5/12/12. Chapter 12 Monopoly

Monopoly - A market with a single firm that produces a good or service for which no close substitute exists and has high barrier of entry

Arises because: no close substitutes
Barriers to entry

Natural Barriers To entry

Natural barriers create natural monopoly - market in which economies of scale enable 1 firm to supply entire market at lowest possible cost.
eg. electricity

Ownership barriers:
If 1 firm owns a significant portion of a resource (De beers 90% diamonds)

Legal Barriers:
- Legal barrier create legal monopoly
- Market in which competition and entry are restricted by granting of a monopoly franchise, a government licence, patent or copyright.

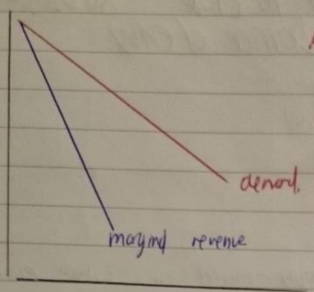
- MONOPOLY FRANCHISE - exclusive right to supply a good - Post office
- GOVERNMENT LICIENSE - controls entry into particular occupation/profession
medicine, law - restricts competition
- PATENT - exclusive right granted to inventor of product - valid 16 years

Monopoly Price-Setting Strategies:
Single Price - monopoly that must sell each unit of its output for same price to all customers

Price Discrimination - Sells different units of a good for different price
Microsoft sells its products at different prices to diff
It charges highest possible price for each unit it sells generating largest possible profit

Single Price Monopoly's Output and Price Decision

Price and Marginal revenue



	price	Q demanded	Total revenue	Marginal revenue $\frac{\Delta TR}{\Delta Q}$
A	20	0	0	
B	18	1	18	18
C	16	2	32	14
D	14	3	42	10
E	12	4	48	6
F	10	5	50	2

- Marginal venenue is lower than price beare when the price is lowered to sell one more unit, two opposing forces affect total revenue
- lower price equals revenue lost and increased quantity increased revenue gain

Marginal Revenue and Elasticity:

Single price monopoly's revenue relatd to elasticity of demand.

- If demand is elastic (greater than 1) Fall in price brings on increase in total revenue
- If inelastic fall in price → fall in total revenue

In monopoly demand is always Elastic

If it ever produces output in inelastic range, produce smaller quantity and charges higher price to increase profit

Price and Output Decision:

Maximising economic Profit:

- Total cost and total revenue rise as output increases but TC increases and TR decreases
- Profit which = TR - TC gets bigger then hits maximum

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Marginal Revenue Equals Marginal Cost:
- When Marginal Revenue exceeds Marginal cost, profit increases if output increases.
- When MC exceeds MR profit increases if output decreases

Monopoly produces profit maximizing quantity when Marginal cost = Marginal revenue.

Single-price Monopoly and Competition Compared:

Perfect competition - equilibrium occurs where supply and demand curve intersect. Maximises profit by producing output which its own Marginal cost equals the price

Monopoly - Maximises profit by producing quantity at which marginal revenue equals Marginal cost.
- Produces smaller output with higher price

Efficiency Comparison:
- Monopoly gains from a higher price it loses some of the original producer surplus because of smaller output - deadweight loss
- Monopoly consumer interest - produces less, increases the cost of production, raises price to above increased cost of production

Rent Seeking:
Any surplus (consumer or producer or profit) is economic rent
Rent seeking is the pursuit of wealth by capturing economic rent.

Buy a monopoly
Buy monopoly for sale at lower price than its profit (taxi licence)

Or Create monopoly

Price Discrimination

Selling good/service at number of different prices
Not all price differences are price discrimination

Capturing Consumer Surplus:

Discriminating among groups of buyers:
- People differ in value they place on good
- Firms discriminate against different groups of buyers

Discriminating among units of a good.
- Everyone experiences diminishing marginal benefit and has downward sloping demand curve
- Units of good sold for a single price – buyers end up with a consumer surplus equal to value they get from each unit of good minus price
- Charges lower for second, third product

Profiting by Price Discriminating:

Creating fare structures to categorise customers into different price ranges

Perfect price discrimination:
- Occurs if a firm is able to sell each unit of output for the highest price anyone will pay
- Entire consumer surplus is eliminated and captured by producer.

- With perfect price discrimination. Market demand becomes marginal revenue curve but MR = price.
- Can increase profit by producing larger quantity MR = MC

Efficiency and Rent Seeking with Price Discrimination:

- Consumer Surplus = 0. Producer = producer surplus
- The more perfectly the monopoly can price discriminate the closer its output gets to competitive output and the more efficient is the outcome

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2 differences between perfect competition and perfect price discrimination

- The distribution of total surplus is different - It is shared by consumers and producers in perfect competition. Producer gets all with PD
- Because the producer grabs the entire total surplus, rent seeking becomes profitable

Monopoly Regulation:

Regulation - rules administered by a government agency to influence prices, quantities, entry etc.

Deregulation - removing regulation

Social interest theory: The political and regulatory process relentlessly seeks out inefficiency and introduces regulation that eliminates deadweight loss and allocates resources efficiently

Capture Theory: Regulation serves the self interest of the producer who captures the regulator and maxes economic profit

Efficient regulation of a natural monopoly:

Marginal cost pricing rule: The Q demanded at a price equal to marginal cost is the efficient Q. The Q at which marginal social benefit equals marginal social cost.

Second-best Regulation of a natural Monopoly.

Average Cost Pricing: sets price equal to total cost. Firm produces Q at which long run average cost curve cuts demand curve - firm breaks even

Government Subsidy: Direct payment to firm equal to its economic loss

Which method is best?

Rate of return Regulation: Firm must justify its price by showing that its return on capital doesn't exceed a specified target rate - can end up serving self interest.
- incentive to inflate other costs to make money

Price cap regulation: a price ceiling - specified highest price firm can set. - incentive to operate efficiently and keep costs down