EC 103 Principles of Economics:

Microeconomics:

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A Monopoly exists where only one seller or potential seller is in a particular industry, and the monopolist set's the price to a preferred level of profit. Ther e are no substitutes for the product, which means if the consumer requires or needs to the product, they have to purchase the product off the monopolist firm. There is a very high efficient scale, with barriers of entry into the industry, which means that entry cannot be achieved into the market by small-scale production. The Demand curve for the firm is the industry's demand curve, meaning that all demand is controlled by the firm. A monopoly is the opposite of perfect competition, where there are many buy ers and sellers and where there is free entry to the market. Unlike under perfect competition, a monopolies marginal revenue is always below actual revenue and it faces the demand curve directly. It could be said that a monopoly practices unfair competitio n, due to the extreme high barriers it sets for competition to enter the industry.

Some monopolies are state owned, and are not necessarily run for profit. However, in the last 25 years, for example when Margaret Thatcher was in power, Britain especially privatised these monopolies and therefore were deregulated from government control, so they could charge whatever prices they wanted. This was good for the economy at the time, as it created money for the government, but in the long term has created unfair competition and high prices to customers.

Unlike a competitive industry, supernormal profits of a monopolist are not eliminated by entry of more firms and a fall in price. Therefore by eliminating the mechanism where by which supernormal profits disappear in the long run. This directly effects consumers, as they have to continually pay high prices for the products sold by monopolies, which can be a burden on consumer purchasing them and a restriction on customers who can't afford the product (eg: Microsoft computers for school work).

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. As well as economies of scale, barriers of entry are set. These include natural cost advantages such as ownership of all key sites in an industry, marketing barriers, restrictive practices designed to force and competitor to leave the market. These barriers to entry seem to be unfair on new entran ts because their chances of breaking into the industry are slim because they are new and need to gain customer loyalty and become a recognised

firm. On top of this, they have these barriers that they need to comply with which will make it almost impossible to survive.

Monopolists are a price setter. If they quote a price at say (P1), they know customers will demand a certain amount at (Q1). Due to this factor, a monopolist doesn't have a supply curve, independent of demand conditions. Rather, they analyse demand and cost to decide how much to produce and what to charge. If the price is set too high, they could be losing out on their maximum profit. Thus because profit gained from sales at a high price could be less than profit lost from even more sales at a lower price. As the monopolistic firm is the only one in the industry, it can decide what price to set and then choose the maximised profit margin. Therefore a monopolist may choose to produce only a certain amounts of goods to sell at the chosen price. This represents a welfare loss since the society desires to have more of the good produced to increase its net social benefit but the monopoly restricts the output, so not all consumers can have the product.

Some economies have a patent system. Inventors of new processes get a temporary monopoly for a fixed period. Therefore customers are only subject to a monopoly for a fixed amount of time then barriers to entry are lowered so that competition and thus price reduction occur to give consumers more value for money. Regulators such as the Monopoly and Mergers commission maybe used to prevent mergers by firms to create monopolies, which would arguably be against public interest.

The existence of monopolies and the high profit margins that they obtain encourages those from outside the industry to destroy monopolies by trying to "leapfrog" the technology used in the industry. This is called the process of creative destruction. For example, the monopoly of canals was destroyed by invention of railways. This theory would tend to suggest monopolies are good because they create more inventors to try to improve technology, but this would still arise in the existence of another monopoly for the new technology and restrict further competition.

A monopoly is a firm who is the only one in the industry. This means that their product is the only one that the consumer uses so they would expect a certain standard from the product. When the price goes up you customers would expect the quality of the product to rise as well. If this doesn't happen, then people will stop buying the product. Some firms have good quality products but to compete in a competitive market they have to set their prices low in order to compete. It could be said that in favour of a monopoly because they will get a reward in higher profits for the quality of their product. However this theory doesn't apply to necessity goods.

As Monopolies are gaining supernormal profits, they can afford to invest in big research and development (R+D) projects to combat the process of creative destruction. As

these big scale research and development projects are taking place, the firm is more likely to create a better alternative to it's product or a new technology to make it's monopoly power even bigger. This process exploits new inventions and also earns abnormal profits. In turn, this discourages other inventors and other smaller companies from using R+D. Monopolies might also bring about X-inefficiency because the high barriers to entry deter any competition and hence the monopolies may not be forced to innovate, which will make them complacent and lazy. Therefore to reduce costs and reduce price of the good sold, they can not invest in research and development and become greedy with profits already obtained rather than investing in higher profits for the future. Lack of innovation and failure to increase productivity and efficiency of production is again bad for the economy

Another disadvantage of monopolies is that they can be discriminating. When a firm knows demand will be higher, it can raise the price to increase its profit margin. This is evident in train companies where train fares are much higher in rush hour rather than mid day trips. This is another disadvantage for consumers as the same product/service is available, but when they most need to use it, prices are increased and is unfair. Monopolies can also discriminate towards the income of the consumer. An example of income discrimination would be that of a hairdresser. They can charge lower prices for OAP's, and higher prices for business customers.

Monopolies however do not all work in the same way. It depends on what type of industry the monopoly is over. If the product is a necessity for example, people will have to buy the product regardless of how much it costs. However, if the monopolist has a monopoly over a luxury item, people can afford to go without the item and therefore they don't have as much monopoly power taking the strain off consumers.

So-called state monopolies can be better for the economy in certain industries. Economics of scale are so great, such as water, that the monopoly can be termed "natural". Whereas most monopolies have the theory of charging high prices and earning supernormal profits, natural monopolies work quite differently. As natural monopolies have quite substantial economies of scale, the monopoly price they set could be lower and therefore output will be higher than that of competition. In this situation, a monopoly would be preferred rather than a competitive industry, as competition in large sectors, such as railways and water industries, would lead to duplication of investment, which would be wasteful for resources.

In conclusion, it can be said that monopoly power can have its good and bad points on the economy. Depending in which industry the monopoly produces and the type of economy it operates in will depend on what effects it has.

References

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