

# Types, causes, and advantages and disadvantages of monopolies



Monopoly is the situation in which there is a single seller of a product (i. e., a good or service) for which there are no close substitutes. The word is derived from the Greek words monos (meaning one) and polein (meaning to sell).

Governmental policy with regard to monopolies can have major effects not only on specific businesses and industries but also on the economy and society as a whole.

## Types

**Oligopoly:** Is a situation in which sales of a product are dominated by a small number of a relatively large seller who is able to collectively exert control over its supply and prices.

**Cartel:** Is a type of oligopoly in which a centralized institution exists for the purpose of coordinating the action of several independent suppliers of a product. The best example today is the Organization of Petroleum Exporting Countries (OPEC)

**Trust:** Popular way to form monopolies in USA. This was an arrangement by which stockholders in several companies transferred their shares to a single set of trustees. In exchange, the stockholders received a certificate entitling them to a specified share of the consolidated earnings of the jointly managed companies. The trust came to dominate a number of major industries (tobacco, sugar, etc.)

**Monopsony:** Is the opposite of a conventional monopoly in the sense that there is only a single buyer or only one dominant buyer for a product for which there are multiple sellers. Some companies are both monopolies and

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monopsonies. By being also a monopsonist, a monopoly can increase its profits even further by putting pressure on the companies that supply inputs for its products to reduce their prices.

### Extreme cases

Pure monopoly: One company has complete control over the supply or sales of a product for which there are no good substitutes.

Perfect competition: There are many sellers of identical or virtually identical products.

### Causes of monopoly

By developing or acquiring control over a unique product that is difficult or costly for others companies to copy.

By having a lower production cost than competitors.

By using various legal and illegal tactics (predatory tactics)

By controlling a platform and using vendor lock-in.

By receiving a government grant of monopoly status, becoming a government-granted monopoly.

### Advantages

Despite their reputation for evil, monopolies can actually generate a net benefit for society under certain circumstances. These are usually situations in which the power and duration of the monopoly are carefully limited.

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Natural monopolies can be particularly beneficial. This is because of their ability to attain lower costs of production, often far lower, than would be possible with competitive firms producing the same product in the same region. However, it is almost always necessary for such monopolies to be regulated by a relatively uncorrupted government in order for society to obtain the potential benefits. This is because such monopolies by themselves, as is the case with all monopolies, have little incentive to charge prices close to cost and, rather, tend to charge profit-maximizing prices and restrict output. Likewise, there is often little incentive to pay much attention to quality.

It has long been recognized that government-granted monopolies can benefit society as a whole by providing financial incentives to inventors, artists, composers, writers, entrepreneurs and others to innovate and produce creative works. In fact, the importance of establishing monopolies of limited duration for this purpose is even mentioned in the U. S. Constitution.

### Disadvantages

Large monopolies have considerable potential to damage both economies and democratic governments and monopolists often go to extreme lengths to disguise or hide such harmful effects.

### Example

The table below illustrates the case of monopoly. Marginal cost is the value of the additional resources needed to produce another unit of output. The marginal benefit to consumers is the price that consumers are willing to pay

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for each unit. You should recognize this column as a demand curve. The maximization principle tells us that the economically efficient amount to produce is five, the amount that gives consumers the greatest value. To produce the first unit, the firm takes resources that have a value of \$5.00 and turns them into something with a value of \$7.01. Because this transformation has increased value, producing the first unit is more economically efficient than producing none. By this logic, producing the sixth unit would decrease economic efficiency because the firm would take resources with a value of \$5.00 and transform them into something with a value of only \$4.51.

The monopolist, however, will find it most profitable to produce only three units because it does not see marginal benefit the same way that buyers see it. For the seller, the extra benefit of the second unit is only \$6.01. It sells the second unit for \$6.51, but to sell the second unit, it had to reduce the price it charged by \$.50. Thus, it "lost" \$.50 on the first unit, so the net increase in its revenue was only \$6.01. (You can get the same answer by computing a total revenue column and then calculating revenue increases.) In a similar manner, the rest of the fourth column can be obtained.

Using the maximization principle, one can see that producing beyond the third unit is not in the interests of the firm. The fourth unit brings in added benefits of only \$4.01 to the firm (it sells for \$5.51, but to sell it, the firm lowers price by \$.50 on three other units), but costs an added \$5.00. From the point of view of the buyers, however, the fourth unit should be produced. It brings them added benefits of \$5.51 and uses resources worth only \$5.00.

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