Monopoly

by Sophia Tutorial

WHAT'S COVERED

This tutorial will cover one of the market structures studied in economics known as a monopoly. We will define this market structure and discuss its main characteristics.

Our discussion breaks down as follows:

1. The Behavior of Firms
2. Monopoly
3. Characteristics of Monopoly
   a. Differentiated Product
   b. One Seller
   c. Imperfect Information
   d. Barriers to Entry
4. Anti-Trust Policy and Regulation
5. Simplified View of a Market

1. The Behavior of Firms

Beginning with some basics, businesses or firms demand the factors of production, known as inputs, and supply goods and services, or outputs.

The field of economics studies this behavior of firms and, given that not all firms are created equal, how it varies depending on certain characteristics:

- Their size
- Their product
- How many competitors they face
- How easy or difficult it was to get into the business

All of these factors affect how firms behave.

THINK ABOUT IT

Do you have some favorite businesses that you love to shop at? Do you feel that some businesses offer great prices and customer service, while others do not? More than likely, the reason why you feel that way about certain businesses has something to do with these characteristics.

2. Monopoly

Today we will look at an extreme end of the spectrum, which is**monopoly**.

If you've ever played the board game Monopoly, you know that the point of the game is to monopolize the board and control everything.

This is exactly what a monopoly as a market structure does: it controls everything.

Looking at the spectrum of competition, we go from one end of the spectrum, an extreme of perfect competition where there are so many competitors that you cannot tell the difference between them, to this tutorial's focus of monopoly, where there is only one seller providing a unique product.

Monopoly is an industry market structure characterized by one firm supplying a unique product to the entire market. Barriers to entry prevent competition, which we will cover later in this tutorial.

TERM TO KNOW

Monopoly
An industry market structure characterized by one firm supplying a unique product to the entire market. Barriers to entry prevent competition

3. Characteristics of Monopoly

Let's explore the different characteristics of monopoly.

3a. Differentiated Product

Monopolists sell a completely differentiated product, meaning it is so unique that no other company provides anything like it.

If a consumer wants this product, they must buy it from this company.

3b. One Seller

In a monopoly, as mentioned, there is only one seller. The monopolist is the*only* firm selling this product, which means that they alone determine the price.

HINT

In economics, firms are sometimes referred to as either "price-takers" or "price-makers." A price-taker is a firm who has no control at all over price, as in the market structure of perfect competition. At the opposite end of the extreme are the "price-makers" like monopolists, who comprise the entire market and therefore they alone can choose the price they want to charge.

In a monopoly, the "price-taker" will choose the price that is going to maximize their profit. Because they have this great ability to charge high prices and make significant profit, regulation from the government is quite prevalent in this market structure.

3c. Imperfect Information

THINK ABOUT IT

Have you ever purchased something without perfect information about it? Have you ever gotten something home and said to yourself, "If I'd only realized that this is going to fall apart within five minutes of wearing it, I wouldn't have spent that money on it!"?

Well, unfortunately for us, information is not perfectly shared between the monopolist and consumer.

Information does not flow freely. We do not know everything about the company, such as their cost structure, what goes into their production process, etc.

Therefore, because of this imperfect information, it is not an ideal situation for the consumer.

The monopolist wants to keep their market power and continue selling a unique good; therefore, consumers are not always going to know everything about the monopolist.

3d. Barriers to Entry

A barrier to entry, as mentioned, is something that prevents other companies from entering the market and competing with the monopoly.
There are a number of different barriers to entry that can exist, representing different reasons why a

monopoly may be in operation.

High Start-Up Costs

Any time there is an industry with high start-up costs or a significant amount of technology, this can present a very high barrier to entry.

> EXAMPLE Consider public utility companies. Does it make sense for more than one water company to service an area?
>
> Not only would that be difficult, with competing water lines, but it may actually not be profitable for more than one company to take on those high initial costs and service one area.

For that reason, public utility companies are, generally speaking, allowed to operate as a monopoly.

> EXAMPLE Another example is sports leagues, such as the NFL, NHL, NBA, and MLB. Consider how expensive it is to start a sports league!

Some of these are what we call "natural monopolies," due to economies of scale, referring to a situation where it simply makes sense for a company to get bigger, because they can spread out those high start-up costs incurred in the beginning.

Government-Created Monopolies

The government actually creates some monopoly. For instance, you may have never thought about a patent or a copyright as a monopoly, but that is what they are creating.

A patent or a copyright allows an inventor to monopolize their good or service for a period of time.

Pharmaceutical companies can exclusively sell new drugs until the patent expires, which makes it quite expensive to buy that medication until the patent expires and a generic version can be developed.

THINK ABOUT IT

So, why do we offer patents and copyrights? Well, if you think about it, why would anyone dedicate their life to finding cures or developing new drugs, if they couldn't reap the profit from that endeavor for at least a period of time? Therefore, patents and copyrights do encourage inventors, but they allow them to monopolize their product for a period of time.

Control Over a Key Resource

Control over a key resource is also a barrier to entry.

If a company has control over a resource, it can be difficult--or almost impossible--for any other companies to acquire it.

> EXAMPLE A classic example is De Beers and their ability to control all of the diamond mines. Similarly, while there is not just one company controlling the resource of oil, it is controlled by a select number of countries or companies.

Predatory Pricing

Next we have predatory pricing, which is an interesting phenomenon.

> ### IN CONTEXT
>
> Suppose a huge superstore opens in a small town. Why might they actually sell their product--at first, when they open--below cost?
>
> Why would they not make a profit on it and sell it below what it costs them to produce it?
>
> Well, the idea is to drive out their competitors or to keep others from entering the market.
>
> If they can do that, they become a monopoly, and once they are a monopoly, they have complete control over price.
>
> Once all of the competition is driven out, they are the ones left standing--and this is known as predatory price-cutting.

4. Anti-Trust Policy and Regulation

Earlier in the tutorial, we mentioned the prevalence of government regulation in monopolies.

Companies that have significant market power can have negative effects on consumers, which explains why there is a history of regulation, at least in the U.S.

In the late 1800s and early 1900s, these three acts were passed to prevent businesses from colluding or restricting competition:

- Sherman Anti-Trust Act of 1890
- Clayton Act of 1914
- Federal Trade Commission Act of 1914

The Federal Trade Commission Act was passed to regulate mergers and acquisitions.

> EXAMPLE For example, under the Federal Trade Commission Act, a large bank may not be allowed to merge with another one, because it may be determined that there would be too much market power held by this one bank.

5. Simplified View of a Market

As a reminder, keep in mind that our spectrum of market structures represents a simplified view of a market, and monopolies are one extreme.

Most companies are not monopolies. Most firms fall somewhere between the two extremes of perfect competition and monopoly.

We study it because it gives us a place to start when looking at the complexities of the real world. It's going to help us compare and contrast.

For instance, the closer we are to a monopoly, the worse it will be for consumers.

SUMMARY

We began today's lesson by discussing the different factors that affect **the behavior of firms**. We learned that **monopoly** is a market structure with the following **characteristics**: **differentiated or unique product**; **one seller** with absolute market power who is a "price-maker"; **imperfect information**; and **barriers to entry**. These barriers to entry can include high start-up costs, government-created monopolies, control over a key resource, and predatory pricing. Lastly, we discussed some of the **anti-trust policy and regulation** meant to protect the consumer. Keep in mind that we study this **simplified view of a market** because it allows us to break down some of the complexities that we see in the real world and provides a place to start for comparison.

Source: Adapted from Sophia instructor Kate Eskra.

TERMS TO KNOW

Monopoly
An industry market structure characterized by one firm supplying a unique product to the entire market. Barriers to entry prevent competition.

