Why monopolies are often regarded as being inefficient

A market structure tries to analyze the economic environment in which a particular company operates. A market consists of all producers and consumers who are able to supply or demand a good or service at any given price. Therefore by observing the market structure, we can extract information and judge whether there is competition, consumers are not overcharged and understand if resources are used effectively. One market structure which i will analyse more detailed below is monopoly which exists when there is one producer or seller of a product. Although producers can control either the price or the output, not both!

A firm can be described as a monopoly if it is the only supplier of a good for which there is no close substitute. Under the United Kingdom and the European law monopoly occurs when a firm controls more than 40% of the market which it operates. Therefore, monopoly can be described as the opposite extreme to perfect competition. Perfect competition is a supreme market situation where many sellers and buyers exist who are well informed about goods and services and they can all be active as price takers. Suppliers aim is to maximise their profit so the way producers use their resources is the best way and the most efficient. On the other hand consumers are not loyal to producers since their aim is to maximise their benefits. Although the most important characteristic of a perfect competition is the fact that there are no barriers of entry or exit which means that supernormal profits can be achieved in the short run whether in the long run only normal profits can be achieved.

Diagram of perfect competition handbook

The only market which is close to monopoly is oligopoly. Although there are still some important differences like the fact that in an oligopoly even though there are barriers of entry, limited entry to the market can be done. Also, producers try to avoid price-based competition by forming either secret agreements, cartels or use non-price based competition methods which eventually will kick out future producers out of business. In an oligopoly market there are just very few suppliers. An example of such an industry is the soft drink industry. Goods and services in an oligopoly have very close substitutes and supernormal profits can be earned in the short run and long run.

Diagram of oligopoly-kinked diagram uni handbook

Although, in order for monopolies to exist some important reasons should exist. That is why monopoly can be divided into four categories. The first type of monopoly which exists is the Natural monopoly which exists in cases of expected full control of natural resources. An example of such a firm is DeBeers which is the producer of diamonds in Africa. Since they have almost the control of all natural resources it is impossible for a new firm to enter the specific market and be able to compete them. The second type of monopoly is technological monopoly which exists when a firm has control in terms of technology. This happens when just one firm has the know-how, the technology and the money to invest on a specific good or service. Such an example is software by Microsoft. The third kind of monopoly is the Statutory monopoly which exists in cases of companies which are protected by the government. So, the government impose a law which does not allow any rivals to enter the market. An example of such a firm is the Cyprus Electricity

Authority. In this way government can control prices and resources. The last but not least type of monopoly is Cartels. This formal or informal agreement exists when two or more companies form groups and work together to face competition. So, an example of such an agreement is for the specific firms to charge the same price for their good.

The features that can best describe a monopoly are various but the most important one is the fact that there is no competition due to existence of only one large firm who has the power to control the whole market. Since there are so powerful they can act as price makers and provide consumers with imperfect knowledge. In this way a firm is able to charge different prices to different group of consumers. In addition the fact that the goods and services provided by a monopolistic firm are non homogeneous it automatically means that is extremely difficult for other firms to copy the exact good. So, since there is just one such a kind of good in the market is easy for the firm to enjoy supernormal profits. Although the characteristic that can best describes a monopoly is the fact that there are extreme high barriers of entry which makes the entry of a new firm in the market almost impossible!

As I mentioned above the high barriers of entry makes the market regarded to be as a non-contestable one. Such barriers of entry can be the transportation costs which will certainly need a lot of money to carry out this expense since for a large firm to transport it's goods, will be needed a lot of containers and tankers. Also, economies of scale can be a really high barrier of entry since a new firm will surely not be able to benefit in the same amount of economies of scale as a large well known already existing firm.

One more barrier of entry can be branding. If a very famous brand name exists in the market it is often very difficult for a new and unknown firm to compete against them. Another barrier which can make a new firm to reconsider of entering the market is the capital costs since capital needed for setting up a new business who aim to compete a monopolistic firm is very high. In addition to all these barriers of exit can be considered as another reason to think about it since sunk costs which will cost a lot of money are not recoverable by a firm if it fails. Examples of sunk costs can be advertising and wages.

Diagram of loss case monopoly handbook

Some very serious disadvantages arise in the monopoly market which is mainly due to low or no competition. Since barriers of entry and exit are extremely high, this prevents new companies enter the market or may force smaller firms out of business. In addition, consumers face a poor level and low quality of services since there is no competition. Since demand remains constant there is no need for the firm to improve the quality of their goods and services offer to the consumers. The large firm enjoys producer sovereignty since they have the absolute control over the use of scarce resources. Also, the firm can use the imperfect knowledge to charge different prices to different groups of consumers as well as lower output by reducing supply and higher prices at any given time. Since they do not have the pressure of other competitive firms, basically they can act as they want regarding people’s need.

On the other hand, some advantages mostly enjoyed by the firm who controls the market power like economies of scale. The fact that they are so powerful give them the ability to compete in global markets thus acting as a multinational. The larger the firm means that they can lower their average costs by different methods carried out and achieve economies of scale. For example a multinational can lower its average costs by decreasing transportation costs. Since there are more products needed to be transferred at different places cost is divided equally to all of them therefore average cost is lower. Furthermore, a firm acting as a monopoly can enjoy supernormal profits in the short run as well as in the long run. For that reason they have the incentive to invest more money for research and development in order to earn even higher profits and keep these by using barriers to entry.

Diagram of profit case monopoly handbook

On evaluation, a monopoly can often various advantages but they can be only enjoyed by the large firm who owes the biggest market power. On the other hand, it is often regarded as being inefficient since there is no competition or any incentives for a new firm to enter the market. In this way the large firm can provide consumers with imperfect knowledge and act as it likes since there is nothing to stop her for doing that. Due to no competition there is no good use of scarce resources and supply can be changed for the producer’s preference. In contrast with the perfect competition market where resources are allocated efficiently since a lot of firms compete against each other with the objective to increase their profits. Therefore, in my opinion a monopoly is not a market which works for the consumers benefit since consumers have no power or knowledge to change something for their favour.