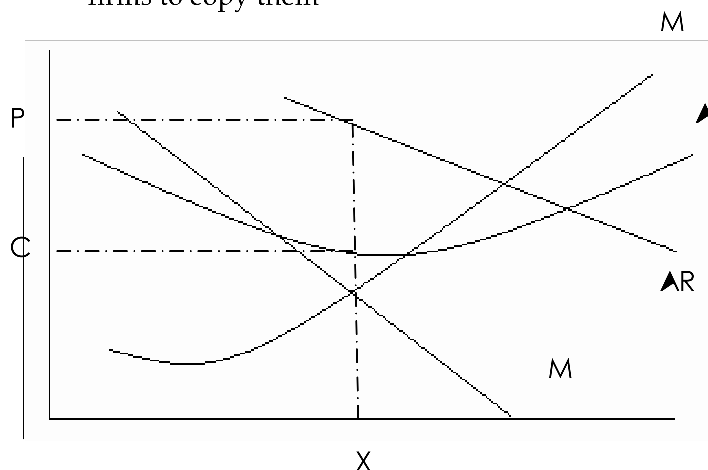
Monopoly

The definition of monopoly in theory is when one firm produces the whole output of a given industry. These are mostly natural monopolies e.g.: Thames water. The definition implies that other firms are not able to enter the market because of barriers to entry. These normally take the form of some cost advantages which are available to the monopolist, but which are not available to newcomers. The most likely reason for this is the existence of economies of scale which require a producer to obtain large sales in order to reduce costs to the minimum possible. The other definition of monopoly is defined as being where one firm has 25% share of the total market output e.g.: Tesco.

Characteristics of a monopoly are:

- No Competition, as they are the only supplier of a good or service
- Abnormal Profits, because monopolies are price makers so are able to charge any price that they want
- Barriers to entry, large barriers to entry preventing other firms entering the market
- Imperfect information
- Non-homogenous products, produce variety of goods so that it is difficult for other firms to copy them



In the short run, a monopoly would produce at where mc=mr, and receive abnormal profits (difference between costs and revenue), in the long the firm will receive competition as new firms enter the industry to receive the abnormal profit, reducing the abnormal profits for the monopoly in the long run, however if the firm controls all the market the monopoly will still receive abnormal profit in the long run as well.

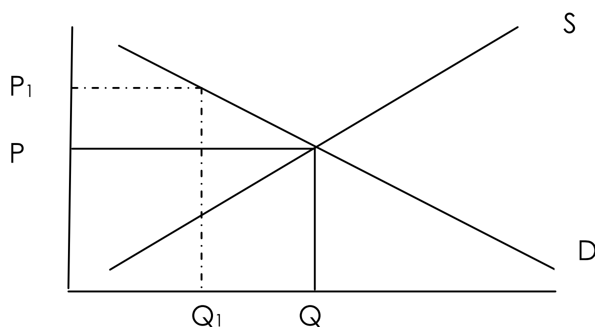
The ways in which monopolist can develop are from successful internal growth of a business or through mergers. The different types of mergers are horizontal and vertical integration. Horizontal integration is where two firms join at the same stage of production on one industry. E.g.: recently Safeway and Morrison merged to create the UK's fourth largest national food retailer. Vertical integration is where a firm mergers with another firm at a different stage of production in the industry. E.g.: Oil industry where many of the leading companies produce oil and have their own retail networks for the sale of petrol and diesel and other products.

The problems of monopolies are now discussed. Competition in a monopolistic industry is very little or none at all because of barriers to entry. They have large barriers to entry which prevent competition from existing. There are several types of barriers to entry.

- Patents – these are legal property rights to prevent the entry of rivals. They give the owner an exclusive right to prevent other from copying their idea; this is valid for 17-20 years. Owner can sell their patents to other business.
- Advertising and Marketing – this develops consumer loyalty by establishing branded products can make successful entry into the market by new firms more expensive and less successful.
- Economies of scale – this is the fall in the average cost of production in the long run as output rises. This is experience by large firm which can generally produce goods at lower costs then small, inexperienced firms.
- Hugh sunk costs often known as irretrievable cost are also a barrier to entry as if they are high, e.g. the oil industry. Firms m ay no decide to set up shop as the fear that the larger competitor my run them out and the cost would not be retrieved.

Monopolies have poor level of service. This is because they face no competition, so they don't have to worry about losing customers, because of this they can be very inefficient and provide poor services e.g.: before the UK gas and electricity industries were privatised and competing companies were formed, many customers complained of the poor levels of services provided by these nationalised industries.

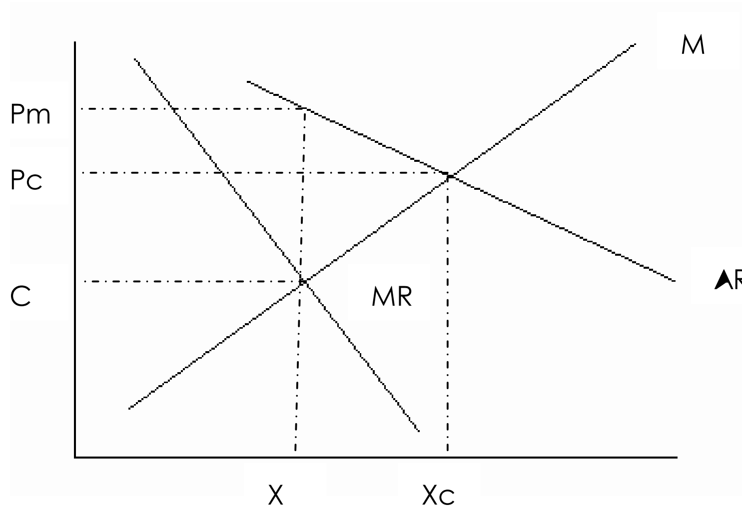
In an attempt to make abnormal profits, monopolies restrict supply of their products in order to force up the market price, this can be seen in the diagram below.



The diagram shows that as monopolies restrict supply of their products from Q to Q_1 price rises from P to P_1, how much price rises depends on the elasticity of supply and demand

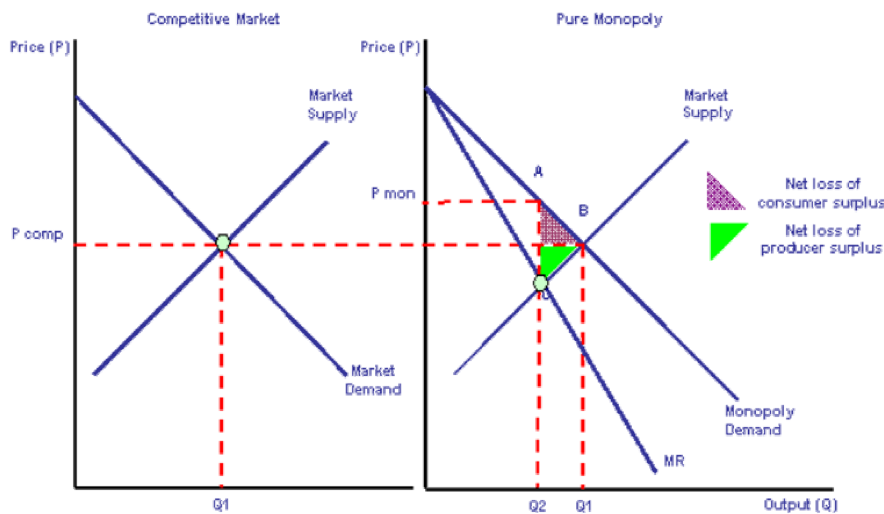
Producer sovereignty is another disadvantage of monopolies; this is when the producer has control over the use of scarce resources there is said to be producer sovereignty, so monopolies decide what goods and services to produce for consumers. This arises because monopolies prevent consumers from obtaining a wide range of goods and services by using barriers to entry to prevent competition. They can influence the goods and services that consumers want through the use of advertising.

Monopolies are price makers so are able to charge any price that they want. Main objective of the firm is to make abnormal profit and increase their market share which leads to the problems with monopolies being inefficient both allocatively and productively. Comparing monopoly to perfect competition, the firm in perfect competition would be at the lowest point on its average cost curve, while in monopoly, in order to increase price, the firm will reduce output. This means that the firm sells the last unit produced at a price which exceeds the actual cost of producing that unit. So the economy does not achieve allocative efficiency, since the price does not equal marginal cost.



This diagram illustrates that the consumer is prepared to Pm for the last unit bought. It would only cost the firm C to produce an extra unit and so it would be an efficient use of resources to allow an extra unit to be produced. However it is not in the interests of the monopolies to reduce the extra nit since it will reduce its profits because of the need to reduce the price of all other units produced. This means that resources are not allocated so as to make consumers well off as possible. So it is

If the industry is taken over by a monopolist the profit-maximising point (MC=MR) is at price Pmon and output Q2. The monopolist is able to charge a higher price restrict total output and thereby reduce economic welfare. The rise in price to Pmon reduces consumer surplus. Some of this reduction in consumer welfare is a pure transfer to the producer through higher profits, but some of the loss is not reassigned to any other economic agent. This is known as the deadweight welfare loss and is equal to the area ABC.



In order to overcome these disadvantages Government has adopted controls over industries where firms have obtained monopoly position. The types of control that the government can take place are.

Anti monopoly legislation, this can give the courts the power to dissolve an existing monopoly into a larger number of independent companies. This is the attitude of the Americans. It is based on the belief that monopolies are inherently undesirable and that competition is to be encouraged at all times.

The UK approach is to attempt to regulate the behaviour of monopolists. So the monopoly is allowed to persist, but the government ensures that it does not act against the public interest this may take the form of a referral to the restrictive practises court which investigates practices that restrict competition, or could be referred to Monopolies and Mergers commission that may prevent a merger taking place altogether if it might create a monopoly.

The government may actually directly control the industry, especially if it a natural monopoly.

However there are some benefits of a monopoly. National grids Company which owns and manages the electricity supply grid in UK have natural monopolies. This is where average cost of production continues to fall as output increases so that is efficient for one large firm to be the only supplier in the market. It would be a waste of resources for each electricity supply company to provide its own network of transformers, pylons and cables to supply electricity to their customers, so there is only one firm that provides this. The UK government regulates natural monopolies to make sure that they do not exploit their customer or charge excessive prices.

Another Advantage of a monopoly is the large amount of money that they spend on research and development of new products and techniques, because they know it can earn them high profits and keep these by using barriers to entry to stop new firms from competing with them and using their ideas.

Another advantage is that of lower prices, monopolies produces a very large output and can benefit from economies of scale, as a result the average cost of production for the monopolist may be lower than a smaller competitive firm producing a lower output and so the monopolist can afford to charge consumers a lower price and still earn high profits.

Another advantage is that monopolies need to be large so that they have the financial, technological and marketing resources they need to compete against huge overseas firms.

A contestable market is defined as where there are no/low barriers to entry and exit, and therefore the threat of competition keeps prices down. The theory of contestable market suggests that even if there is only one seller, the seller may be forced to act as if there were many more. Sellers have the incentive to act in this way because it will increase profits. A perfectly contestable market is one in which entry and exit is absolutely costless. In such a market, competitive pressures supplied by the threat of entry as well as by the pressure of actually current rivals, can prevent monopoly behaviour of higher prices and restricted output.

Everyone has a problem with monopolies from the economist to consumers for their own reasons. Economist have problems with monopolist because of the deadweight loss, whereas the consumer have problems because they feel that monopolies take advantage of their power by charging consumer higher prices. According to the theory of contestable markets there is a way of dealing with monopolies without the intervention of the

government. This to me is the best solution as it allows the free market to run its course and consumers are not taken advantage of. However I do see the drawback to this solution as it does not always come about as many monopolies in the UK and worldwide are far too big to fear competition.