

Econ 301: Microeconomic Analysis

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Industry Supply

Motivation

- ▶ Last time we looked at supply decision of one firm
- ▶ Now we figure out what the supply decision of the whole industry will be
- ▶ For this section, we are still assuming a competitive market

The Industry Supply Curves in the Short Run

- ▶ Suppose there are n firms, each with supply curve $S_i(p)$
- ▶ Then the *industry supply curve* is

$$S(p) = \sum_{i=1}^n S_i(p)$$

- ▶ Note that individual supply curves add horizontally

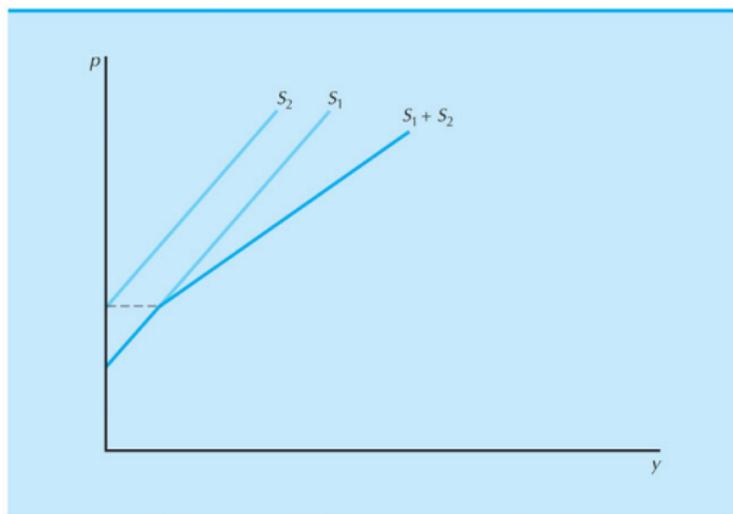


Figure
24.1

Industry Equilibrium in the Short Run

- ▶ We know that equilibrium price is derived from $y^* = S(p^*) = D(p^*)$
- ▶ What are the possible equilibrium profits for the firm in the short run?
 - ▶ Zero profits: $p^* = \frac{c(y^*)}{y^*} = AC(y^*)$
 - ▶ Note that this means price is equal to the minimum of the AC curve
 - ▶ Positive profits: $p^* > AC(y^*)$
 - ▶ Negative profits: $p^* < AC(y^*)$
 - ▶ OK as long as we are not below shutdown condition
 - ▶ That is, must have $p^* > AVC(y^*)$, ie equilibrium price above the AVC curve

Entry and Exit in the Long Run

- ▶ What profits are sustainable in the long-run?
 - ▶ Can't have negative profits in LR; otherwise firms would *exit* the market
 - ▶ Can't have positive profits in LR; otherwise firms would *enter* the market
- ▶ Thus firm profits must be zero in the long run
 - ▶ Note this just means industry is not growing
 - ▶ All inputs are still getting paid for
- ▶ One caveat: assuming *free entry into industry*
 - ▶ No *barriers to entry* put up by government or incumbent firms

The Long Run Supply Curve

- ▶ Suppose there are many firms with identical cost function $c(y)$
- ▶ Write p^* for the price equal to the minimum of the average cost curve for any one firm
- ▶ As firms enter one-by-one, industry supply curve moves out and becomes steeper
- ▶ Firms will enter until adding one more firm will lower equilibrium price below p^*
 - ▶ Beyond this point, profits for all firms will be negative
- ▶ If the number of firms entering is very large (which we are assuming anyways), then the **LR supply curve is flat (ie perfectly elastic) at price p^***

Long Run Supply: Graphically, Part 1

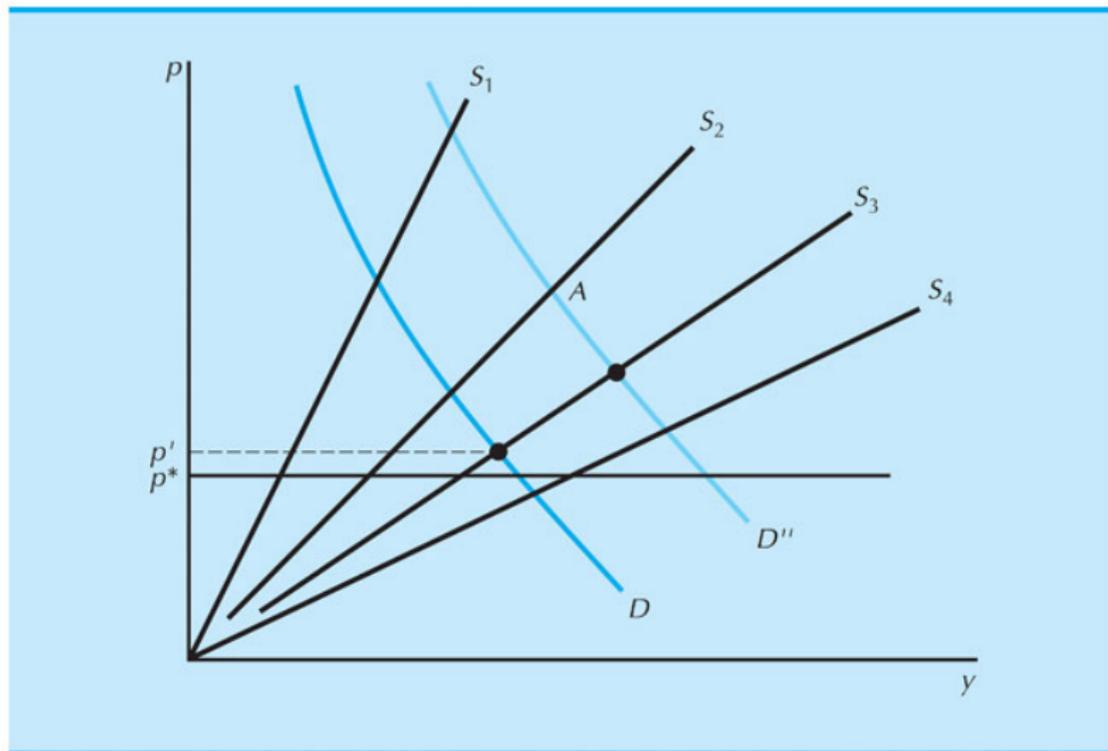


Figure
24.3

Long Run Supply: Graphically, Part 2

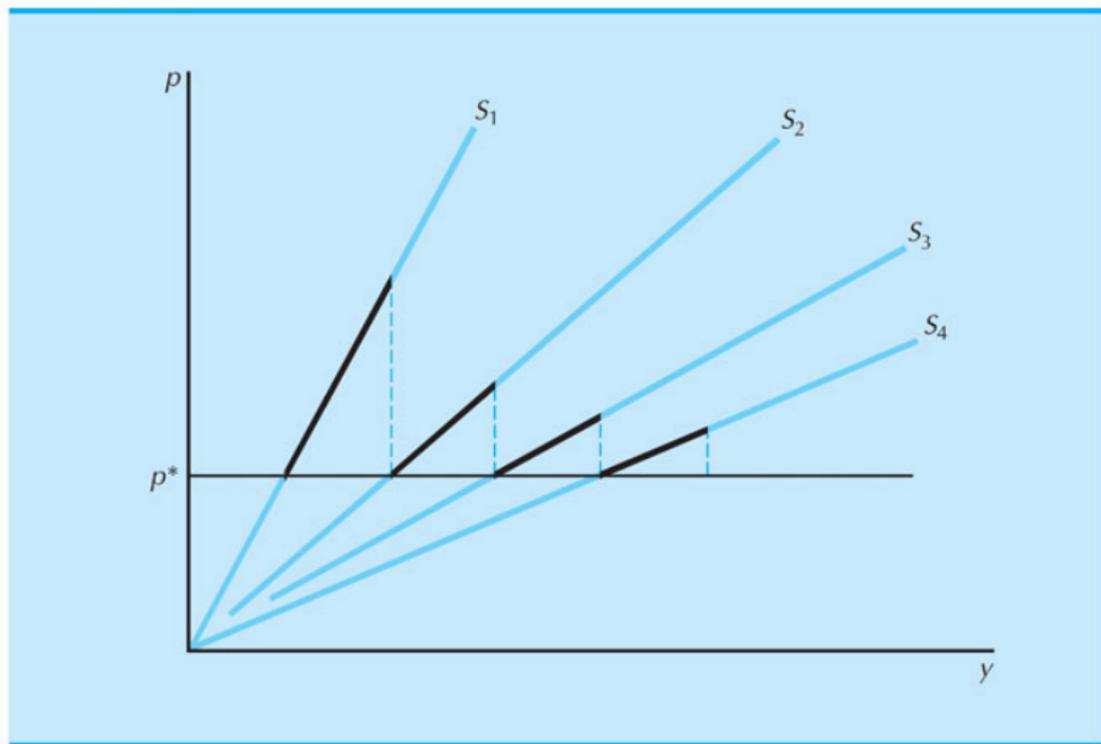


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Long Run Supply: Graphically, Part 3

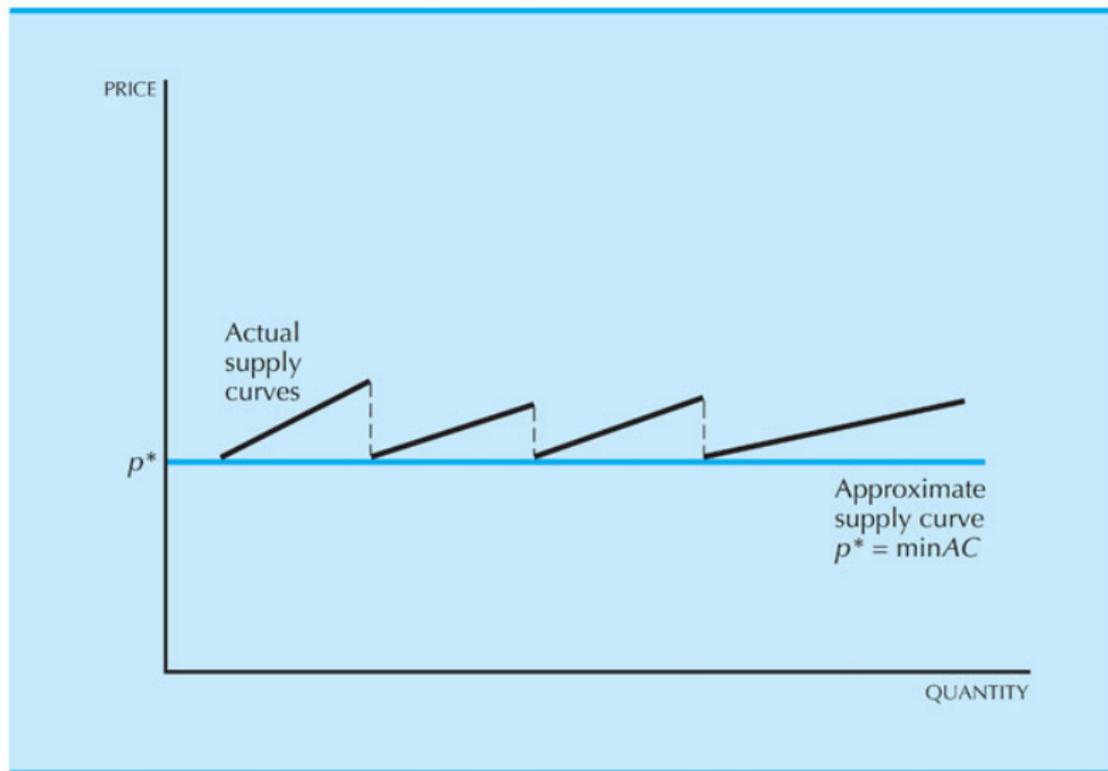


Figure
24.5

Taxes in the Long Run

- ▶ We have seen that in the short run, in general taxes affect both producer price and consumer price
- ▶ However, in the long run that same tax will fall entirely on the consumer
 - ▶ Producers will supply only at $p^* = \min AC$, so tax cannot affect producer price at all

Monopoly

Introduction

- ▶ So far our assumption has been that we have a very large number of firms in the market
- ▶ Now we go to the opposite extreme: one firm in the market, ie a *monopoly*
- ▶ Note that the demand curve the firm faces is now the market demand curve
 - ▶ Thus the firm can choose quantity y and price will be determined by inverse market demand $p(y)$

Maximizing Monopoly Profits

- ▶ The monopolist solves

$$\max_y p(y)y - c(y)$$

where revenue is $r(y) = p(y)y$ and $p(y)$ is inverse demand

- ▶ First order condition:

$$MR(y) = p(y) + p'(y)y = c'(y) = MC(y)$$

- ▶ So as usual we have $MR=MC$, but the equation for marginal revenue is different because when the monopolist changes their output, price changes as well

Monopolistic Equilibrium Graphically

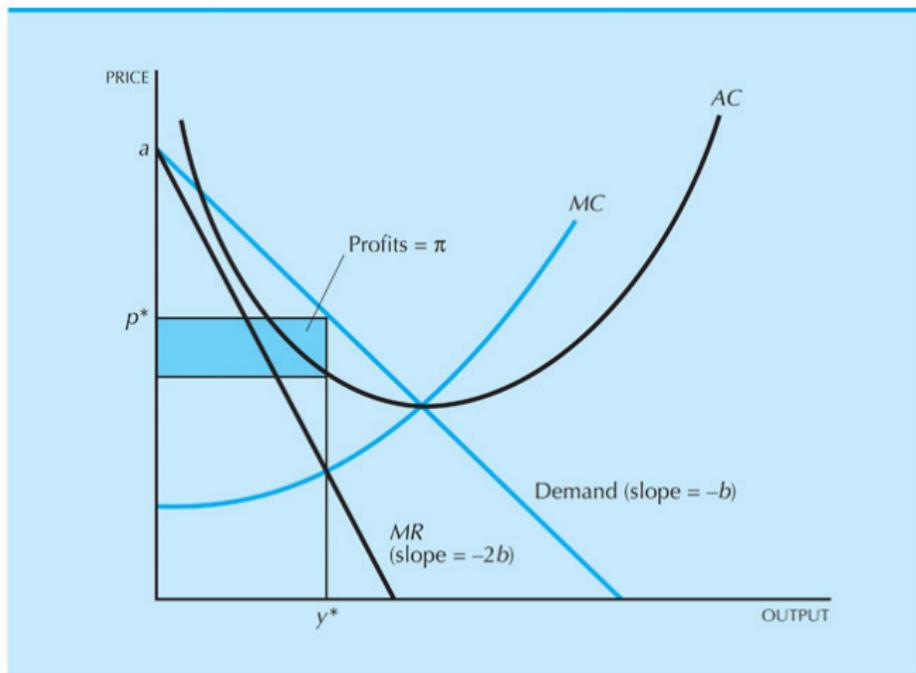


Figure 25.1

Elasticity

- ▶ Note that we can re-write the marginal revenue as

$$MR(y) = p(y) \left[1 + \frac{dp}{dy} \frac{y}{p(y)} \right]$$

- ▶ Recalling that $\frac{dy}{dx} = \frac{1}{\frac{dx}{dy}}$, we can write this as

$$MR(y) = p(y) \left[1 + \frac{1}{\epsilon} \right] = p(y) \left[1 - \frac{1}{|\epsilon|} \right]$$

- ▶ Note ϵ is elasticity of *demand*
- ▶ Will monopolist produce if $|\epsilon| < 1$?
 - ▶ No, this implies $MR(y) < 0$, which is not possible
 - ▶ Thus a monopolist will only operate in part of demand curve where demand is elastic (if anywhere)

Markups

- ▶ Using the fact that $MR(y) = MC(y)$, re-arrange the FOC to get

$$\frac{p(y)}{MC(y)} = \frac{1}{\left(1 - \frac{1}{|\epsilon(y)|}\right)} > 1$$

- ▶ Ratio $\frac{p}{MC}$ called the *markup ratio*, ie how much the monopolist charges relative to their marginal costs
- ▶ What would the markup ratio be for competitive firm? $p = MC$, so markup = 1

Example: Linear Demand

- ▶ Let inverse demand be given by $p = a - by$ and cost function be given by $c(y) = cy$
- ▶ What is monopolistic equilibrium supply and price?
 - ▶ Monopolist's problem is

$$\max_y (a - by)y - cy = ay - by^2 - cy$$

- ▶ FOC: $a - c = 2by$
 - ▶ Thus $y^* = \frac{a-c}{2b}$ and $p^* = \frac{a+c}{2}$
- ▶ What is markup ratio?
 - ▶ Note $MC = c$, so $\frac{p}{MC} = \frac{a+c}{2c}$

Example: Taxes and Monopoly

- ▶ Suppose government imposes quantity tax t
- ▶ What is effect on price in previous example?
- ▶ Monopolist's problem becomes

$$\max_y (a - by - t)y - cy = ay - by^2 - cy$$

- ▶ By same approach as previous slide, $y^* = \frac{a-c-t}{2b}$ and $p_m^* = \frac{a+c-t}{2}$
- ▶ Thus $\Delta p_m = -\frac{1}{2}\Delta t$

Inefficiency of the Monopoly

- ▶ An allocation is *Pareto efficient* if no one can be made better off without making someone else worse off
- ▶ Is the allocation arrived at in the monopoly setting Pareto efficient?
 - ▶ Let p_m, y_m be the monopoly equilibrium
 - ▶ Note that $p_m < MC(y_m)$, so at any price $p \in (MC(y_m), p_m)$ there are some consumers who would be happy to buy at this price
 - ▶ Monopolist would make additional profit selling to them at this price
 - ▶ Since it is possible to make both monopolist and consumers better off, monopoly is not Pareto efficient
- ▶ Given this argument, why is p_m, y_m still an equilibrium?
 - ▶ Because the firm would have to lower price for everyone, which is not profit maximizing

What Causes Monopolies?

- ▶ Cartels, ie collusion between several producers in the market
 - ▶ Examples? OPEC, DeBeers
- ▶ Incumbents can use pricing as a deterrent
- ▶ Technology
 - ▶ Define the *minimum efficient scale* (MES) as the output at which the average cost curve (for one firm) is minimized
 - ▶ If $MES \ll D(p^*)$, we have a competitive market
 - ▶ If $MES \approx D(p^*)$, monopoly is likely
 - ▶ Example: *natural monopolies* like cable and internet providers

Figure
25.7

