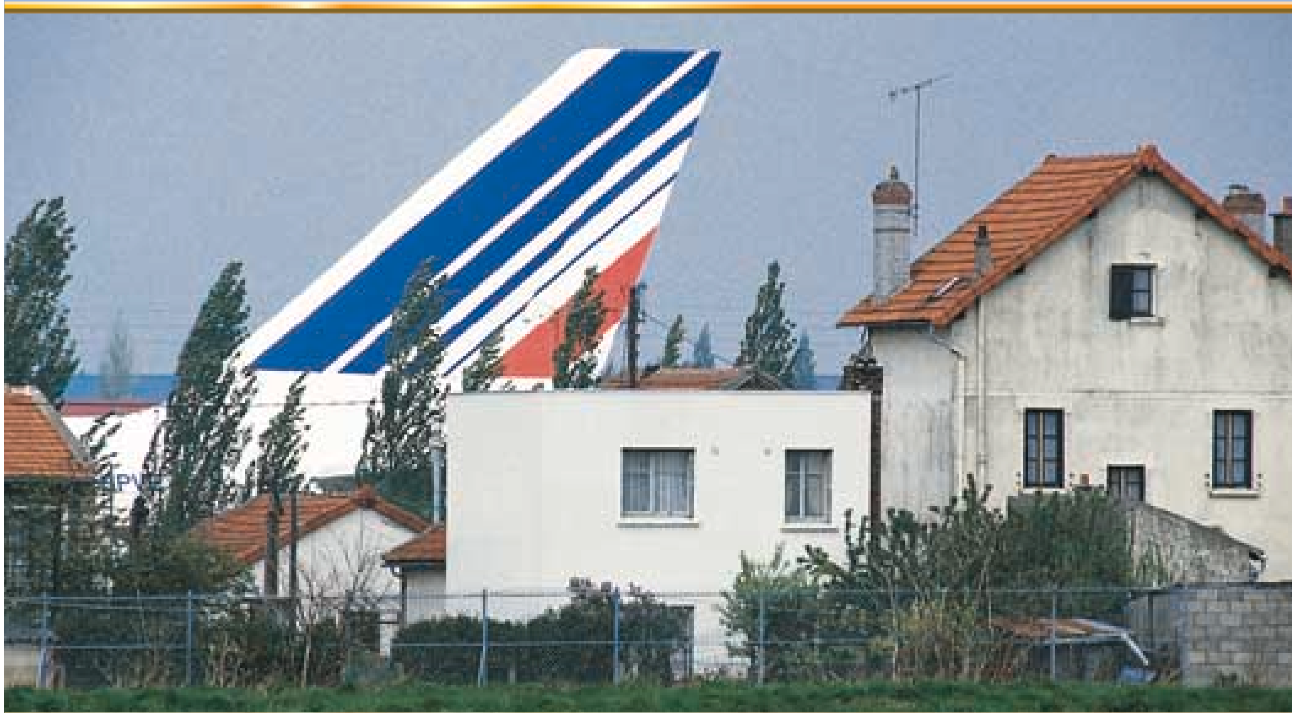
Externalities



Many activities generate some kind of **externality,** or unintended side effect that either benefits or harms a third party not involved in the activity that caused it.

A **negative externality** is the harm, cost, or inconvenience suffered by a third party because of actions by others. The classic case of a negative externality is

Externalities



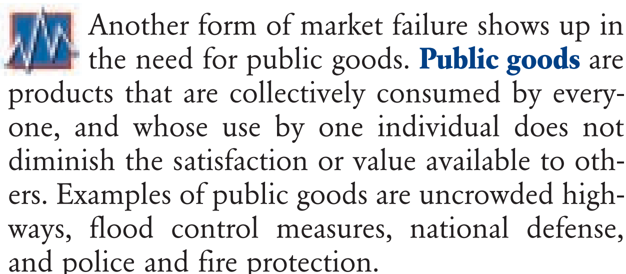
Positive and Negative Most economic activities generate externalities. ***Do you think the nearby airport expansion was a positive or a negative externality for the people living in this neighborhood? Why?***

the noise and inconvenience some people suffer when an airport expands.

A **positive externality** is a benefit received by someone who had nothing to do with the activity that generated the benefit. For example, people living on the other side of town may benefit from the additional jobs generated by the airport expansion, or a nearby restaurant may sell more meals, make a greater profit, and hire more workers. Both the owners of the restaurant and the new workers gain from the airport expansion even though they had nothing to do with the expansion in the first place.

Externalities are classified as market failures because their costs and benefits are not reflected in the market prices that buyers and sellers pay for the original product. For example, does the airline or the air traveler compensate the homeowner for the diminished value of the property located near the new runway extension? Does the restaurant owner share the additional good fortune derived from the new business with the airport or the air traveler? In both cases the answer is no. As a result, the prices that travelers pay for air travel will not reflect the external costs and benefits that the airport expansion generates.

Public Goods



Another form of market failure shows up in the need for public goods. **Public goods** are products that are collectively consumed by everyone, and whose use by one individual does not diminish the satisfaction or value available to others. Examples of public goods are uncrowded highways, flood control measures, national defense, and police and fire protection.

The market, however, when left to itself, does not supply these items–or only supplies them inadequately. This is because a market economy produces only those items that can be withheld if people refuse to pay for them. It would be difficult, for example, to deny one person the benefits of national defense while supplying it to others. Because it is so difficult to get everyone to pay for their fair share of a public good, private markets cannot efficiently produce them and will therefore produce other things.

The case of public goods illustrates that while the market is very successful in satisfying *individual* wants and needs, it may fail to satisfy them on a *collective* basis. If public goods are to be supplied, the government usually has to provide them.

Section 2 Assessment

Checking for Understanding

1. **Main Idea** Using your notes from the graphic organizer activity on page 173, explain why maintaining adequate competition is a worthwhile goal.
2. **Key Terms** Define market failure, externality, negative externality, positive externality, public goods.
3. **Define** "adequate competition" in your own words and explain why markets need adequate competition.
4. **Explain** the importance of having adequate information.
5. **Explain** why resources are not always mobile and willing to move.
6. **Describe** the similarities and differences between positive and negative externalities.

Applying Economic Concepts

7. **Market Failures** Cite at least two examples of situations in your community in which resources did not move from one market or industry to another because they were either unable or unwilling to move.

Critical Thinking

8. **Understanding Cause and Effect** Identify one possible positive externality and one possible negative externality from the closing of a military base.

Practice and **assess** key social studies skills with the *Glencoe Skillbuilder Interactive Workbook, Level 2.*

BusinessWeek

AUGUST 3, 1998

Newsclip

Coca-Cola and Pepsi are competing for control of the U.S. beverage market. The cola giants are experimenting with new marketing strategies in New York City, where the consumer market is considered one of the toughest in the country.

Cola Wars

With $30 billion in beverage sales between them, Coca-Cola Co. and Pepsico Inc. have long battled each other with multimillion dollar ad campaigns and country-by-country marketing coups. . . .

But to make sure all that marketing money translates into bottles sold, both Coke and Pepsi are intensifying their efforts at the local level. . . . And nowhere is the fighting more heated than in the intensely competitive, intensely difficult New York market. "Many soft-drink executives think New York is the toughest market in the country," says John Sicher, editor of industry newsletter *Beverage Digest.* "The traffic is huge, the population is dense, and the neighborhoods are complicated."

But it's also a huge price–and one PepsiCo, headquartered in Purchase, N.Y., would be loath to lose. Pepsi has always spent big to stay ahead on its home turf. New York is one of only four U.S. markets where Pepsi-Cola outsells Coca-Cola Classic. . . .

The showdown over the Big Apple began . . . when Coke's largest bottler, Coca-Cola Enterprises Inc. (CCE), moved into the New York market. CCE has since added 600 more marketing people and 60 new trucks to its delivery fleet. . . .

. . . Each marketing representative visits up to 120 small stores a week, [where they are] pushing for snazzier displays, better placement, and more promotions. . . .

. . . Pepsi is pushing its own New York campaign to the hilt. But rather than send out fresh new troops, Pepsi is relying heavily on its bottler's local distribution force to boost its presence in stores, with new racks, coolers, and giveaways. It is also making a big push to get the most from its sponsorships of Lincoln Center, Radio City Music Hall, and the Bronx Zoo with ticket giveaways and advertising tie-ins. . . .

. . . In this hard-fought battle, Coke and Pepsi are doing everything they can to come out on top.

–Reprinted from August 3, 1998 issue of *Business Week*, by special permission, copyright © 1998 by The McGraw-Hill Companies, Inc.

Examining the Newsclip

1. **Finding the Main Idea** Explain how the cola companies are trying to dominate the New York consumer markets.
2. **Making Predictions** What might you expect to happen to Pepsi and Coke prices as the companies try to dominate the New York City market?

SECTION 3

The Role of Government

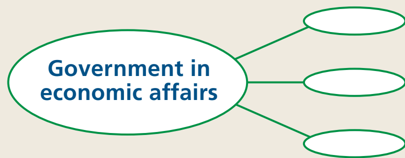
Study Guide

Main Idea

One of the economic functions of government in a market economy is to maintain competition.

Reading Strategy

Graphic Organizer As you read the section, give three reasons government takes part in economic affairs. Complete an organizer similar to the one below to help you organize your answer.



Key Terms

trust, price discrimination, cease and desist order, public disclosure

Objectives

After studying this section, you will be able to:

1. **Discuss** major antitrust legislation in the United States.
2. **Understand** the need for limited government regulation.
3. **Explain** the value of public disclosure.
4. **Discuss** the modifications to our free enterprise economy.

Applying Economic Concepts

Public Disclosure Do you have a credit card or a car loan? Do you know the size of the monthly payments, the computation of the interest, and other important terms of the agreement? Did someone take the time to explain all these details? Disclosing this information is not merely an act of kindness on the part of the business: it is required by a federal public disclosure law to assure that you are a well-informed consumer.

Cover Story

Toys "R" Us, Mattel, Settle Anti-Trust Suit

Toys for Tots program

Retailing giant Toys "R" Us and two top toy makers agreed to give away $50 million in toys and cash to needy kids as part of a settlement of a nationwide anti-trust suit.

Two years ago, New York and 43 other states joined to sue Toys "R" Us . . . Mattel, Hasbro and Little Tikes for allegedly conspiring to limit toy supplies to discount retailers such as Sam's Club and Price-Costco.

According to the complaint [Toys "R" Us] used its market power over the manufacturers to maintain a stranglehold on the industry. . . . The national toy give-away will be run over the next three years by the U.S. Marine Corps' Toys for Tots program.

—*New York Daily News*, May 26, 1999

Today, government has the power to encourage competition and to regulate monopolies that exist for the public welfare. In some cases, government has taken over certain economic activities and runs them as government-owned monopolies. The government also has the power to punish companies—like those in the cover story—by forcing firms to pay penalties when they act in a manner that restrains competition.

Antitrust Legislation

In the late 1800s, the United States passed laws to restrict monopolies, combinations, and **trusts**—legally formed combinations of corporations or companies. Since then, a number of key laws have been passed that allow the government to either prevent or break up monopolies. Collectively, this legislation is designed to prevent market failures due to *inadequate competition.*

In 1890 Congress passed the Sherman Antitrust Act "to protect trade and commerce against unlawful restraint and monopoly." The Sherman Act, described in **Figure 7.3,** was the country's first significant law against monopolies. It sought to do away with monopolies and restraints that hindered competition. By the early 1900s, a number of business organizations had been convicted under the Sherman Act.

The Sherman Act laid down broad foundations for maintaining competition. The act was not specific enough, however, to stop many practices that restrained trade and competition. In 1914 Congress passed the Clayton Antitrust Act to give the government greater power against monopolies. Among other provisions, this act outlawed **price discrimination**—the practice of charging customers different prices for the same product.

The Federal Trade Commission Act was passed in the same year to enforce the Clayton Antitrust Act. The act set up the Federal Trade Commission (FTC) and gave it the authority to issue cease and desist orders. A **cease and desist order** is an FTC ruling requiring a company to stop an unfair business practice, such as price-fixing, that reduces or limits competition among firms.

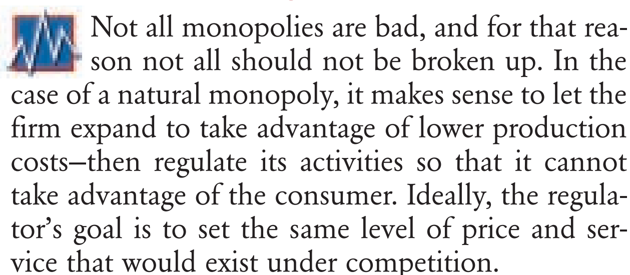
In 1936 Congress passed the Robinson-Patman Act in an effort to strengthen the Clayton Act, particularly the provisions that dealt with price discrimination. Under this act, companies could no longer offer special discounts to some customers while denying them to others. This law primarily affected national organizations and chain stores that were offering goods and services at lower prices than those paid by small independent businesses.

CYBERNOMICS SPOTLIGHT

Consumer Protection

Accurate and reliable information about products helps consumers determine which ones are the best buys. Consumer information is available on many online sites. Included are studies and tests about products and services, personal finance, health and nutrition, and other consumer concerns.

Government Regulation



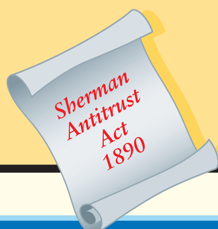
Not all monopolies are bad, and for that reason not all should not be broken up. In the case of a natural monopoly, it makes sense to let the firm expand to take advantage of lower production costs—then regulate its activities so that it cannot take advantage of the consumer. Ideally, the regulator's goal is to set the same level of price and service that would exist under competition.

ECONOMICS AT A GLANCE

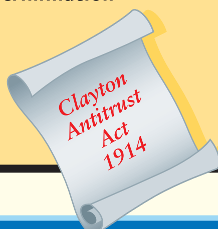
Figure 7.3

Anti-Monopoly Legislation

Outlawed all contracts "in restraint of trade" to halt the growth of trusts and monopolies

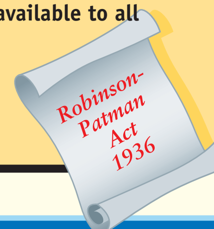


Strengthened the Sherman Act by outlawing price discrimination



Established the Federal Trade Commission to regulate unfair methods of competition in interstate commerce

Forbade rebates and discounts on the sale of goods to large buyers unless the rebate and discount were available to all



Using Charts The federal government enacted four major legislative acts to curb monopolistic practices. **What is the purpose of the Federal Trade Commission?**

ECONOMICS AT A GLANCE

Figure 7.4

Federal Regulatory Agencies

Agency	Function
Food and Drug Administration (FDA), 1906	Enforces laws to ensure purity, effectiveness, and truthful labeling of food, drugs, and cosmetics; inspects production and shipment of these products
Federal Trade Commission (FTC), 1914	Administers antitrust laws forbidding unfair competition, price fixing, and other deceptive practices
Federal Communications Commission (FCC), 1934	Licenses and regulates radio and television stations and regulates interstate telephone, telegraph rates and services
Securities and Exchange Commission (SEC), 1934	Regulates and supervises the sale of listed and unlisted securities and the brokers, dealers, and bankers who sell them
National Labor Relations Board (NLRB), 1935	Administers federal labor-management relations laws; settles labor disputes; prevents unfair labor practices
Federal Aviation Administration (FAA), 1958	Oversees the airline industry
Equal Employment Opportunity Commission (EEOC), 1964	Investigates and rules on charges of discrimination by employers and labor unions
Environmental Protection Agency (EPA), 1970	Protects and enhances the environment
Occupational Safety and Health Administration (OSHA), 1970	Investigates accidents at the workplace; enforces regulations to protect employees at work
Consumer Product Safety Commission (CPSC), 1972	Develops standards of safety for consumer goods
Nuclear Regulatory Commission (NRC), 1974	Regulates civilian use of nuclear materials and facilities
Federal Energy Regulatory Commission (FERC), 1977	Supervises transmission of the various forms of energy

Using Charts The government has created a number of federal regulatory agencies to oversee the economy. Because of government's involvement in the economy, we have a modified free enterprise system. **With which of the agencies listed in the table are you familiar? Which affect you directly? Why?**

Examples of Regulation

Local and state governments regulate many monopolies, such as cable television companies, water and electric utilities, and even telephone companies. A public commission or other government agency usually approves prices for their services. If a company wants to raise rates, it must argue and prove its case before the commission.

Agencies of the national government, such as those listed in **Figure 7.4,** regulate many businesses. Privately owned agencies, such as the Federal Reserve System, have certain regulatory powers, including the power to regulate the money supply, some daily bank operations, and even bank mergers.

Internalizing Externalities

The government can also use the tax system to lessen some of the negative externalities in the economy. Suppose, for example, that firms in a certain industry are causing pollution, which is flowing into a nearby river or even affecting the atmosphere. Because they are using the environment as a giant waste-disposal system, their costs of production are lower than they should be.

If government taxes these producers, several things happen. First, every firm's cost of production goes up, causing each to produce a little less at every possible price. This causes the market supply curve to shift and the price of the product to rise. Consumers of the product react predictably by buying less of the product. Meanwhile, the government uses the tax proceeds to clean up the pollution.

Figure 7.5 shows how this works. First, a $1 tax is placed on every unit of output that a firm produces. This shifts the supply curve up by exactly $1. The new intersection of supply and demand takes place at $15.60–indicating that the firm paid 40¢ of the tax and passed 60¢ on to the consumer.

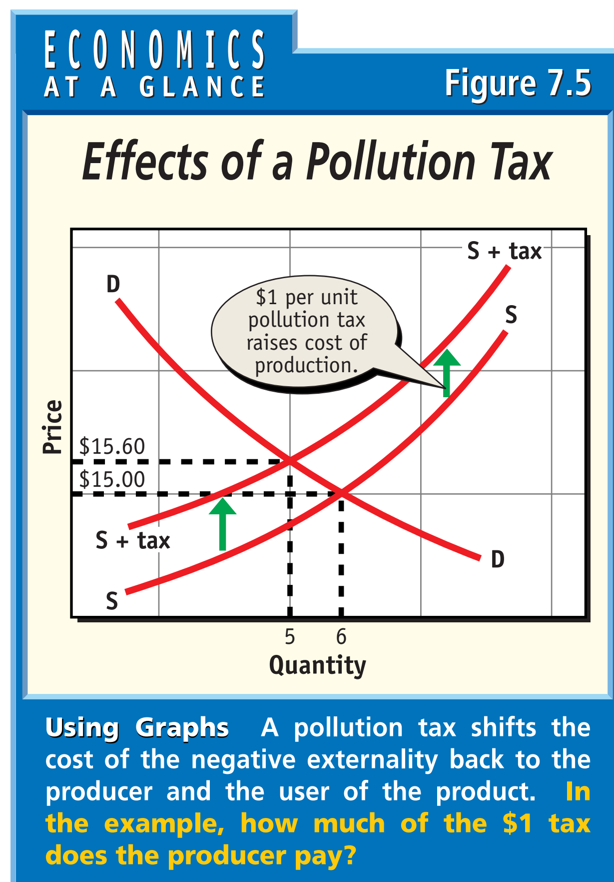
Economists call this "internalizing an externality" because it forces the polluting firm and its customers, rather than innocent third parties, to pay for the cost of pollution. Consequently, the government uses policies like this to prevent market failures due to *negative externalities.*

Public Disclosure

The purpose of public disclosure is to provide the market with enough data to prevent market failures due to *inadequate information.* While there is some cost involved, and while some businesses might prefer to not disclose anything, the benefits to society far outweigh the costs.

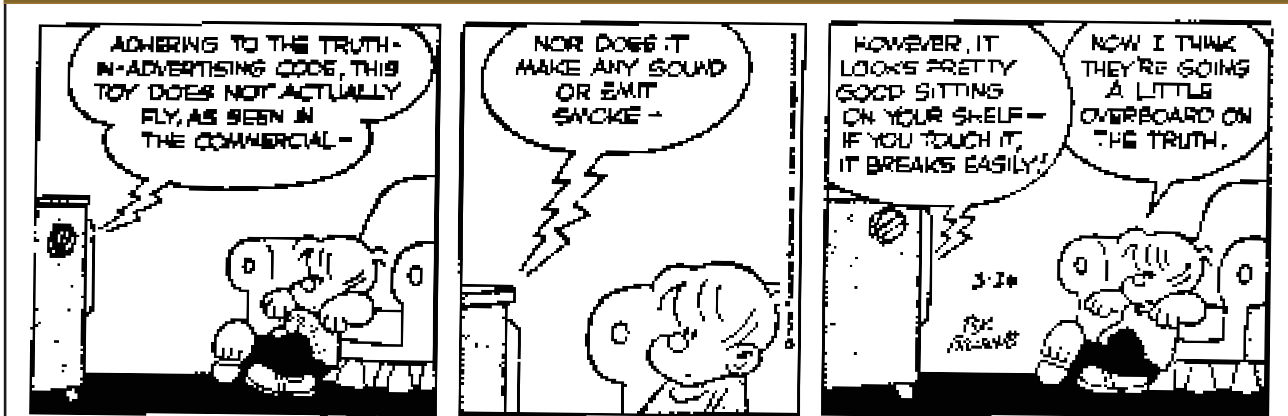
One of the more potent weapons available to the government is **public disclosure,** or the requirement that businesses reveal information to the public. The degree of disclosure is more extensive than most people realize, going beyond the content labels that the Food and Drug Administration requires on foods and medicines.

For example, the government requires that all corporations selling stock to the public must disclose financial and operating information on a regular basis to both its shareholders and to the Securities and Exchange Commission (SEC). The



Using Graphs A pollution tax shifts the cost of the negative externality back to the producer and the user of the product. **In the example, how much of the $1 tax does the producer pay?**

Consumer Protection



King Features Syndicate. All rights reserved.

The Role of Government Truth-in-advertising laws are one way the federal government tries to improve the quality of information in the economy. ***How do these laws protect consumers?***

SEC retains this data electronically in its Electronic Data Gathering Analysis and Retrieval (EDGAR) system, which can be accessed by anyone over the Internet. Access is free, and you need not be an owner to see the extremely detailed financial and operating information for any firm.

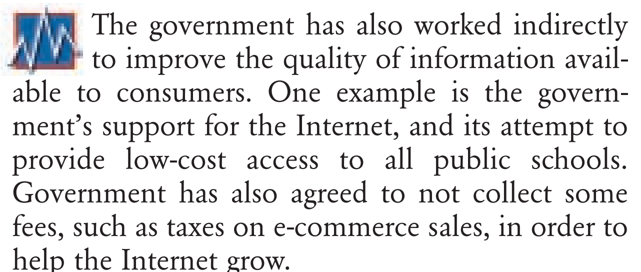
Banks are required to file periodic reports to the Federal Reserve System and other federal agencies such as the Federal Deposit Insurance Corporation (FDIC) that insures the nation's banks. Most of this information is available to the bank's competitors as well as to its shareholders, and it is highly sought after by almost all firms in the industry.

There are also disclosure regulations for businesses that lend to consumers. If you obtain a credit card or borrow money to buy a car, the lender will take considerable time to explain how the monthly interest is computed, the length of the loan, the size of the payments, and other important terms of the agreement. This is not an act of kindness on the lender's part—federal law requires that lenders make these disclosures so that consumers know what they are getting into. Finally, there are "truth-in-advertising" laws that prevent sellers from making false claims about their products.

STANDARD & POOR'S INFOBYTE

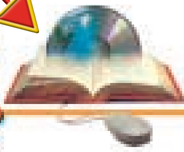
The SEC The Securities and Exchange Commission (SEC) is a regulatory agency that is responsible for administering federal securities laws. The purpose of these laws is to protect investors from improper practices in securities markets and to ensure that they have access to disclosure of all material information concerning publicly traded securities. The commission also regulates firms engaged in the purchase or sale of securities, people who provide investment advice, and investment companies.

Indirect Disclosure



The government has also worked indirectly to improve the quality of information available to consumers. One example is the government's support for the Internet, and its attempt to provide low-cost access to all public schools. Government has also agreed to not collect some fees, such as taxes on e-commerce sales, in order to help the Internet grow.

CLICK HERE



ECONOMICS Online

Student Web Activity Visit the *Economics: Principles and Practices* Web site at epp.glencoe.com and click on ***Chapter 7—Student Web Activities*** for an activity on the government's role in promoting fair business practices.

Businesses have joined the rush to the Web by posting extensive information about their activities. The Internet provides other information to consumers as well. The savvy user can talk to others in chat rooms, participate in user forums, or read product reviews to find out more about a good or service before making a purchase. Other services allow consumers to search for the best prices.

Finally, virtually every government document, study, and report is available in some fashion on the Internet. This includes the annual budget of the U.S. government, and reports by the President's Council of Economic Advisors. Also available online are information from the *Statistical Abstract of the United States*, bulletins by the Bureau of Labor Statistics, reports by the Census Bureau, and almost every other publication that you can find in the government documents section of a major research library.

Modified Free Enterprise

Concern over the costs of imperfect competition is one reason the government intervenes in the economy. Historically, the freedom to pursue self-interests led some people and businesses to seek economic gain at the expense of others. Under the label of competition, some larger firms used their power to take advantage of smaller ones. In some markets, monopoly replaced competition.

Because of such conditions, Congress passed laws to prevent "evil monopolies" and to protect the rights of workers. Its support of labor unions gave workers more bargaining power. New food and drug laws protected people from false claims and harmful products. Government strictly regulated some industries, such as public utilities. All these actions led to a modification of free enterprise.

In summary, government takes part in economic affairs for several reasons. One is to promote and to encourage competition for the benefit of society. Another is to prevent monopolies and reduce the costs of imperfect competition wherever possible. A third is to regulate industries in which a monopoly is clearly in the best interest of the public. A fourth is to fulfill the need for public goods. As a result, today's modified private enterprise economy is a mixture of different market structures, different kinds of business organizations, and varying degrees of government regulation.

Section 3 Assessment

Checking for Understanding

1. **Main Idea** Using your notes from the graphic organizer activity on page 178, explain why the government is involved in economic affairs.
2. **Key Terms** Define trust, price discrimination, cease and desist order, public disclosure.
3. **Describe** four important antitrust laws.
4. **Explain** why there is a need for limited government regulation within the economy.
5. **Describe** the value of public disclosure.
6. **Explain** why the United States has a modified free enterprise economy.

Applying Economic Concepts

7. **Public Disclosure** Visit a bank in your community and ask for literature describing the computation of interest and conditions for withdrawal on various savings accounts. Why do you think the bank is so forthcoming on these issues?

Critical Thinking

8. **Synthesizing Information** Identify five examples of how government has intervened in your community.

Practice and assess key social studies skills with the *Glencoe Skillbuilder Interactive Workbook, Level 2.*

CRITICAL THINKING

Skill

Finding the Main Idea

Finding the main idea will help you see the "big picture." Organizing information will help you understand and assess the most important concepts.

Learning the Skill

To find the main idea, follow these steps:

- Find out the setting of the article.
- As you read the material, ask "What is the purpose of this article?"
- Skim the material to identify its general subject. Look at headings and subheadings.
- Identify any details that support a larger idea or issue.
- Identify the central issue. Ask "What part of the selection conveys the main idea?"

Chimneys obscured by smoke at coal-fired power plant

Practicing the Skill

Read the excerpt below, then answer the questions that follow.

Does [economic] growth threaten the environment? The connection between growth and environment is tenuous, say growth proponents. Increases in economic growth need not mean increases in pollution. Pollution is not so much a by-product of growth as it is a "problem of the commons." Much of the environment–streams, lakes, oceans, and the air–is treated as "common property," with no restrictions on its use. The commons have become our dumping grounds; we have overused and debased them. Environmental pollution is a case of spillover or external costs, and correcting this problem involves regulatory legislation or specific taxes to remedy misuse of the environment.

There are serious pollution problems. But limiting growth is the wrong solution. Growth has allowed economies to reduce pollution, be more sensitive to environmental considerations, set aside wilderness, and clean up hazardous waste, while still enabling rising household incomes.

–Alice M. Rivlin, *Reviving the American Dream*
Washington Brookings Institutions, 1992

1. Who wrote this passage?
2. When was it written?
3. What was the purpose of this article?
4. What is the main idea that the author of the article is expressing?
5. What additional details in the excerpt support the main idea?
6. Do you find the article persuasive? Explain your response.

Application Activity

Bring to class a news article that deals with competition in the marketplace. Identify the main idea and explain why it is important.

Practice and **assess** key social studies skills with the *Glencoe Skillbuilder Interactive Workbook, Level 2.*

Chapter 7 Summary

Section 1

Competition and Market Structures (pages 163–171)

- **Perfect competition** is a **market structure** with a large numbers of buyers and sellers, identical economic products, independent action by buyers and sellers, reasonably well-informed participants, and freedom for firms to enter or leave the market.
- Perfect competition is a largely theoretical situation used as a benchmark to evaluate other market structures. Market situations lacking one or more of these conditions are called **imperfect competition.**
- **Monopolistic competition** has all the characteristics of **perfect competition** except for identical products.
- **Oligopoly** is a market structure dominated by a few very large firms, and the actions by one affects the welfare of others.
- The **monopolist** is a single producer with the most control over supply and price. Various forms of monopoly include the **natural monopoly,** the **geographic monopoly,** the **technological monopoly,** and the **government monopoly.**

- All private firms, regardless of market structure, maximize profits by producing at the level of output where marginal cost is equal to marginal revenue.

Section 2

Market Failures (pages 173–176)

- **Market failures** occur when sizable deviations from one or more of the conditions required for perfect competition take place.
- Three of the five common market failures include *inadequate competition, inadquate information,* and *resource immobility.*

- **Externalities,** or economic side effects to third parties, are a fourth market failure. A **negative externality** is a harmful side effect and a **positive externality** is a beneficial side effect.
- Externalities are regarded as market failures because they are not reflected in the market prices of the activities that caused the side effects.
- Finally, a market economy often fails to provide **public goods** such as national defense and public education because it cannot withhold supply from those who refuse to pay.

Section 3

The Role of Government (pages 178–183)

- The Sherman Antitrust Act of 1890 was enacted to prohibit **trusts,** monopolies, and other arrangements that restrain competition. The Clayton Antitrust Act was passed in 1914 to outlaw **price discrimination.** The Robinson-Patman Act of 1936 was passed to strengthen the price discrimination provisions of the Clayton Antitrust Act.
- **Public disclosure** is used as a tool to promote competition. Any corporation that sells its stock publicly is required to supply periodic financial reports to both its investors and to the SEC.
- Banks are covered by additional disclosure laws and report to various federal agencies.
- Today, government takes part in economic affairs to promote and encourage competition. As a result, the modern economy is a mixture of different market structures, different forms of business organizations, and some degree of government regulation.

Chapter 7 Assessment and Activities

Self-Check Quiz Visit the *Economics: Principles and Practices* Web site at epp.glencoe.com and click on ***Chapter 7—Self-Check Quizzes*** to prepare for the chapter test.

CLICK HERE

Identifying Key Terms

Use all the terms below in four paragraphs, with each paragraph describing one of the major types of market structures.

collusion
geographic monopoly
imperfect competition
monopolistic competition
natural monopoly
oligopoly
product differentiation
technological monopoly
price-fixing
monopoly
nonprice competition
perfect competition

Reviewing the Facts

Section 1 (pages 163–171)

1. **Describe** the five characteristics of perfect competition.
2. **Explain** the main characteristics of the monopolistic competitor.
3. **Contrast** the oligopolist and the perfect competitor.
4. **Describe** the four types of monopolies.

Section 2 (pages 173–176)

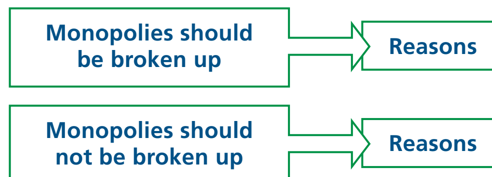
5. **Explain** what happens when markets do not have enough competition.
6. **Provide** two examples of inadequate information in a market.
7. **Explain** what is meant by resource immobility.
8. **Explain** what is meant by positive and negative externalities.
9. **Account** for the reluctance of the private sector to produce public goods.

Section 3 (pages 178–183)

10. **Identify** four major antitrust laws.
11. **List** 10 major federal government regulatory agencies.
12. **Explain** how public disclosure is used as a tool to prevent market failures.
13. **Describe** a modified free enterprise economy.

Thinking Critically

1. **Drawing Inferences** Do you think there would be any advantages to making monopolies or near monopolies break up into smaller, competing firms? If so, what are they? If not, why would there not be? Use a chart like the one below to help you organize the answers to these questions.



2. **Understanding Cause and Effect** How are natural monopolies prevented from practicing monopolistic practices?
3. **Making Generalizations** To what extent do you think government should be involved in the free enterprise economy? Defend your answer.
4. **Finding the Main Idea** What problems do the Federal Trade Commission, the Securities and Exchange Commission, and the Consumer Product Safety Commission address?
5. **Summarizing Information** Why do private producers fail to provide public goods?

Chapter 7 Assessment and Activities

Applying Economic Concepts

1. **Market Failures** Explain how your newspaper, with its help-wanted ads and weekly sale prices, helps prevent market failures.
2. **Market Structures** Identify a fast-food product that you consume regularly. Count the number of firms in your community that supply a similar product, and then identify the market structure for that product in your community.
3. **Free Enterprise** How does the federal government attempt to preserve competition among business enterprises?

Math Practice

The table below shows the price, market demand, market supply, and the surplus and shortage for a firm providing a product under perfect competition. Study the information in the table, then answer the questions.

Price	Market Demand	Market Supply	Surplus/ Shortage
10	600	1550	950
9	-----	1500	780
8	850	1450	-----
7	990	1400	-----
6	-----	1350	210
5	1300	-----	0
4	1470	-----	–220
3	1650	1200	-----
2	1840	1150	–690

1. Some of the information is missing from the table. Calculate the correct information.
2. What is the equilibrium price? How can you tell?
3. What price(s) will produce a surplus?
4. What price(s) will produce a shortage?

Thinking Like an Economist

Profit Maximization Economists like to analyze decisions incrementally–taking small steps and analyzing the costs and benefits of the steps as they are made. How is this way of thinking similar to the profit maximization logic illustrated in **Figure 7.1** on page 165?

Technology Skill

Developing Multimedia Presentations Choose a product offered by several producers that is advertised in newspapers or magazines. For one week, clip and save at least three different advertisements about your product. Keep a journal in which you evaluate each advertisement and summarize why you would or would not buy a particular brand. Use your evaluations and a video camera to develop a commercial advertising a product of your choice. Have other students evaluate your commercial for its effectiveness.

Building Skills

Finding the Main Idea Read the excerpt below, then answer the questions that follow.

> *Monopolistic competition occurs when there are many producers of products that are almost the same. Firms in such a market try to make customers believe that the similar products are actually different. Each producer uses advertising to persuade the customer that his or her brand is superior. Firms that are successful have a monopoly on their name and reputation more than on their product. Customers are willing to pay more for the product because they associate its name with quality or value. Many beauty products, soaps, household cleaners, and over-the-counter medicines fall into this group.*

1. What is monopolistic competition?
2. What main idea is expressed?
3. What details support the main idea?

Practice and assess key social studies skills with the *Glencoe Skillbuilder Interactive Workbook, Level 2.*

A Case Study:

THE FUTURE OF SOCIAL SECURITY

The Social Security Act of 1935 and its later amendments created a social insurance system to help America's most needy: elderly, ill, and unemployed citizens. The core of the program was retirement benefits, funded by taxes on workers and employers, that people could collect when they stopped working at age 65. For decades the system, though criticized, was largely recognized as fundamentally sound.

But in the 1980s the system faced a severe cash shortage: outgoing payments rose faster than incoming taxes. The federal government responded with some changes (such as raising the retirement age from 65 to 67 by the year 2027) that forestalled the problem. But as the baby boomer generation ages, Social Security may be facing another crisis.

Many experts fear that the system will be drained of funds in the twenty-first century, leaving whole generations bereft of benefits. The solution, they say, is the privatization of the system. Others maintain that the problems facing Social Security are overstated and that, while some fine-tuning may be necessary, a fundamental change like privatization is uncalled for, and dangerous.

Who is right? As you read the selections, ask yourself: Is Social Security working, or does the United States need a new system?

Social Security Is Secure

During the 21st century, when all the Boomers have put work behind them, 20 percent of all Americans will be elderly—a larger percentage than ever before in our history. And these retirees will get Social Security benefits from taxes collected from a much smaller pool of working people. . . .

While it's true that in 2030 there will be fewer workers per retiree than there are today, a more reliable measure is to look at workers per dependent—which means not just the elderly but also those too young to work. Why is this important? Because it allows us to point out, reassuringly, that in 1965, the last year of the Baby Boom, there were 95 dependents for every 100 workers, compared to 71 today and 79 in 2030. If society could handle the massive needs (education, health care, for example) of our generation in our preproductive years, it can manage to see us through our post-productive years as well. . . .

Social Security works because it offers universal coverage. . . . Certainly some people would rake in more money under privatization than they would under the current

system. But others would get less and some would lose everything. . . . If that doesn't make you uneasy, try this: these privatization schemes would increase taxes and add considerably to the administrative costs of Social Security (which today stand at an almost unbelievable 1 percent compared to 12–14 percent for private sector insurance). Social Security isn't without problems. Quite simply, people are living longer and so there will have to be adjustments like a higher retirement and maybe somewhat lower benefits phased in gradually over decades so no one gets a surprise they can't plan for. But Social Security ain't broke–in the fiscal or structural sense. . . .

–John Shure, Vice President of the Twentieth Century Fund

A New System Is Needed

Back in 1940, when the Social Security program was just getting under way, average life expectancy was less than 64 years. The program's designers expected that many people would contribute to the program most of their lives and die before collecting a dime in retirement benefits. . . . Today, average life expectancy in the United States is more than 75 years. More important, the population that reaches age 65 is also living longer. An average person that lives to 65 will live for approximately another 17 years. . . .

As life expectancy has soared, birthrates have declined, leaving fewer and fewer workers to support the ballooning number of retirees. In 1950, this pyramid scheme was solidly supported with 16 workers paying for each retiree; today, there are just over three workers per beneficiary. The [Social Security Administration's] own estimates indicate that the ratio of workers to beneficiaries will continue to decrease, reaching just two workers per beneficiary by 2030.

Moreover, those projections ignore one of the most promising facts of our time: Not only does life expectancy continue to grow; the rate of growth is accelerating. From 1940 to 1965, life expectancy for men over age 65 increased by one year; during the next quarter century it grew by 2.1 years. . . .

Social Security needs fundamental reform if it is to cope with our increasing longevity. . . . [A]ll workers should be given the option of redirecting their payroll taxes to personal retirement accounts.

Those accounts, which will be invested in productive enterprises, will grow and all workers will accrue a substantial asset of far greater value than the benefits promised–but not yet paid for–by the current Social Security system. . . . As the savings rate increases, young innovative companies . . . will have easier access to investment capital and will flourish.

–Carrie Lips, Cato Institute's Project on Social Security Privatization

Analyzing the Issue

1. How does Shure's discussion of the "workers-per-dependent" ratio suggest that the Social Security system is not in crisis? Why does he oppose privatization of the system?
2. What evidence does Lips use to support her argument that "Social Security needs fundamental reform"? Why does she support privatization?
3. With which opinion do you agree? Explain your reasoning.