Economics 1: Fall 2010

J. Bradford DeLong, Michael Urbancic, and a cast of thousands...

http://delong.typepad.com/econ_1_fall_2010/

Ladies and Gentlemen, to Your iClickers...

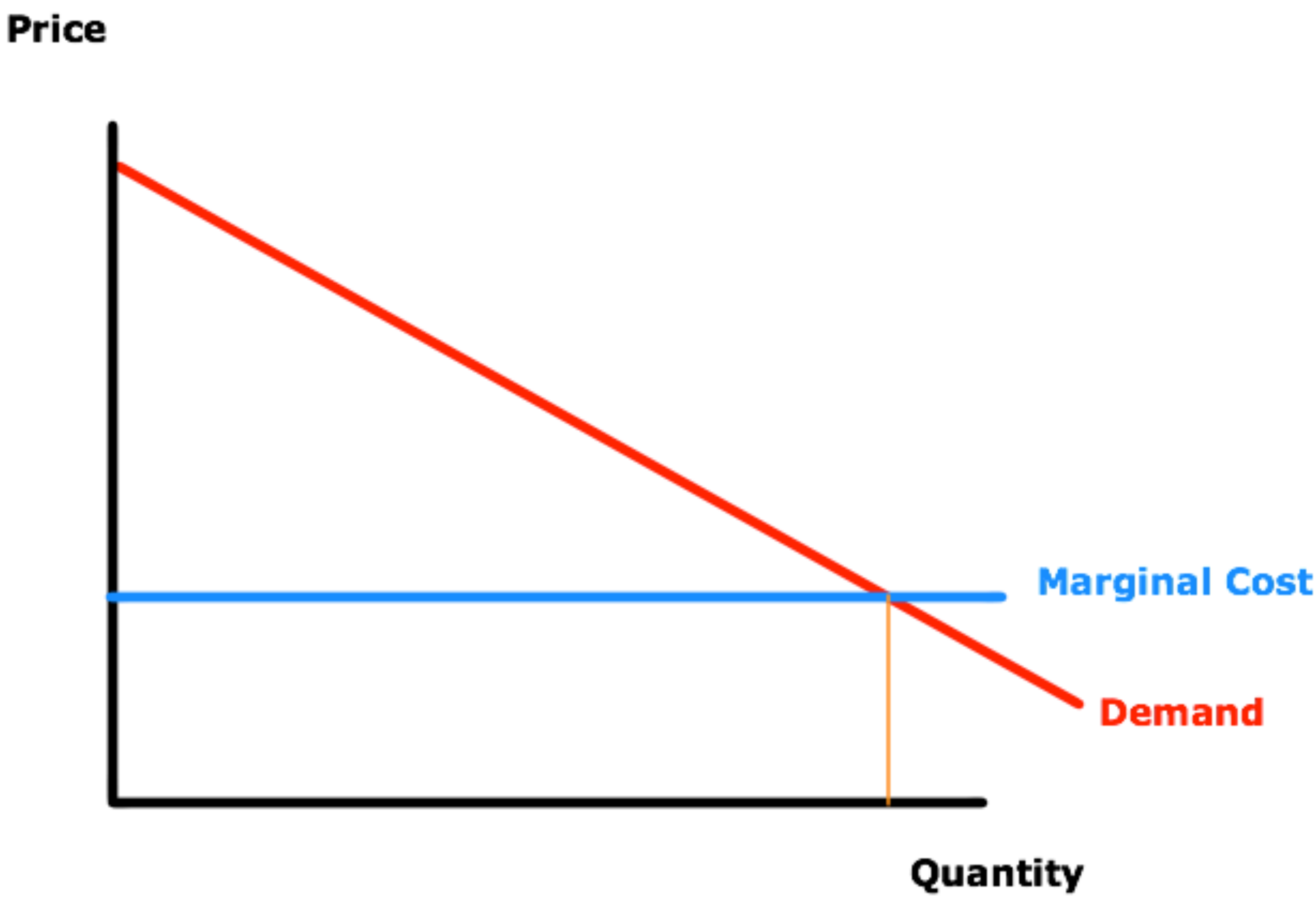
- My reaction to the fact that problem set 6 is the shortest problem set yet:
  - A. Joy
  - B. Meh
  - C. Dismay—I won’t have the opportunity to learn as much

Economics 1: Fall 2010: Monopoly

J. Bradford DeLong

November 1, 2010, 12-1
Wheeler Auditorium, U.C. Berkeley

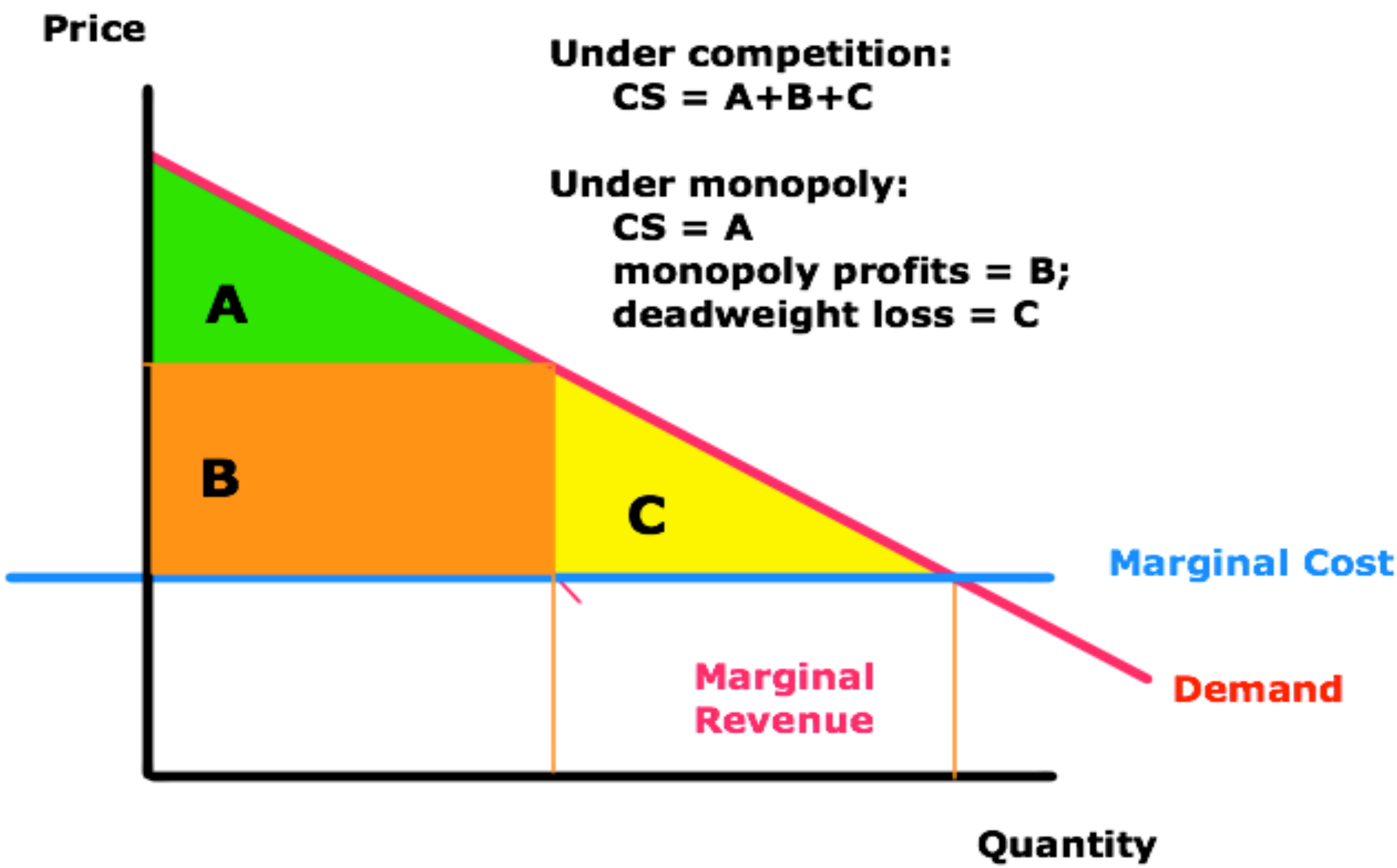
Competitive Market



Let's Do the Math...

- Marginal Revenue = R' – R = $(P - Q/\beta) - 1/\beta$
- Monopolist will set marginal revenue equal to marginal cost
  - $(P - Q/\beta) = C$
- Competitive market sets marginal revenue *for the swing producer* equal to marginal cost
  - P = MC
- Since $P = (Q_0 - Q)/\beta$:
  - Competition: $C = (Q_0 - Q)/\beta \longrightarrow Q = Q_0 - \beta(C)$
  - Monopoly: $C = (Q_0 - 2Q)/\beta \longrightarrow Q = \frac{1}{2} \times (Q_0 - \beta(C))$
  - With linear demand and flat marginal cost, a monopolist produces at half the scale of a competitive industry
    - And produces ¼ of the consumer surplus and ¾ of the total surplus of the competitive industry

If You Are Into Analytic Geometry: Consumer Surplus Down by 3/4



How Important Is Controlling Monopoly?

- Used to be a big deal
- Milton Friedman's teacher Henry Simons:
  - The most important arm of government is the Bureau of Antitrust of the Federal Trade Commission
- The Stigler-Bork countermove:
  - There are substitutes, which will curb the power of monopoly
  - There will be entry, which will erode and eventually vanquish monopoly
  - The Bureau of Antitrust is ineffective
    - At least as likely to take its mission as the protection of inefficient producers from competition as the protection of consumers from monopolists
    - At least as likely to put constraints on efficient bigness as to remove harmful monopolies
    - Likely to be captured by the industry
  - Maybe monopolies are "efficient" after all
- Why are these arguments more convincing to economists today than they were back in 1910?

Ladies and Gentlemen, to Your iClickers...

- Have you seen “The Social Network”?
  - A. Yes, more than once.
  - B. Yes, once.
  - C. No, but I am planning to
  - D. No, but if it’s on the boob tube when I am mindlessly staring at it, I won’t turn it off
  - E. No

Where Do Monopolies Come From?

- Are Monopolists mean, nasty people?
- Sheryl Sandberg on Mark Zuckerberg of Facebook:
  - He is shy and introverted and he often does not seem very warm to people who don't know him, but he is warm. He really cares about the people who work here...
- Facebook does not have a near-monopoly on its market segment because Mark Zuckerberg is meaner than average...

Where Do Monopolies Come From II?

- Monopolists are not Albert Schweitzer figures
  - But they are not meaner than usual, at least for executives
- Monopolies come from mergers
  - U.S. Steel
  - International Harvester
  - Federated Department Stores
- Monopolist-like behavior comes from coordination
  - Who wants to start a price war? "Ruinous competition"
- Monopolies come from intellectual property
  - The old Ford, the old IBM
- Monopolies come from economies of scale
  - The old AT&T
  - Economies of scale on both the producer and the consumer side
    - Not just AT&T, but Facebook, Google, Microsoft

The Dilemma

- You want people to be properly rewarded for their investments in intellectual property, large-scale operations, et cetera
- You also want price to equal marginal cost at the level of the margin of production
- When there are increasing returns to scale, it is not possible to do both of these things at once
  - That is what we saw on problem set 5
    - Monopolist: $P \neq MC$
    - Non-profit: investments are not rewarded
    - Public provision: costs are not covered
  - Abandoning the market also creates incentive problems
    - Monopolists really like making money; what do non-profits and public bureaucracies like?

Ladies and Gentlemen, to Your iClickers

- How important do you think controlling monopoly is?
  - A. I’m with modern Chicago: government is too thumb-fingered and too many monopolies are the result of efficiency-enhancing investments for antitrust policy to be worth pursuing.
  - B. I’m with pre-WWII Chicago: the Bureau of Antitrust of the FTC should be the largest and most powerful instrumentality of government
  - C. Monopolies that grow up “organically” should be let alone—but mergers between competitors should be subject to very strict scrutiny
  - D. Even monopolies that grow up “organically” should be broken up as soon as their phase of rapid growth is over

Economics 1: Fall 2010: Monopolistic Competition

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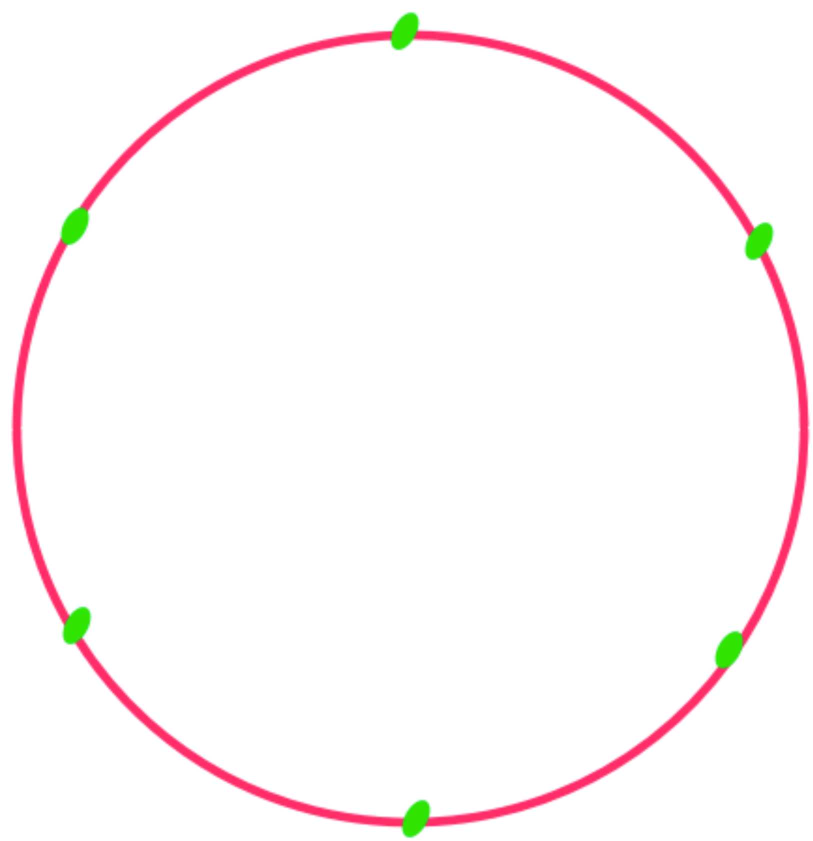
Monopolistic Competition

- Each firm makes its own unique good
- Each good made is a close—but not a perfect—substitute with other goods
- There is free entry—but with a fixed cost
  - You have to set up your production line
  - Constant marginal cost thereafter
- This actually describes most of economic life, doesn't it?
  - So why are our standard cases of market structure either competition or monopoly? Good question!

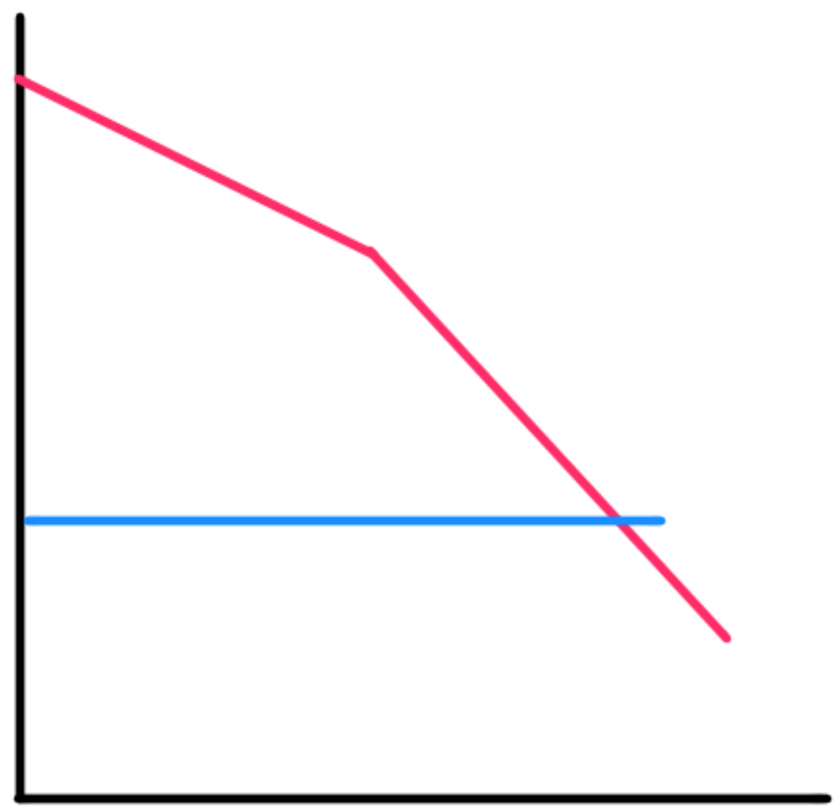
Standard Way of Thinking About Monopolistic Competition



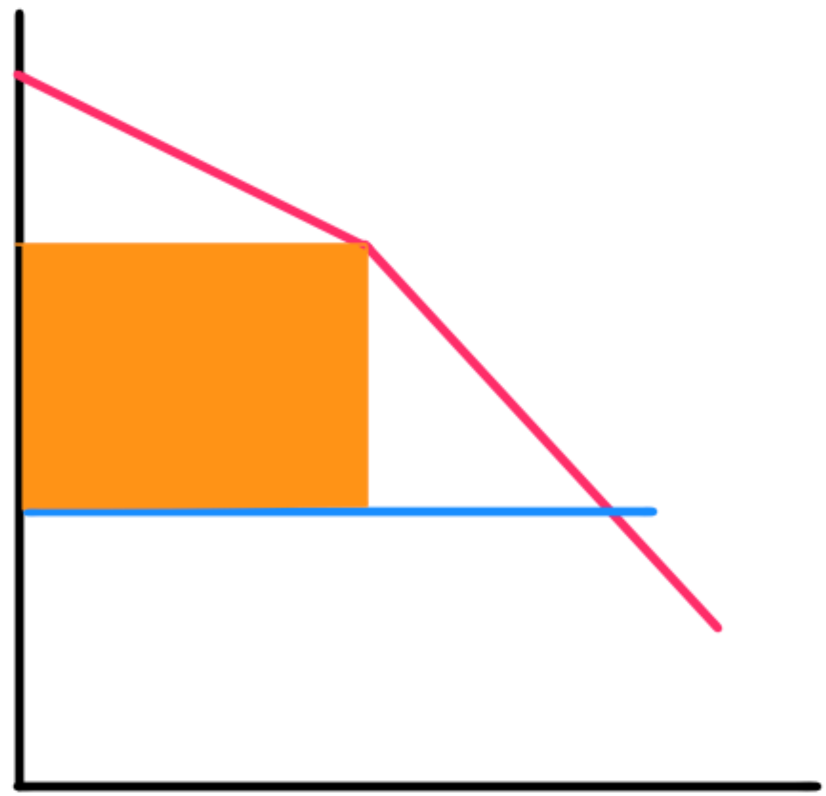
Two Types of Customers

- Your “home customers”—those who like your variety a lot more
- The “battleground customers”—those who might actually prefer some other variety to your variety
- This induces a kink in your demand curve
  - Tendency to try to squeeze as much as you can out of your home customers, and not try to gain extra battleground customers by cutting prices

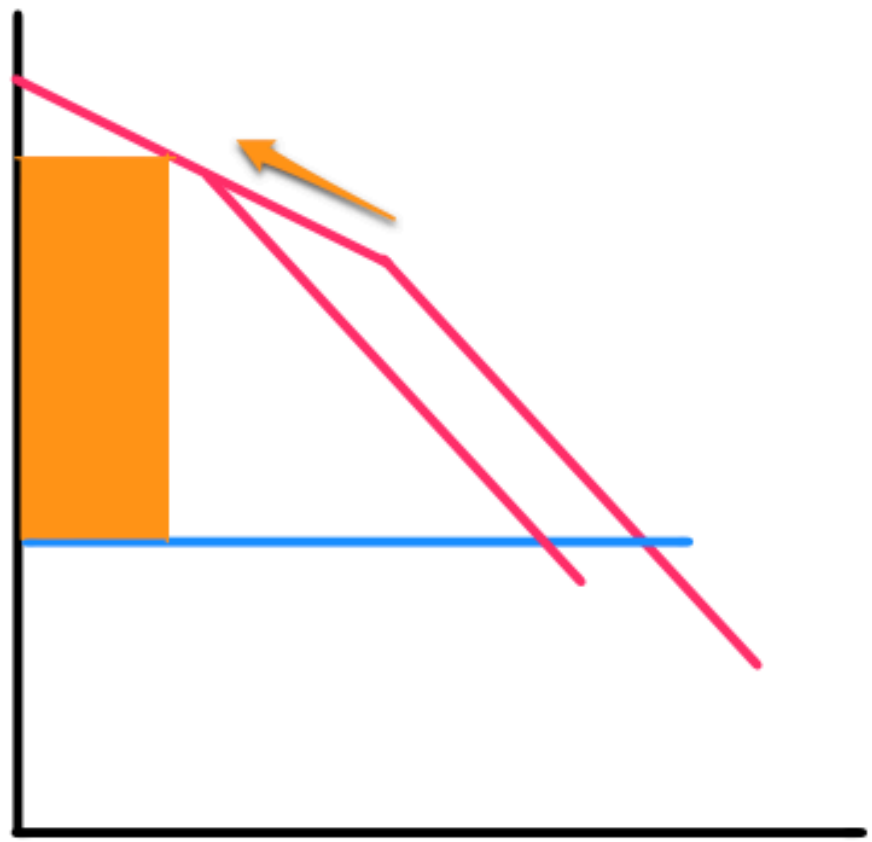
A Kink in the Demand Curve



Compare the Profits to the Fixed Costs



Entry Continues Until the Next Entrant Will Not Cover Their Fixed Costs...



What Can We Say About Long-Run Equilibrium?

- Demand:
  - $Q = Q_0 - \beta P$; $P = (Q_0 - Q)/\beta$
- Entry and symmetry:
  - $Q = M/n$
  - $P = (Q_0 - (M/n))/\beta$
- If no variable costs, entry will continue until:
  - $F > QP = Q_0 M/n - (M/n)^2)/\beta$
- If no variable costs, entry should continue until:
  - $F > (M/n)^2/2\beta$

Overprovision of Variety

- Incumbent producers are collecting a lot of producer surplus from their local market power
- Some of the gains from adding a variety stem from taking producer surplus away from other producers
- Only some of the gains come from providing a better variety to customers

And High Prices

- There are lots of producers
- But there is relatively little competition among them
- For they tend to focus on extracting revenue from their home customers
- Strategic interaction questions...

Test Your Knowledge

- Why do monopolists tend to produce too little?
- What are the New Chicago arguments against antitrust?
- What were the Old Chicago arguments for very aggressive antitrust?
- Why do their tend to be too many monopolistic competitors making too many varieties?
- What steps might governments take to improve the allocation of the number of varieties?