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A firm has no need to advertise if it has monopoly power over the product. Discuss.

A monopoly is an extreme case of market structure where there is a single supplier in the industry, and hence no competition. Monopolies are commonly either existing private ones or state-owned monopolies that have been privatised. Both however share similar characteristics. This essay will describe the characteristics of these monopolies and will highlight the differences between perfect competition and monopoly. This comparison, along with the behaviour of monopolies will lead us to conclude whether monopolists need to advertise.

Characteristics of a Monopoly

As with firms in other market structures, monopolists aim to maximise profits, where marginal revenue = marginal cost (MR = MC). They enjoy large economies of scale which along with other factors, lead to high barriers to entry. This prevents other firms from entering the market. The products provided by monopolists have no close substitutes therefore the firm faces an inelastic demand curve, which coincides with the industry's demand curve.

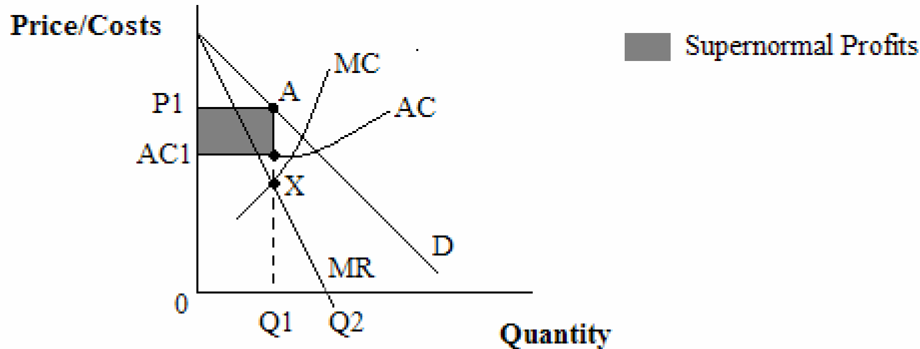
Unlike firms under perfect competition, a monopoly is a price maker. This signifies that it can choose what price to charge, but it is forced to accept the level of output demanded at that price. Therefore its decisions are made by the industry, whereas in perfect competition firms may choose the level of output to produce.

Monopoly Power

Rank Xerox was an example of a monopoly supplier of photocopiers until the 1970s. (A Short Course of Economics, 1993) For producers to have monopoly power, they must have a downward-sloping demand curve as opposed to a horizontal demand curve (as in perfect competition). (A short course of economics, 1993) At all levels of output, price (shown by the downward sloping demand curve in Figure 1 on the following page) exceeds marginal revenue. Given that monopolists are profit maximisers producing where MR = MC, the price set by the monopolist is greater than the marginal cost of the product. The difference between the price and the marginal cost is what determines the degree of a firm's monopoly power. Conversely, competitive firms always equate price and marginal cost therefore they do not have monopoly power. The degree of monopoly power which a firm has may be determined by the elasticity of its demand curve. The more inelastic the demand curve, the more that marginal revenue is lower than price, and the more is price greater than marginal cost, therefore the more monopoly power the firm has. (Economics, 2003)

Profit-maximisation

Monopolists aim to maximize profits. This occurs at the level of output where MR = MC.

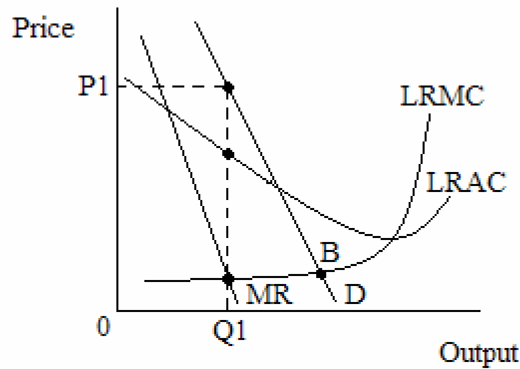


Similarly, perfectly competitive firms aim to maximise profits but differ from monopolies in that marginal revenue is equal to price. In the case of a monopoly, marginal revenue is less than price. Not only do monopolists need to produce at a level where MR = MC, but also where the set price or the average revenue covers average variable costs in the short run and average total costs in the long-run. These two conditions indicate that the monopolist will be selling output equal to Q1 at a price P1 and will earn supernormal profits (SNP's), represented by the grey area (P1 to AC1) in Figure 1 (AC1 represents the lowest point on the AC curve). Unlike in perfect competition, SNP's under monopoly are not eliminated due to the high entry barriers. (Economics, 2003)

Barriers to Entry
As a result of the barriers to entry, monopolies are able to maintain monopoly power. There are various forms of barriers, some which occur naturally due to technical factors and others such as legal barriers, which are created.

Economies of Scale
Natural barriers are usually a result of economies of scale. In the case of a large firm such as a monopoly, the long run average cost (LRAC) curve declines over the range of output, generating a low average cost for the firm. The LRAC curve in Figure 2 on the following page is the cost curve for all possible firms. The monopoly would produce Q1 at a price P1 and earn profit. However if it were a small competitive firm it would produce at point B where price is equal to long-run marginal cost (LRMC), thus making losses. If many small firms were to produce part of the total output, their average costs would be much greater.

Figure 2 - A Natural Monopoly with Economies of Scale



Thus economies of scale achieved by monopolies are advantageous as they avoid duplication of assets that may be efficiently used by a single firm. This is known as a natural monopoly. It is 'a situation where long-run average costs would be lower if an industry were under monopoly than if it were shared between two or more competitors'. (Economics, 1997: 182)

Start-up Costs
A new firm entering the market is likely to face many development costs that would make it unprofitable. (Economics for Business and Management, 1997) An established firm will already be familiar with the market making it difficult for the new firm to compete. (Economics, 1997) The existing monopoly could lower its prices and drive the firm out of business.

Brand Loyalty
If the existing monopoly is producing a clearly differentiated product and consumers are extremely brand loyal, new firms will face difficulty trying to enter the market. (Economics, 1997)

Control over supply of inputs or retail outlets
If the existing firm owns the supply of the inputs or the outlets where the products are sold, it can prevent other firms from accessing them. (Economics, 1997)

Legal Barriers
Many barriers, such as patent laws, copyright, licensing and tariffs, created by the government may restrict other firms from entering the market. Patent laws, for example may provide only the patent holder the right to produce a particular product or to operate in a particular area. (Economics, 1997)

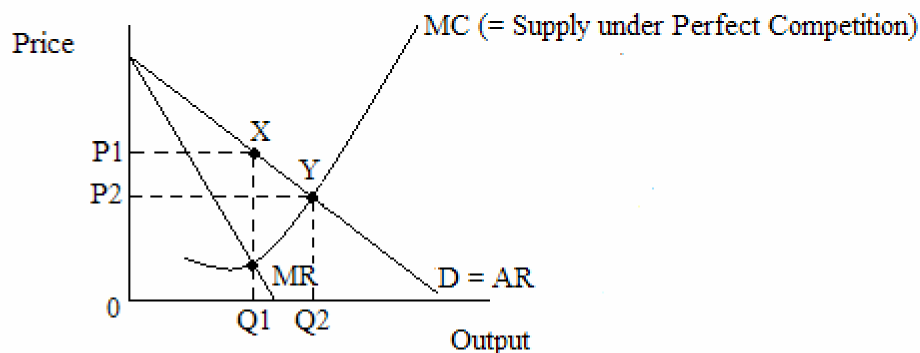
Threat of Merger/Takeover
If a monopolist 'puts in a takeover bid' for a newly entering firm, it will not enter in fear of being taken over. (Economics, 1997: 183)

Other tactics
An established monopolist may engage in a price war, develop large advertising campaigns, introduce new brands or use other aggressive tactics to drive new firms out of the business. (Economics, 1997)

Monopolists may also use other forceful 'forms of harassment', legal or illegal to prevent new entrants. (Economics, 1997)

Comparing Monopoly and Perfect Competition
Despite the fact that competitive firms do not have many barriers to entry like monopolies, the two opposite market structures share similar characteristic. In order to compare the two structures, we need to assume that both industries are facing the same demand and cost conditions. The major difference between perfect competition and monopoly is monopolies set higher prices and produce less output. However, both aim to maximise profit (shown on Figure 3 below). In the short-run, the monopolist will produce at point X, where price is P1 and output is Q1 (where MR = MC), however the firm in perfect competition would produce at point Y where price is P2 and output is Q2. Clearly the perfectly competitive firm is producing a higher level of output at a lower price. This point is where the industry's supply and demand meet. Since the supply curve of a perfectly competitive firm is its MC curve, the industry's supply curve is also the industry's MC curve. (Economics, 1997) This is presented on Figure 3. Therefore under perfect competition, firms produce where Price = MC, which is the optimum production level. Monopolists on the other hand produce where Price > MC (at point X) and this is seen as allocatively inefficient.

Figure 3 - Perfect Competition Vs Monopoly



In the long-run however, firms in perfect competition cannot earn supernormal profits due to new firms easily entering the market. Therefore they produce at the lowest point on their LRAC curve and hence achieve productive efficiency. However, in the case of a monopoly, due to the high barriers of entry, the firm may earn supernormal profit. The monopolist does not produce at the lowest point on its AC curve and hence experiences productive inefficiency. Therefore under monopoly, if everything remains equal, prices in the long-run will be higher and output lower. (Economics, 1997)

Firms under perfect competition need to gain productive efficiency in order to survive, however monopolists who have no threat of entry by other firms can continue to operate inefficiently and achieve high profits. Monopolies also have the advantage of achieving profits through price discrimination. We have assumed that all consumers are being charged the same price, however a 'discriminating monopoly' may charge different prices to different consumers. (Economics, 2003)

Therefore monopolies have easy access to profit and face no competition. For this reason they have no incentive to develop new products, better techniques or even to advertise their product. Nevertheless the theory of contestability proposes a valid argument. It states, 'what is crucial in determining price and output is not whether an industry is actually a monopoly or competitive, but whether there is the real threat of competition'. (Economics, 1997: 187)

The argument presented by this theory is that no consideration is made of potential competition. If it were to occur, the firm operating under monopoly would behave like a competitive firm. This theory highlights to us the importance of entry barriers and potential competition, nevertheless it does not focus sufficiently on the size of the barriers and the possibility of the established firm to engage in aggressive competition. (Economics, 1997)

In conclusion, according to monopoly theory, a large firm that is protected by barriers to entry will have no incentive to innovate and will not need to advertise. Nevertheless, advertising is an important part of marketing which provides product information to consumers and aids in product development. (Economics, 1997) It is also important that monopolists do not disregard the possibility of another firm entering the market. In such a situation, the monopolist may need to drive its competitor out of business by mounting large advertising campaigns.

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