

Monopoly

BY AARON STEELMAN

Economic terms don't often find their way into everyday parlance. There are a few exceptions, though. Consider the term "monopoly." In a debate, for instance, you might hear one person tell the other that "no one has a monopoly on the truth." What the person means is that there isn't just one side to an issue — there are two or maybe even more.

In economics, the term "monopoly" is used in a similar way. When there is only one seller of a good or service, that company is dubbed a monopoly.

Economists object to monopolies because they can lower social welfare. The reason is that the monopolist can raise the price of its good or service above the competitive level, to a point where consumers demand less of the product than they would otherwise.

Consider the case of a monopolist widget maker. He can produce widgets at a constant cost of \$2 per unit. If he charges \$3 for the good, he can sell 600 units, while if he charges \$4, he can sell only 400. You might initially think that he would choose to charge \$3 so that he could sell more widgets. But charging \$4 is actually more profitable. Under that scenario, he makes a profit of \$800 (400 x \$2). At \$3 per widget, his profit is just \$600 (600 x \$1). From the point of view of the widget maker, producing fewer widgets is the rational thing to do. But society is made worse off. If the market were competitive, more widgets would be produced and consumed.

Similar problems can arise in the case of an "oligopoly." This is when a market is dominated by a small number of firms. If those firms decide to coordinate their actions and raise prices above a competitive rate — thus forming a "cartel" — the oligopolists in effect act like monopolists.

How common are monopolies and oligopolies in the real world? And do they typically lower social welfare in the way described above?

Some industries *have* been dominated by only a few firms. Take the auto industry, for example. From the 1950s through the mid-1970s, the "Big Three" automakers — General Motors, Ford, and Chrysler — dominated the U.S. auto market. During that period, they regularly produced about 90 percent of all vehicles purchased domestically. Now, however, that figure is down to about 58 percent.

Many Americans were unhappy with the choices offered by Detroit, and turned instead to cars from foreign automakers. Ultimately, competition from abroad forced the

American companies to improve their products — to the benefit of everyone. This is the case of an oligopoly collapsing, as consumer sentiment shifted and barriers to entry — such as import restrictions — became less burdensome.

But what if an oligopoly doesn't collapse? How dangerous is it? The late George Stigler, whose work on industrial organization won him the Nobel Prize in economics in 1982, long favored antitrust laws aimed to break up oligopolies, but over time lost his "enthusiasm for antitrust policy and much of our fear of oligopolies."

Antitrust laws, Stigler believed, were actually being used by some companies to prevent competition rather than to increase it. And in other cases, they were a barrier to potentially useful mergers.

In addition, empirical analysis led Stigler to believe that oligopolies often were unable to earn returns much above what we would expect in a competitive market. "The relationship between profitability and concentration is almost invariably loose: less than 25 percent of the variation in profit rates across industries can be attributed to concentration," Stigler wrote.

Why might this be the case? There are several possibilities. One is that cartels are inherently unstable. A small number of firms may collude to raise prices. But there is always an incentive for one of those firms to defect, lower its price, and gain the lion's share of the market for itself. Another reason is that the mere threat of a startup company entering the market and taking business

away from existing companies can exert discipline on monopolists and oligopolists, making them behave as if competition were brisk.

Some monopolists and oligopolists, however, enjoy government protections that shield them from such competition. The taxi industry is one example. In many cities, the number of cabs in operation is tightly controlled by local officials. The U.S. Postal Service is another. Companies like FedEx can compete on the shipment of packages, but with a few exceptions cannot deliver letters.

In theory, it's easy to see why monopolies and oligopolies could be socially undesirable. In practice, though, the evidence is not so clear, and the actions used to prevent industries from becoming concentrated sometimes can produce effects worse than the problem itself. **RF**



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