Test Yourself: Monopolies

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

Nancy Pearcey

What is a monopoly?

A monopoly market has a

- single seller
- unique product
- difficult entry into the market

What are the most common monopolies?

Local monopolies are more common real-world approximations of the model than national or world market monopolies.

What does it mean to have a unique product?

Having a *unique* product means there are no close substitutes for the monopolist’s product.

What are some examples of difficult market entry?

Some examples of difficult market entry are

- someone else owns a vital resource
- legal barriers - public franchise, government license, patent or copyright
- economies of scale

What is the advantage of economies of scale?

The advantage of **economies of scale** is that a single firm in an industry can produce output at a lower per-unit cost than two or more firms.

What is a natural monopoly?

A **natural monopoly** is an industry in which the long-run average cost of production declines throughout the entire market.

It is an industry where the fixed cost of the capital goods is so high that it is not profitable for a second firm to enter and compete. There is a “natural” reason for this industry being a monopoly, namely that the economies of scale requires one, rather than several, firm. Small-scale ownership would be less efficient.

What is unique about a natural monopoly?

What is unique about a natural monopoly is that a single firm will produce output at a lower per-unit cost than two or more firms in the industry.

What is a price-maker?

A **price-maker** is a firm that faces a downward-sloping demand curve.

It is a monopolistic company that can dictate the prices of its goods because there are no substitutes for it.

The firm is a price-maker since they are able to take the market's demand curve as their own. The monopoly firm is able to set the price anywhere on this demand curve.

The ability of the monopoly firm to set price is dependent on the price elasticity of the product. If demand is elastic it will limit the firm's price setting power.

What is the difference between a monopoly and perfect competition?

The demand and marginal revenue curves of a monopoly are *downward* sloping. In a perfectly competitive market they are both *horizontal*.

What is unique about the demand curve for a monopolist?

What is unique about the demand curve for a monopoly is that the monopolist's demand curve and the industry's demand curve are one and the same.

The downward slope of a monopolistic demand curve signifies that the firms in this industry have market power. Market power allows firms to increase their prices without losing all of their customers.

The downward slope of the demand curve contributes to the inefficiency of the market, leading to a loss in consumer surplus, deadweight loss and excess production capacity.

What determines price for a monopolist?

Demand determines price for a monopolist.

The monopolist finds the profit maximizing output by finding that quantity where marginal revenue equals marginal cost, then projects that quantity on to the market demand curve to determine what market price corresponds to that quantity.

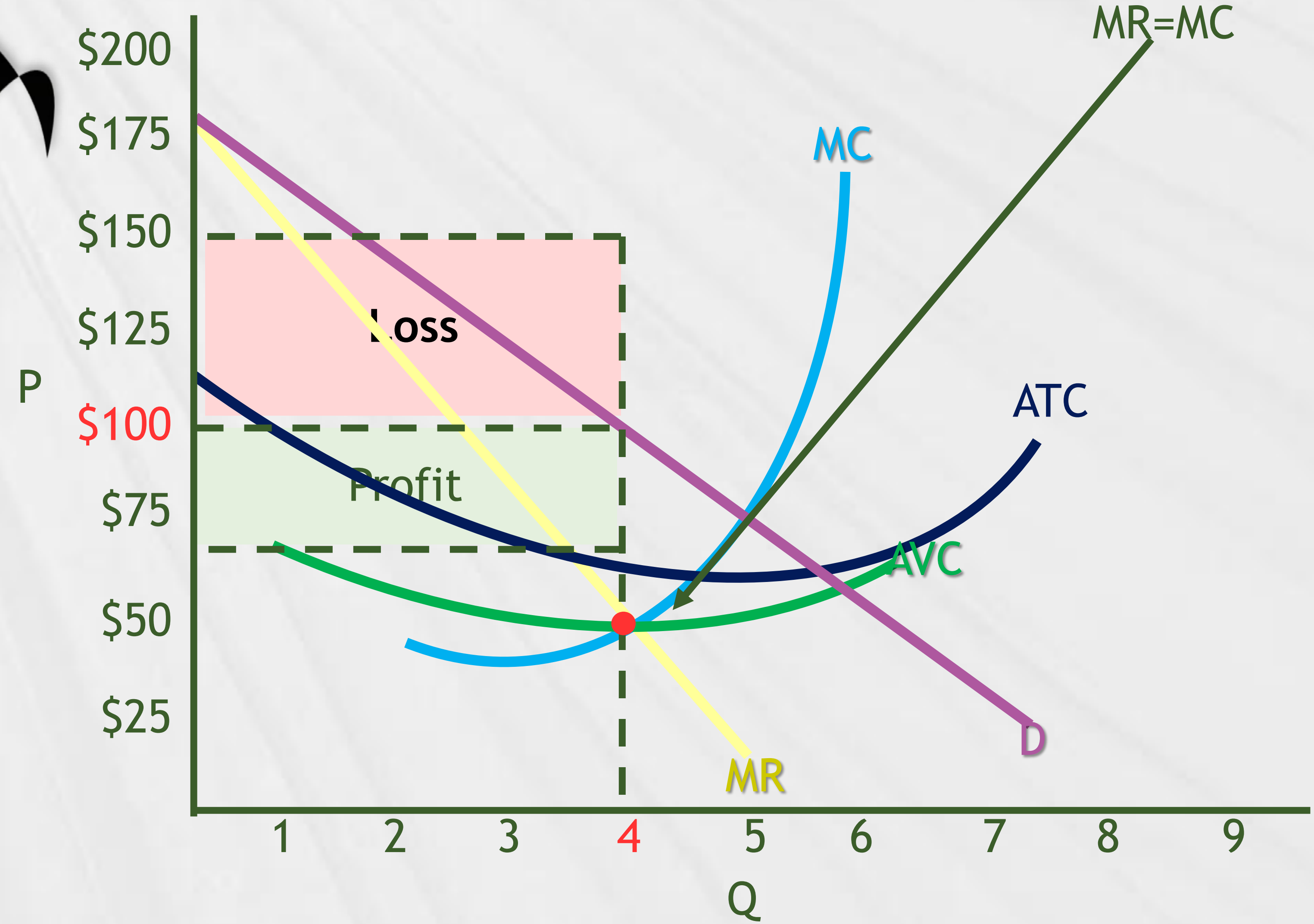
Why is MR < P for all but the first unit of output?

$MR < P$ for all but the first unit of output because, to sell additional units, the price has to be lowered. This price-cut applies to all units, not just the last unit.

Where does a monopolist produce to maximize profits or minimize losses?

To maximize profits or minimize losses, a monopolist produces at the point where MR = MC.

Maximize Profit and Minimize Loss



Can a monopolist make a profit in the long-run?

If the positions of a monopolist's demand and cost curves give it a profit and nothing disturbs these curves, it can make a profit in the long-run.

What is arbitrage?

Arbitrage is the practice of earning a profit by buying a good at a low price and reselling the good at a higher price.

Third-parties often take up the arbitrage opportunity created by differential pricing and create leakages between markets. For example, Canadian pharmacies sell Canadian-priced medication in the US where the pharmaceutical companies typically set much higher prices for the same or similar products.

What is
price discrimination?

Price discrimination is the practice of a seller charging different prices for the same product even though the price differences are not justified by cost differences.

Is price discrimination unfair?

Many buyers benefit from price discrimination because it makes it possible for them to purchase the product.

In order for price discrimination to work, buyers must have differing abilities and the willingness to pay different prices for goods and services, and sellers must be able to recognize that and capitalize on it.

People exchange goods in a market economy to their mutual advantage. Each party to an exchange values what he receives at least as much as what he exchanges for it. Both parties are of necessity better off after an exchange than they were before the exchange, or else they would never have made the exchange.

Is a monopoly efficient?

A monopoly is inefficient because resources are under-allocated to the production of its product.

Monopolists can earn abnormal profits at the expense of efficiency and the welfare of consumers and society.

The higher average cost, if there are inefficiencies in production, means that the firm is not making optimum use of scarce resources.

Is perfect competition efficient?

A perfectly competitive firm that produces where P = MC achieves an efficient allocation of resources.

How does a monopoly harm consumers?

A monopoly charges a higher price and produces a lower quantity than would be the case in a perfectly competitive situation.

A monopoly's potential to raise prices indefinitely is its most critical detriment to consumers. Even at high prices, customers will not be able to substitute the good or service with a more affordable alternative.

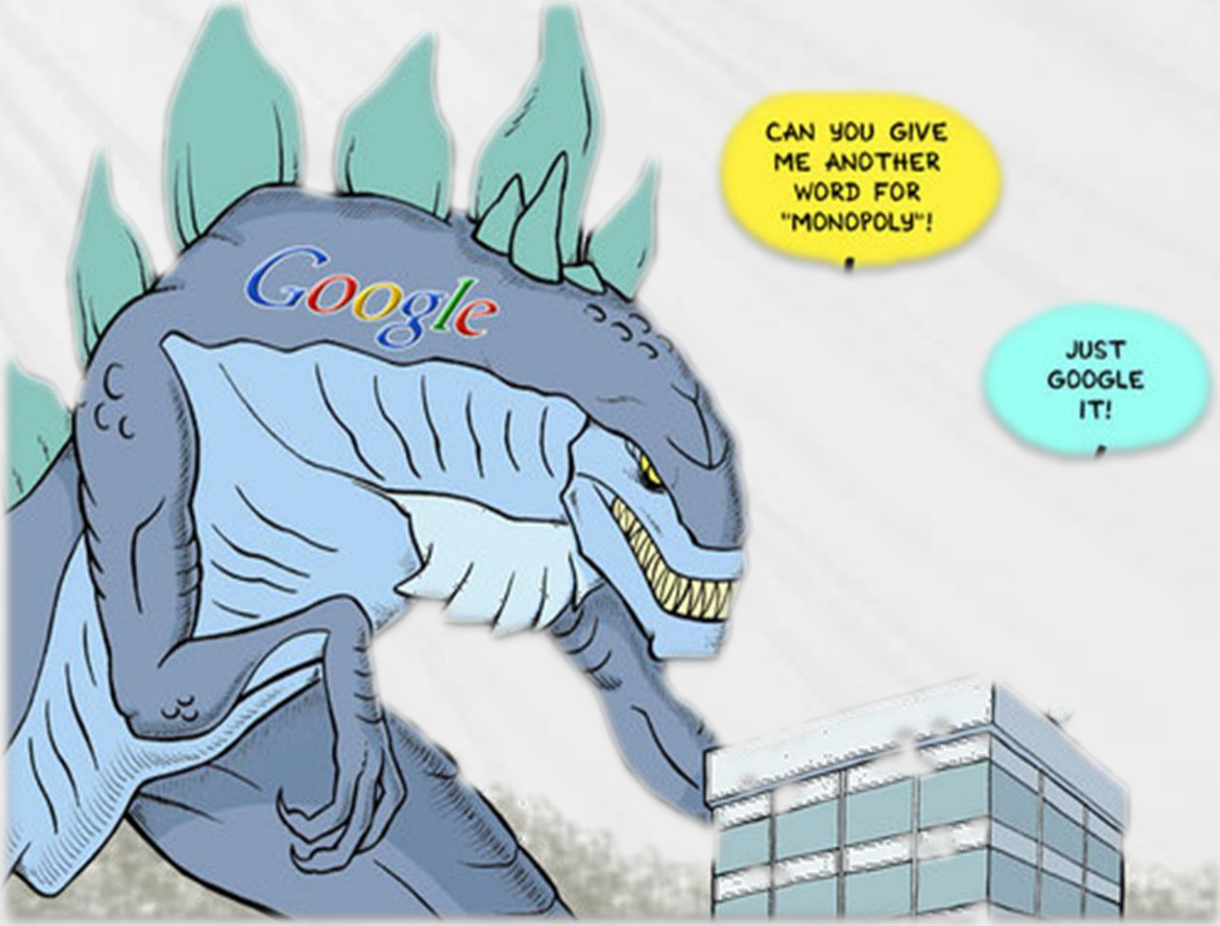
As the sole supplier, a monopoly can also refuse to serve customers. If a monopoly refuses to sell an important good to a company, it has the potential to indirectly shut down that business. If the supplier sells to consumers, it can refuse to serve areas that have lower profit potential, which could further impoverish a region.

What is the case against monopolies?

The case against monopolies includes the following.

- Consumers pay a higher price than they would in a competitive market.
- With a monopoly, price > mc.
- A monopolist makes a long-run economic profit.
- A monopoly alters the distribution of income to favor the monopolist.
- When the monopolist raises prices above the competitive level, customers buy less of the product, less is produced and society as a whole is worse off. In short, a monopoly reduces society’s income.

How did you do?! If you didn't do as well as you'd like, review the margin notes and presentations and test yourself again.



Continued in
Test Yourself: Monopolistic Competition