Intro to Economic Analysis essay 2   Spring Term   Alastair Snook

Is the existence of a monopoly against The public interest? Using diagrams explain the conditions under which this might be true and also the conditions under which this may not be true.

A monopoly is defined as the sole supplier of a good or service with no close substitutes in a given price range. A pure monopoly will therefore have a 100% market share i.e. the firm is the industry. They exist and can only remain as monopolies if there are high barriers to entry to the industry. In the case of a natural monopoly, economies of scale are so large that any new entrant would find it impossible to match the costs and prices of the established firm in the industry. Other barriers to entry include legal barriers such as patents, natural cost advantages such as ownership of all key sites in the industry, marketing barriers such as advertising, and restrictive practises designed to force any competition to leave the market. In this market structure it is also assumed profits are maximised and there is consumer rationality.

Traditionally monopoly is thought to be a potentially harmful market structure with unwelcome consequences for the consumer and the economy. Competition has always therefore been seen to be desirable. It could be said therefore to be against the public interest. However there are arguments not only against monopolies but also for their existence.

One of the main arguments against monopolies is that they raise prices, restrict output and therefore exploit consumers. This is because the neo-classical theory of the firm assumes that a monopolist will maximise profits which means it will produce where MC=MR. The equilibrium profit maximising level of output will therefore be where MC-MR. This is shown below:

The diagram above shows the firm will produce the quantity Qe and will charge the price Pe. As the monopolist above is also making supernormal profit in the short run it will also make supernormal profit in the long run because no other firms will be able to enter the market due to big barriers to entry.

As a monopolist will always produce where MC=MR then this means that output will be produced, effectively leaving more demand than there is supply and will drive prices up to maximise profits. This means that assuming costs are constant there will be a large social welfare loss as shown by the Harberger triangle below, which compares a monopoly to competitive conditions:

Unlike perfect competition, monopolies won't produce at the bottom of their AC curve. This is because monopolies want to maximise profits and will therefore be productively inefficient. This comparison is shown below:

Monopolistic firms are also less likely to produce on their AC curve due to 'X-inefficiency'. This is where a company becomes too large to organise efficiently, meaning organisational slack. It is basically wastefulness and because monopolies are complacent they don't have the pressure to cut costs so there will be no incentive to be efficient.

Another argument against monopolies is the way there is allocative inefficiency. This is because monopolies create 'contrived scarcity' by limiting the supply of the good or service. Price is greater than MC, and some consumers are therefore unable to purchase the good at this price.

Other arguments against monopolies include that lack of competition will prevent a monopoly from innovating or developing new products. Also that monopolies can abuse their market position by charging different customers different prices for the same good or service in order to increase their supernormal profits. This is also known as price discrimination. There is also the view competition leads to greater choice and variety of goods for consumers.

There also arguments for monopolies being in the public interest. The main argument is that it may not be the case that monopolies restrict output and increase prices because they may have economies of scale which may reduce unit costs. In this case, its possible a monopolist could charge lower prices than a competitive firm.

As the above shows if economies of scale lead to the MC curve being substantially below that of the same industry under perfect competition the monopoly will produce a higher output at a lower price. Therefore on this evidence is inefficiency really a problem.

Another argument for monopolies concerns the social welfare loss caused by monopolies and the way measures of this welfare loss often show it to be relatively insignificant. Economies of scale can reduce this effect, or even wipe it out entirely.

There is also the Schumpter argument which says that monopolies will want to innovate in order to keep their demand curve. Big companies have the money to do the research and will usually do it to keep its position. They will also have the money to invest in new inventions, a good example being the Mini Disc player. Without monopolies you could argue there would be no way forward.

Price discrimination by monopolies can also be seen not always to be so bad. This is because some goods and services may not be produced or be possible at all if monopolies weren’t able to price discriminate, a good example being rural train routes.

It can be seen that monopolies can produce stability and variety. Variety produced by firms in amore competitive market can sometimes be seen as a wasteful duplication of resources (i.e. do we really need 37 varieties of toilet to choose from?). Prices may be more stable in a monopoly as well.

Governments need to make a decision concerning its attitudes to large firms in the economy. Should it split them up or promote such firms. Competition policy therefore reflects the attitude towards monopoly. At the moment the UK has a pragmatic approach where monopoly can be good or bad. I t uses the monopolies and mergers commission to use a case-by-case approach. Competition policy is a government policy to influence the degree of competition in individual markets within the economy. Governments can also attempt to correct market failure caused by monopolies by taxing supernormal profit away, set maximum price levels, subsidise production, nationalise the industry, break it up or reduce entry barriers.

In the past economists have generally come out against monopolies and in favour of competitive markets. However, this is clearly not conclusive as monopolies have many potential advantages and disadvantages.