**Question 6**

***Indian Railways is an Indian state-owned railway company, in 2012, India's Railway Minister Dinesh Trivedi has announced a price hike in railway fares which would have a negative impact on most passengers.***

***http://www.bbc.co.uk, 14th March 2012***

**Contrast the features of perfect competition with those of monopoly. [10]**

Introduction

State that the perfect competition differs from the monopoly as there are perfect market information and mobility of resource in the perfect market competition while there are imperfect market information and immobility of resources. These two forms of market structures will differ in term of the structure, behaviours and performance

Main Body

**1. Explain how the types of market structure will differ in term of the structure or characteristics**

In the PC market, there are many firms and these firms produce goods which are homogeneous while there is only one firm in the monopoly market. Firms in the PC market has ease of entry and exit while there are strong barriers to entry in the monopoly market

**2. Explain how the types of market structure will differ in term of the behaviours of the firm**

The firms in the PC market abide to the price set by the industry but it will determine the production level based on profit maximisation. As such, its MR and AR are perfectly-elastic as there is perfect information on the price level which will influence the value of AR and MR. As for the monopoly, the MR and AR are downward sloping, given the presence of market power which will allow the monopoly power to conduct price setting. As such, the presence of market power will create a price-inelastic demand which means that it can set price at a higher level.

Firms in the PC and monopoly markets can make subnormal profit, normal profit and supernormal profit in the short run but firms in the PC market will only make normal profit while the monopoly can make normal and supernormal profit in the long run. Both firms do not engage in price competition as there is perfect market information and homogeneous product while the monopoly does not need to set pricing as it has complete market power to control the market. However, the monopoly will conduct non-price competition such as the creation of barriers to entry to block contestable market while firms in the PC market need not conduct non-price competition as the product is homogeneous, ignoring the need for product differentiation.

The firms in the PC market will be able to attain production and allocative efficiency in the short run and long run due to perfect market information, enabling the firm to adjust production equilibrium to social equilibrium. However, it may not be able to reap dynamic efficiency and has very little capacity to reap economies of scale due to the small scale of production. On the other hand, the monopoly may not achieve allocative efficiency in the short run since the firm’s market equilibrium at profit-maximisation level, where MC=MR, is not equal to social equilibrium at social optimisation, where P=MC. Since the monopoly’s MR and AR are downward-sloping due to the presence of market power, the monopoly is unable to achieve production efficiency as it is producing at excess capacity in the short run when it produces at profit-maximising level. However, the monopoly will attain production efficiency in the long run, given that production level of the respective level is lowest. Nonetheless, the monopoly is able to have lower average cost, since it has greater capacity for economies of scale.

Conclusion

In conclusion, it can be observed that the characteristics of the imperfect market and perfect market and the size of the firm in the two types of market structure will have strong influence in the behaviours and performance of the firm in these markets.

**(b) Discuss the view that there should be more regulation of monopolies in an economy. [15] (TPJC Q4)**

Introduction

The regulation of the monopoly is needed when there are adverse impacts on the economy but the advantages of the monopoly may defuse the rationale to regulate monopoly. When the monopoly does act in the interest of the society, there is no need for the government to regulate the monopoly.

Main Body

**1. Explain why the government needs to regulate the monopoly in the interest of the economy**

* Prevent consumer exploitation – high degree of market power – price-setting behaviour – P>MC, higher price / lower output 🡪↓consumer surplus
* Regulate price discrimination in the interest of the society – MRT and Bus fares
* Ensure that the natural monopoly acts in the interest of the society – affordability to lower income group / assurance of the provision of services
* Prevent the firm experiencing X-inefficiency / improve the innovation

**2. Explain why the government need not regulate the monopoly because there are benefits for the monopoly to exist**

* Advantages of large firm
* Can reap EOS
* Achieve optimal rationalization of capacity of production
* Benefits of MES at very large output

**3. Explain the circumstances that government regulation may not be needed**

* Natural monopoly is a state enterprise – direct provision – produce at MC pricing 🡪 maximisation of net social benefit gain
* Use of public fund for the development of the firm – accountable to the state only

Conclusion

**Part C: Monopolistic Competition and Oligopoly**

**Essay Question 8**

**(a) Explain how the different features of monopolistic competition and oligopoly affect price and output determination in these market structures. [12]**

Basis of Comparison

i. Structure, behavior and performance

ii. Price and output determination

Introduction

State that monopolistic competitive and oligopolistic markets are part of imperfect market structures and the characteristics will affect how these firms set price and output which is often based on the notion of profit-maximization.

Main Body

**1. Explain the characteristics of imperfect market structure**

* Imperfect market information - producers can have market power to set price
* immobility of resources – Occupational immobility and concentration of resources – uneven distribution of natural endowment

**2. Explain the characteristics of firm in the monopolistic competitive market and the oligopolistic competitive market**

* Monopolistic Competition
* Low barriers to entry, large number of firms, product is differentiated 🡪 limited market power – MR/AR downward-sloping – price-elastic
* Oligopoly
* Strong barriers to entry, few firms, product is either homogeneous or differentiated 🡪 Strong market power – MR/AR downward-sloping – price-inelastic and kinked (mutual interdependency)

**3. Explain how the notion of profit maximization is conducted to determine production equilibrium**

Based on this downward-sloping MR and AR, firms in the imperfect market can set the price level when the production equilibrium is attained; abiding to the profit-maximising rule. Under this rule, the firm will increase production when the MR is greater than the MC since additional net profit can be reaped and decrease production level when the MR is less than the MC since additional net loss may be incurred. Thus, firms will attain production equilibrium at the level of output where MR is equal to MC.

**4. Explain how price and output is determined for the firm in the MC market with a diagram (description of diagram)**

MC

AR

MR

Q**0**

P0

P

Qty

As seen from the diagram, the MR and AR are downward sloping and the MC rises upward. The price and output is set at Po and Q0 respectively where production equilibrium based on profit maximisation is attained when MR=MC.

**5. Explain how price and output is determined for the oligopolistic market with a diagram (need to explain why the MR and AR are kinked)**

AR

P

MC

P0

Qty

MR

Q**0**

As seen from the diagram, the firm in the competitive oligopolistic market has downward-sloping but kinked MR and AR due to the condition of mutual interdependency, while the MC slopes upward. The production equilibrium will be at the level where price and quantity is at P0 and Q0 respectively based on the notion of profit maximisation where MC=MR.

**6. Evaluation**

* Both market structures abide to the notion of profit maximisation to determine price and output level
* Price and output level depends on the slope of the MR and AR 🡪 affected by the number of producers, the degree of competition and degree of market power

Conclusion