Is competition always necessarily beneficial to consumers

Introduction

In analysing whether ‘ competition is always necessarily beneficial to consumers’, it is vital to address operation of two extreme sides of the market organisation. The extreme sides of market organisation are Perfect competition and Monopoly. Once we accustom ourselves with the working of this dichotomy of market organisation, only then we can compare monopoly and perfect competition on the basis of efficiency in the market and specifically its impact on the consumers. Thus, in this essay we would first go through a brief description of perfect competition and monopoly and how the resources are organised in these two different market structures to achieve the goal of profit maximisation. By the allocation of resources and the level of output to be produced in these two different markets, we would compare their efficiency and inefficiency and the possible benefits and limitations of these market structures in different industries to the consumers.

Perfect Competition

Perfect competitive markets are those where there are large number of small buyers and sellers dealing with a homogeneous product and a single small firm do not have influence on the price allocation and acts as a price taker (Mankiw & Taylor, 2006). In addition to this, in a perfectly competitive market both the producers and the consumers have perfect information regarding the product (Frank, 2003). A competitive firm being the price taker, to achieve the goal of profit maximisation, it produces a certain level of output where the price is equal to the marginal cost of producing an extra unit of product, a ‘ Pareto efficient’ output level (Varian, 2006). As the price is also the marginal revenue for a competitive firm, so the profit is

maximised at the condition where marginal revenue is equal to the marginal cost (Frank, 2003). This means that for a company to remain in business, it has to cover its cost, which is to say the price must be at least greater than the ‘ minimum value of the average variable cost’ (ibid.)

Monopoly

At the extreme opposite end of the market organisation is monopoly. Monopoly is a market structure, where a single firm serves the entire market and is the only seller of a particular product with no close substitutes (Frank, 2003). Moreover, being the only firm in the market, it does not take any price but instead it has influence over the market price and produces a level of output at a particular price where the firms’ profits are the highest (Varian, 2006). Monopoly is created when a firm either takes control of key resources or the government issues a license and give them exclusive right for the production of goods and services (Mankiw & Taylor, 2006). An economy of scale is another source of monopoly for a firm, where a single firm has more efficient cost of production as compared to a large number of firms and creates a natural monopoly that arises with public utilities like gas, electricity etc ((Varian, 2006)). Furthermore, a monopolist will set his price higher than his marginal cost at a point where his marginal revenue is equal to marginal cost, in order to make positive economic profit (Frank, 2003). However the demand curve is negative for a monopolist and being a ‘ price setter’, it cannot just randomly set a high price. It would rather set a price that the market could bear and maximises its profit (Mankiw & Taylor, 2006).

Comparing Perfect Competition and Monopoly

A common appealing characteristic of the competitive market is that ‘ Allocative efficiency’ is achieved in this market when price is equal to marginal cost in both the short and long run of market equilibrium (Frank, 2003). As mentioned earlier, in competitive markets ‘ Pareto Efficient’ output level is achieved where the consumer’s willingness to pay for an additional unit of the good is equal to the producers willingness to get paid for an additional unit of the good (Varian, 2006). Hence, the total economics surplus is achieved, which is equal to the total consumer surplus and total producer surplus (Frank, 2003), as shown in Figure1 below. Moreover in perfective competition, ‘ Productive efficiency’ is achieved where the product is produced at the minimum average cost, and the firm charging price equal to marginal cost enables the consumers to enjoy the lower prices in the competitive firms (Riley, Perfect Competitiom, 2006). So, the firms earning normal profit in the competitive firms means lower price for the consumers and leads to more equality in society. According to Riley (2006), in perfect competition the resources of the economy are used in a more efficient way, and hence enhance the performance of the firms’ productivity rewarding consumers with low prices, better quality and wider choice. Baily (1993) illustrate the benefits of competition in his paper by comparing the banking in Germany and United Kingdom. He implies that EC commission argued in 1988 that the higher prices of the banking services to the customers in the EC countries were result of restrictions on competitions and these prices could have dropped by 33 percent in Germany and 18 percent in UK within a single European competitive market. In his paper he contrasts the airline industry in U. S and Europe, and argues that network externalities were

developed by deregulated U. S airlines, whereas the European Airlines ability to make best use of route networks was strongly limited by bilateral agreements (Baily, 1993).

Figure (Riley, Monopoly & Economic Efficiency, 2006)

pic1. bmp

In contrast to the perfect competition, the common debate against monopoly from the consumers' point of view is that monopolist charges a price higher than marginal cost and the benefit the producer receives is greater than the consumers' welfare, hence resulting in reduction of the consumer surplus (deadweight loss) and output produced is less than the socially optimum level causing allocative inefficiency (Mankiw & Taylor, 2006). The shaded area in the right panel of the above figure shows the ' deadweight loss' due to monopoly. The higher prices by monopolist deprive some potential consumers from buying the product and restrain from taking place some common beneficial trades (ibid.).

However, in contrast to the above discussion the monopoly sometimes is not as inefficient as commonly thought and perfect competition might not be as efficient as thought (Olsen, 2010). An example of efficient monopoly is of housing insurance in Switzerland (Sternberg, 1996). Sternberg (1996) illustrates that competitions are significantly inefficient than state monopolies. He claims that the private insurance companies are substantially costly as compared to the state monopolies, as the former spend a huge amount on ' sales and administrative costs' and also the state run monopolies do not hire agents to seek customers, causing state

monopolies insurance premiums be 70% cheaper (ibid.). Likewise in their article Epple & Schafer (1996) argue that state run monopolies clearly performed better than privately owned firms by analysing the housing insurance in Germany. The competition led to increase in prices by imposing additional costs and risk of ' adverse selection'. Whereas in case of state monopoly, the compulsory insurance and ' law of large numbers' enable the state to balance risks to a great extent and allow the state to charge reasonable premiums and since 1992 by the introduction of competition the premium rates rose by ' 84% to 117%' (Epple & Schafer, 1996). A similar example of fire insurance in Germany illustrates the fact that the state monopolies had 22% lower markup compared to competitive firms due to lower selling cost of the state monopolies and general expenses (Felder, 1996).

Furthermore, the monopolist is in a better position to apply economies of scale leading to higher output with lower costs and price (Riley, Monopoly & Economic Efficiency, 2006). The economies of scale result in ' natural monopoly', where a single firm can produce at a much lower cost than the large number of firms with downward sloping long run average cost curve (Olsen, 2010). These lower costs in the form of lower prices are passed to the consumers by most of the state monopolies in the form of major public utilities like gas, electricity and water (Riley, Monopoly & Economic Efficiency, 2006).

Moreover, the super-normal profits by monopolies are often invested in Research and Development leading to innovation and technological

development at a faster rate, reducing costs and increasing quality of the product for the consumers (Riley, Potential benefits from Monopoly, 2006).

Conclusion

We can conclude from our above discussion that the classical thinking of competition being always more efficient and favourable to consumers is not valid. Rather we should identify that in some industries the monopoly outperformed perfect competition and is best suited for that industry. Natural monopoly is a convincing example, in particular to the state monopolies, where the State always works for the benefit and betterment of its people, the ultimate consumers. So, the monopoly regulated and controlled by the government can perform better than certain competitions and the lost efficiency due to the higher price can also be regained until some point by ‘ price discrimination’. Hence it is evident that the competition is not always necessarily beneficial to consumers.

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