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AS Economics

Monopoly and Market Failure

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Revision Focus on Monopoly and Market Failure (AS)

AS Syllabus Requirements

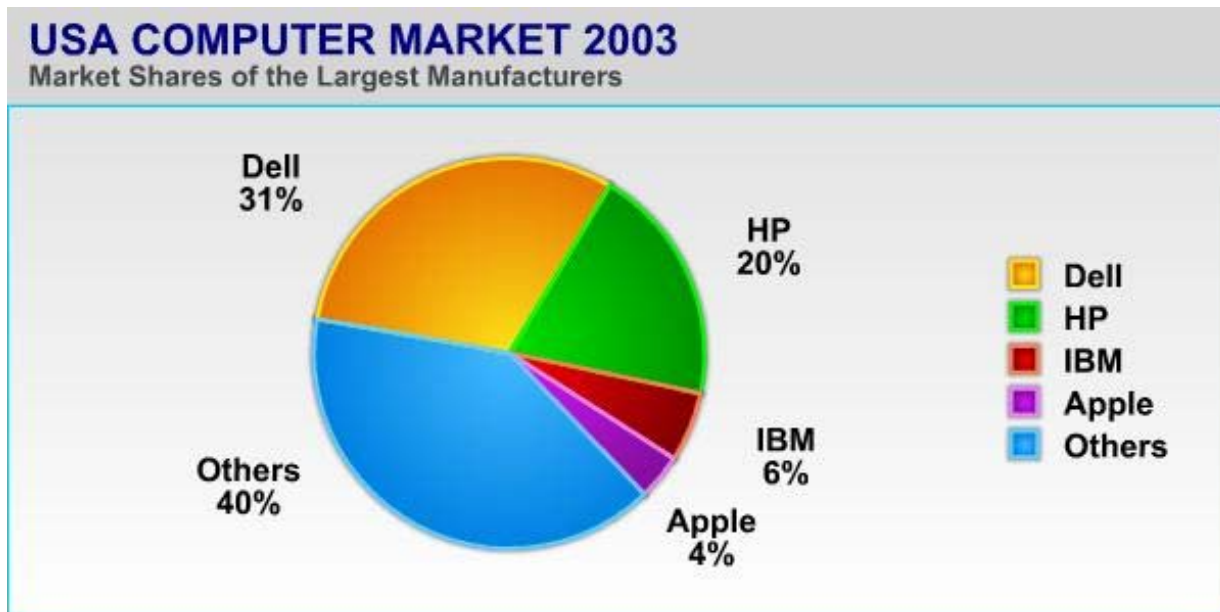
Monopoly and Market Failure

Candidates should understand that **monopolies have market power** and that the basic model of monopoly suggests that **higher prices, inefficiency and a misallocation of resources** may result. Candidates should understand the **potential benefits from monopoly**, for example, **economies of scale and possibly more invention and innovation**

A definition of monopoly power:

There are several meanings of the term monopoly:

1. **A pure monopolist** is a **single seller** of a product in a given market or industry. It is actually quite rare for a firm to have a pure monopoly – except when the industry is state owned and has a legally protected monopoly position. The Royal Mail used to have a **statutory monopoly** on delivering household mail. But this is now changing as the postal service industry is being liberalised (i.e. opened up to fresh competition)
2. **A working monopoly:** The working definition of a monopoly relates to any firm with greater than 25% of the industries' total sales. In practice, there are many markets where businesses enjoy some monopoly power. An **oligopolistic industry** is characterised by the existence of a few dominant firms, each has significant market power and which seeks to protect and improve its market position over time.



Microsoft for example has a 90% share of the market for computer operating systems whereas in computer manufacturing in the United States, Dell and HP-invent both have important market positions with other 50% of the total market. If a market is dominated by two firms, this is called a duopoly.

How monopolies can develop

Monopoly power can come from the successful organic growth of a business or through mergers and acquisitions (known as the integration of firms).

Horizontal Integration

This is where two firms join at the same stage of production in one industry. For example two car manufacturers may decide to merge, or a leading bank successfully takes-over another bank. A good recent example is the merger between Safeway and Morrisons.

Vertical Integration

This is where a firm develops market dominance by integrating with different stages of production in the industry e.g. by buying its suppliers or controlling the main retail outlets. A good example is the oil industry where many of the leading companies are both producers and refiners of crude oil.

- **Forward vertical integration** occurs when a business merges with another business further forward in the supply chain
- **Backward vertical integration** occurs when a firm merges with another business at a previous stage of the supply chain

The Internal Expansion of a Business

Firms can generate higher sales and increased market share by expanding their operations and exploiting possible economies of scale. This is internal rather than external growth (i.e. organic growth) and therefore tends to be a slower means of expansion contrasted to mergers and acquisitions. Tesco has enjoyed phenomenal growth in recent years taking them into a clear market lead (ahead of Sainsbury's and Walmart/Asda) – much of this has been based on organic growth together with the purchase of a chain of smaller food retailers.

Preventing competition in a market - barriers to entry

Barriers to entry are the means by which potential competitors are blocked. Monopolies can then enjoy higher profits in the long run as rivals have not diluted market share. There are several different types of entry barrier – these are summarised below:

Patents

Patents are legal property rights to prevent the entry of rivals. They are generally valid for 17-20 years and give the owner an exclusive right to prevent others from using patented products, inventions, or processes. The owners of patents can sell licences to other businesses to produce versions of their patented product – this can prove to be lucrative.

Vertical Integration

Control over supplies and distribution can be important. For example many major oil companies are vertically integrated. They control, oil extraction refining and retail outlets maintain their market power. Vertical integration gives a business control over different stages of the supply chain.

Advertising and Marketing

Developing consumer loyalty by establishing branded products can make successful entry into the market by new firms much more expensive and less successful. Advertising can also cause an outward shift of the demand curve and also make demand less sensitive to price

Brand Proliferation

In many industries multi-product firms engaging in brand proliferation can give a false appearance of competition to the consumer. This is common in markets such as detergents, confectionery and household goods – it is an essential part of **non-price competition**.

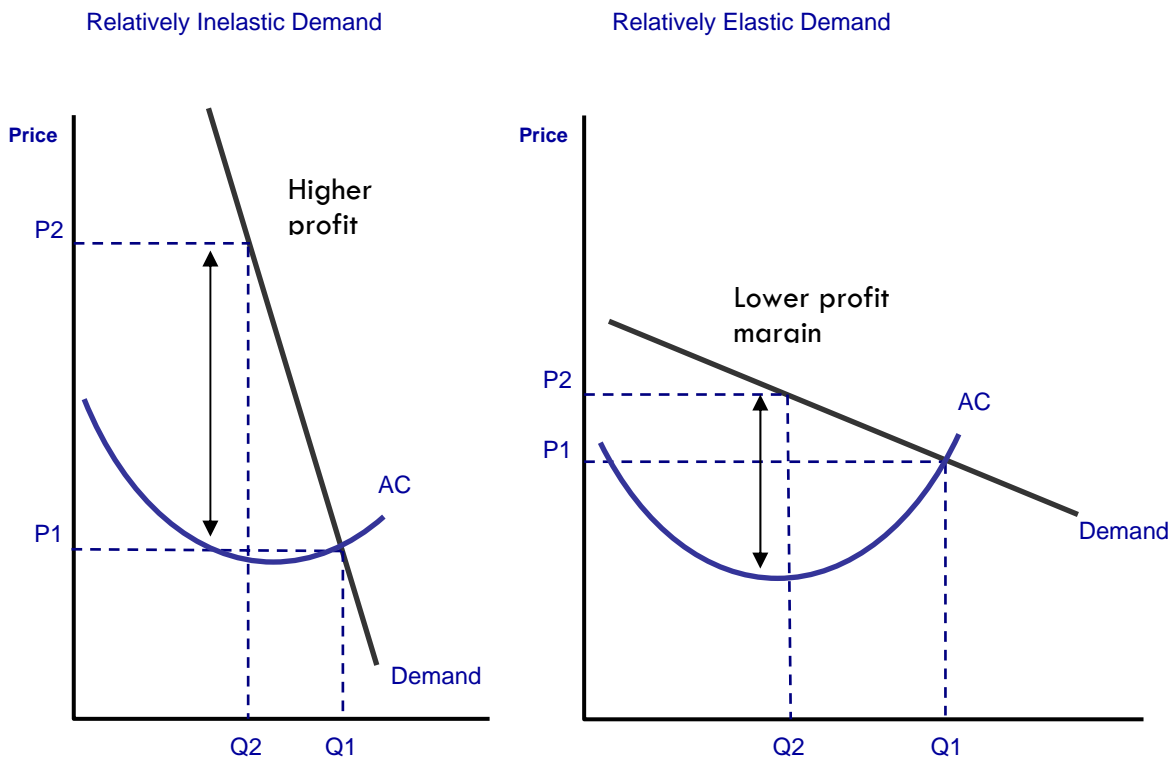
Monopoly and government intervention

Should the government intervene to break up or control the monopoly power of firms in markets? This class debate about the merits and costs of government intervention revolves around the advantages and disadvantages of businesses holding monopoly power.

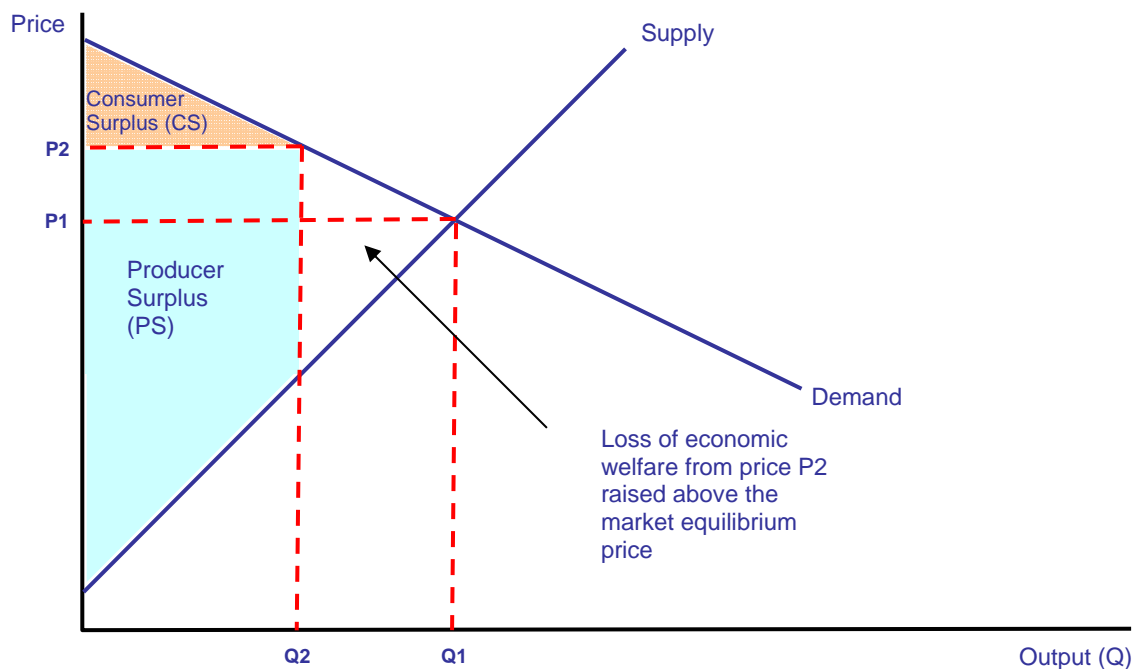
A monopolist is able to enjoy and exploit some power over the setting of prices or output. But be careful of stating that monopolists can “charge any price that they like”! This is unlikely to be true in reality. Indeed a monopolist cannot, however, charge a price that the consumers in the market will not bear! In this sense, the price elasticity of the demand curve acts as a constraint on the pricing behaviour of the monopolist. This is worth bearing in mind when analysing the economic effects of monopoly power in any given market or industry.

The economic and social costs of monopoly

Exploitation of the consumer: The main case against a monopoly is that these businesses can earn **higher profits at the expense of allocative efficiency**. The monopolist will seek to extract a price from consumers that is above the cost of resources used in making the product. And higher prices mean that consumers’ needs and wants are not being satisfied, as the product is being under-consumed. Consumer sovereignty has been replaced by producer sovereignty if the monopolist exploits their market dominance.



In the diagrams above we contrast a market where demand is price inelastic (i.e. $Ped < 1$) with one where demand is sensitive to price changes (i.e. $Ped > 1$). The former is associated with a monopoly where consumers have few close substitutes to choose from. When demand is inelastic, the level of **consumer surplus** is high, raising the possibility that the monopolist can reduce output and raise price above cost thereby operating with a **higher profit margin** (the difference between price and average cost).



One way of showing the loss of economic welfare that comes from monopolistic firms exploiting their power is to use supply and demand analysis and the concepts of **consumer and producer surplus**. If a monopoly reduces output from the equilibrium at Q_1 to Q_2 then it can sell this at a higher price P_2 . This

results in a **transfer of consumer surplus into extra producer surplus**. But because price is now about the cost of supplying extra units, there is a **loss of allocative efficiency**. This is shown in the diagram by the shaded area which is not transferred to the producer, merely lost completely because output is lower than it would otherwise be in a competitive market.

Higher costs – loss of productive efficiency:

Another possible cost of monopoly power is that businesses may allow the lack of real competition to affect them leading to a rise in production costs and a loss of productive efficiency. When competition is very tough, businesses must seek to keep firm control of their costs and keep productivity high because otherwise, they risk losing market share. Some economists go further and say that monopolists may be even less efficient because, if they believe that they have a protected market, they may be less inclined to spend money on research and improved management. These inefficiencies can lead to a waste of scarce resources.

The potential economic and social benefits of monopoly

The possible economic benefits of monopoly power suggest that the government and the competition authorities should be careful about intervening directly in markets and try to break up a monopoly. Market power can bring advantages both to the firms themselves and also to consumers and these should be included in any evaluation of a particular market or industry.

Research and Development Spending

Huge corporations enjoying a high level of profits are well placed to allocate some of their profits to fund high-cost capital investment spending and research and development projects. The **positive spill-over effects of research** can be seen in a **faster pace of innovation** and the development of improved products for consumers. This is particularly the case in industries such as telecommunications and pharmaceuticals. This can lead to gains in **dynamic efficiency** and **social benefits** (i.e. **positive externalities**).

Exploitation of Economies of Scale

Because monopoly producers are often supplying goods and services on a large scale, they may achieve **economies of scale** – leading to a **fall in long run average costs**. Lower costs will lead to an increase in profits but gains in productive efficiency might be passed onto consumers through lower prices. Economies of scale provide gains in welfare for both producers and consumers.

Monopolies and International Competitiveness

One argument in support of businesses with monopoly power is that the British economy needs multinational companies operating on a scale large enough to compete in global markets. A firm may enjoy domestic monopoly power, but still face competition in overseas markets. Two good examples of these are UK Coal and Corus, the steel manufacturer.

Intervention in markets – the role of competition policy

Competition policy involves the regulation of markets so that consumer welfare is protected and improved. It operates in different ways – three of the main competition bodies are the **Competition Commission**, the **Office of Fair Trading** and the **European Union Competition Authority**.

The Competition Commission carries out inquiries into matters referred to it by the other UK competition authorities. Their main concern is to investigate mergers and takeovers to examine if these mergers will have a negative effect on overall competition.

The Office of Fair Trading reports on allegations of anti-competitive practices including claims of collusive behaviour where firms are thought to be engaging in price-fixing.

The European Competition Authority monitors competition in the European single market. They examine anti-competitive behaviour, mergers between European businesses and investigate state aid to struggling businesses to make sure that subsidies do not reduce or distort competition

Utility regulators monitor the industries that were privatised during the 1980s and 1990s. The regulators have used the power to introduce and review price capping and they have also have sought to bring fresh competition into markets. Competition was introduced into the telecommunications in 1984; in Gas from 1996-98 and in Electricity from 1998.

Another key role for the regulatory agencies is to monitor the quality of service provision and improve standards for consumers.

Many markets have firms with monopoly power but they seem to work perfectly well from the point of view of the consumer. Although there is a consensus among many economists that **competition** is a force for good in the long-run, we should be careful not simply to assume that monopoly power is bad and competition is good. There are persuasive arguments on both sides.

In recent years many markets have become more competitive with the entry of new suppliers and much greater choice for consumers. Many factors have contributed to this including:

1. **Technological change** – e.g. the rise of e-commerce and the internet
2. **Globalisation** – e.g. fresh low-cost competition from emerging market economies such as China and India
3. **Deliberate government policies** (in the UK and the EU) to open up markets and give new businesses the right to compete (e.g. postal services, car retailing and telecommunications)