

What criteria should be applied in judging whether monopolies are acting in public interest? (25)

In judging whether monopolies are acting in public interests, we are essentially examining their relative merits and demerits to the society. A monopoly is a single producer in the market that produces a unique product with no close substitutes. The monopoly is so large that the firm is considered to be the industry in producing the good. The monopoly also has high barriers to entry to potential competitors. The barriers to entry can be natural barriers like the monopoly control of supply of inputs or the high initial setup costs or artificial, man-made barriers like copyright laws, market franchise etc.

Public interests refer to the general welfare of the society which consists of both the firms and the consumers. The households and the producers make up the public and the welfare of these groups of people is usually termed as public interest.

Let us first consider how the monopoly acts against public interest of the society at large.

The basic economic problem of scarce resources and unlimited human wants forces us to make choices and try to achieve an optimal allocation of resources (i.e. an utmost efficiency in the allocation of resources). However, the monopolies often fail to achieve a efficiency in the allocation of resources.

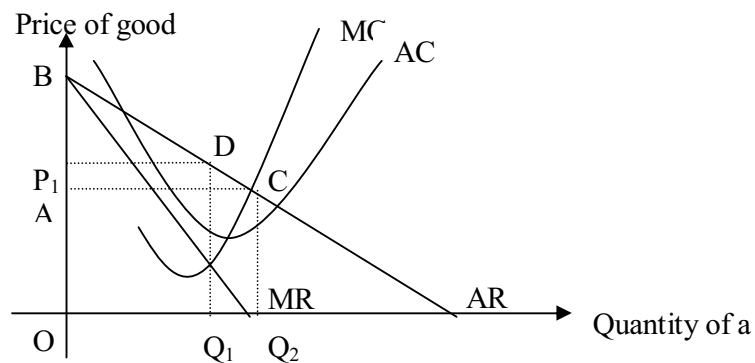


Figure 1

Refer to figure 1. The monopoly faces a downward sloping demand curve since the firm is an industry and quantity demanded increases as prices falls. The monopoly can either fix price and let market forces determine the equilibrium output, or fix the output and let market forces determine the price. Very often, the profit-maximising monopoly will set the quantity to be sold at marginal revenue equals to marginal cost ($MR=MC$) at OQ_1 . He will then charge a price of OP_1 . However this output level (OQ_1) is not at the productive efficient output level (OQ_2). Productive efficiency is achieved when the production is at the lowest point of the average cost curve (OQ_2). Any output less than OQ_2 represent excess capacity as average costs can be reduced when output increases (to OQ_2). Any output more than the productive

efficient output will mean that the production is at over capacity and the output should be reduced to OQ_2 so as to reduce the average costs. As illustrated, monopoly will be producing as excess capacity most of the time and this represent a waste to the society as costs are not minimised and resources are not efficiently allocated. It is by fluke if the OQ_1 output level correspond to the minimum point of the AC curve.

From figure 1, we can also see that there is a loss of consumer surplus equivalent to the shaded area. The monopoly restricts output to OQ_1 and raises the price level to OP_1 such that consumer surplus is reduced from ABC to P_1BD . The loss in consumer surplus is an undesirable consequence to the consumers as a result of monopolies' pricing decision. The consumer will now have to pay more for smaller quantity consumed. It is especially undesirable if the poor can now no longer afford to buy the good because of higher prices and this is definitely going against public interests of equity (i.e. the rich should not gain at the expense of the poor).

However, if the loss in consumers' surplus is recovered by the gain in the producers' surplus, the total welfare loss is zero. Because the surplus is merely transferred from the consumers to the producers, there is no net loss (i.e. the society utilisation of resources remain unchanged). However, this does not happen unfortunately, because part of the loss in consumer surplus is not recovered by the gain in producers' surplus. This will bring about allocative inefficiency in the production of the good.

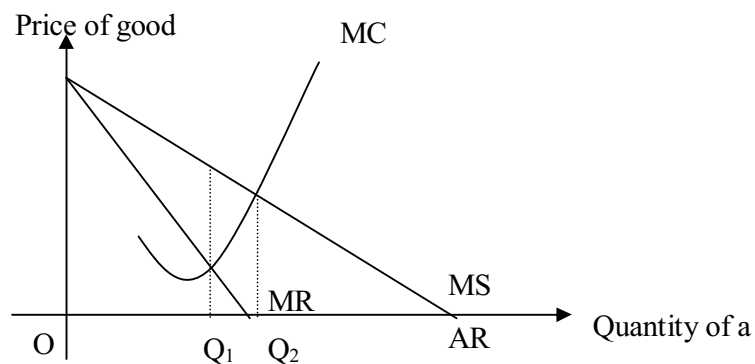


Figure 2

Allocative efficiency occurs when price, $P=MC$, marginal cost. When $P=MC$, the marginal valuation of the society on the unit of the good consumed is equal to the marginal cost in producing the good. This mean that the marginal social benefit (MSB) is equal to the marginal social cost (MSC) in terms of alternative goods foregone. Since $MSB=MSC$, there is efficient allocation of resources as resources are channeled into producing goods that the society wants. Society welfare is maximised and Pareto optimality is reached.

However the monopoly pricing decision lead to a welfare loss shown by the shaded triangle in figure 2. The monopoly is not producing at output level OQ_2 (which the perfectly competitive industry will produce) and all previous units (Q_1Q_2) have a greater MSB than MSC since the demand curve (MSB) is higher than the MC curve at all output levels from OQ_1 to OQ_2 . This represent a welfare loss since the society desires to have more of the good produced to increase its net social benefit but the monopoly restricts output to OQ_1 .

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 so as to reduce costs and reduce price of the good sold. Lack of innovation and failure to increase productivity and efficiency of production is against public interests to get the most out of the limited resources to satisfy unlimited wants.

However, monopolies do sometimes act in public interest. For example, natural monopolies allow consumers to purchase goods at a lower price as compared to prices charged by a small competitive firm.

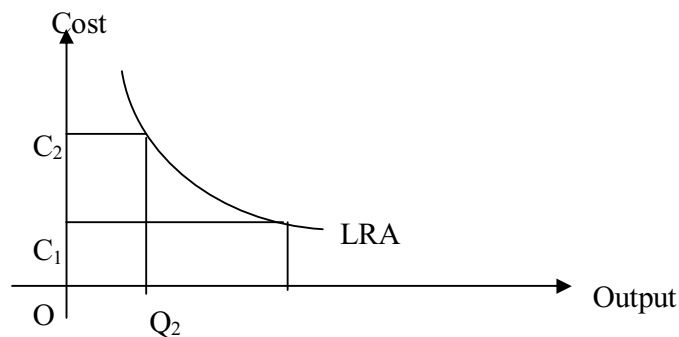


Figure 3

As illustrated in figure 3, the long run average cost (LRAC) slope downwards for a great output level. Because of the substantial economies of scale (EOS) reaped by monopolies due to large scale production, it is better for the monopoly to produce at OQ_1 and at a cost of OC_1 , rather than having a small firm to produce at OQ_2 at a higher cost of OC_2 . Lower costs represent a better utilisation of resources and hence a better allocation of resources. As such, vital commodities like water and electricity are provided by natural monopolies, which can actually charge lower prices such that the masses can afford instead of only a privileged few who are rich.

Also, monopolies can practice price discrimination if the average cost curve lies above the demand curve over the entire demand curve.

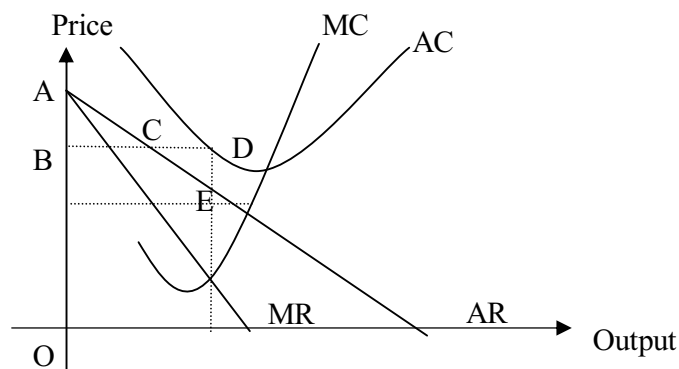


Figure 4

Refer figure 4, if the monopoly can practice first degree price discrimination, the production of good can still be continued as long as the revenue gain (ABC) is greater than the loss (CDE).

This is especially important in the provision of essential items like water and electricity. Left to the perfectly competitive firm, the firm may not want to go into production since it cannot practice price discrimination. However since the monopoly can practice price discrimination, such 'loss making' services can still be provided and the society can still enjoy the consumption of such good thereby increasing' society's level of satisfaction and promoting public interests.

Also, if the monopoly can practice MC pricing due to price discrimination, allocative efficiency will be achieved since price equals marginal costs.

Lastly, price discrimination can allow monopolies to charge a lower price to the poor and a higher price to the rich. Hence, the poor who previously cannot afford can now afford to buy the good. This will serve to allocate goods to all people of different incomes thereby promoting social equity and enhancing public interest.

In conclusion, monopolies can act against or in public interest because of its ability to set either price or quantity sold. Its unique pricing and output decision can either seek to maximise social welfare and achieve pareto optimality or create deadweight losses and cost inefficiencies which will reduce the well-being of the society.