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

[Diagram showing price vs. quantity, with a downward sloping line representing demand and a horizontal line representing marginal cost.]
Let’s Do the Math...

• Marginal Revenue = \( R' - R = (P - \frac{Q}{\beta}) \cdot \frac{1}{\beta} \)
• Monopolist will set marginal revenue equal to marginal cost
  – \( (P - \frac{Q}{\beta}) = C \)
• Competitive market sets marginal revenue *for the swing producer* equal to marginal cost
  – \( P = MC \)
• Since \( P = (Q_0 - Q)/\beta \):
  – Competition: \( C = (Q_0 - Q)/\beta \) \( \rightarrow Q = Q_0 - \beta(C) \)
  – Monopoly: \( C = (Q_0 - 2Q)/\beta \) \( \rightarrow Q = \frac{1}{2} \times (Q_0 - \beta(C)) \)
  – With linear demand and flat marginal cost, a monopolist produces at half the scale of a competitive industry
    • And produces \( \frac{1}{4} \) of the consumer surplus and \( \frac{3}{4} \) 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 ≠ 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:**
  
  \[ Q = Q_0 - \beta P; \quad P = (Q_0 - Q)/\beta \]

- **Entry and symmetry:**
  
  \[ Q = M/n \]
  \[ P = (Q_0 - (M/n))/\beta \]

- **If no variable costs, entry will continue until:**
  
  \[ F > QP = Q_0M/n - (M/n)^2)/\beta \]

- **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?