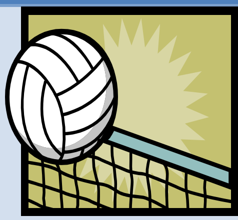
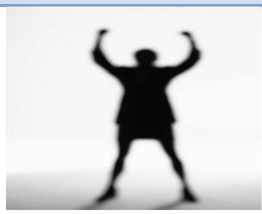
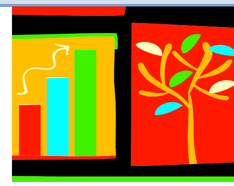
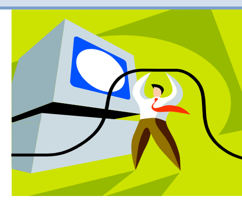
Monopoly vs. Monopolistic Competition: What's the Difference?

MONOPOLY	VS	MONOPOLISTIC COMPETITION
 **NO COMPETITION**		 LARGE NUMBER OF FIRMS
 **JUST ONE SUPPLIER**		 **PRODUCT DIFFERNTITAION**
 **MONOPOLIST CONTROLS THE PRICE**		 **PRODUCT VARIATION**
 **VERY HARD TO ENTER THE MARKET**		 **FREE ENTRY & EXIT**
		 **SOME CONTROL OVER THE PRICE**
		 **HEAVY EXPENDITURES ON ADVERTISEMENTS AND OTHER SELLING COST**

Monopoly v. perfect competition

Monopoly compared with perfect competition

Consumer and producer sovereignty

Because of the conditions of perfect competition - many buyers and sellers, perfect knowledge and freedom of entry - firms would be forced to produce those goods and services which consumers most wanted. Any firm or even group of firms not behaving in this way would be unable to survive for very long as the competitive pressures from those firms who were responding to consumers' wishes would soon drive them into extinction. From this point of view it could be argued that consumers are sovereign in as much that it is they who 'call all the shots'.

However, monopoly producers may well decide on which types of goods they are going to supply and at what prices, and then set about manipulating and moulding consumers' tastes, via their marketing activities, to match their pre-determined output plans - a situation in which the producer and not the consumer is sovereign.

Under monopoly price is likely to be higher and output lower as compared with perfect competition.

Summary of Comparison: A general comparison between monopoly and perfect competition for easy understanding has been depicted as under:

Features	Monopoly	Perfect Competition
1. Description	Extreme market situation, where there is only one seller. He has no competition and so controls supply and price.	A fair, direct competition between buyers and buyers : sellers and sellers ; and finally between buyers and sellers.
2. Buyers and sellers	Only one seller and practically all buyers depend on him. Hence he has absolute control over the market.	Large number or buyers and sellers. hence no sellers or buyers can alter the price in the market.
3. Supply	Supply from only one seller, hence absolute control over the supply.	(*i*) Supply comes from large number of sellers (*ii*) individual supply is negligible.
4. Demand	Demand is inelastic. Demand curve slopes downward.	Demand is perfectly elastic. Demand curve is a horizontal straight line.
5. Product	Homogeneous product.	Homogeneous product.
6. Nature of Competition	No competition at all.No price or product competititon.	Pure and perfect competition in price.
7. Price	Higher price higher than all competitive price $P > MR = MC$	Normal Price $P = MR = MC$
8. Output	Small output fixed by the sole seller.	Large output fixed by $MR = MC$
9. Profit	Excess profit monopoly gain.	Normal profit realised by price competition.
10. Application	Pure Monopoly is rare but elements of monopoly are there in markets.	Quite unreal

The distinction between monopoly and perfect competition is only a difference of degree and not of kind.

Difference:

Following points make clear difference between both the competitions:

1. Output and Price:

Under perfect competition price is equal to marginal cost at the equilibrium output. While under monopoly, the price is greater than average cost.

2. Equilibrium:

Under perfect competition equilibrium is possible only when MR = MC and MC cuts the MR curve from below. But under simple monopoly, equilibrium can be realized whether marginal cost is rising, constant or falling.

3. Entry:

Under perfect competition, there exist no restrictions on the entry or exit of firms into the industry. Under simple monopoly, there are strong barriers on the entry and exit of firms.

4. Discrimination:

Under simple monopoly, a monopolist can charge different prices from the different groups of buyers. But, in the perfectly competitive market, it is absent by definition.

5. Profits:

The difference between price and marginal cost under monopoly results in super-normal profits to the monopolist. Under perfect competition, a firm in the long run enjoys only normal profits.

6. Supply Curve of Firm:

Under perfect competition, supply curve can be known. It is so because all firms can sell desired quantity at the prevailing price. Moreover, there is no price discrimination. Under monopoly, supply curve cannot be known. MC curve is not the supply curve of the monopolist.

7. Slope of Demand Curve:

Under perfect competition, demand curve is perfectly elastic. It is due to the existence of large number of firms. Price of the product is determined by the industry and each firm has to accept that price. On the other hand, under monopoly, average revenue curve slopes downward. AR and MR curves are separate from each other. Price is determined by the monopolist. It has been shown in Figure 10.

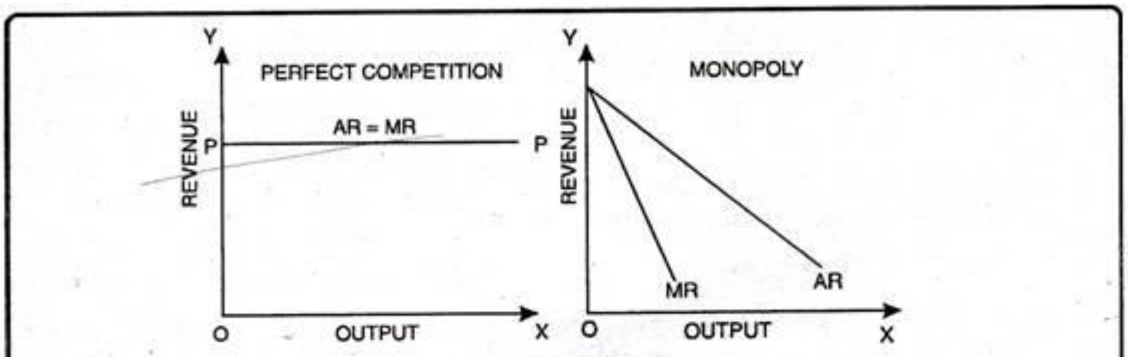


Fig. 10.

8. Goals of Firms:

Under perfect competition and monopoly the firm aims at to maximize its profits. The firm which aims at to maximize its profits is known as rational firm.

9. Comparison of Price:

Monopoly price is higher than perfect competition price. In long period, under perfect competition, price is equal to average cost. In monopoly, price is higher as is shown in Fig. 11. The perfect competition price is OP_1, whereas monopoly price is OP. In equilibrium, monopoly sells ON output at OP price but a perfectly competitive firm sells higher output ON_1 at lower price OP_1.

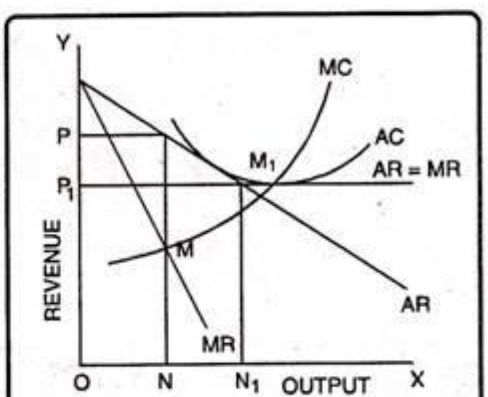


Fig. 11.

10. Comparison of Output:

Perfect competition output is higher than monopoly price. Under perfect competition the firm is in equilibrium at point M_1 (As shown in Fig. 11 (a)), AR = MR = AC = MC are equal. The equilibrium output is ON_1. On the other hand monopoly firm is in equilibrium at point M where MC=MR. The equilibrium output is ON. The monopoly output is lower than perfectly competitive firm output.

The Advantages And Disadvantages Of A Monopoly Economics Essay

Introduction

Markets are the heart and soul of a capitalist or free market economy which is based on the notion of competition. Varying degrees of competition ultimately lead to different market structures with different outcomes to the market. The main market structures are perfect competition, monopolistic competition, oligopoly and monopoly, each with a different outcome to the market which leads economists to consider some market structures to be more desirable for the society such as perfect competition while others are less desirable such as Monopoly.

Definition of a monopoly market

However, if monopolies are always assumed bad then questions of why firms seek to be monopolies and why governments accept or tolerate monopolistic firms will rise.

In theory monopoly is a market with only one seller that dominates and sets price and quantity of the good. The market's demand curve is the firm's demand curve and it is assumed that there are no substitutes and thus a firm is a price-maker that is motivated by profit maximisation and is supported by restrictive barriers to entry of the market that subsequently prevents competition.

In reality it is hard to find a market in which some form of substitute firm or product does not exist. Therefore, the Competition Commission in the UK defines a market as a monopoly if there is a firm possessing over a 25% market share and facing no significant competition.

In order to evaluate monopoly and to determine whether it should be allowed or not, it is vital to understand the characteristics of monopoly and to apply various efficiency concepts such as productive efficiency, allocative efficiency and X-efficiency to both extremes of the market structure, perfect competition and monopoly, to understand their effect on both consumer and producer surplus in the form of households and firms which consequently affect the general economic welfare.

Characteristics of Monopoly

There are various characteristics of monopoly but it is mainly distinguished from other market structures by its barriers to entry. These barriers are a variety of obstacles or boundaries that prevent other firms from breaking into the monopolistic firm's market, thus allowing the monopolistic firm to maintain its monopoly and therefore continue to earn supernormal profits.

Entry barriers

It is often argued that monopoly restricts competition through entry barriers and therefore should be forbidden. This is supported by a strong case against monopoly as it restricts consumer choice and prevents small innovative businesses from being established. In addition, a monopoly will produce at a lower output and charge higher prices than a competitive market, with the same cost structure. This leads to a loss of economic welfare and efficiency.

Sloman (2010) suggests that barriers to the entry of new firms are a must for an existing firm to maintain its monopoly position. There are a number of entry barriers that would exist in a market in different forms such as economies of scale, economies of scope, legal patents, licences, product differentiation and high start-up costs.

Economies of scale are considered as one major barrier, this occurs when a reduction in unit costs depends on the output size. In such case, a large firm is most efficient and new firms cannot afford to enter the market and gain market shares. The industry may not be able to accommodate more than one producer which is known as natural monopoly. This is the case with public utilities such as water, gas, electricity where these firms have economies of scale to prevent new firms from entering the market.

Economies of scope is another barrier as firms who produce a range of products are likely to achieve lower average costs of production and undercut prices to drive new firms out of the market. Proctor & Gamble enjoys economies of scope as it produces hundreds of products but could afford to hire expensive skilled workers and experts who can use their skills across the product line and therefore spread the costs and lower the average total cost for each product. (Alesina and Spolaore, 2005)

Patents and licences are also considered main entry barriers. The US Patent and Trademark office issues patents for 20 years period, in accordance with the 1995 GATT agreement. (USPTO, 1995)
These patents give an inventor the exclusive right to produce a product for a 20 years period such as the case of the pharmaceutical giant, Pfizer, which has a patent on Viagra until 2014. (Stevens, 2007)
Likewise, licences are granted by governments which allow one or a few firms to operate in a specific market under government regulations and control.

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Product differentiation and brand loyalty where a firm produces a differentiated product and the consumer associates that product with the brand.

An example of product differentiation would be the car industry, where different firms would produce substitutes but they are not considered as perfect substitutes as required in perfect competition, so each firm would have some form of monopoly power in its product category. This is clearly evident in the luxury sport cars market such as Ferrari, Porsche and Lotus.

Other forms of entry barriers may include high start-up costs for new firms in comparison with an established monopoly firm which is likely to have gained enough experience and efficiency techniques to be able to reduce costs and hence prices for any potential new firms to be able to compete.

Based on the characteristics of monopoly, it is important to evaluate its economic efficiency and therefore its effect on consumer surplus and social welfare in general. In the next section, we compare the economic efficiency of both extremes of the market structure.

Economic efficiency

In economic terms, monopoly and perfect competition should be judged on the extent to which they contribute to improving the human wellbeing and social welfare, therefore, it is important to assess whether the market structure is efficient or inefficient.
Nellis and Parker (2006) point out that the success or failure of firms is directly affected by the extent to which they are managed efficiently. The lower the cost per unit of output, without reducing the quality of the product, the higher the economic efficiency of a firm.
This is evident in a competitive market where firms strive to be economically efficient in order to survive. However, this is not the case in a monopoly which is generally considered as an inefficient market structure. This can be clarified by the following analysis of various economic terms of efficiency.

Allocative efficiency
Assuming an initial distribution of income and wealth, allocative efficiency occurs at the point when it is impossible to improve overall economic welfare by reallocating resources between markets.
For the whole economy to be allocatively efficient, price must equal marginal cost in every market. However, it is unlikely that a monopoly seeking profit maximisation would be allocatively efficient. A monopoly tends to restrict output below the market equilibrium to force up the prices.

PRC MC AC

Welfare loss

MR AR=Industry demand=MU

Q2 Q1 Output

Figure 1 – Allocative inefficiency and welfare loss

Figure 1 demonstrates how a monopoly is allocatively inefficient. While a perfectly competitive market would have an output Q1 where the price P is equal to both MC and MU based on demand curve so all units produced add more to welfare (MU) than the resources they cost to make (MC). A monopolist is in equilibrium with an output Q2 where MC=MR, which means some units that would have been benefited society are no longer produced and thus an overall welfare loss.

Productive efficiency

This can only be achieved if a firm uses the available techniques and factors of production at the lowest possible cost per unit of output. Lipsey (1992) states that in the context of an industry, the interpretation of productive efficiency is that firms are operating so that costs are minimized.

In monopoly, in contrast to perfect competition, there are no competitive forces that would make a firm hold costs down to a minimum.

PRC

MC AC

C2

C1

MR AR

Q2 Q1 Output

Figure 2 – Productive efficiency

Figure 2 illustrates the productively efficient output Q1 which is the minimum point of the AC curve where unit cost is C1, where the least amount of scarce resources possible are being used per unit of output. However, a monopolist will produce the profit maximising output Q2 with higher costs C2 per unit which can be passed to the consumer, hence demonstrating productive inefficiency.

X-efficiency

The concept of x-efficiency requires that the lowest possible prices are paid for inputs or factors of production. However, there is less incentive for a monopoly to make full use of the available technology, mainly due to lack of competition.

Monopolies are more likely to be technically and productively inefficient, incurring unnecessary production costs and wasted resources.

A firm could be employing too many workers or investing in machines that are never used, deeming it technically inefficient. It could be paying its workers unnecessary high wages or buying capital or raw material at unnecessary high prices.

This means that the monopolist's LRAC is above that which would be technically possible, therefore resources are wasted.

Costs

LRAC monopoly

LRAC possible

= X-inefficiency

Output

Figure 3 – X-efficiency gap

The x-inefficiency gap, as shown in figure 3, is considered as unnecessary production costs that a firm can reduce.

In a perfectly competitive market, a firm must eliminate any form of x-inefficiency in order to survive and make normal profits.

However, this is not the case with monopoly, which are able to survive while incurring unnecessary production costs and making satisfactory rather than maximum profits.

The evaluation of economic efficiency of a monopoly compared to perfect competition has highlighted a number of disadvantages to support economists' case against monopolistic firms.

4.0 Disadvantages of Monopoly

In general, a monopolistic market structure would produce less output and charge higher prices which leads to a decline in consumer surplus and a deadweight welfare loss. The higher prices would lead to allocative inefficiency and supernormal profits, leading to reduced benefits to consumers and unequal distribution of income. This also raises a question about equity. The higher prices would exploit low income consumers and their purchasing power might be transferred to shareholders in the form of dividends leading again to unequal distribution of income. A monopoly tends to be less motivated towards economic efficiency such as cutting costs or increasing productivity. There is also a possibility that a monopoly would experience diseconomies of scale as the higher it gets bigger, their average costs increase. Further more, the lack of competition could discourage a monopoly from investing in research and development, leading to lack of innovation and worse products. However, with all the evidence against monopoly, there are still the questions of why do monopolies still exist, why firms seek to be monopolies and why do governments seem to tolerate them?

Advantages of monopoly

On economic terms, perfect competition is generally regarded as more desirable than monopoly. However, monopolies are not necessarily bad, considering they are as highly motivated and public-spirited as competitive industries.

Economic theory assumes that everyone is motivated by self-interest; this applies to competitive markets as well as to monopolies.

Firms in competitive markets would aspire to be a monopoly by eliminating competition but this is unlikely achieved due to market forces and the absence of barriers to entry and exit.

The fact that monopolies make supernormal profits allows them to invest in research and development and allows them to fund high cost investment spending into new technology. This is likely to result, if successful, in improved products and lower costs on the long run.

An innovative monopoly could therefore be considered dynamically efficient over a long term as it reaps the reward of investment in research and development. Microsoft did not start as a monopoly but the introduction of Windows version 3.0 in 1990 followed by various Microsoft Office applications provided the market power to become a monopoly. Its position as a monopoly was further cemented by the continuous investment in research and development.

It is generally argued that monopoly in high technology sectors is good as it provides firms with a greater incentive to invest in research and development. Patents for new ideas are normally acceptable as it encourages firms to fund the initial research and development and it allows these firms to recoup their investment.

Another advantage of monopoly is economies of scale. An increased output would lead to a decrease in average costs of production, which can be passed to consumers in the form of lower prices. Likewise, cutting prices would be an advantage for a monopoly as it would increase sales and maximise economies of scale.

PRC

S (Perf comp) =€ �“��C

Ppc

Pm

LRMC (monopoly)

D industry

Qpc Qm

MR (monopoly)

Figure 4 – Market equilibrium under monopoly

Figure 4 shows the market equilibrium in perfect competition at output Qpc and supply = demand. A monopoly would generate economies of scale on the long run and drive down marginal costs to LRMC. A monopoly would therefore be able produce a profit maximising output Qm at a price Pm which is lower than perfect competition. Profits and consumer surplus are higher under monopoly and both consumer and producer would benefit.

Kerr and Gaisford (2008) highlight the impact of international trade on domestic trade and the need for a domestic monopoly capable of generating the economies of scale required to compete in the international market. BT is a good example of domestic monopoly in the 1980s that had to invest in systems and technology to be able to compete in the international market. Also, the threat of international imports would force a domestic monopoly to set marginal revenue equal to marginal cost and reducing its prices, which is a boost to consumer surplus and social welfare.

6. 0 Conclusion

Despite the fact that monopoly produces less output at higher prices and the negative implications on consumer surplus and social welfare, nevertheless, the existence of monopolies are inevitable as long as firms seek profit maximisation as well as increased market share and ultimately market dominance.

In a free market economy, the chances of supernormal profits will eventually encourage other firms to attempt to break into a monopolistic market. The threat of competition or even a financial threat of a takeover will force a monopoly to become highly economic efficient. The American economist William Baumol argues in his theory of contestable markets that a monopoly may be forced over time to make the same production and pricing decisions as a competitive market would, merely due to the possibility of future competition. (Griffiths and Ison, 2001)

From the above analysis, it is easy to conclude that perfect competition is productively more efficient than monopoly. However, if we take into account the substantial economies of scale that a monopoly would have, then it is more likely that a monopoly is more productively efficient than competition. In some cases, such as a natural monopoly, it is more acceptable to have just one firm as a monopoly provided that its price and productivity are regulated.

Von Mises (1966) concludes that the mere existence of monopoly does not mean anything. The publisher of a copyright book is a monopolist, but he may not be able to sell a single copy, no matter how low the price he asks. Not every price at which a monopolist sells a monopolized commodity is a monopoly price. Monopoly prices are only prices at which it is more advantageous for the monopolist to restrict the total amount to be sold than to expand sales to the limit which a competitive market would allow.

Monopolies are not illegal but their abuse of market power to limit competition is illegal

Although monopoly is not desirable as it restricts competition and causes a reduction in consumer surplus and social welfare, it is however inevitable in a real business market that a firm would often take advantage of its strong market position to control the supply of goods or services.

Monopolies are not illegal but their abuse of market power to limit competition is illegal and therefore actions by governments to regulate the market would be required.

Finally, all firms are concerned with determining the price level that would give them sufficient profit while maintaining the consumer's attraction and demand. This should work in the benefit of consumers and the society if regulations are in place for governments to intervene when a firm abuses its monopoly power to the detriment of consumers.

[Source : Essays, UK. (November 2013). The Advantages And Disadvantages Of A Monopoly Economics Essay. Retrieved from https://www.ukessays.com/essays/economics/the-advantages-and-disadvantages-of-monopoly.php?vref=1]