Monopoly 2

Bad things that monopolist do!

Laugher Curve

The First Law of Economics:
For every economist, there exists an equal and opposite economist.

The Second Law of Economics:
They're both wrong.

The Welfare Loss from Monopoly

- People’s purchase decisions don’t reflect the true cost to society because monopolies charge a price higher than marginal cost.

The Welfare Loss from Monopoly

- The marginal cost of increasing output is lower than the marginal benefit of increasing output.
The Welfare Loss from Monopoly

- The welfare loss of a monopolist is represented by the triangles $B$ and $D$.
- The welfare loss is often called the deadweight loss or welfare loss triangle.

The Price-Discriminating Monopolist

- Price discrimination is the ability to charge different prices to different individuals or groups of individuals.

The Price-Discriminating Monopolist*

- In order to price discriminate, a monopolist must be able to:
  - Identify groups of customers who have different elasticities of demand;
  - Separate them in some way; and
  - Limit their ability to resell its product between groups.
### The Price-Discriminating Monopolist
- A price-discriminating monopolist can increase both output and profit.
- It can charge customers with more inelastic demands a higher price.
- It can charge customers with more elastic demands a lower price.

### Price Discrimination Occurs in the Real World
- Movie theaters give senior citizens and child discounts.
- All airline Super Saver fares include Saturday night stopovers.
- Automobiles are seldom sold at their sticker price.
- Theaters have midweek special rates.

### Price Discrimination Occurs in the Real World
- Retail tire stores run special sales about half the time.
- Restaurants generally make most of their profit on alcoholic drinks and just break even on food.
- College-town stores often give students discounts.

### Barriers to Entry and Monopoly
- Monopolies exist because of some barrier to entry.
- **Barrier to entry** – a social, political, or economic impediment that prevents firms from entering the market.
Barriers to Entry and Monopoly

- If there were no barriers to entry, profit-maximizing firms would always compete away monopoly profits.

Barriers to Entry and Monopoly

- Three important barriers to entry are natural ability, increasing returns to scale, and government restrictions.

Natural Ability

- One firm may be more efficient than other firms because it is better at producing a good than those other firms making it.

Natural Ability

- The public views “just monopolies” as those which accrue to the firm because of the firm’s ability.
Economies of Scale

- If significant economies of scale are possible, it is inefficient to have two producers.
- If each produced half of the output, neither could take advantage of economies of scale.

Economies of Scale*

- A natural monopoly is an industry in which one firm can produce at a lower cost than can two or more firms.

Economies of Scale

- A natural monopoly will occur when indivisible set up costs are so large that average total costs fall within the range of potential output.

Economies of Scale*

- There is no welfare loss in the natural monopoly situation.
- There can actually be a welfare gain because a single firm is so much more efficient than several firms producing the good.

This can be debated!
A Natural Monopolist

Natural Monopoly

- A natural monopolist produces $Q_M$ and charges $P_M$ and earns a profit.
- If the government regulates a competitive solution where $P=MC$, the monopolist charges $P_C$ and produces $Q_C$ for a loss.

Government Restrictions

- Monopolies can be created by government.
Normative Views of Monopoly

- The public generally views monopolies the way the Classical economists did – they consider them unfair and wrong.

- The public accepts patents which are a type of government-created monopoly.
  - **Patent** – a legal protection of a technical innovation that gives the person holding the patent a monopoly on using that innovation for a specified period of time.

- The public does not like the distributional effects of monopoly.
- They believe that it transfers income from “deserving” consumers to “undeserving” monopolists.

- It is possible for the well-financed and the well-connected to garner government favors.
- The public prefers that firms do “productive” things rather than lobby for government favors.
Government Policy and Monopoly: AIDS Drugs

What should the government do?
- Should it force the producer to charge a price equal to its marginal cost.
- Doing so would create a significant disincentive for drug companies to do further research on other life-threatening diseases.

The government could buy the patents.
- Payment would come from increased taxes and would be quite expensive.
- The cost of regulation would drop, but it would raise the question as to which patents the government should buy.

Summary
- Monopoly is a market structure, protected by barriers to entry, in which a single firm produces a product for which there are no close substitutes.
- A monopolist maximizes profit or minimizes losses where MR=MC.
- To determine a monopolist’s profit or loss:
  - Find output where MR=MC.
  - Determine price and ATC at that output.
  - Profit or loss = (P – ATC) * Q.

Monopoly output is lower and price is higher than in competitive markets.
- Because monopolies reduce output and charge P > MC, monopolies create a welfare loss for society.
- A price-discriminating monopolist earns more profit than a normal monopolist by charging a higher price to those with less elastic demand and a lower price to those with more elastic demand.
In order to discriminate a monopolist must:
- Identify and separate groups of customers with different elasticities of demand.
- Limit their ability to resell its product between groups.

Three important barriers to entry are:
- Natural ability
- Increasing returns to scale
- Government restrictions

Natural monopolies exist in industries with strong economies of scale, so it is more efficient for one firm to produce the entire output.

In a natural monopoly the competitive outcome where P=MC results in losses.

Normative arguments against monopoly are:
- Monopolies are inconsistent with freedom.
- Distributional effects of monopoly are unfair.
- Monopolies encourage people to waste time and money trying to get monopolies.

### Review Question 12-1
Given the following demand and cost information, complete the table and find the profit-maximizing price and output.

<table>
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<tr>
<th>Output</th>
<th>Price</th>
<th>Total Revenue</th>
<th>Marginal Revenue</th>
<th>Marginal Cost</th>
<th>Average Total Cost</th>
<th>Profit</th>
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</table>

### Review Question 12-2
Show the equilibrium output, price, and profit from question 12-1 on a graph.

MR = MC between 3 and 4 units, so the monopolist maximizes profit at Q = 3 and P = $14.

Profit = (P-ATC)*Q = (14-9.33)*3 = $14