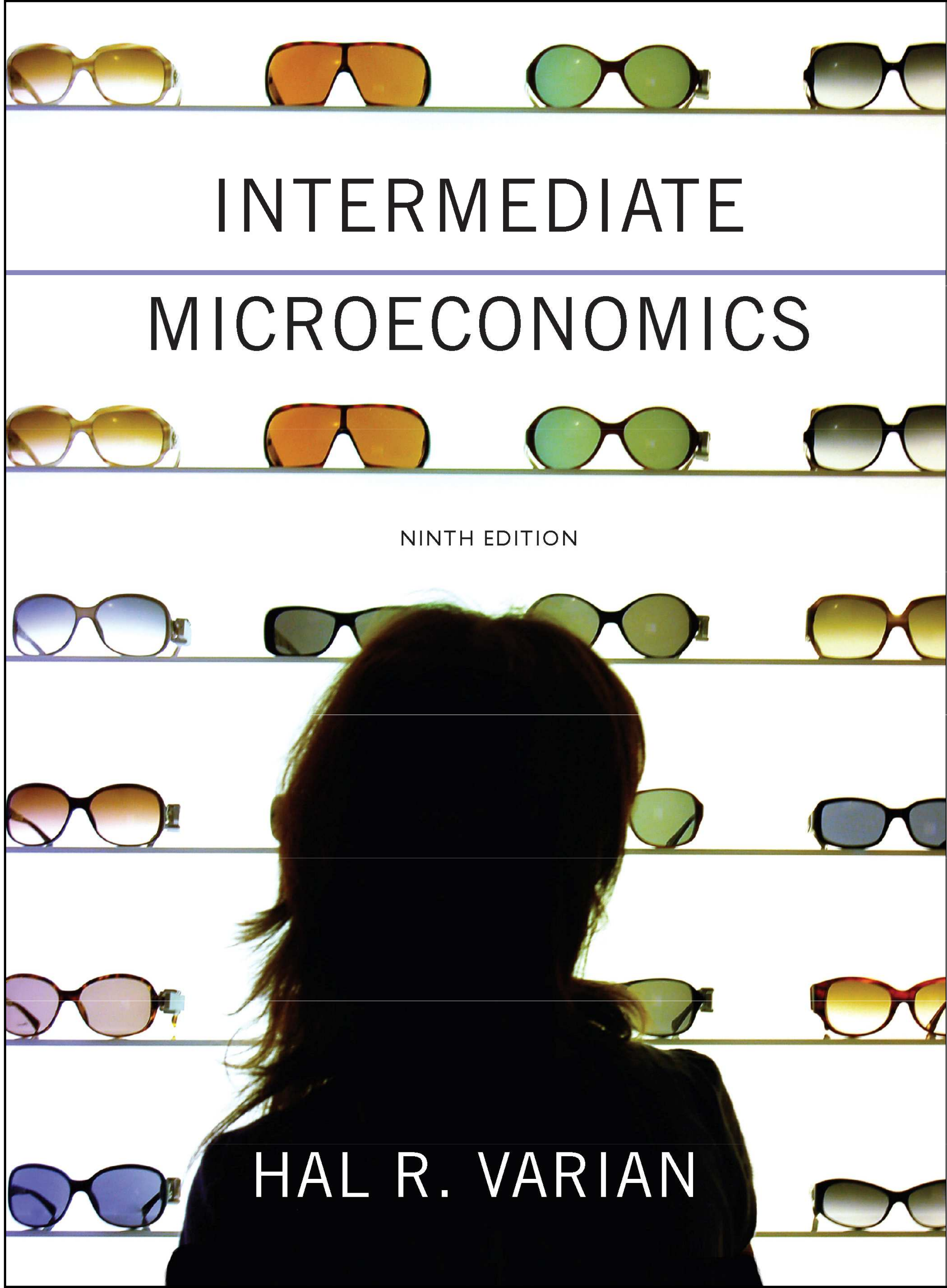


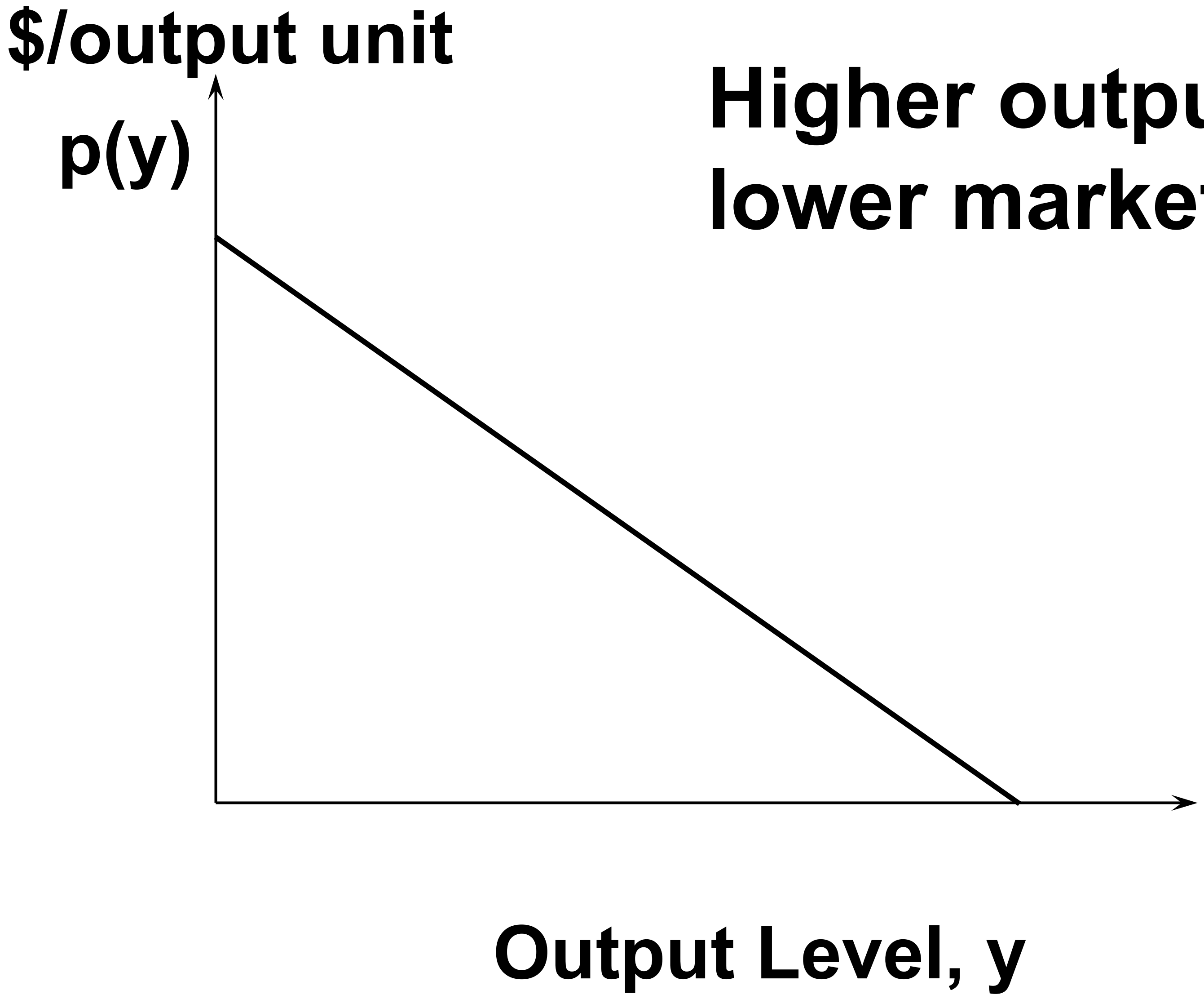
Chapter 25

Monopoly

Pure Monopoly

- **A monopolized market has a single seller.**
- **The monopolist's demand curve is the (downward sloping) market demand curve.**
- **So the monopolist can alter the market price by adjusting its output level.**

Pure Monopoly



Higher output y causes a lower market price, p(y).

Why Monopolies?

- **What causes monopolies?**
  - **a legal fiat; e.g. US Postal Service**

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  - **sole ownership of a resource; e.g. a toll highway**
  - **formation of a cartel; e.g. OPEC**
  - **large economies of scale; e.g. local utility companies.**

Pure Monopoly

- **Suppose that the monopolist seeks to maximize its economic profit,**

$$\Pi(y) = p(y)y - c(y).$$

- **What output level y* maximizes profit?**

Profit-Maximization

$$\Pi(y) = p(y)y - c(y).$$

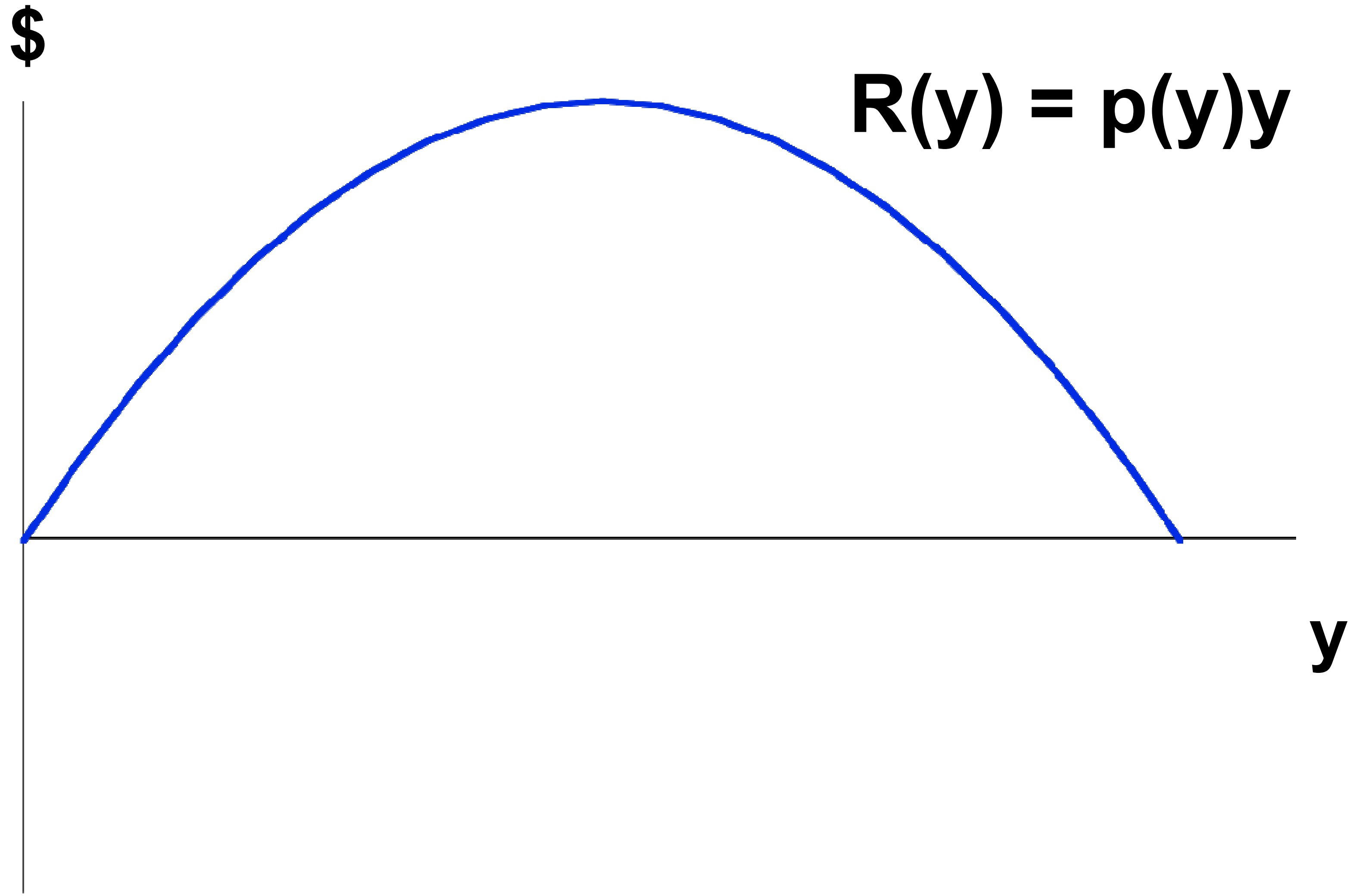
At the profit-maximizing output level y*

$$\frac{d\Pi(y)}{dy} = \frac{d}{dy}\big(p(y)y\big) - \frac{dc(y)}{dy} = 0$$

so, for y = y*,

$$\frac{d}{dy}\big(p(y)y\big) = \frac{dc(y)}{dy}.$$

Profit-Maximization



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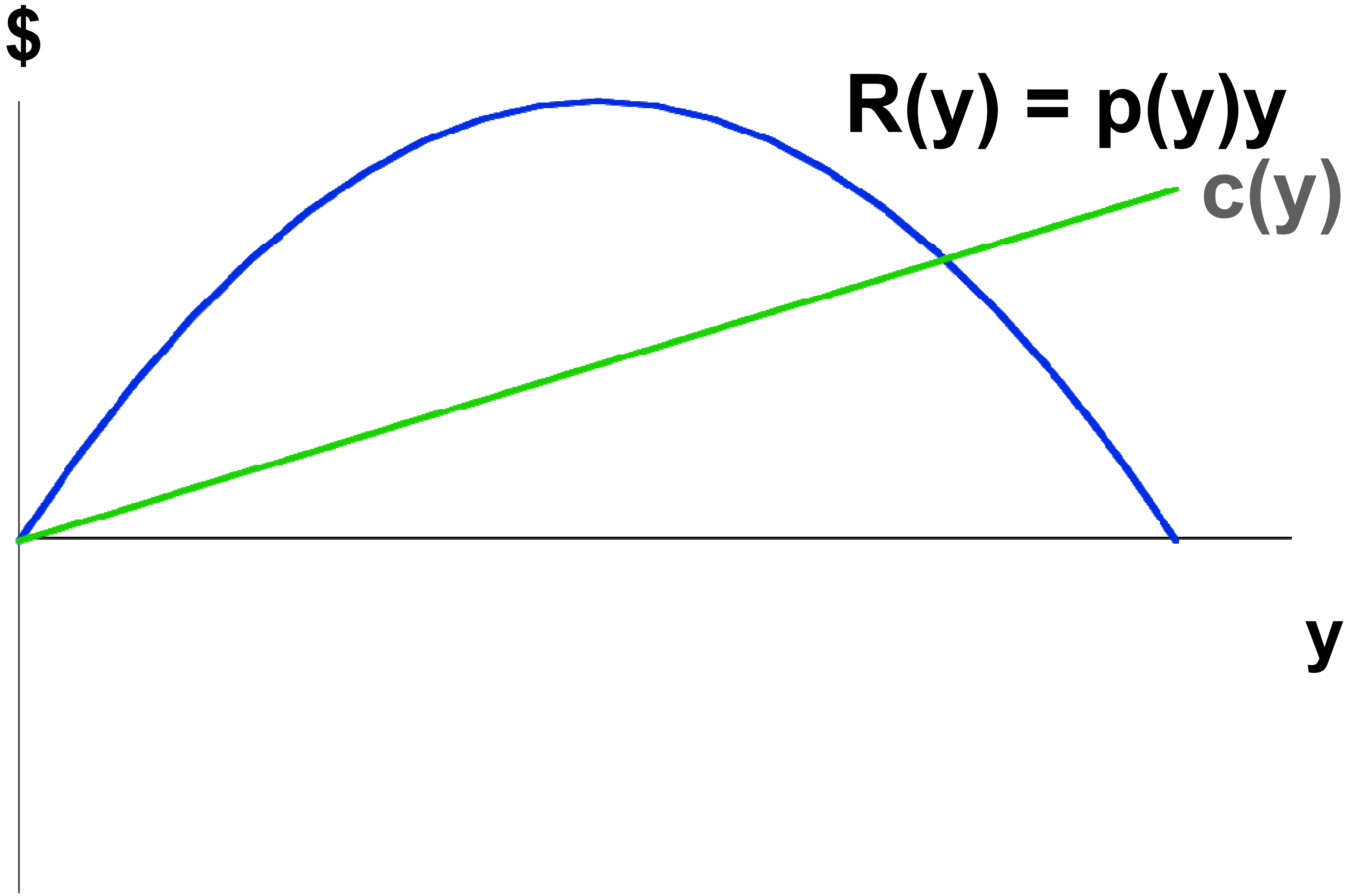

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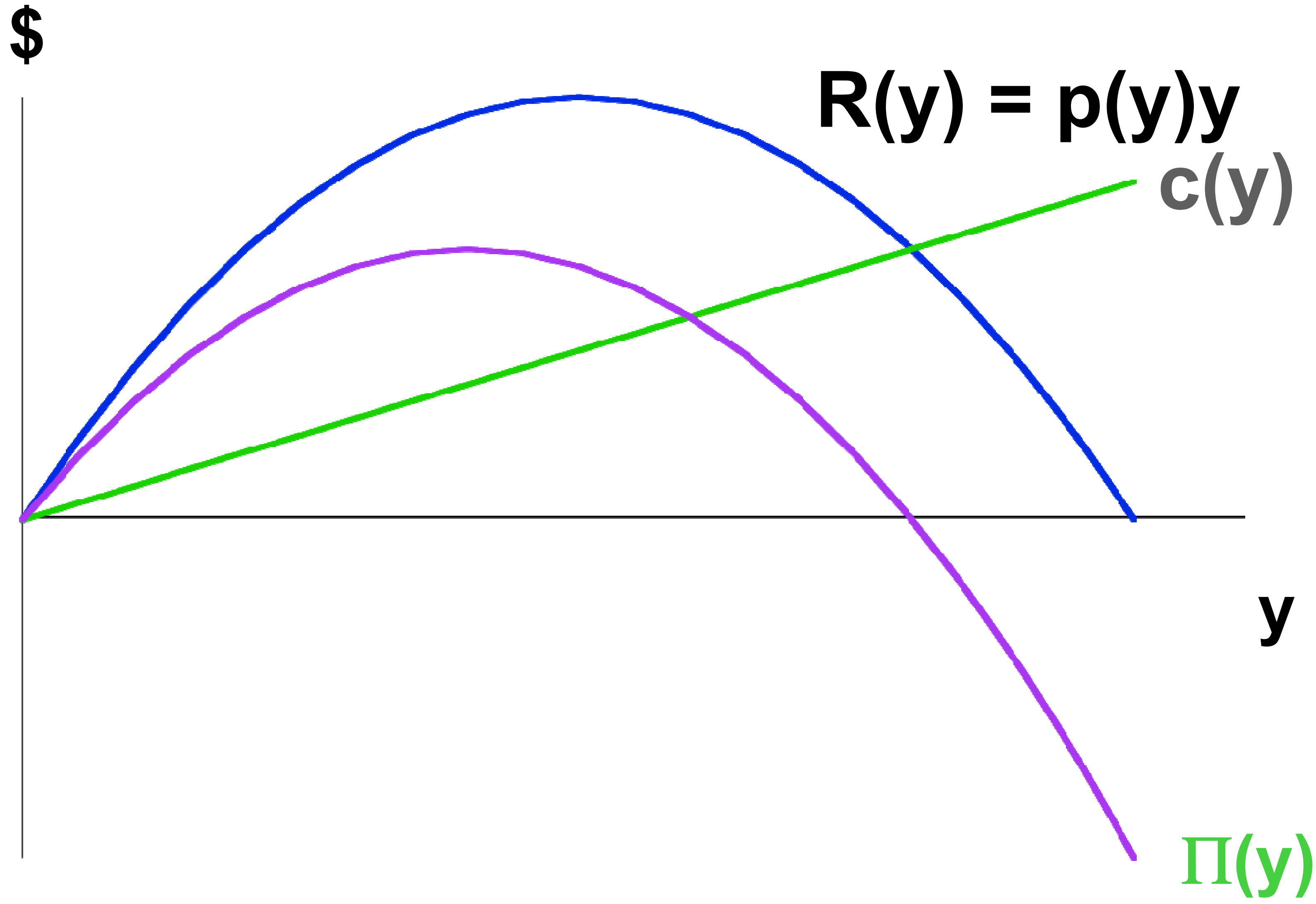

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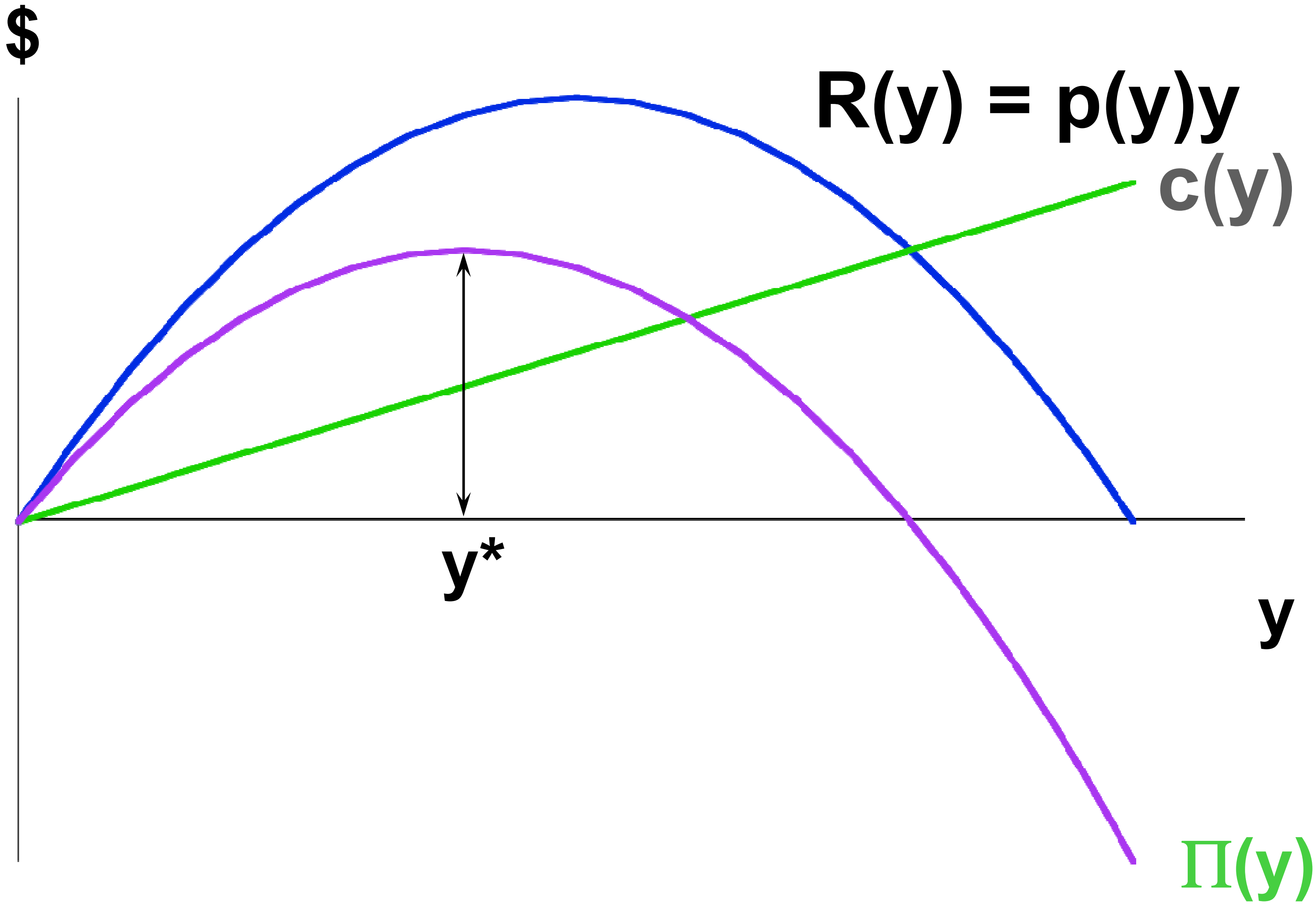

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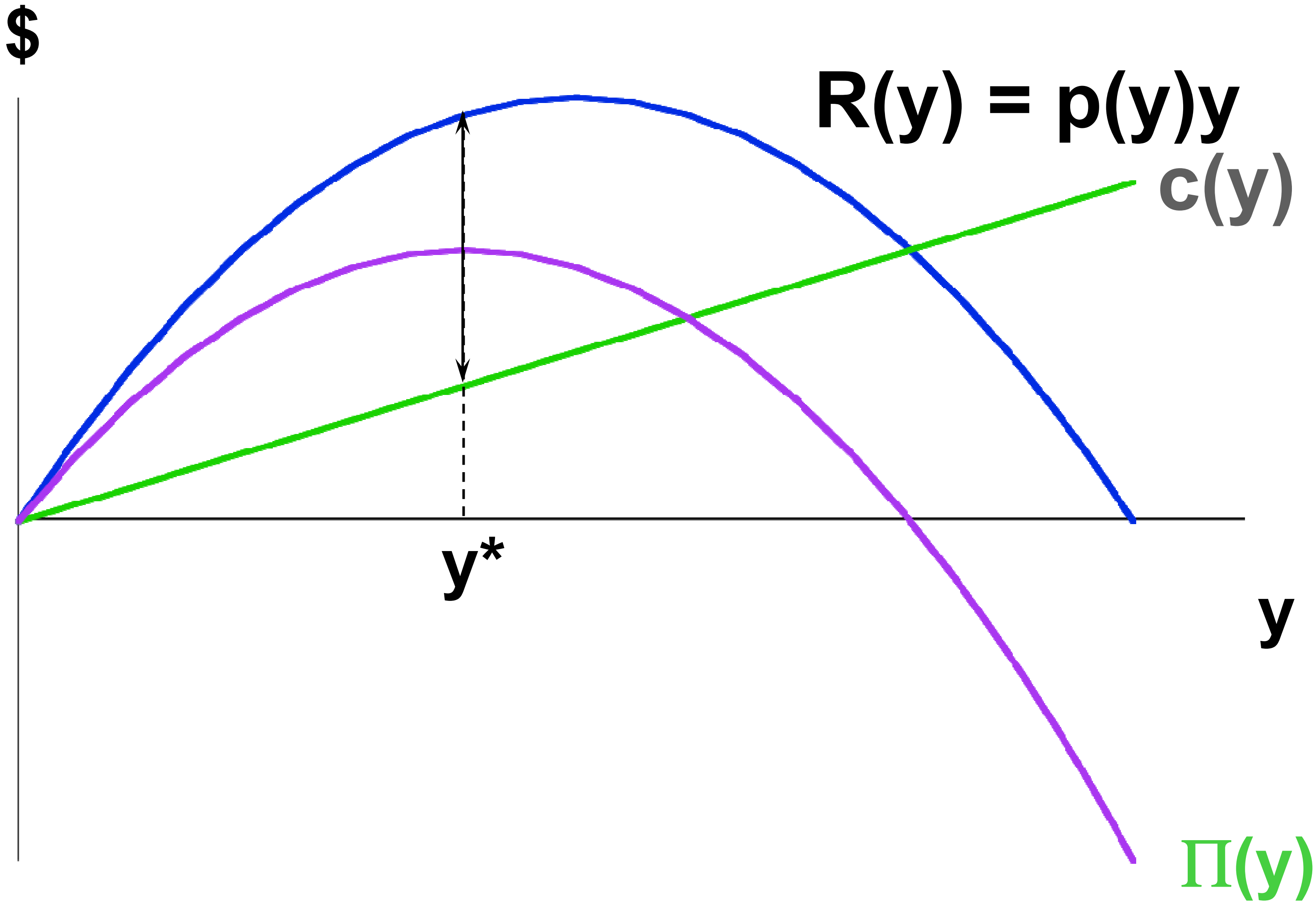

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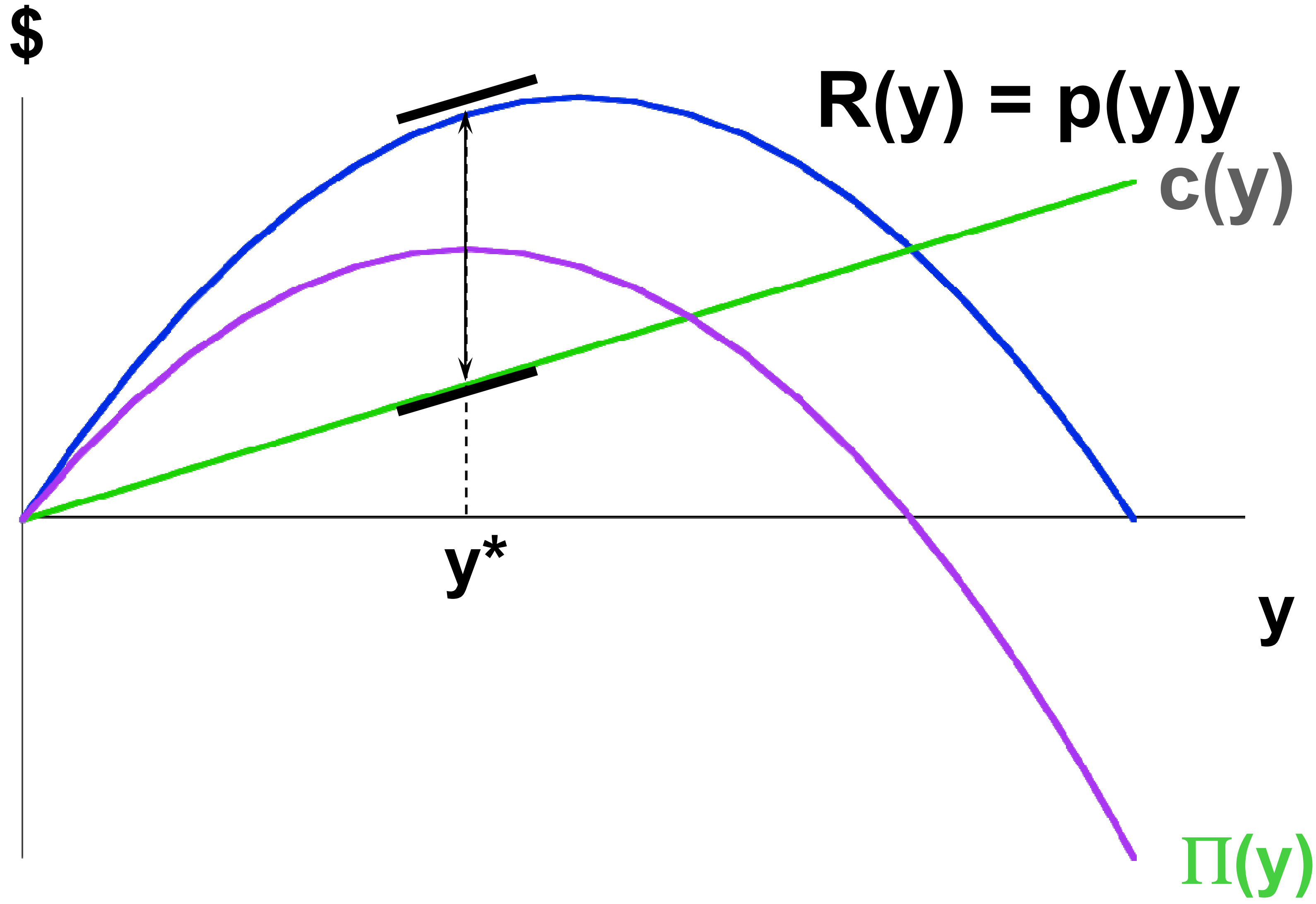

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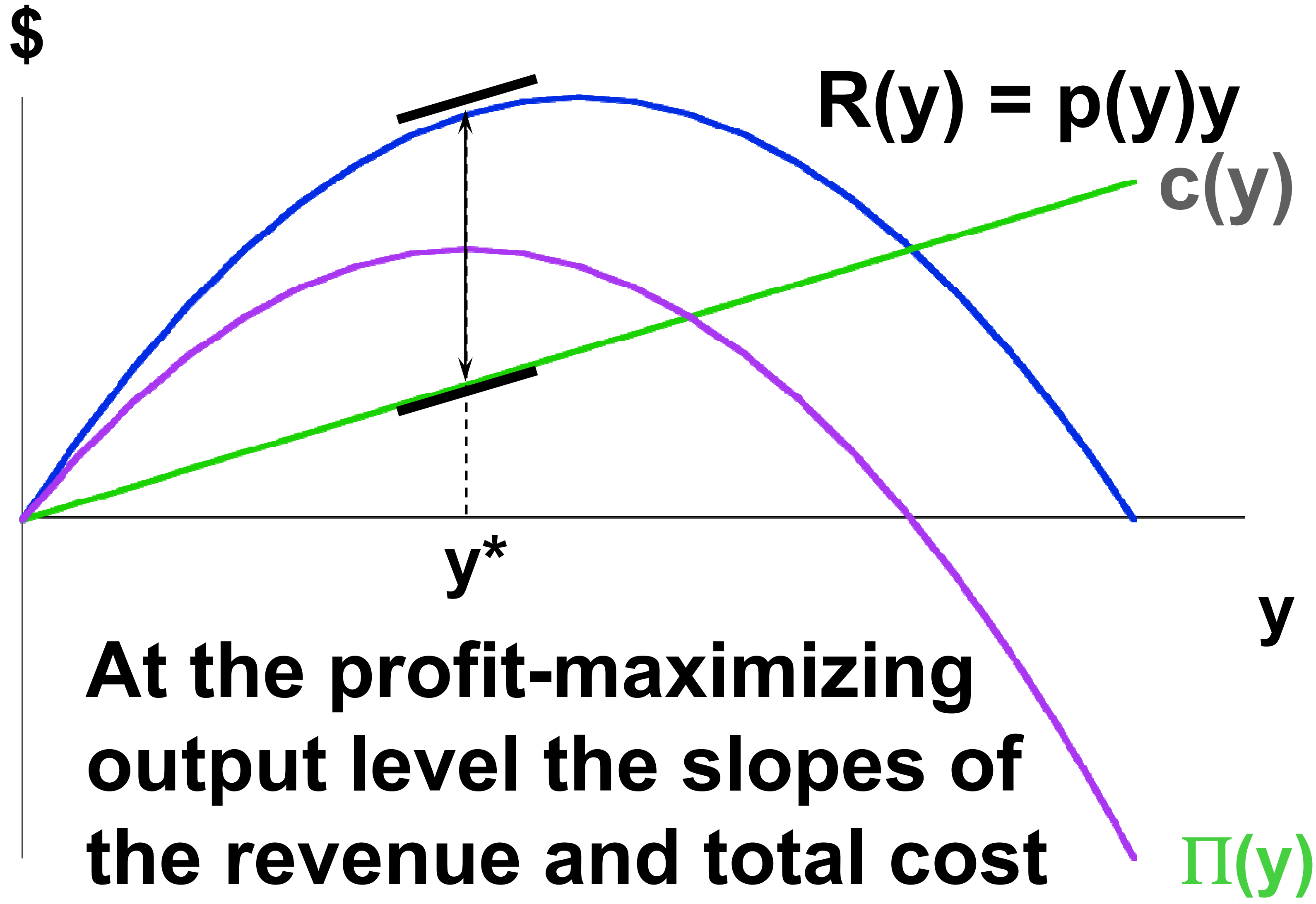

At the profit-maximizing output level the slopes of the revenue and total cost curves are equal; MR(y*) = MC(y*).

Marginal Revenue

Marginal revenue is the rate-of-change of revenue as the output level y increases;

$$MR(y) = \frac{d}{dy}\left(p(y)y\right) = p(y) + y\frac{dp(y)}{dy}.$$

Marginal Revenue

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$$MR(y) = \frac{d}{dy}\left(p(y)y\right) = p(y) + y\frac{dp(y)}{dy}.$$

dp(y)/dy is the slope of the market inverse demand function so dp(y)/dy < 0. Therefore

$$MR(y) = p(y) + y\frac{dp(y)}{dy} \quad < \quad p(y)$$

for y > 0.

Marginal Revenue

E.g. if $p(y) = a - by$ then

$R(y) = p(y)y = ay - by^2$

and so

$MR(y) = a - 2by < a - by = p(y)$ for $y > 0$.

Marginal Revenue

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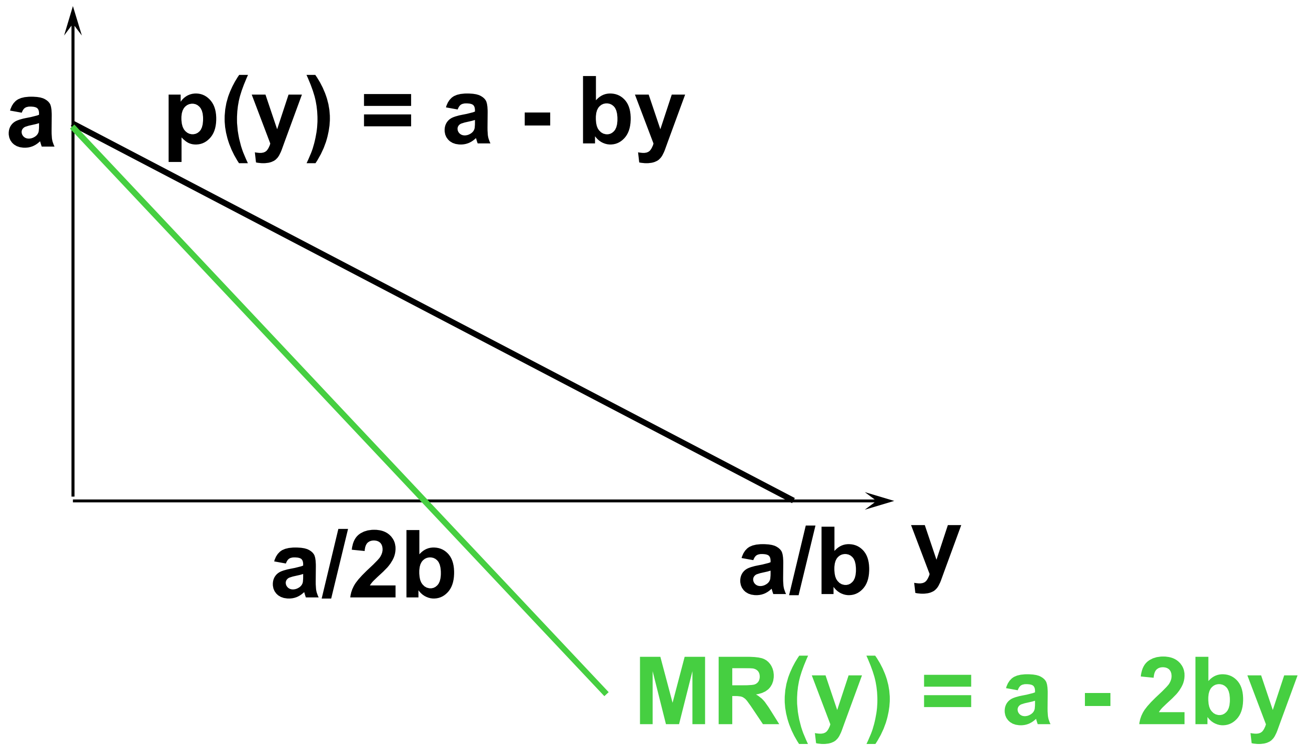


Marginal Cost

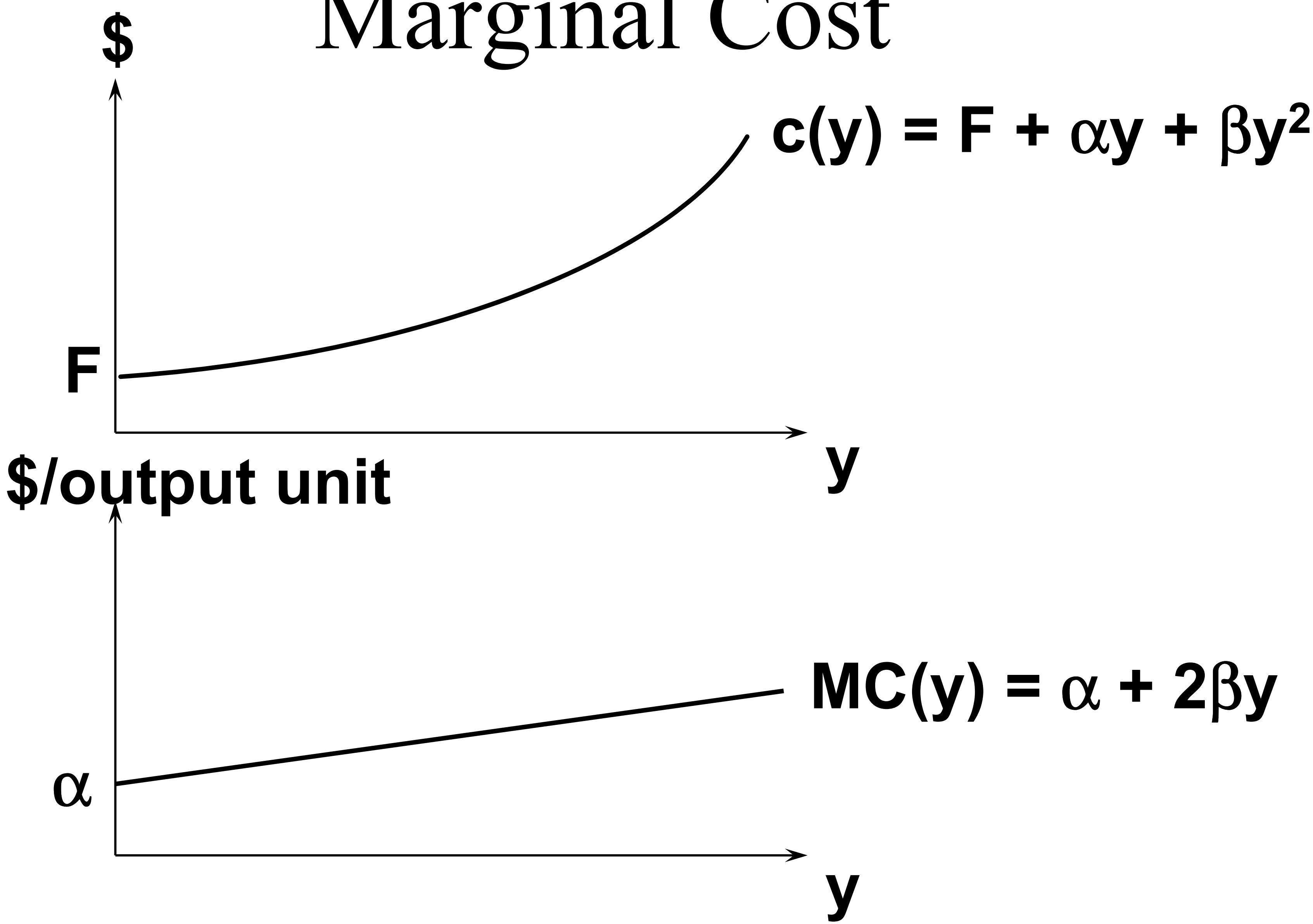
Marginal cost is the rate-of-change of total cost as the output level y increases;

$$MC(y) = \frac{dc(y)}{dy}.$$

E.g. if $c(y) = F + \alpha y + \beta y^2$ then

$$MC(y) = \alpha + 2\beta y.$$

Marginal Cost



Profit-Maximization; An Example

At the profit-maximizing output level y^*, $MR(y^*) = MC(y^*)$. So if $p(y) = a - by$ and $c(y) = F + \alpha y + \beta y^2$ then

$$MR(y^*) = a - 2by^* = \alpha + 2\beta y^* = MC(y^*)$$

Profit-Maximization; An Example

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and the profit-maximizing output level is

$$y^* = \frac{a - \alpha}{2(b + \beta)}$$

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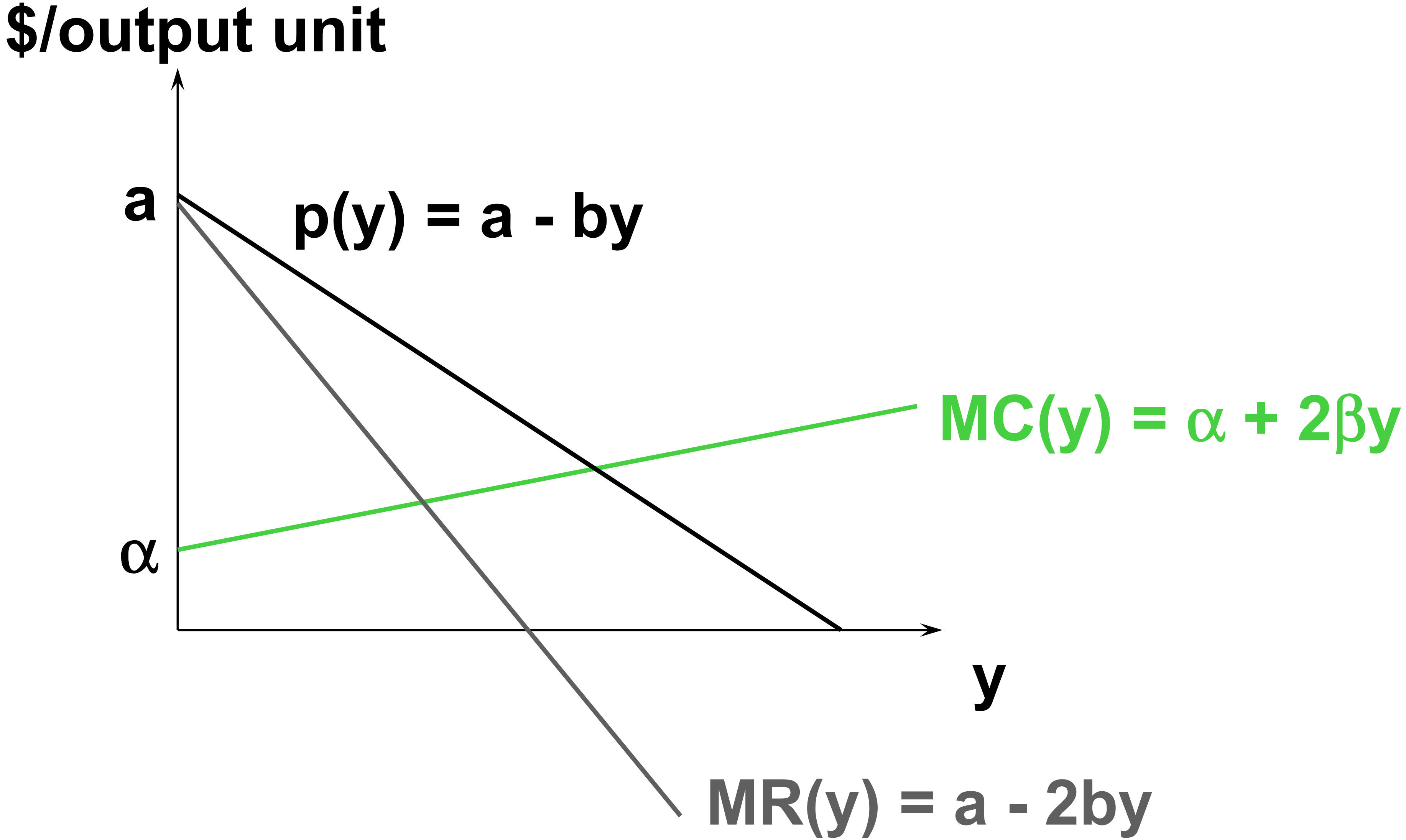
and the profit-maximizing output level is

$$y^* = \frac{a - \alpha}{2(b + \beta)}$$

causing the market price to be

$$p(y^*) = a - by^* = a - b\frac{a - \alpha}{2(b + \beta)}.$$

Profit-Maximization; An Example



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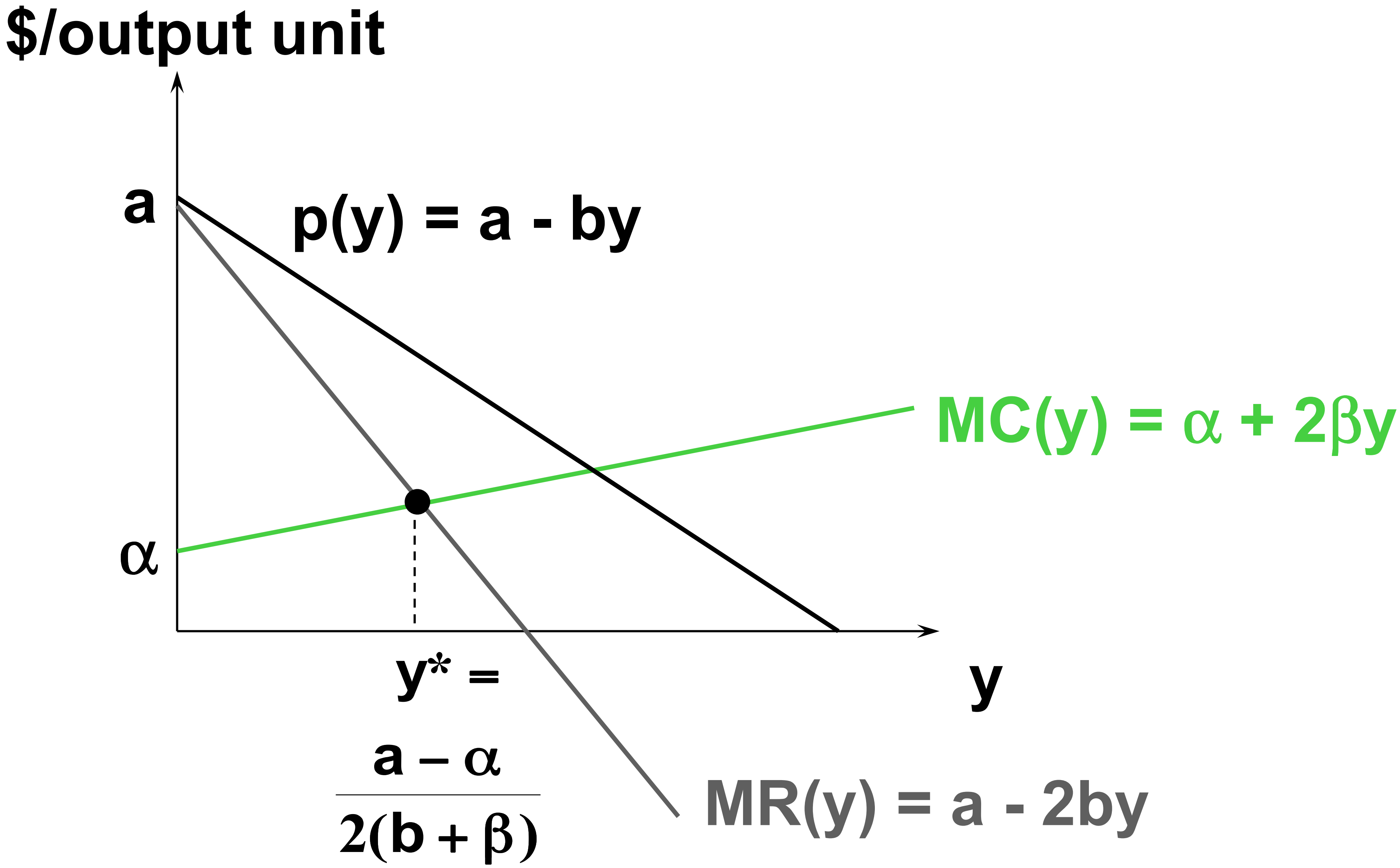

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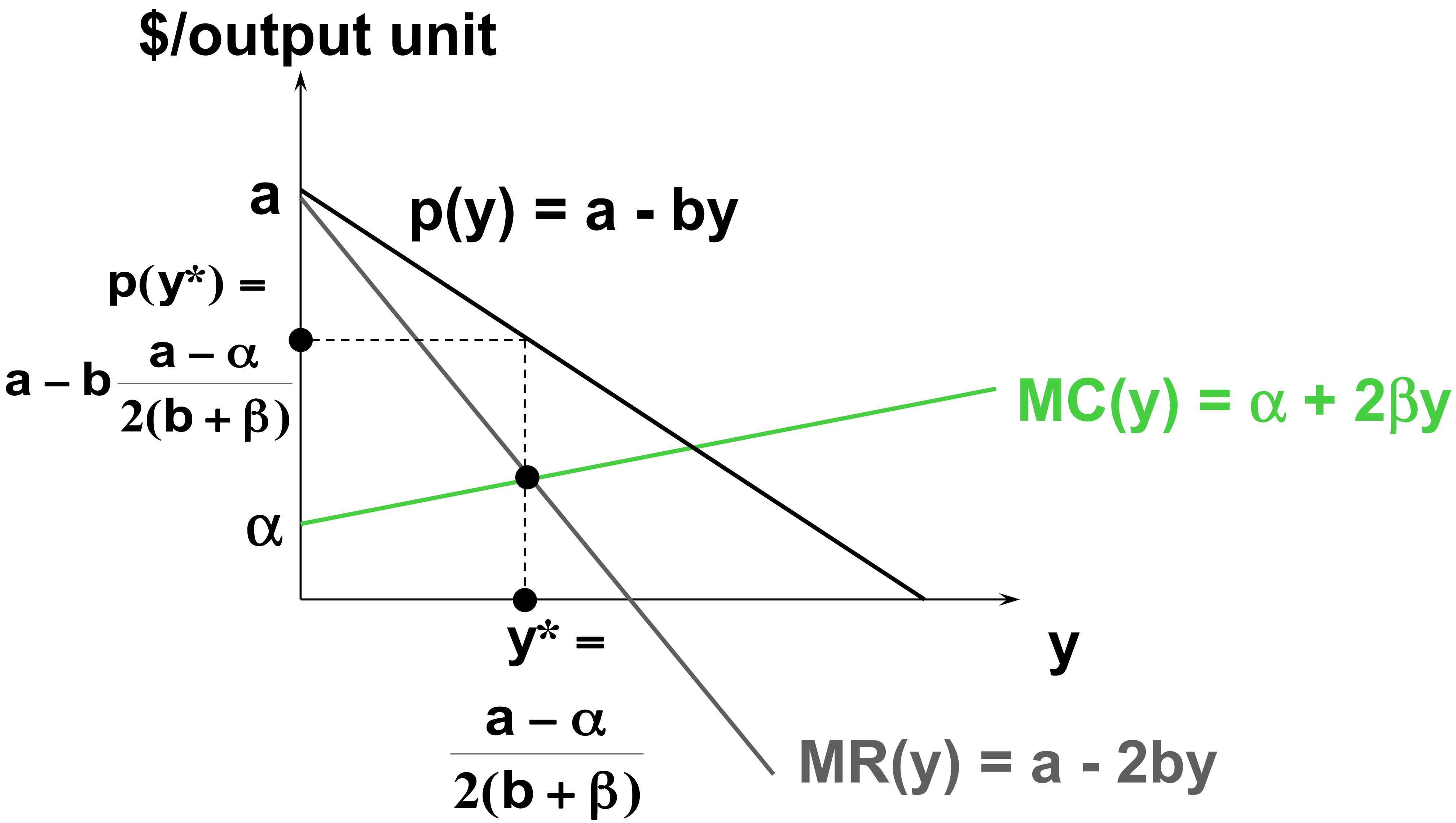

Monopolistic Pricing & Own-Price Elasticity of Demand

- **Suppose that market demand becomes less sensitive to changes in price (*i.e*. the own-price elasticity of demand becomes less negative). Does the monopolist exploit this by causing the market price to rise?**

Monopolistic Pricing & Own-Price Elasticity of Demand

$$\mathbf{MR(y) = \frac{d}{dy}\left(p(y)y\right) = p(y) + y\frac{dp(y)}{dy}}$$

$$\mathbf{= p(y)\left[1 + \frac{y}{p(y)}\frac{dp(y)}{dy}\right].}$$

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Own-price elasticity of demand is

$$\varepsilon = \frac{p(y)}{y}\frac{dy}{dp(y)}$$

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Own-price elasticity of demand is

$$\varepsilon = \frac{p(y)}{y}\frac{dy}{dp(y)} \quad \text{so} \quad MR(y) = p(y)\left[1 + \frac{1}{\varepsilon}\right].$$

Monopolistic Pricing & Own-Price Elasticity of Demand

$$MR(y) = p(y)\left[1 + \frac{1}{\varepsilon}\right].$$

Suppose the monopolist's marginal cost of production is constant, at $k/output unit. For a profit-maximum

$$MR(y^*) = p(y^*)\left[1 + \frac{1}{\varepsilon}\right] = k$$ **which is**

$$p(y^*) = \frac{k}{1 + \frac{1}{\varepsilon}}.$$

Monopolistic Pricing & Own-Price Elasticity of Demand

$$p(y^*) = \frac{k}{1 + \frac{1}{\varepsilon}}.$$

E.g. if $\varepsilon = -3$ then $p(y^*) = 3k/2$,
and if $\varepsilon = -2$ then $p(y^*) = 2k$.
So as ε rises towards -1 the monopolist alters its output level to make the market price of its product to rise.

Monopolistic Pricing & Own-Price Elasticity of Demand

Notice that, since $MR(y^*) = p(y^*)\left[1 + \frac{1}{\varepsilon}\right] = k,$

$$p(y^*)\left[1 + \frac{1}{\varepsilon}\right] > 0$$

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That is, $\frac{1}{\varepsilon} > -1 \quad \Rightarrow \quad \varepsilon < -1.$

So a profit-maximizing monopolist always selects an output level for which market demand is own-price elastic.

Markup Pricing

- **Markup pricing: Output price is the marginal cost of production plus a "markup."**
- **How big is a monopolist's markup and how does it change with the own-price elasticity of demand?**

Markup Pricing

$$p(y^*)\left[1+\frac{1}{\varepsilon}\right]=k \quad \Rightarrow \quad p(y^*)=\frac{k}{1+\frac{1}{\varepsilon}}=\frac{k\varepsilon}{1+\varepsilon}$$

is the monopolist's price.

Markup Pricing

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is the monopolist's price. The markup is

$$p(y^*)-k=\frac{k\varepsilon}{1+\varepsilon}-k=-\frac{k}{1+\varepsilon}.$$

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$$p(y^*)-k=\frac{k\varepsilon}{1+\varepsilon}-k=-\frac{k}{1+\varepsilon}.$$

E.g. if ε = -3 then the markup is k/2, and if ε = -2 then the markup is k. The markup rises as the own-price elasticity of demand rises towards -1.

A Profits Tax Levied on a Monopoly

- **A profits tax levied at rate t reduces profit from Π(y*) to (1-t)Π(y*).**
- **Q: How is after-tax profit, (1-t)Π(y*), maximized?**

A Profits Tax Levied on a Monopoly

- **A profits tax levied at rate t reduces profit from $\Pi(y^*)$ to $(1-t)\Pi(y^*)$.**
- **Q: How is after-tax profit, $(1-t)\Pi(y^*)$, maximized?**
- **A: By maximizing before-tax profit, $\Pi(y^*)$.**

A Profits Tax Levied on a Monopoly

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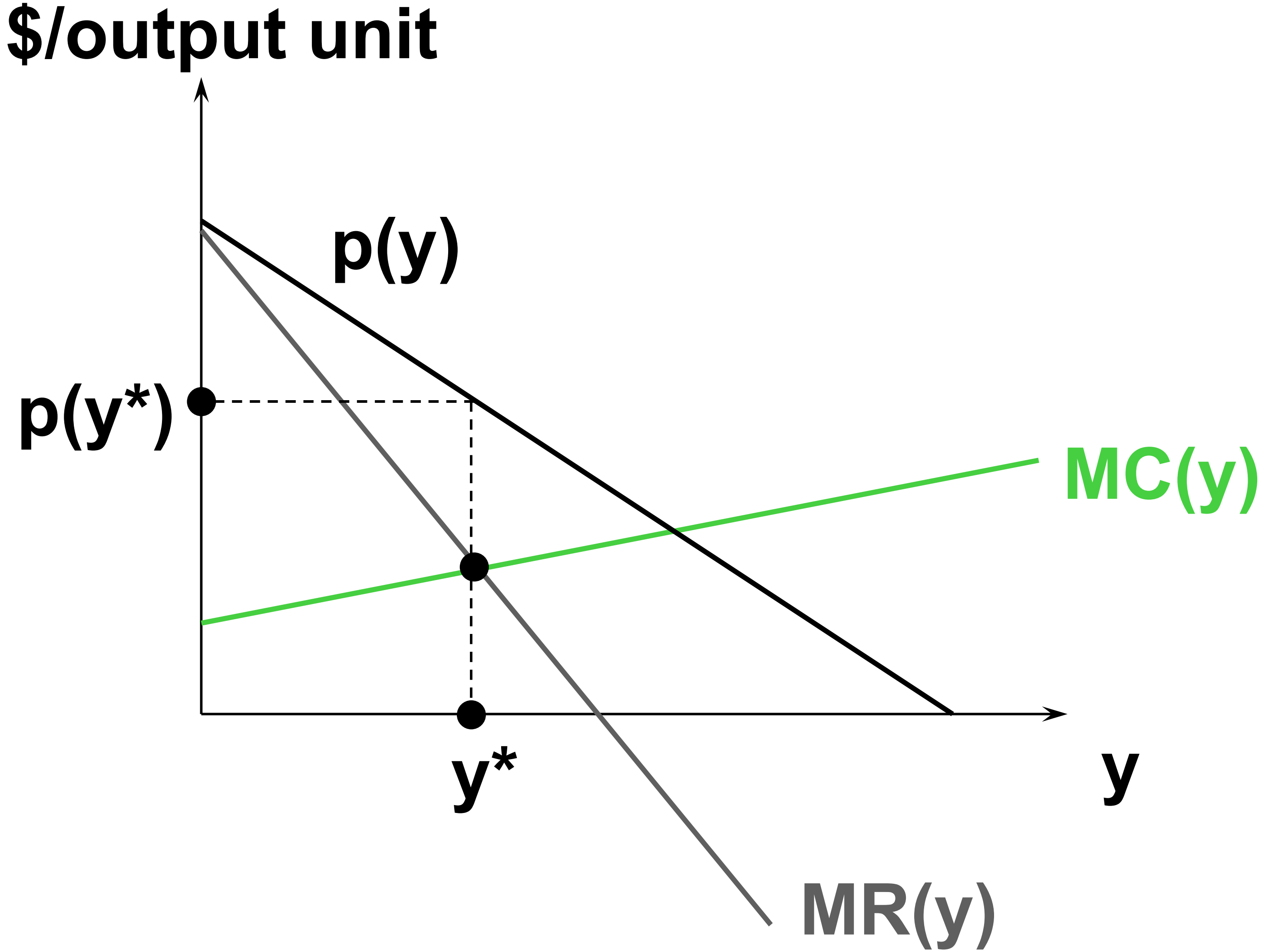
- **Q: How is after-tax profit, $(1-t)\Pi(y^*)$, maximized?**
- **A: By maximizing before-tax profit, $\Pi(y^*)$.**
- **So a profits tax has no effect on the monopolist's choices of output level, output price, or demands for inputs.**
- **I.e. the profits tax is a neutral tax.**

Quantity Tax Levied on a Monopolist

- **A quantity tax of $t/output unit raises the marginal cost of production by $t.**
- **So the tax reduces the profit-maximizing output level, causes the market price to rise, and input demands to fall.**
- **The quantity tax is distortionary.**

Quantity Tax Levied on a Monopolist



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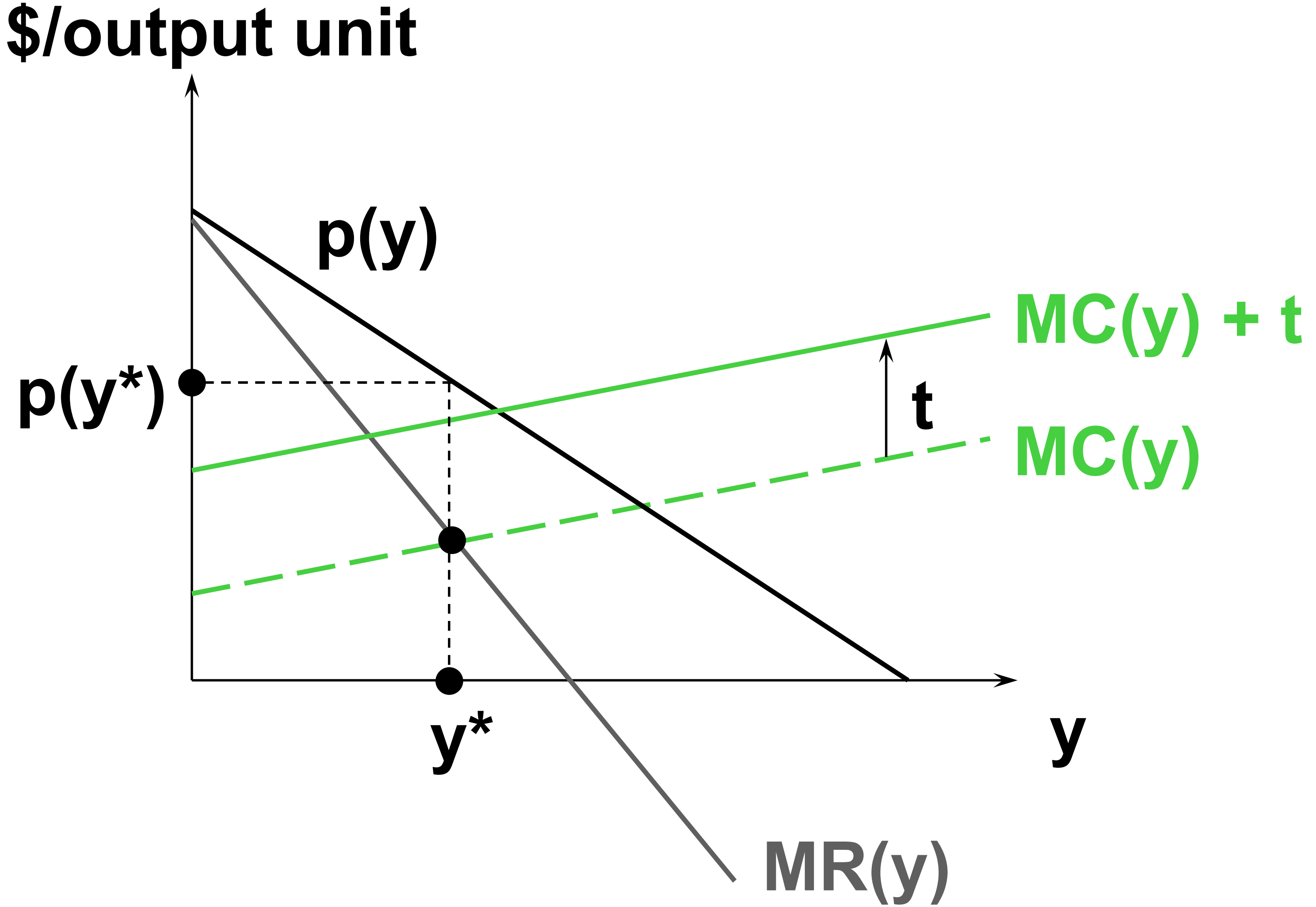

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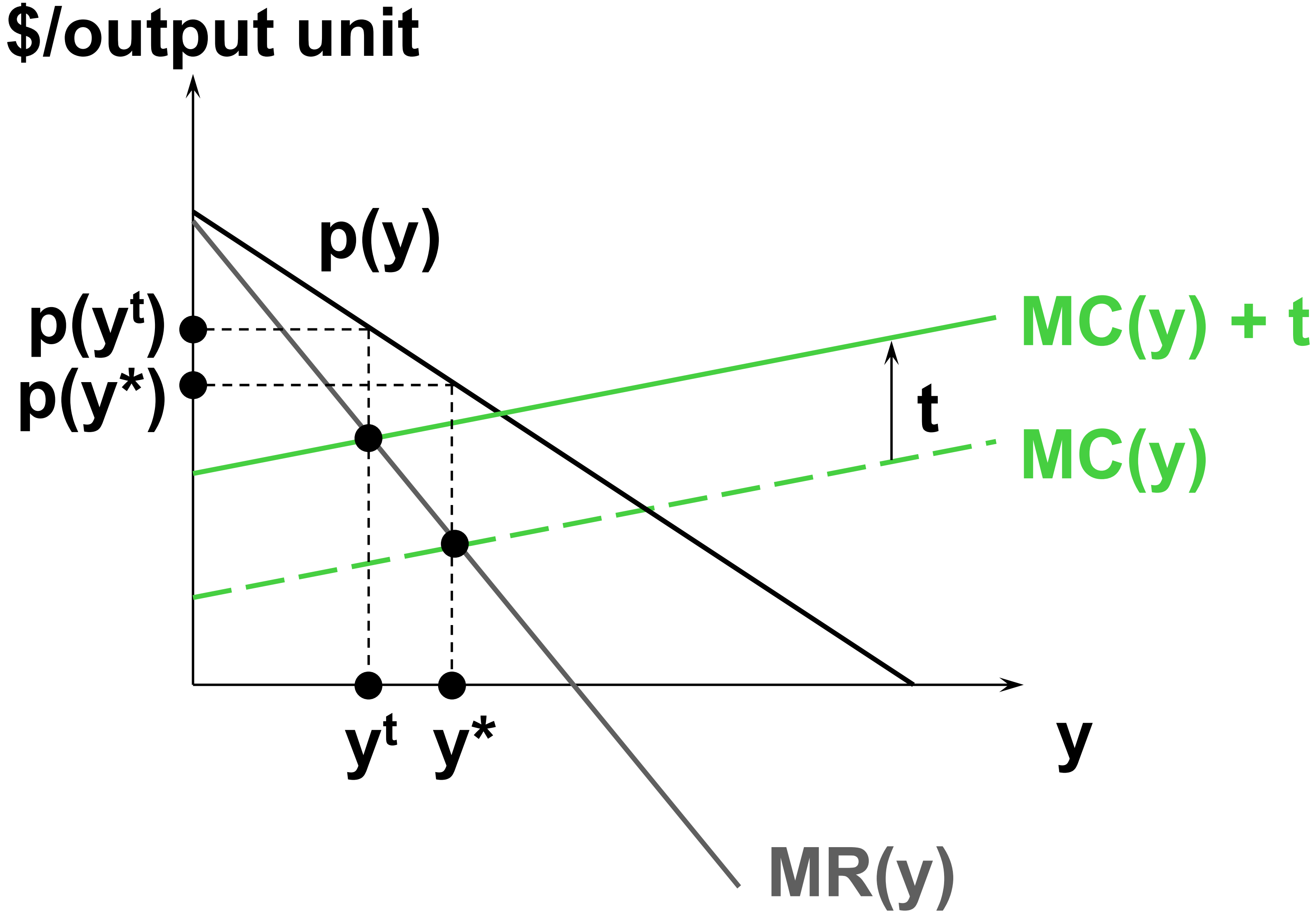
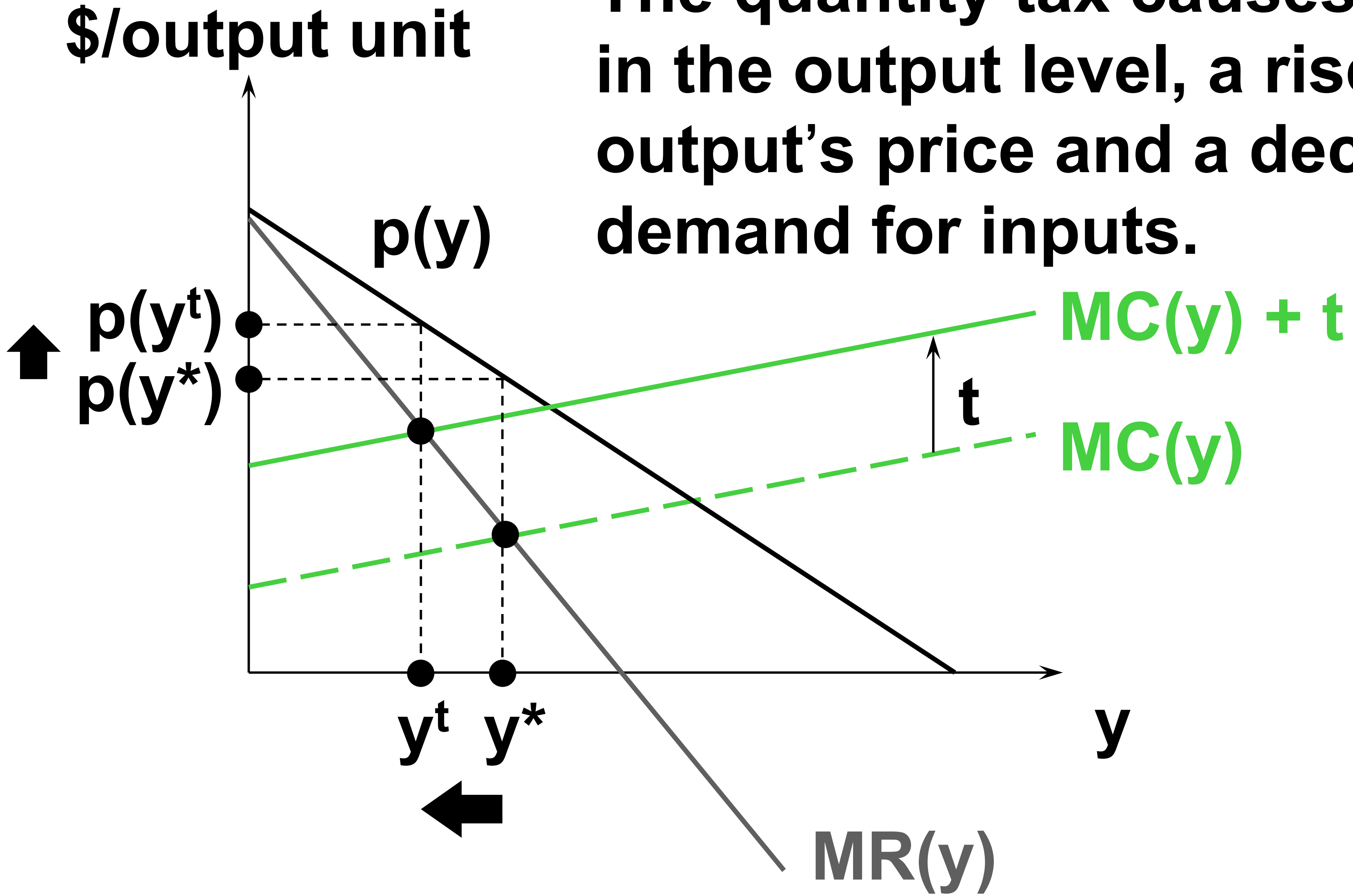


Quantity Tax Levied on a Monopolist

The quantity tax causes a drop in the output level, a rise in the output's price and a decline in demand for inputs.



Quantity Tax Levied on a Monopolist

- **Can a monopolist "pass" all of a \$t quantity tax to the consumers?**
- **Suppose the marginal cost of production is constant at \$k/output unit.**
- **With no tax, the monopolist's price is**

$$p(y^*) = \frac{k\varepsilon}{1+\varepsilon}.$$

Quantity Tax Levied on a Monopolist

- **The tax increases marginal cost to \$(k+t)/output unit, changing the profit-maximizing price to**

$$p(y^t) = \frac{(k+t)\varepsilon}{1+\varepsilon}.$$

- **The amount of the tax paid by buyers is** $p(y^t) - p(y^*)$.

Quantity Tax Levied on a Monopolist

$$p(y^t) - p(y^*) = \frac{(k+t)\varepsilon}{1+\varepsilon} - \frac{k\varepsilon}{1+\varepsilon} = \frac{t\varepsilon}{1+\varepsilon}$$

is the amount of the tax passed on to buyers. E.g. if $\varepsilon = -2$, the amount of the tax passed on is 2t.

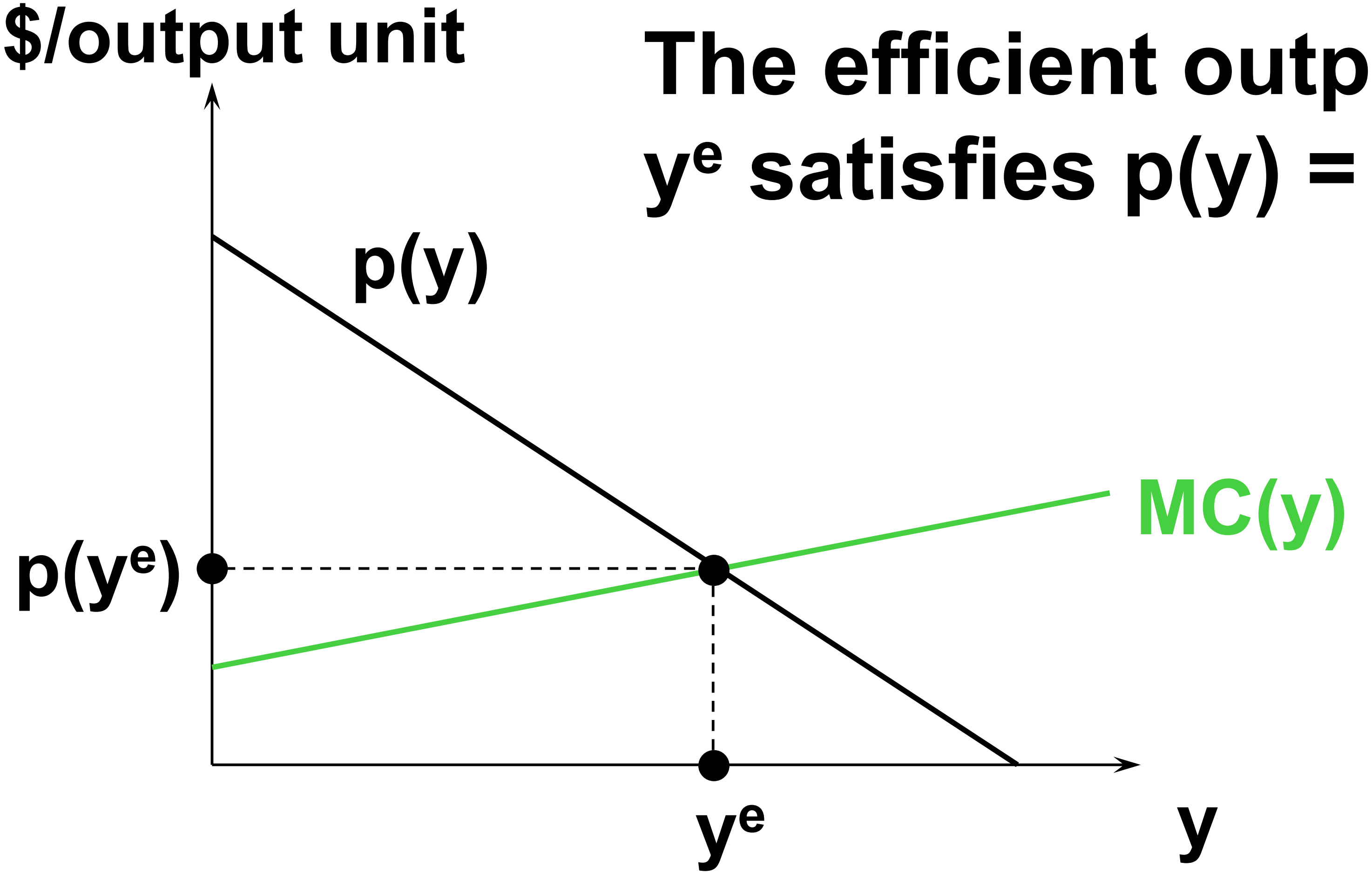
Because $\varepsilon < -1$, $\varepsilon/(1+\varepsilon) > 1$ and so the monopolist passes on to consumers more than the tax!

The Inefficiency of Monopoly

- **A market is Pareto efficient if it achieves the maximum possible total gains-to-trade.**
- **Otherwise a market is Pareto inefficient.**

The Inefficiency of Monopoly

The efficient output level y^e satisfies $p(y) = MC(y)$.



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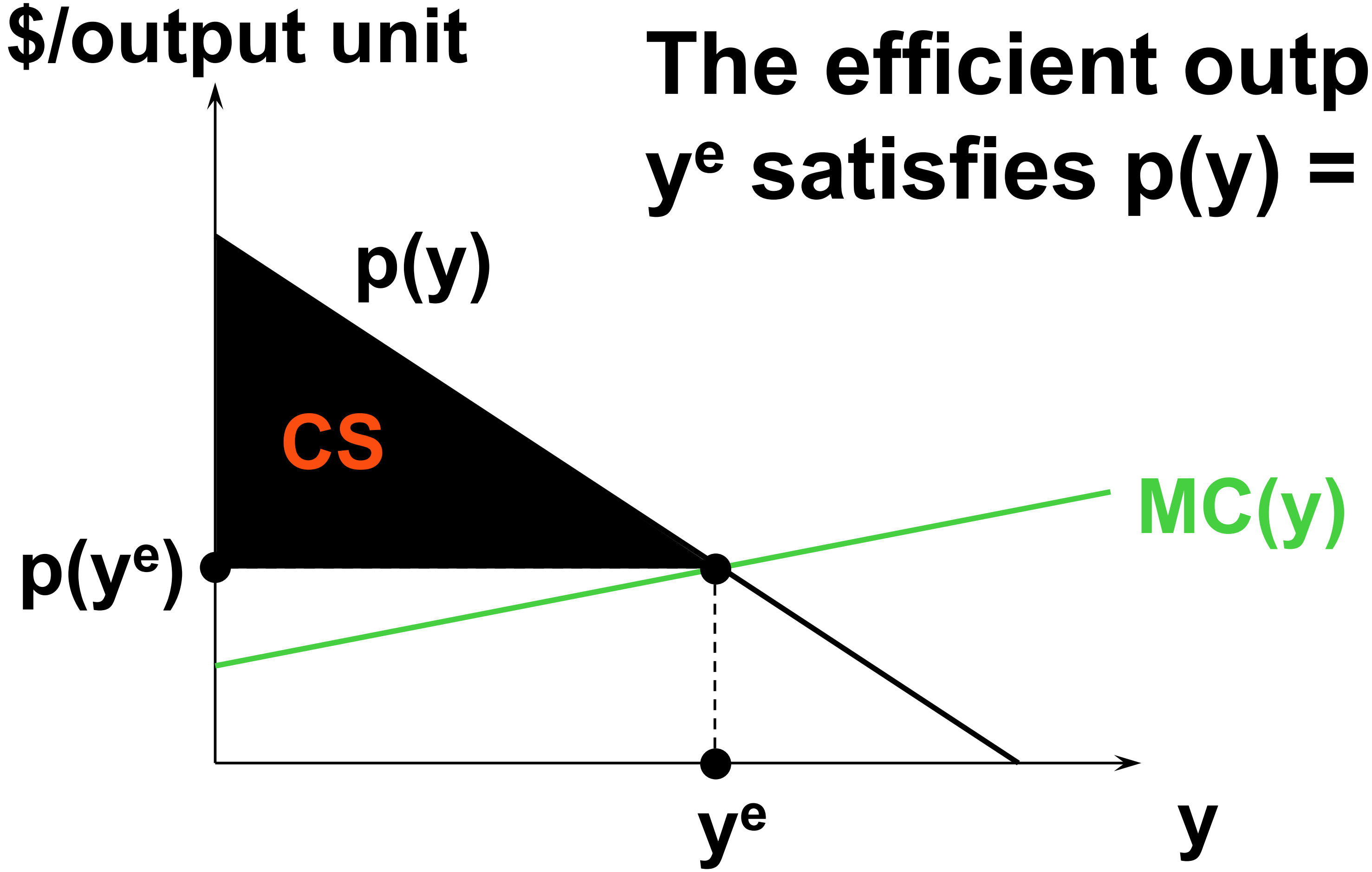

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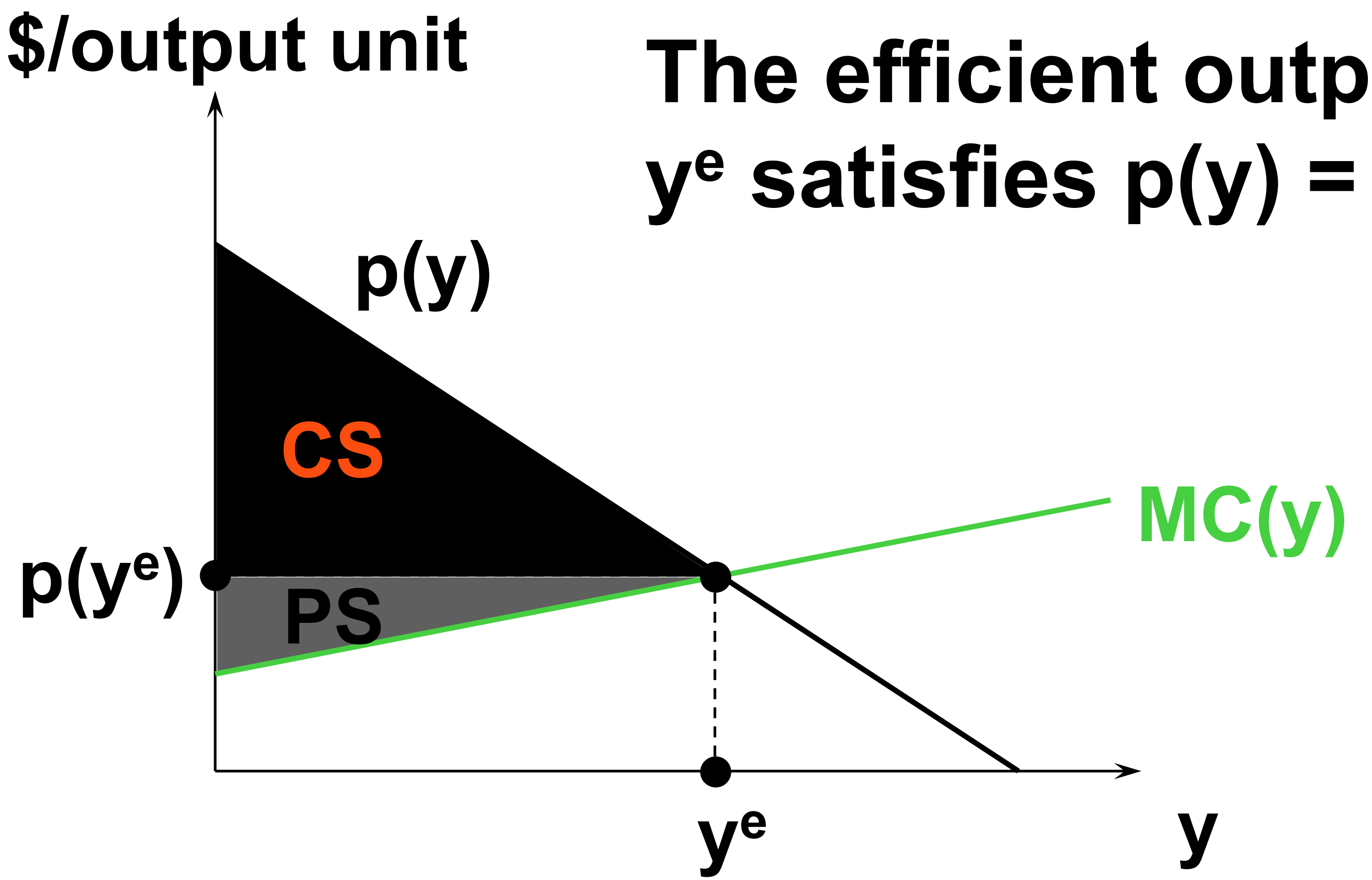
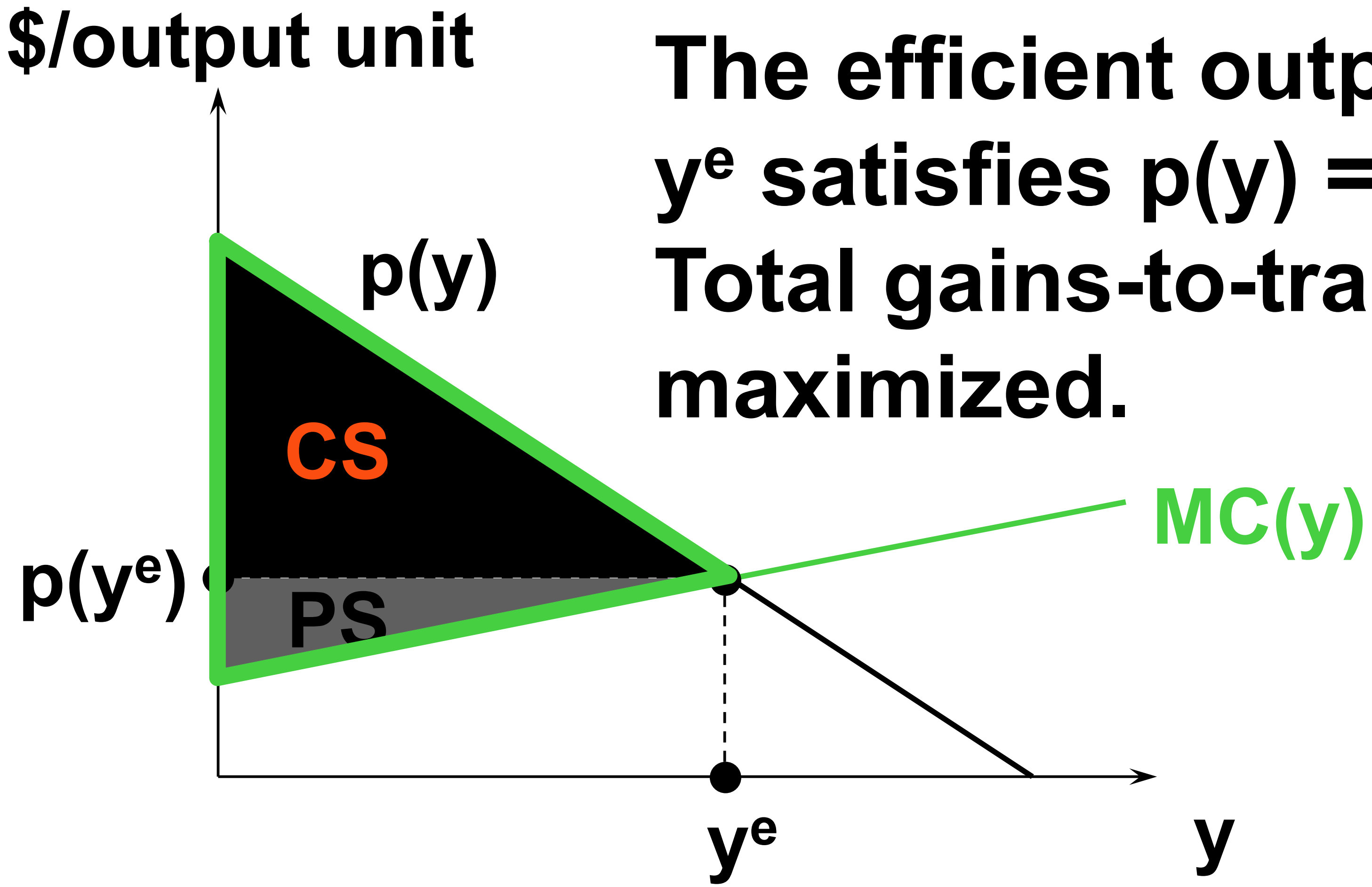
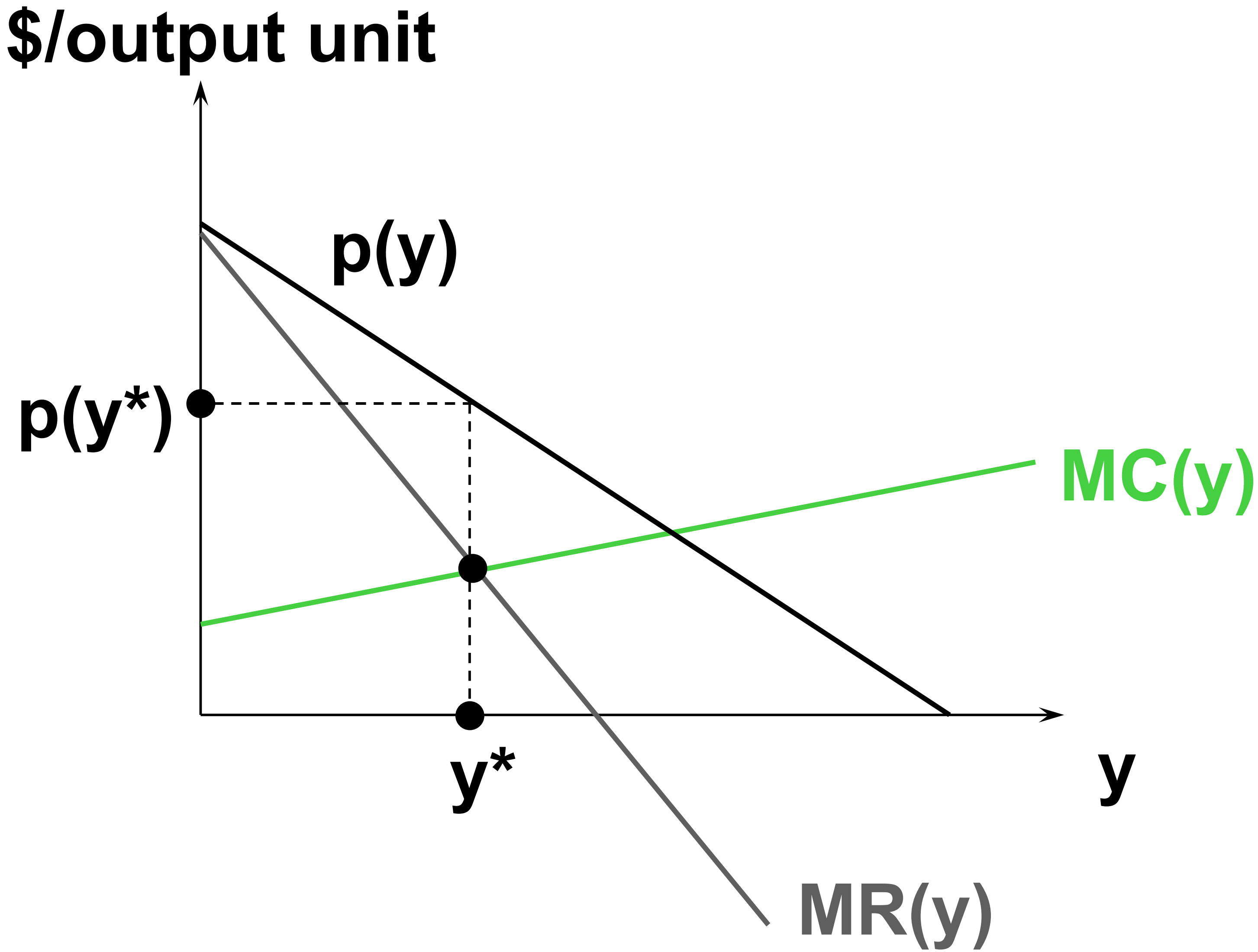


The Inefficiency of Monopoly



The efficient output level y^e satisfies p(y) = MC(y). Total gains-to-trade is maximized.

The Inefficiency of Monopoly



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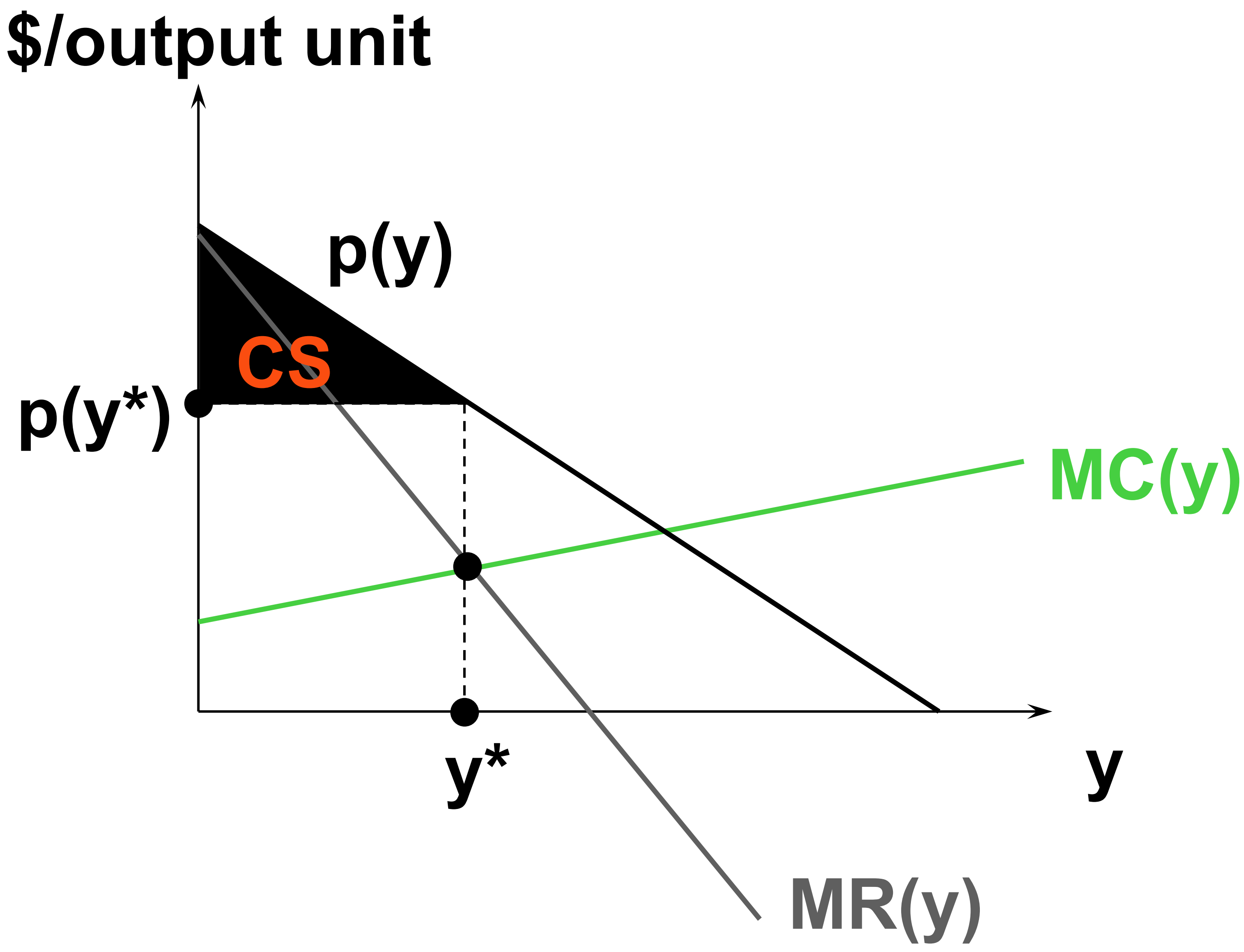

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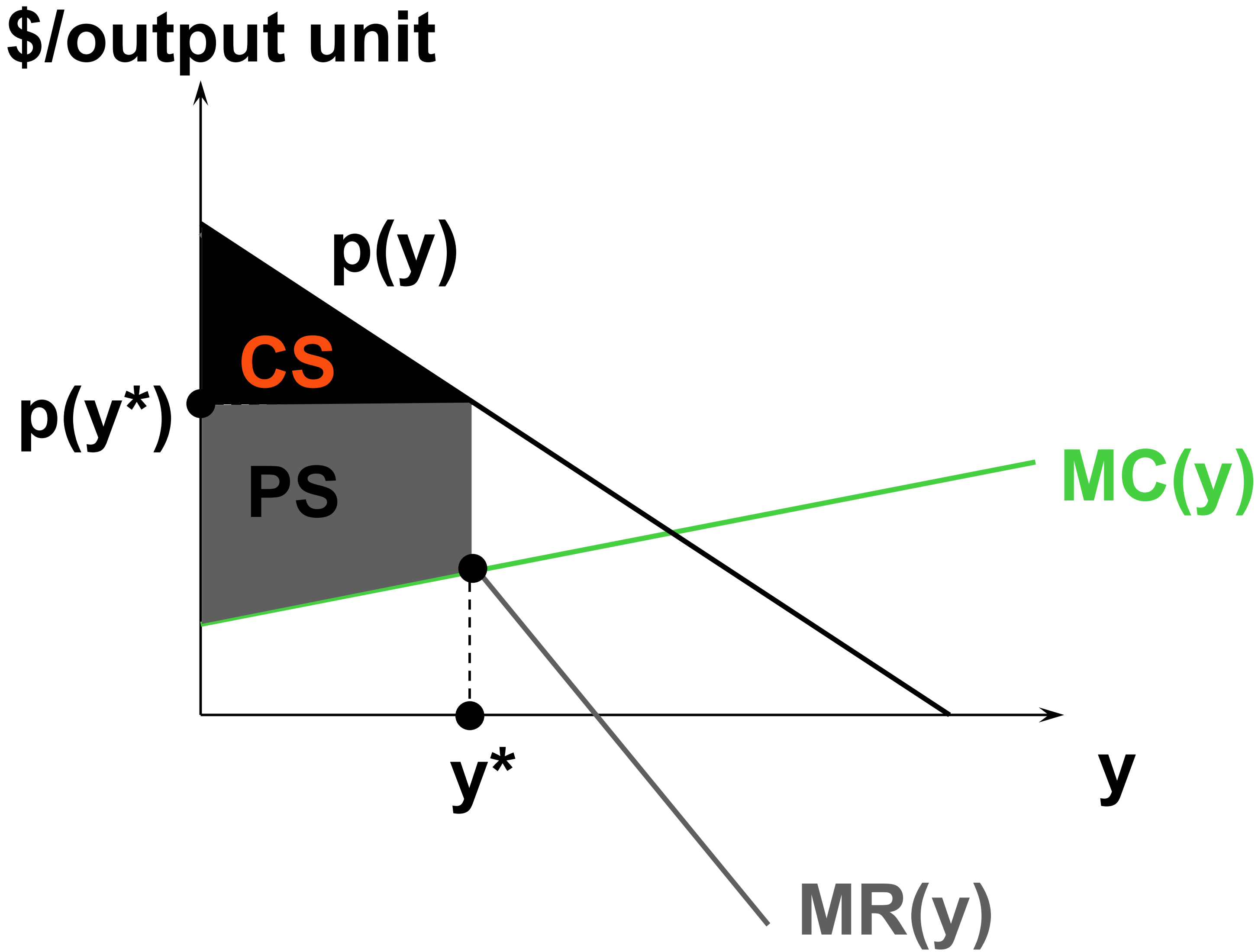

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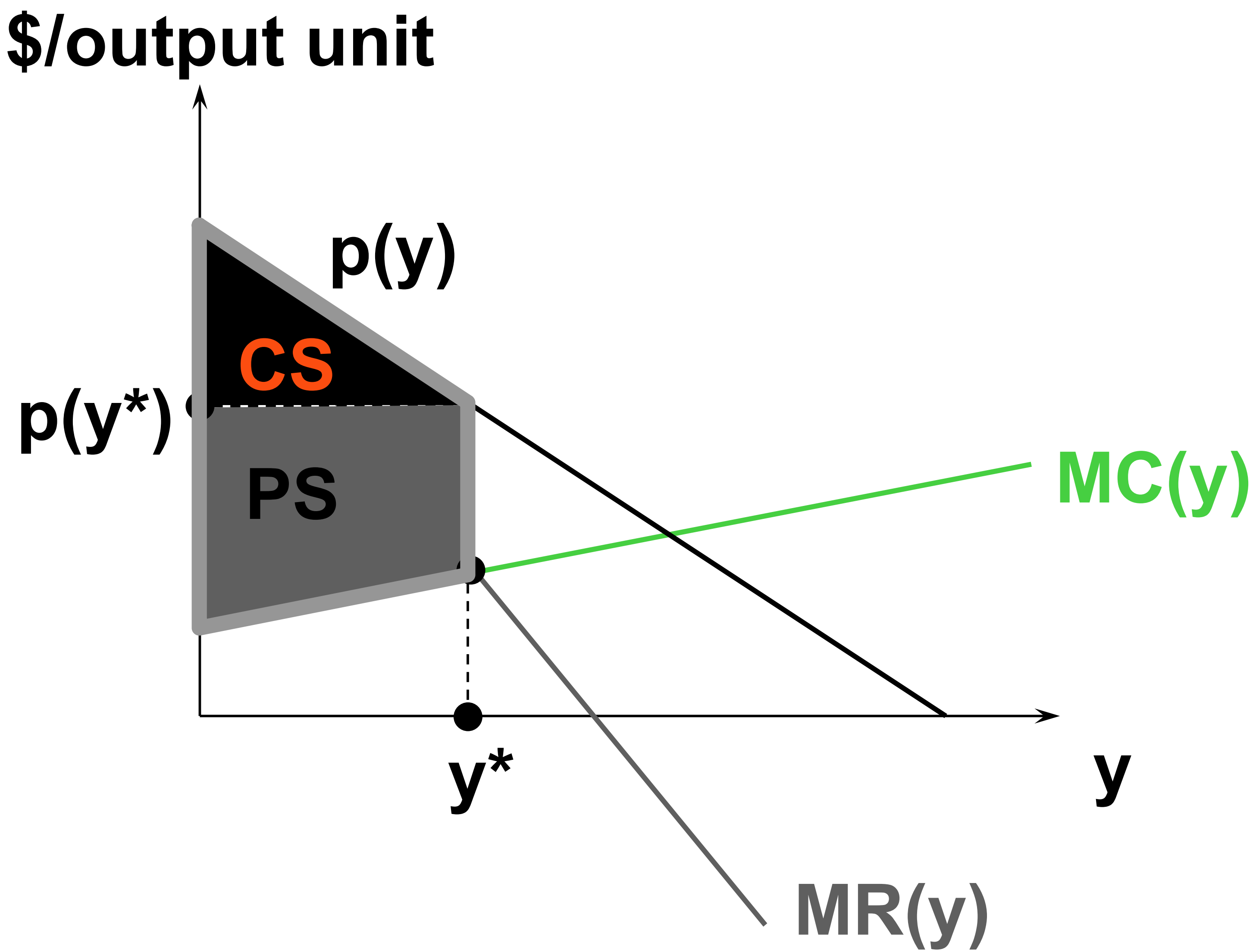

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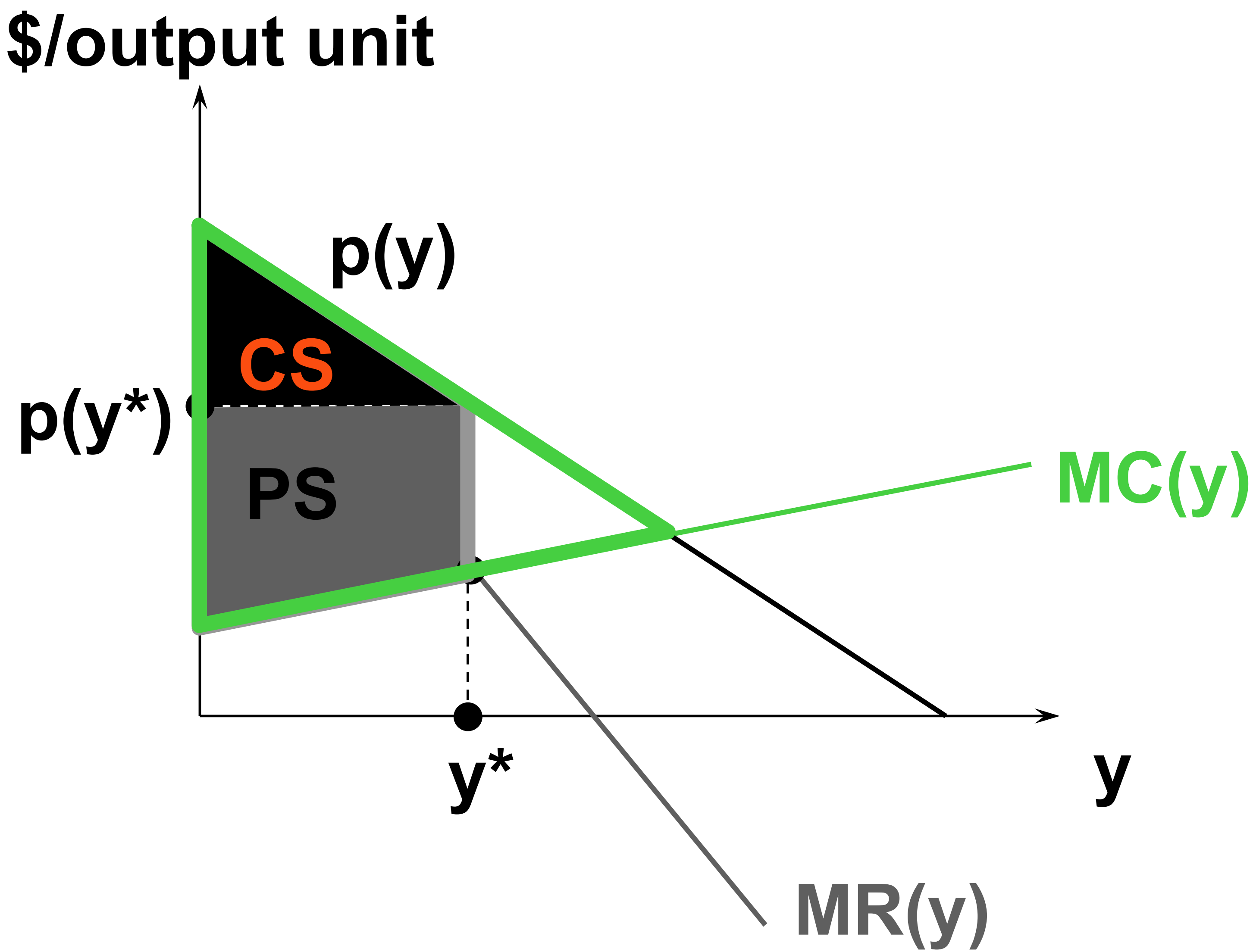

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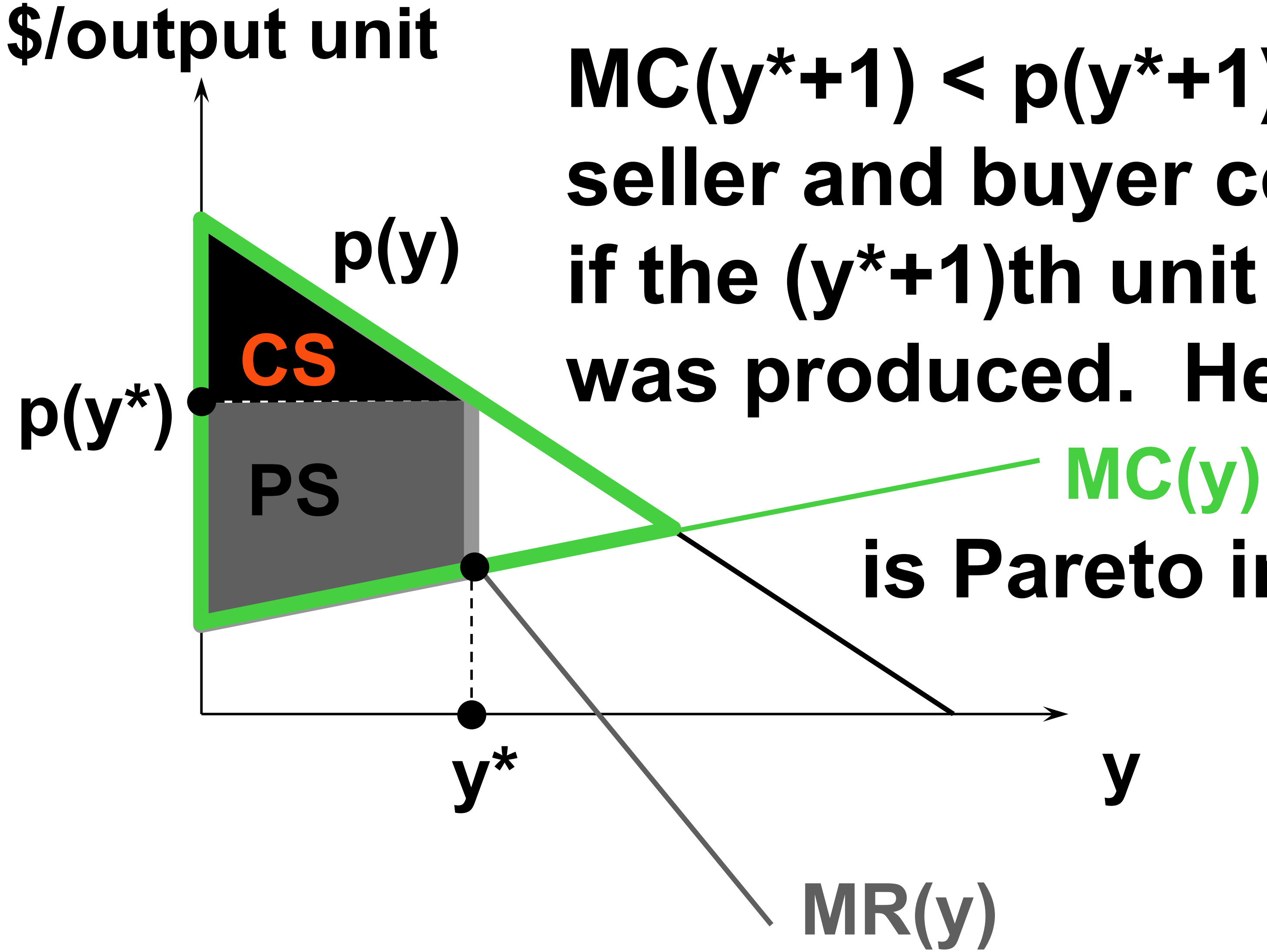
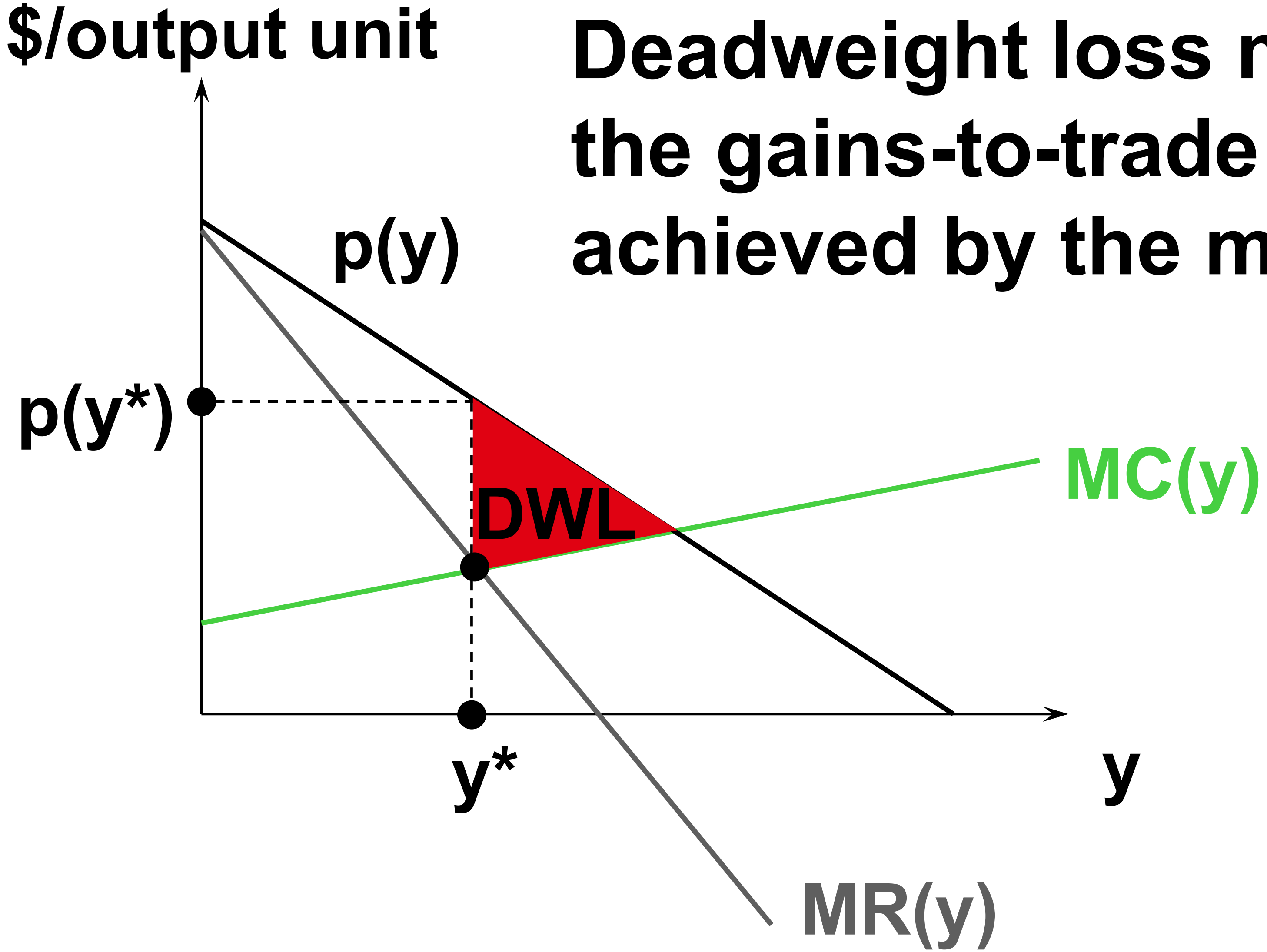


MC(y*+1) < p(y*+1) so both seller and buyer could gain if the (y*+1)th unit of output was produced. Hence the market is Pareto inefficient.

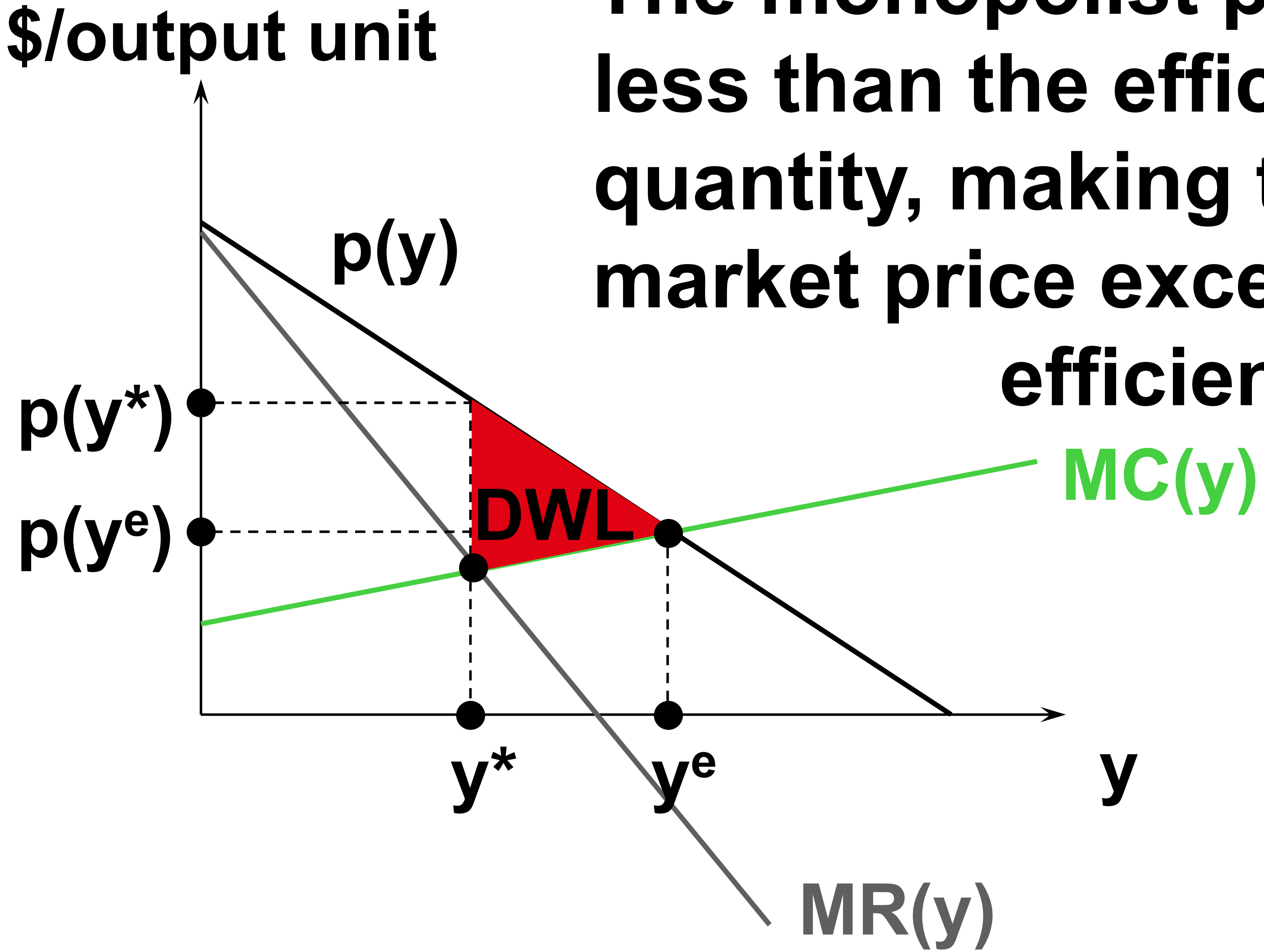
The Inefficiency of Monopoly

Deadweight loss measures the gains-to-trade not achieved by the market.



The Inefficiency of Monopoly

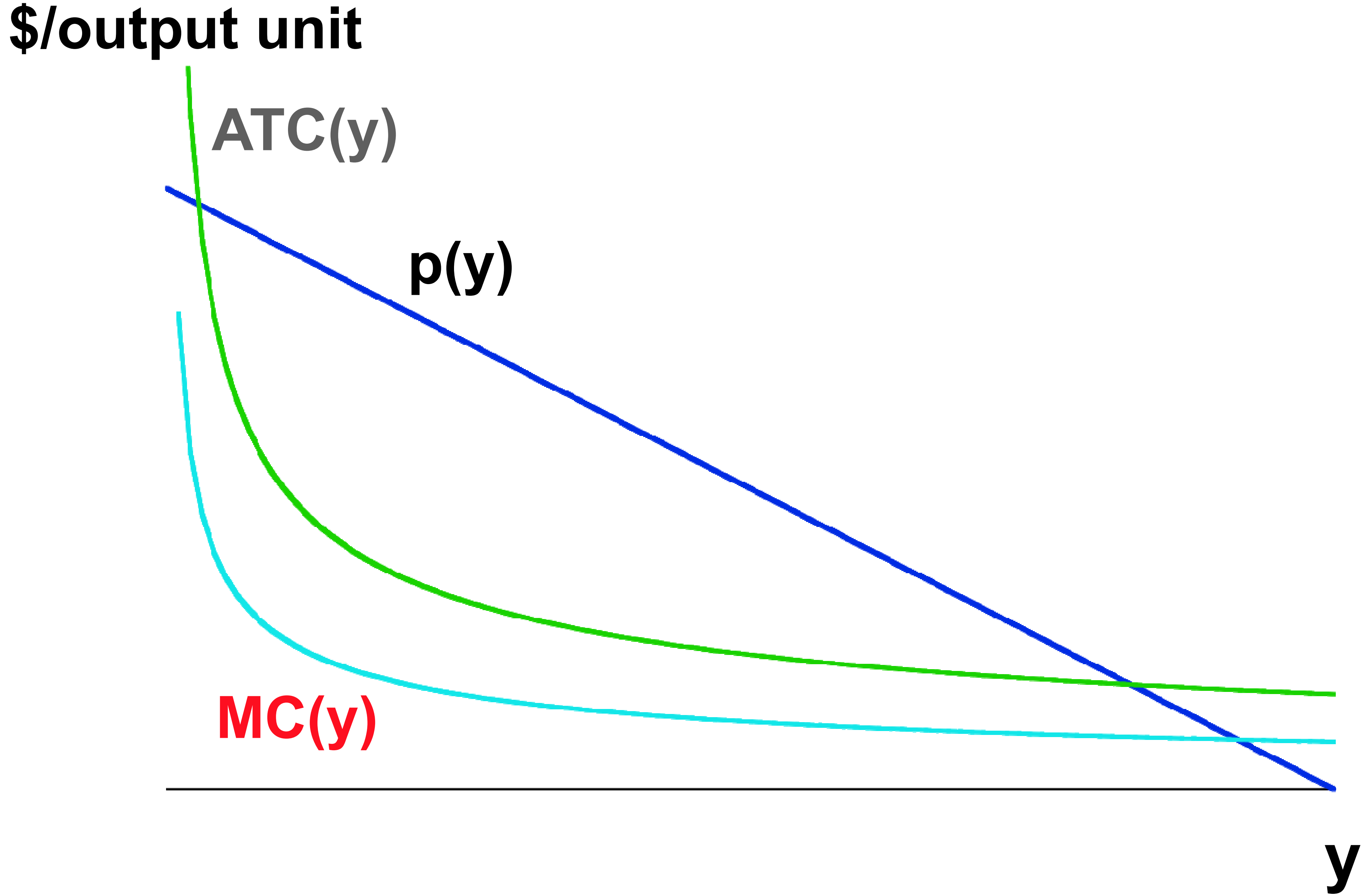
The monopolist produces less than the efficient quantity, making the market price exceed the efficient market price.



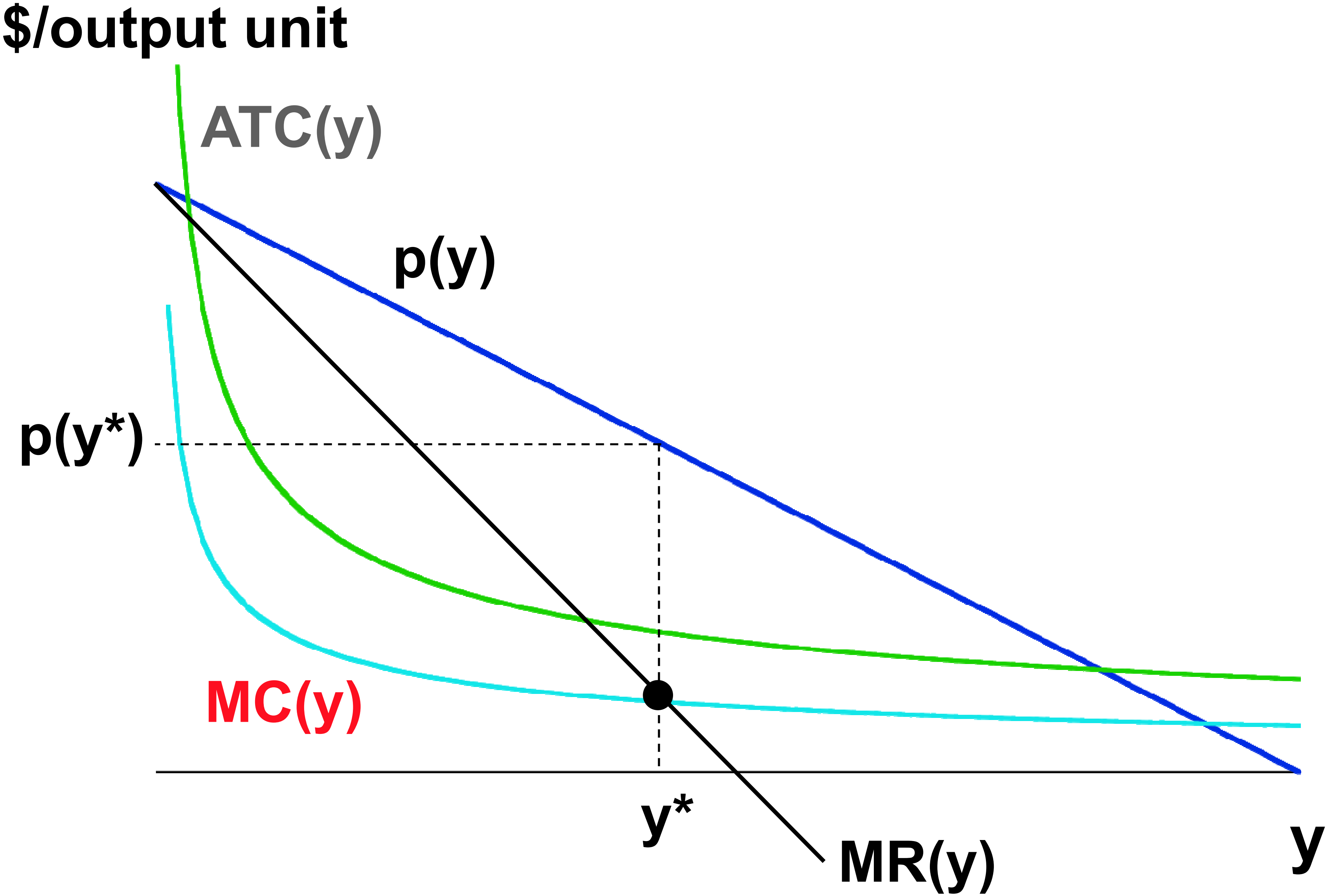
Natural Monopoly

- A natural monopoly arises when the firm's technology has economies-of-scale large enough for it to supply the whole market at a lower average total production cost than is possible with more than one firm in the market.

Natural Monopoly



Natural Monopoly



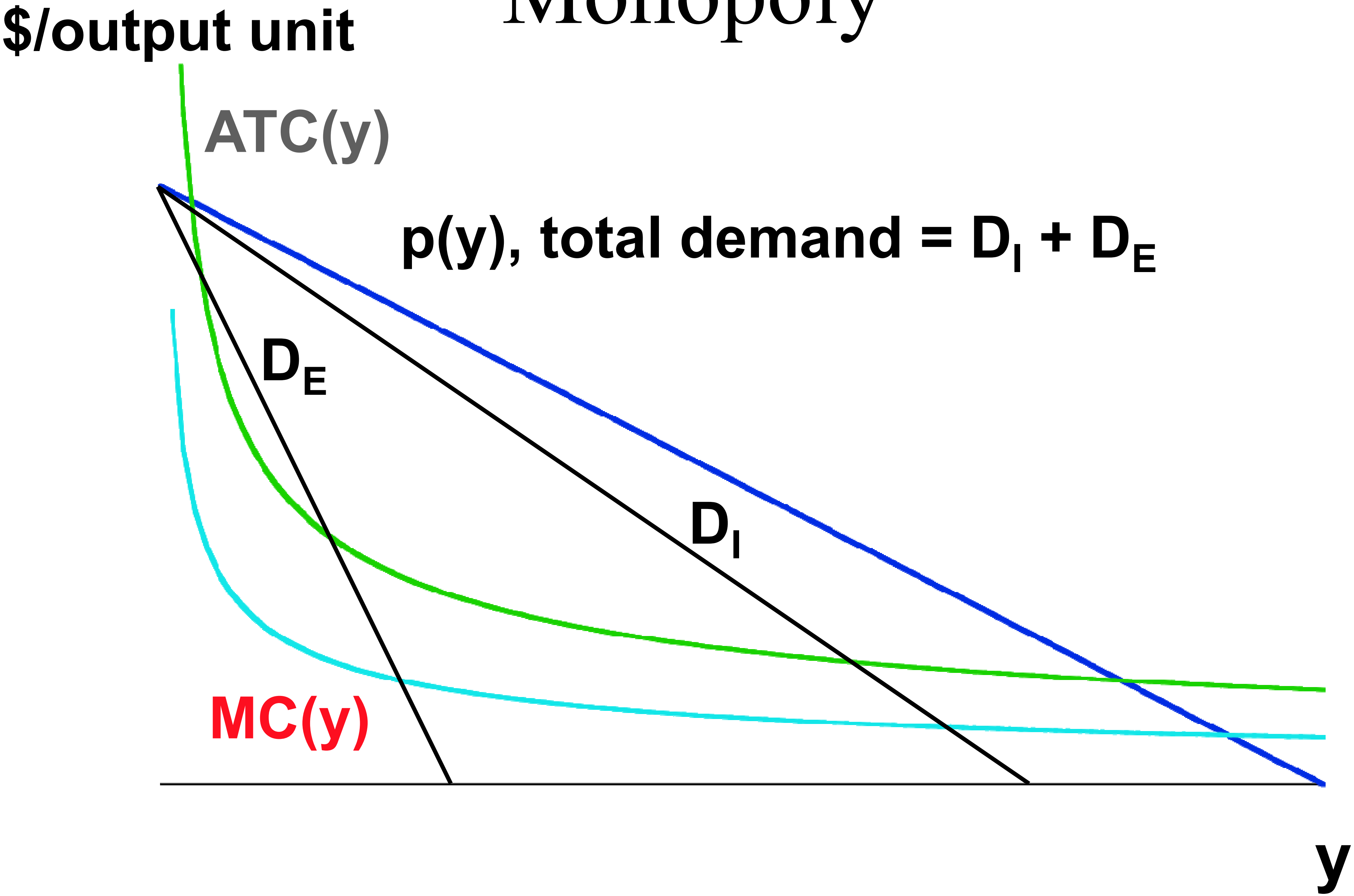
Entry Deterrence by a Natural Monopoly

- **A natural monopoly deters entry by threatening predatory pricing against an entrant.**
- **A predatory price is a low price set by the incumbent firm when an entrant appears, causing the entrant's economic profits to be negative and inducing its exit.**

Entry Deterrence by a Natural Monopoly

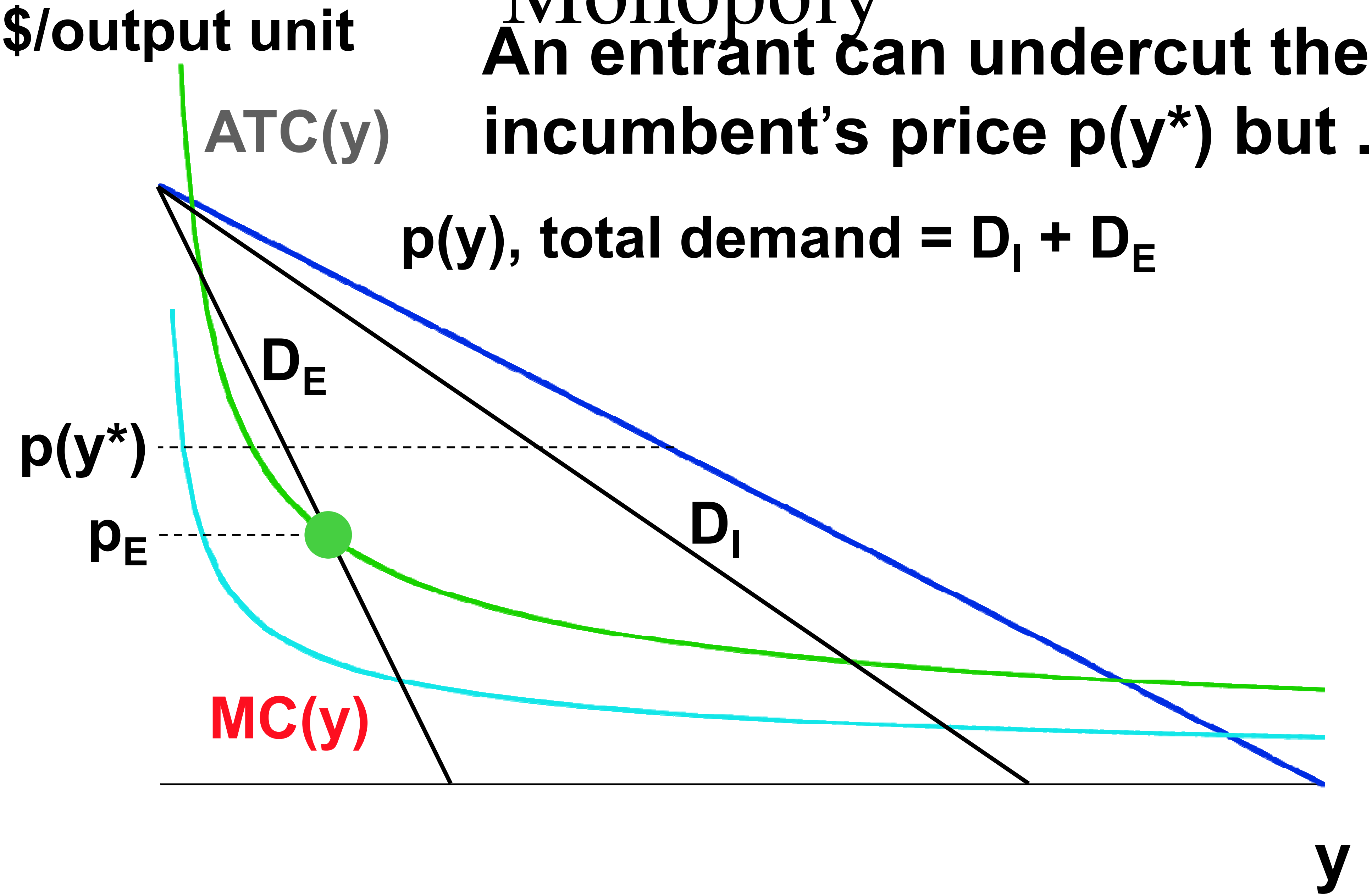
- **E.g. suppose an entrant initially captures one-quarter of the market, leaving the incumbent firm the other three-quarters.**

Entry Deterrence by a Natural Monopoly

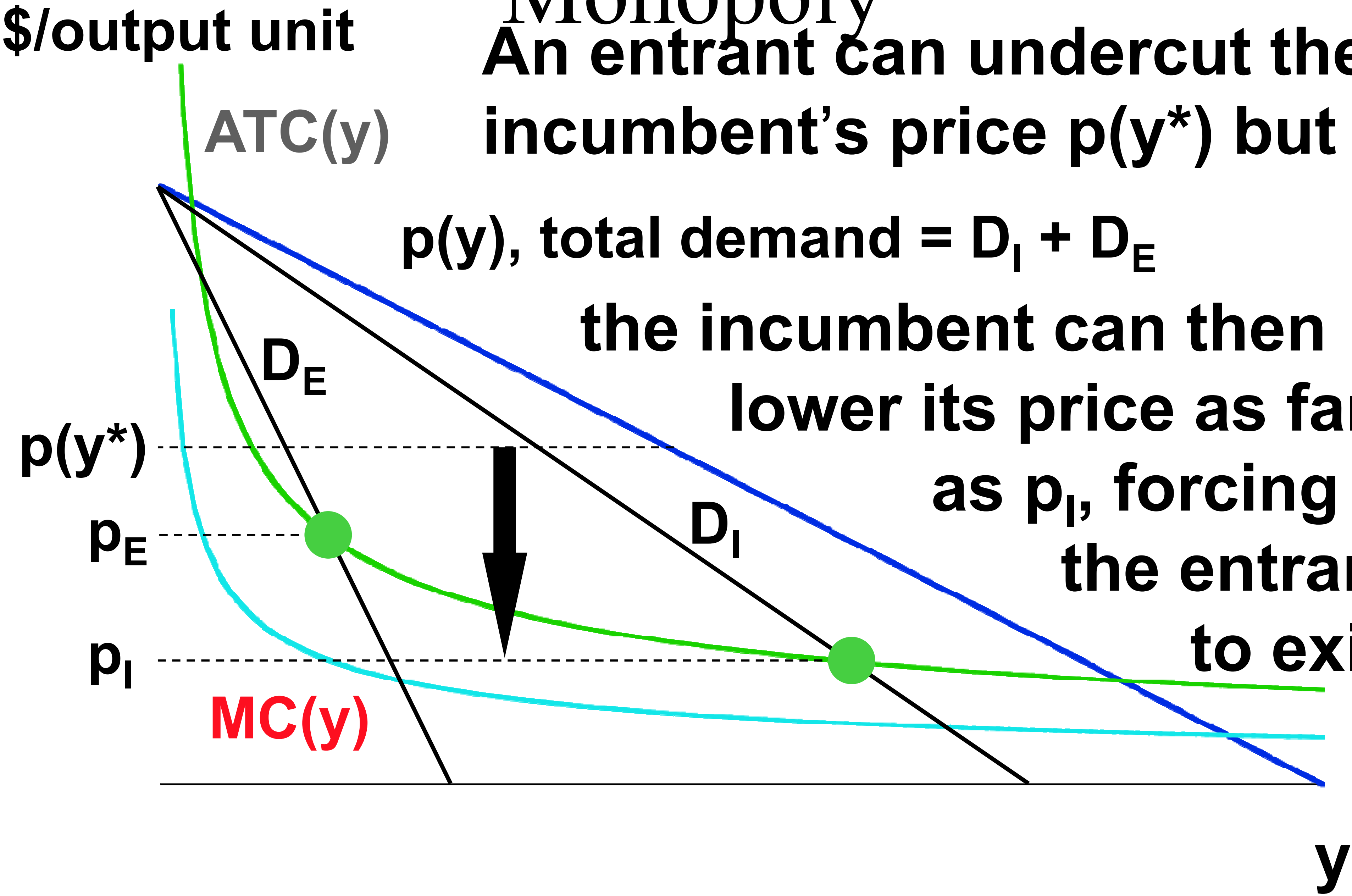


Entry Deterrence by a Natural Monopoly

An entrant can undercut the incumbent's price p(y*) but ...



Entry Deterrence by a Natural Monopoly

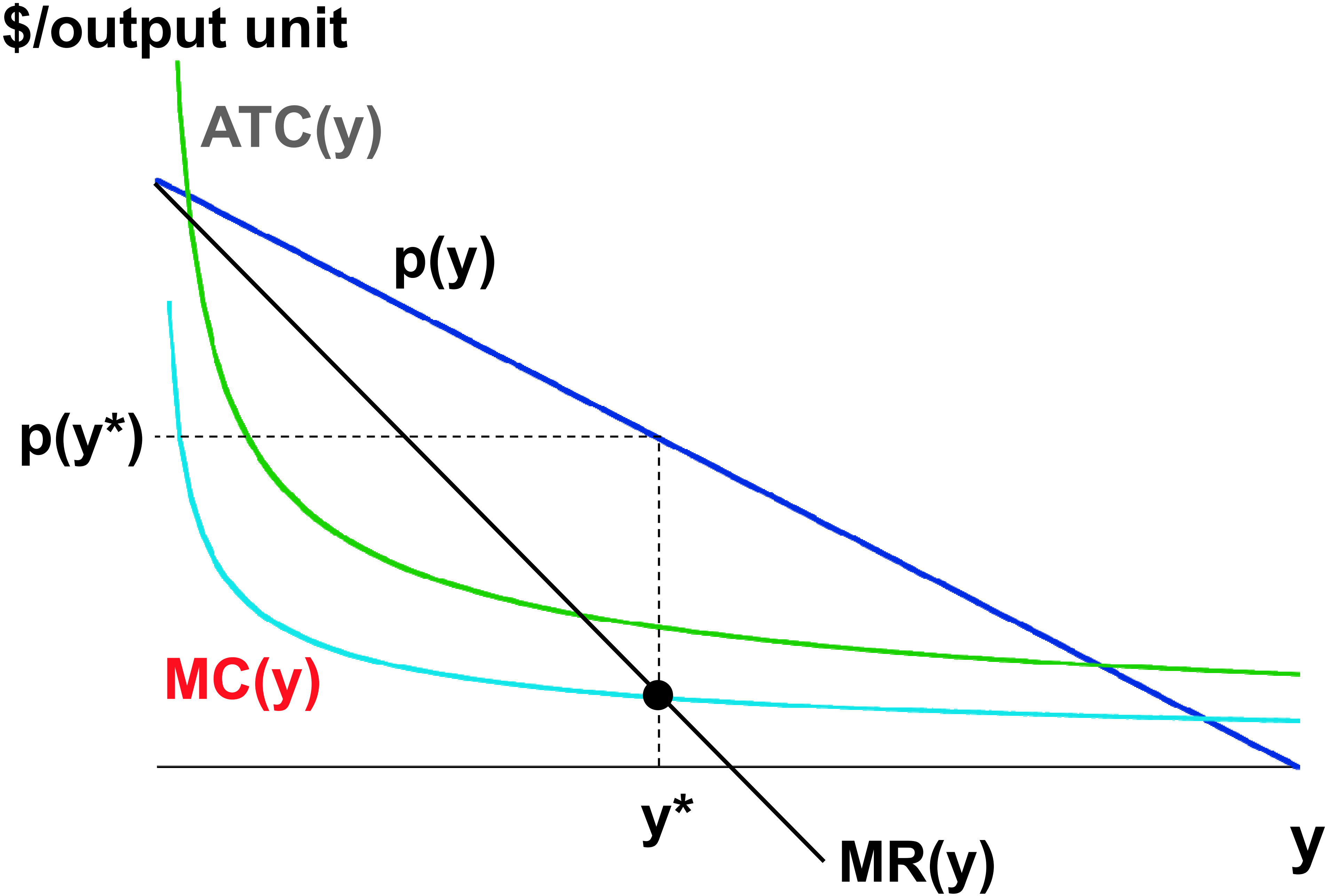


An entrant can undercut the incumbent's price p(y*) but the incumbent can then lower its price as far as p_I, forcing the entrant to exit.

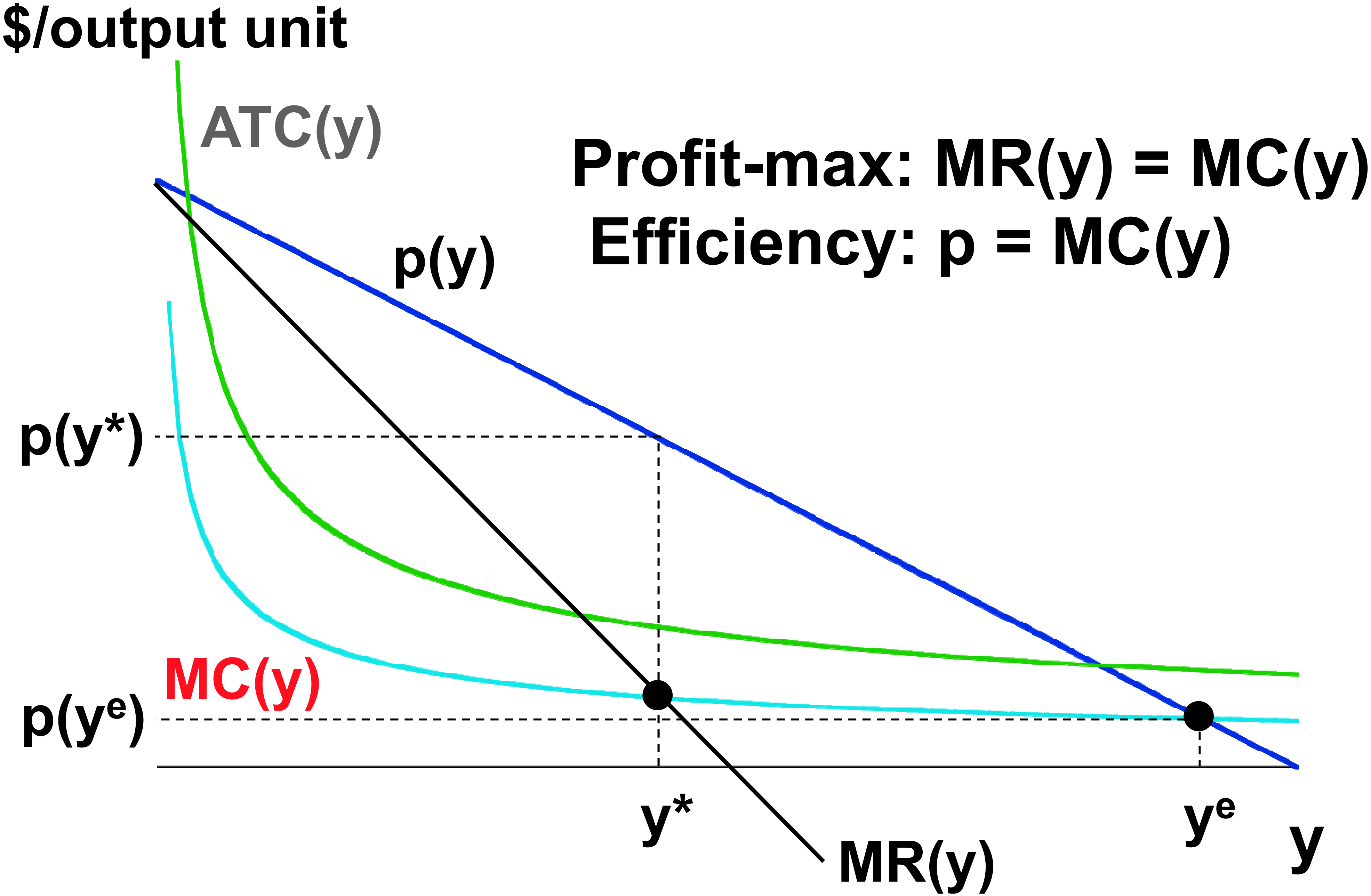
Inefficiency of a Natural Monopolist

- **Like any profit-maximizing monopolist, the natural monopolist causes a deadweight loss.**

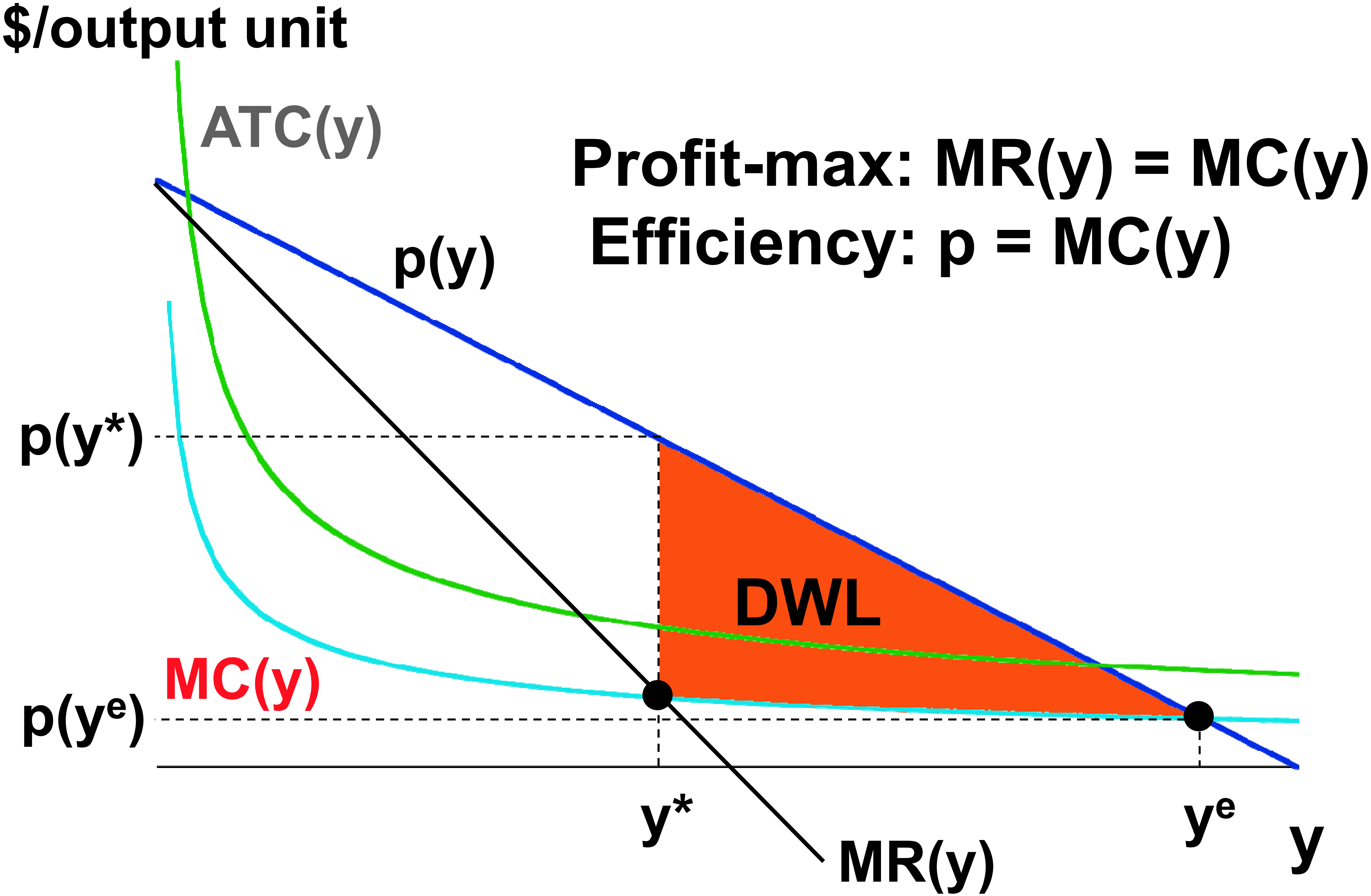
Inefficiency of a Natural Monopoly



Inefficiency of a Natural Monopoly



Inefficiency of a Natural Monopoly

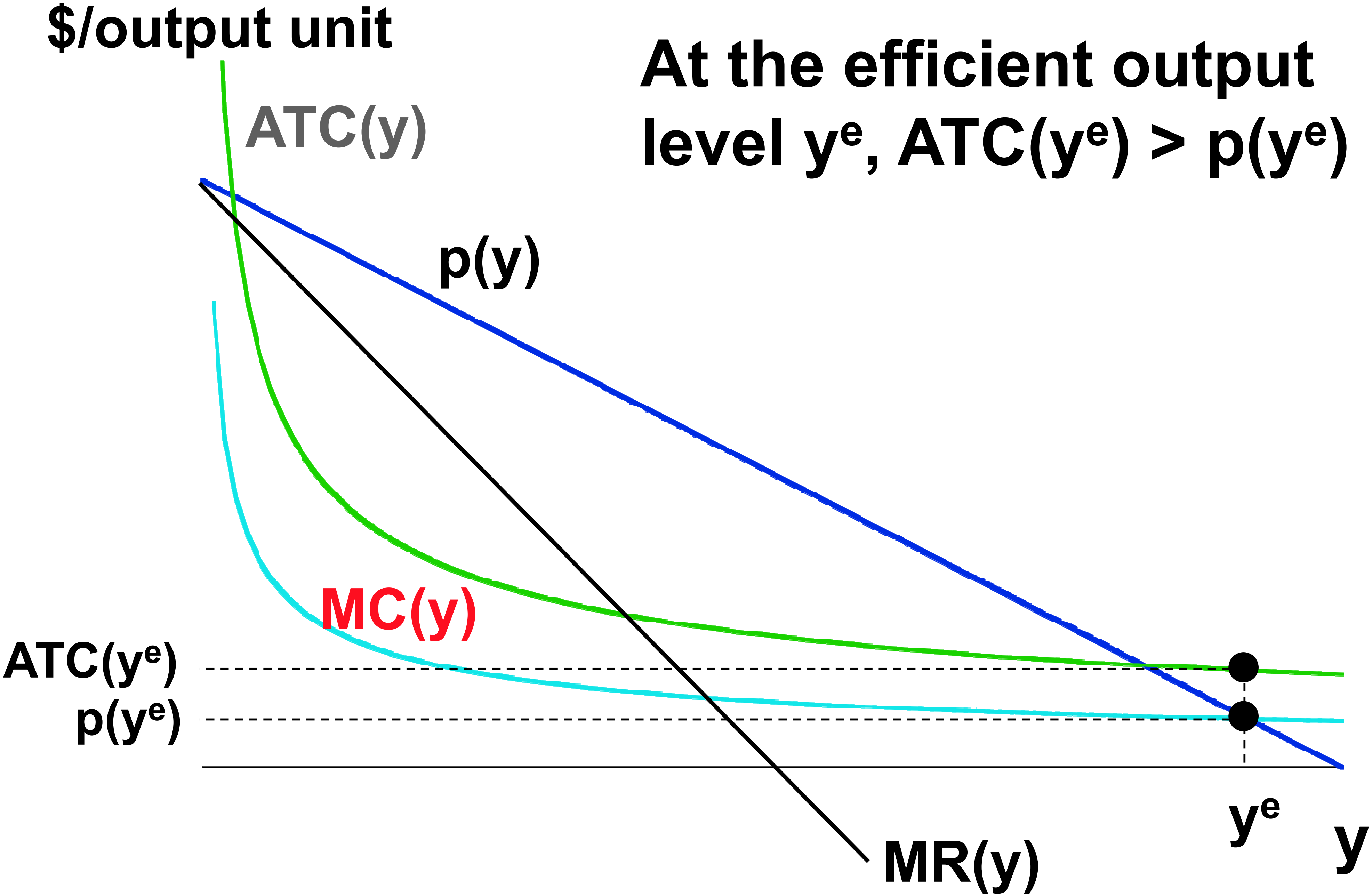


Regulating a Natural Monopoly

- **Why not command that a natural monopoly produce the efficient amount of output?**
- **Then the deadweight loss will be zero, won't it?**

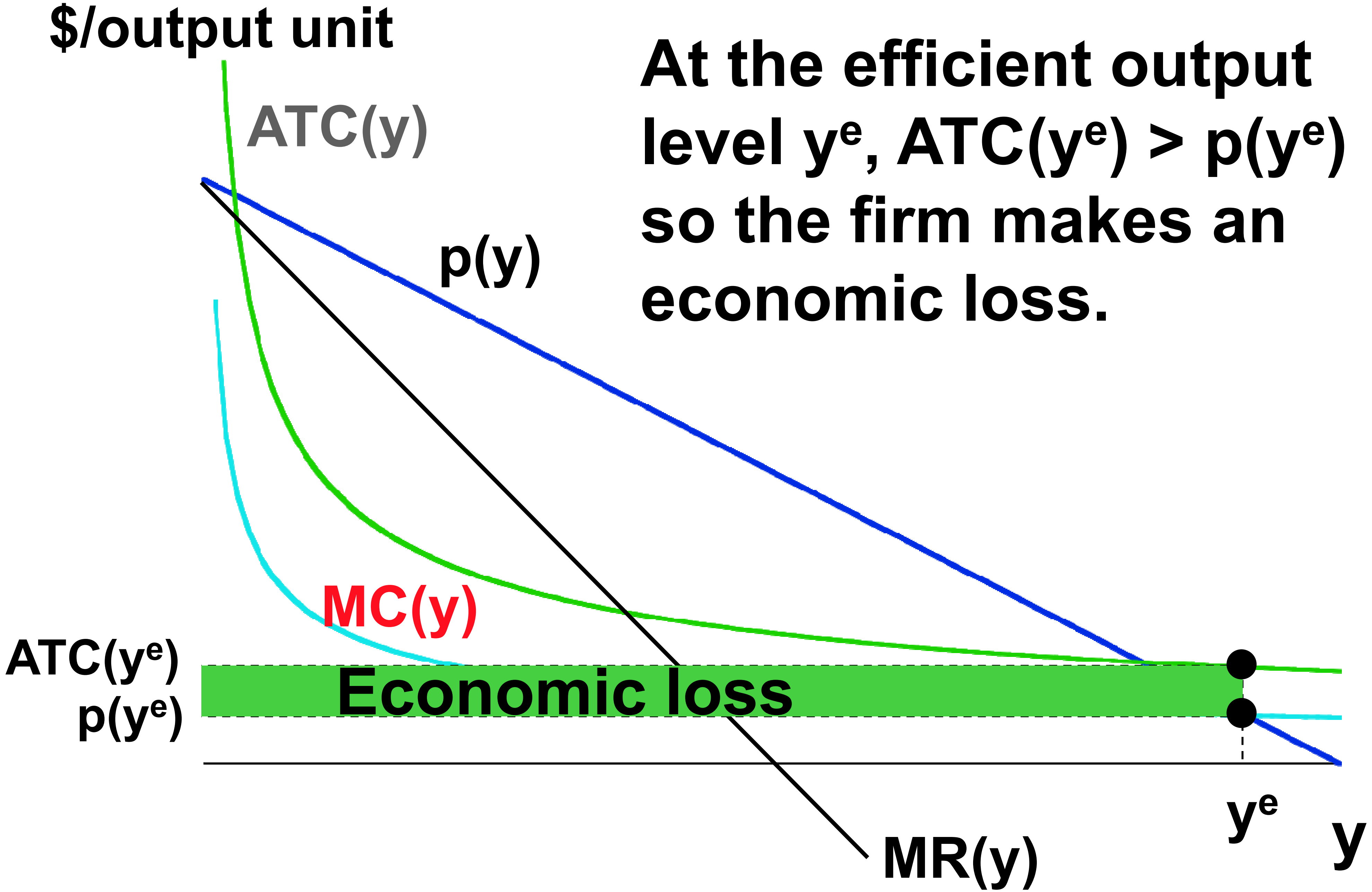
Regulating a Natural Monopoly

At the efficient output level y^e, $ATC(y^e) > p(y^e)$



Regulating a Natural Monopoly

At the efficient output level y^e, $ATC(y^e) > p(y^e)$ so the firm makes an economic loss.



Regulating a Natural Monopoly

- **So a natural monopoly cannot be forced to use marginal cost pricing. Doing so makes the firm exit, destroying both the market and any gains-to-trade.**
- **Regulatory schemes can induce the natural monopolist to produce the efficient output level without exiting.**