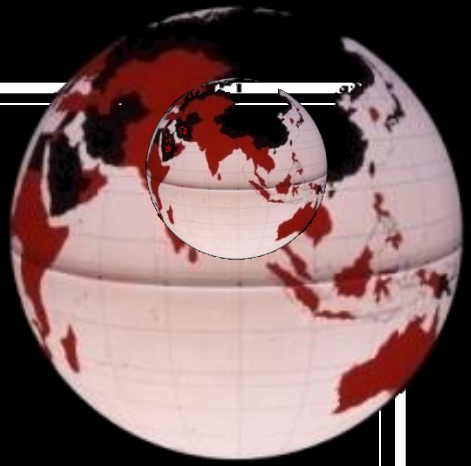
Monopolies Part II



Competition is always a good thing. It forces us to do our best. A monopoly renders people complacent and satisfied with mediocrity.

Nancy Pearcey

Market Power at Work: Computer Market Revisited

- For comparison purposes, Universal is not taking advantage of economies of scale.
- Economies of scale – reductions in minimum average costs that come about through increases in the size (scale) of plants and equipment

The Production Decision

- Like any producer, Universal wants to produce at the rate that maximizes profits.
- Universal faces a production decision concerning its many plants.
  - Production decision – the selection of the short-run rate of output (with existing plant and equipment)

The Production Decision

- A monopolist can foresee the impact of increased production on market price.
- A monopolist prevents production increases by coordinating the production decisions of its plants.

Marginal Revenue

- Each Universal plant faces a downward-sloping demand curve so that the marginal revenue no longer equals price.
- Only firms that confront a horizontal demand curve equate marginal cost and price.

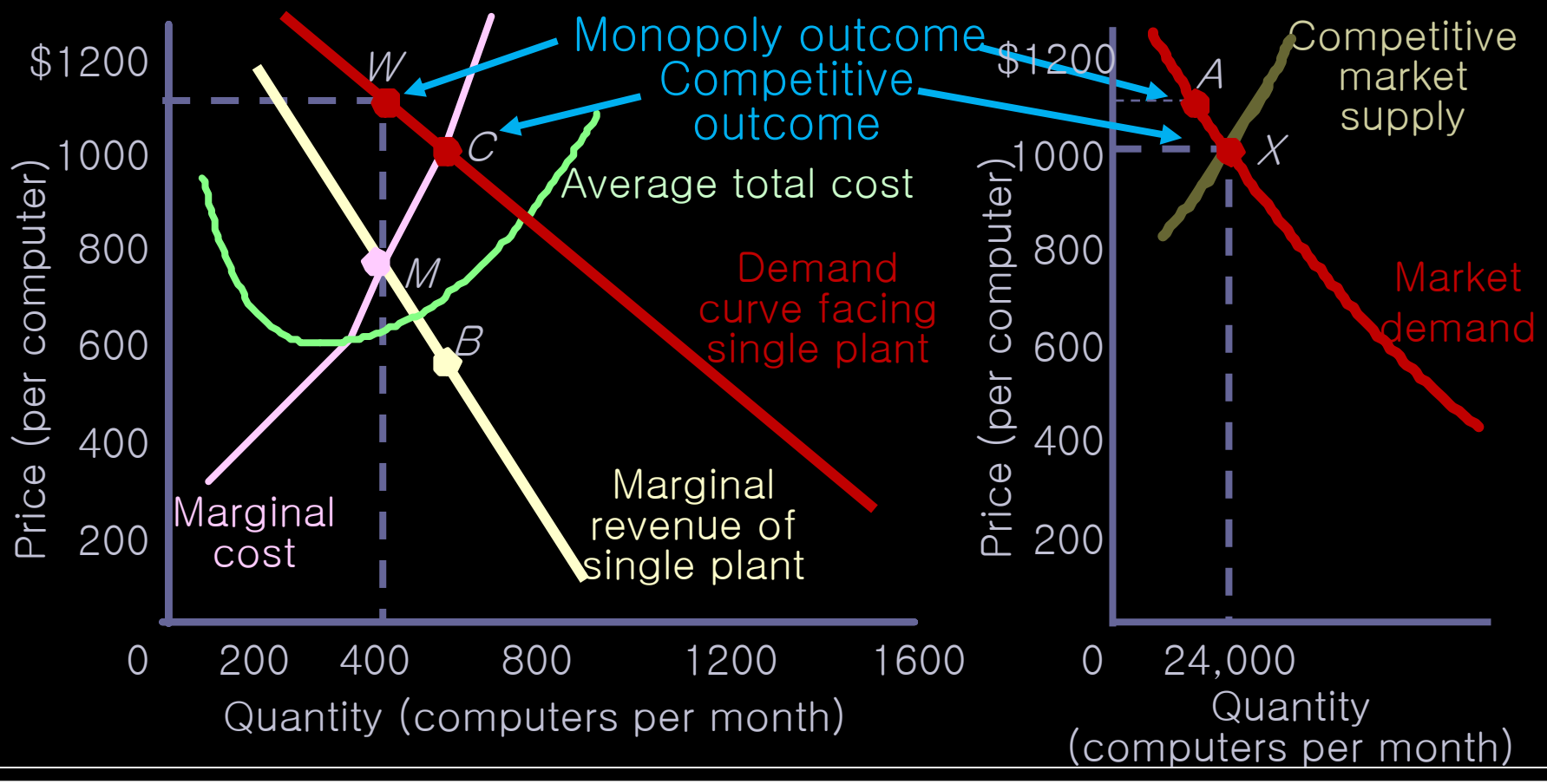
Reduced Output

The typical Universal plant will produce *fewer* computers than would be produced by a typical perfectly competitive firm.

The Monopoly Price

- The intersection of the marginal revenue and marginal cost curves establishes the profit-maximization rate of output.
- The demand curve tells us how much consumers are willing to pay for that output.

Charts: Initial Conditions in the Monopolized Computer Market



Monopoly Profits

Total profit equals average profit per unit times the number of units produced.

Profit per unit = price – average total cost

Profit per unit = p – ATC

Total profits = profit per unit X quantity

Total profits = (p – ATC) X q

Monopoly Profits

A monopoly receives larger profits than a comparable competitive industry by reducing the quantity supplied and pushing prices up.

Chart: Monopoly Profits: The Typical Universal Plant

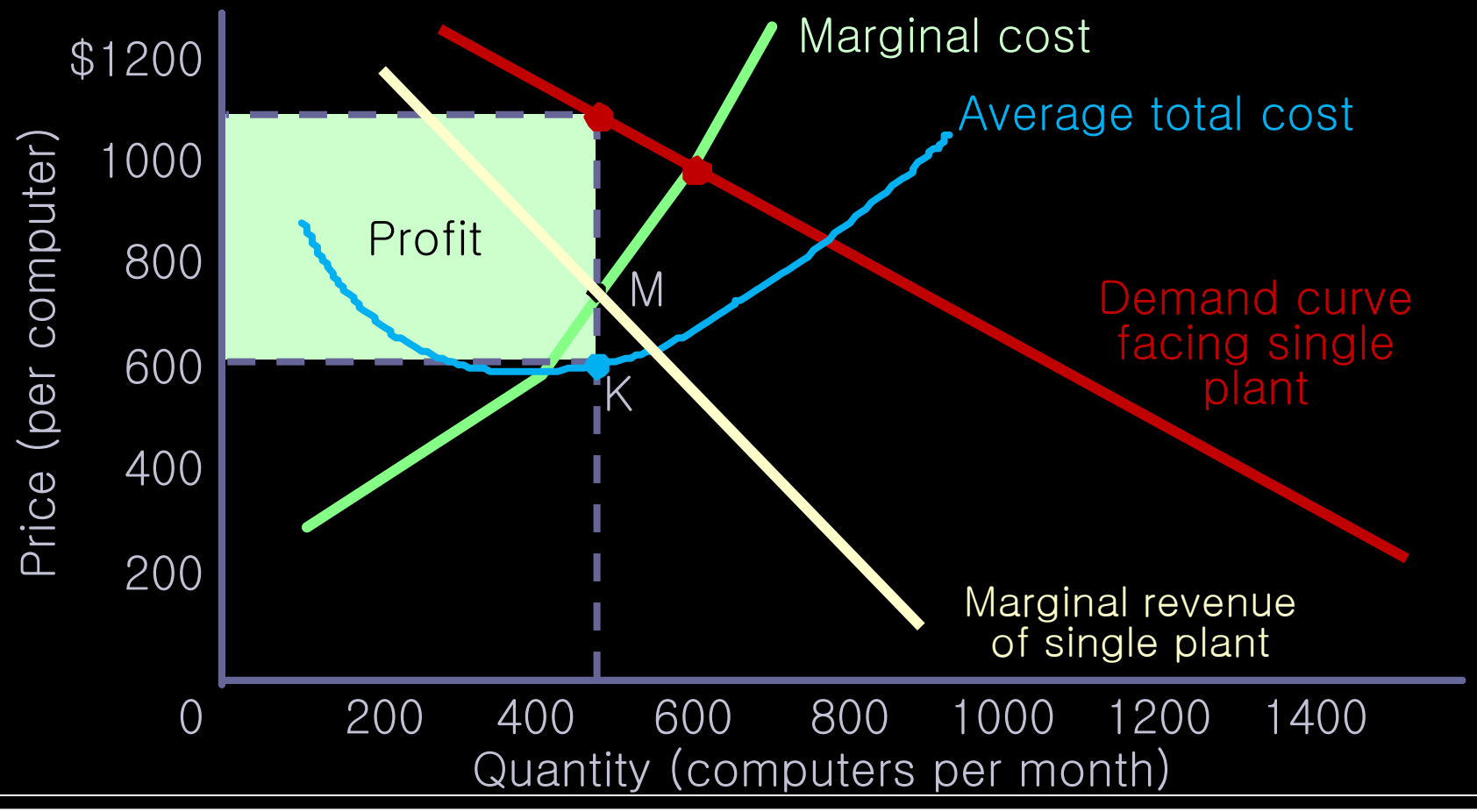
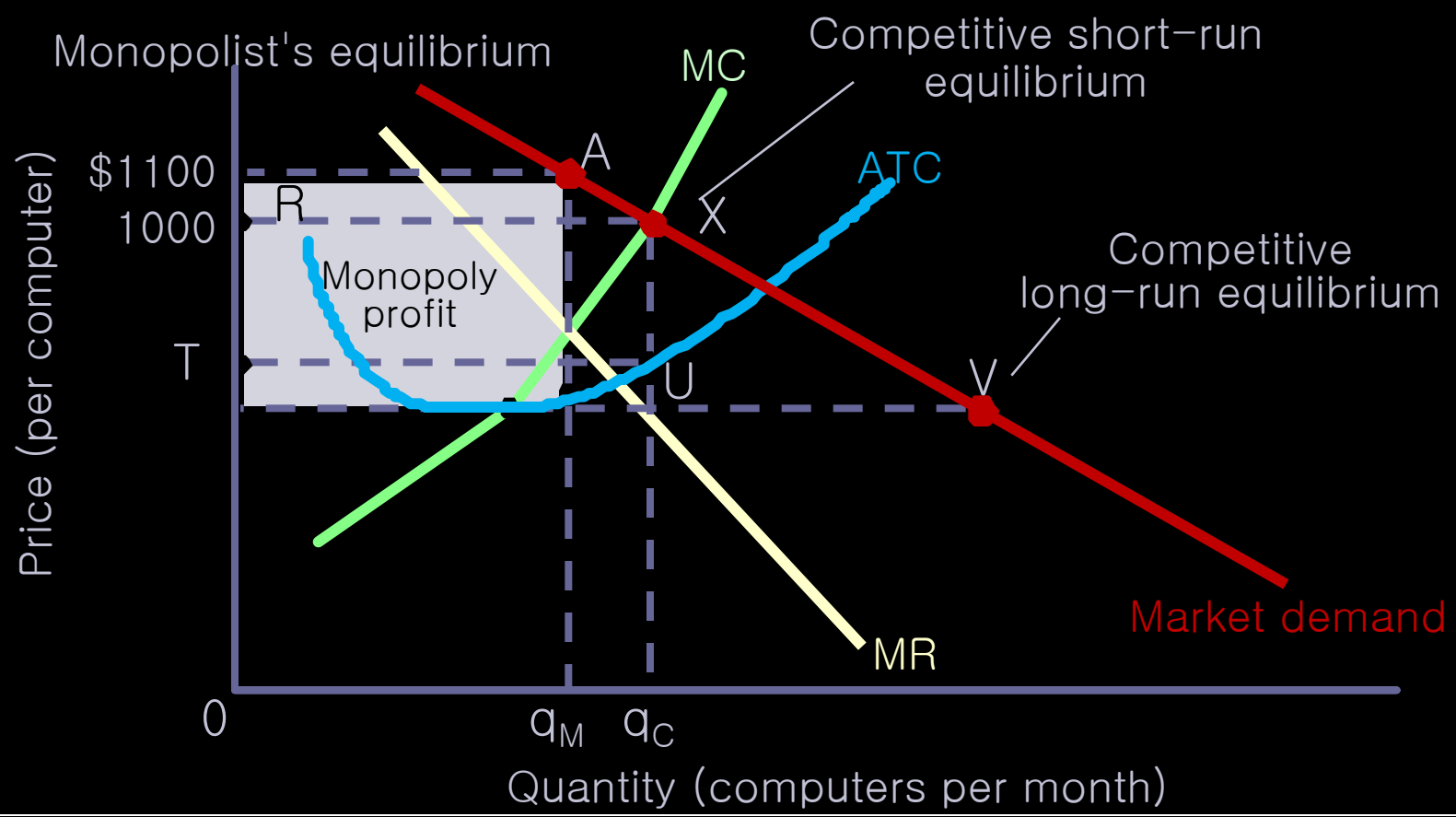


Chart: Monopoly Profits: The Entire Company



Barriers to Entry

- High barriers to entry prevent profit-hungry entrepreneurs from entering the market to compete monopoly profits away.
- Monopoly profits persist as long as barriers to entry prevent competitors from entering the market.

A Comparative Perspective on Market Power

Outcomes differ under competitive and monopoly conditions.

Competitive Industry

- High prices and profits signal consumers' demand for more output.
- The high profits attract new suppliers.
- Production and supplies expand.
- Prices slide down the market demand curve.

Competitive Industry

- A new equilibrium is established.
- Price equals marginal cost at all times.
- Throughout the process, there is great pressure to reduce costs or improve product quality.

Monopoly Industry

- High prices and profits signal consumers' demand for more output.
- Barriers to entry are erected to exclude potential competition.
- Production and supplies are constrained.
- Prices don't move down the market demand curve.

Monopoly Industry

- No new equilibrium is established.
- Price exceeds marginal cost at all times.
- There is no squeeze on profits and thus no pressure to reduce costs or improve product quality.

Monopoly Industry

- Because monopoly markets do not tend towards marginal cost pricing, consumers do not get the mix of output that delivers the most utility from available resources.
- Marginal cost pricing – the offer (supply) of goods at prices equal to their marginal cost

Political Power

A firm with considerable market power is likely to have significant political power as well.

The Limits to Power

- Monopolists only have absolute control of the quantity of output supplied to the market.
- Monopolists must still contend with the market demand curve.

The Limits to Power

- The greater the price elasticity of demand, the more a monopolist will be frustrated in its attempts to establish both high prices and high volume.
- Price elasticity of demand – the percentage change in quantity demanded divided by the percentage change in price

Chart: Competition vs Monopoly

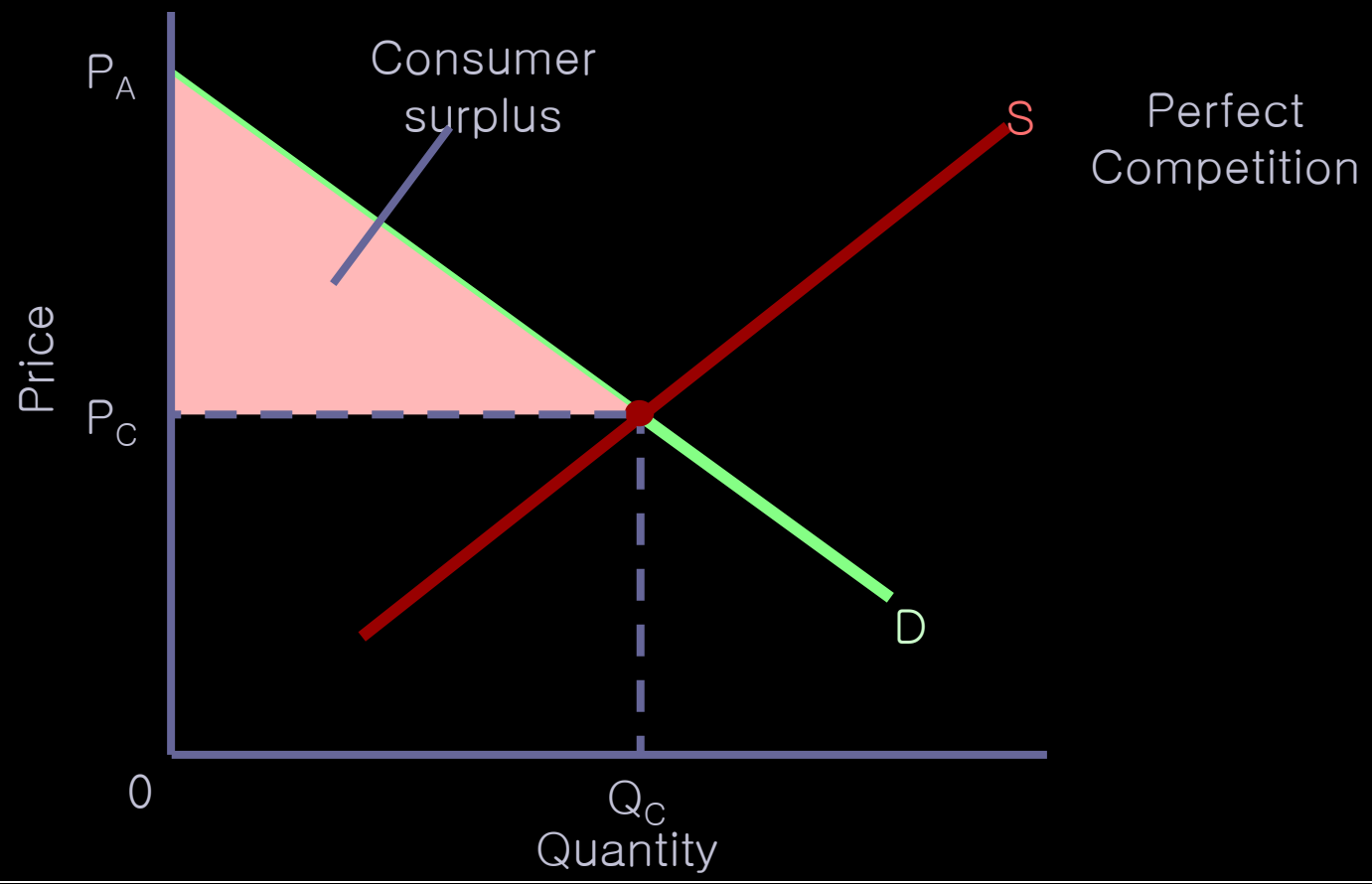
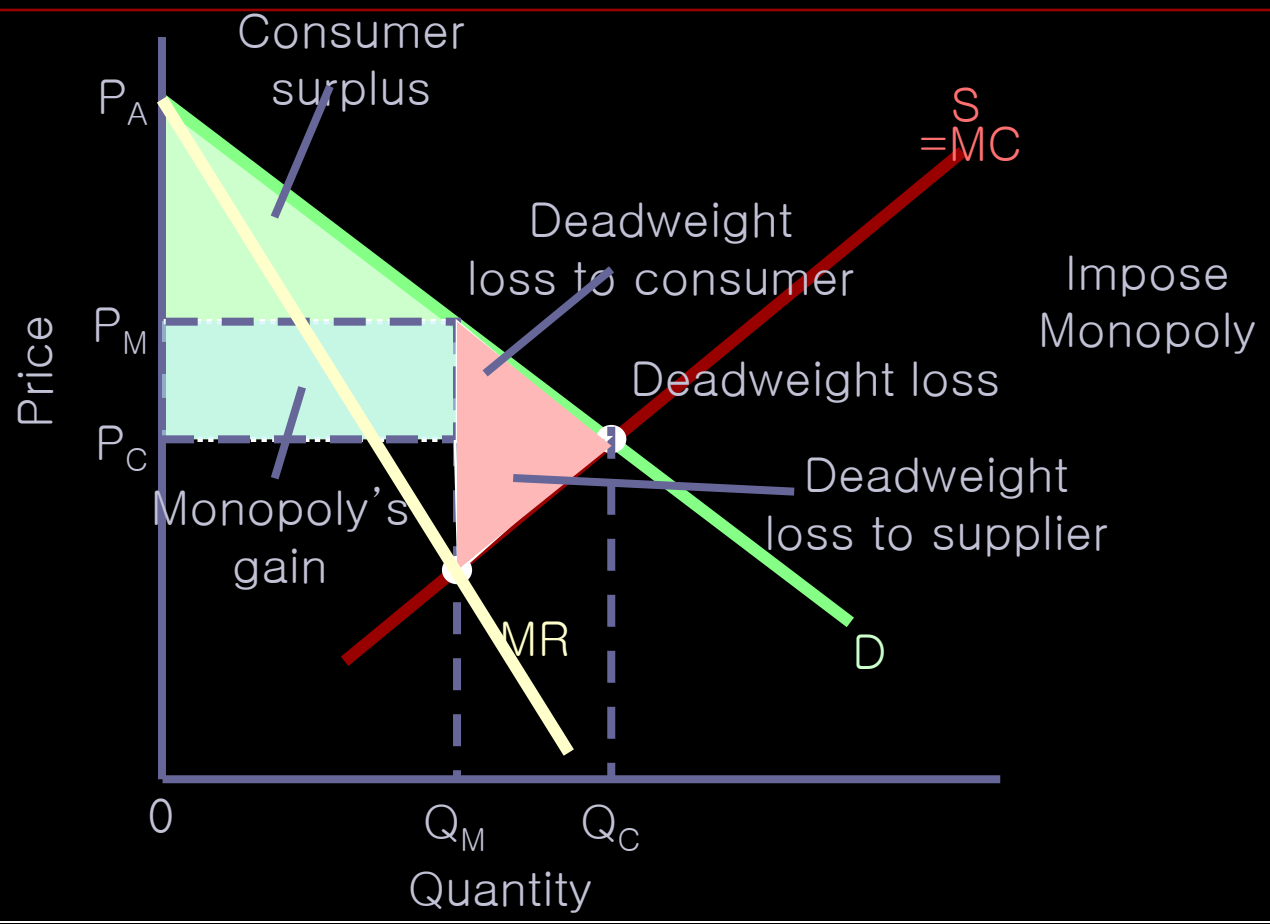


Chart: Competition vs Monopoly



How Does a Monopoly Change When Price Discrimination is Possible?

- Price discrimination – selling a good or service at a number of different prices
- To be able to price discriminate, a monopoly must
  - Identify and separate different buyer types.
  - Sell a product that cannot be resold.

Price Discrimination

Consumer surplus

Price discrimination attempts to capture even more consumer surplus than a single-price monopoly does.

Price Discrimination

- Discriminating among units of a good
  - charging buyers different prices on each good bought (ex. bulk buying discounts)
- Discriminating among individuals
  - Some people value additional units differently (business travelers vs. tourists).

Continued in *Monopolies Part III*