David Youngberg

Econ 301—Bethany College

**Lecture 23: Sources of Monopoly and Rent Seeking**

1. Where do monopolies come from?
   1. *Legal* (laws prevent entry)
      1. There’s a large variety of barriers government has erected to prevent various new comers to the market.
   2. *Natural* (economies of scale makes entry unprofitable)
      1. A firm that can produce the entire output of the market at a cost lower than what it would be if there were several firms.
   3. *Input control* (only one company controls a vital input)
      1. The firm has some sort of control over an input that’s crucial to production.
2. Natural Monopoly
   1. Under most circumstances, we get a natural monopoly when a firm is providing the whole demand curve under economies of scale. Thus ATC must be decreasing for the entire range of the demand curve.[[1]](#footnote-1)
   2. A formal way to check for this is to take the derivative of ATC and find the range of Q when the ATC derivative is negative.
   3. Then set demand equal to zero and isolate Q. If the derivative of ATC is negative for all values below and including that Q, we have a natural monopoly.
      1. Example: Let TC = 16 + Q; D = 4 – Q
      2. ATC’ = (Q – 16 – Q)/Q2
      3. -16/Q2 < 0, or Q is always decreasing
      4. Based on that it’s clear that this is a natural monopoly but let’s just be sure:
      5. 0 = 4 – Q, or Q = 4
      6. Thus this is a natural monopoly.
   4. You’ll usually see natural monopolies when MC is constant, say from the TC function TC = 10 + Q. Of course, firms with zero marginal cost of production also fit into this definition.
3. Rent and Rent Seeking
   1. The monopoly profits price setting firms get is called “rent.”
      1. This term is a relic from when the discipline treated land holders as monopolists. The payment they got for the use of their land, or rent, was seen as monopoly profits.
      2. Today, rent (now better known as economic rent), is a general turn for monopoly profits. Not all land owners collect economic rent and economic rent is collected by non-land owners.
   2. Rent is an excellent way to make money—you’re getting above average profits!—so it’s not surprising that firms pursue rent. This is called *rent seeking*.
   3. Here are some ways organizations seek rent. Note most of these require government action.
      1. Government contracts
      2. Patents and other monopolies
      3. Controlling specific inputs
      4. Licensing requirements
   4. Examples: taxi medallions, doctor licensing, diamond mines, pharmaceuticals
4. Monopsony
   1. A *monopsony* refers to a market where there is only one buyer.
   2. An *oligopsony* refers to a market where there are few buyers.
   3. *Monopsony power* is a buyer’s ability to affect the price of a good.
   4. Just a monopoly uses its monopoly power to charge a higher price for a good, a monopsony uses it monopsony power to get a lower price.
      1. For example, Medicare has monopsony power: it buys a large share of the prescription drugs. Thus Medicare is able to get deep discounts on prescription drugs.
   5. To reflect its price setting power, we construct a standard supply and demand diagram, and then we split up the supply curve into the supply curve and marginal cost curve.
      1. Just as the demand curve and marginal revenue curve, the marginal cost curve will bisect the supply curve.
      2. Then we proceed normally: where marginal cost equals marginal revenue. Note your book calls supply “average expenditure,” marginal cost “marginal expenditure,” and demand “marginal value.”
      3. Then we see how much the market will charge the monopsony by referencing the supply curve. Here, it’s 7 which is lower than the market price of 11.
      4. Finally, we fill in the deadweight loss as normal. Like the monopolist, the monopsonist restrains output.

2

4

6

8

10

12

14

16

18

20

2

10

8

6

4

22

20

18

16

14

12

22

P ($/lb)

Candy (pounds)

**D**

**MC**

**S**

PM

QM

* 1. It’s at first a bit strange that the monopsonist has the same strategy as the monopolist. One would think that it achieves a lower price by forcing an expansion of output, not a constraint on it.
  2. But remember how markets work: consumers compete with consumers and suppliers compete with suppliers. With only one consumer, that consumer could ask for relatively little, forcing many suppliers to bid the price really low. Some suppliers leave the market, it’s so low (but there’s still enough to make it competitive). Thus, a lower output.
     1. A monopolist causes the price to rise by producing little; a monopsonist causes the price to fall by asking for little.
  3. Calculation for monopsony is the same as monopoly, though simpler.
     1. Let S = 4 + Q and D = 10 – Q.
     2. TC = 4Q + Q2; MC = 4 + 2Q
     3. 4 + 2Q = 10 – Q; 3Q = 6; QM = 2; PM = 4 + 2 = 6
     4. 4 + Q = 10 – Q; 2Q = 14; Q\* = 3; P\* = 4 + 3 = 7
     5. 6Q – Q2; [6(3) – 9] – [6(2) – 4] = 9 – 8 = 1 = DWL

1. Technically, a natural monopoly has ATC always less than its competitors. You can have economies of scale throughout the demand curve and not be a natural monopoly or diseconomies of scale and still be one. But this is still a good rule of thumb, regardless. [↑](#footnote-ref-1)