**Essay Question 30**

**(a) Explain how economies of scale determine the market structure in which a firm operates in the real world. [10]**

1) definition and characteristics of economies of scale

2) explain how these features of economies of scale will determine the type of market structure

- economies of scale affect the size of the firm

- economies of scale affect the barrier to entry

- decrease average cost – lower the price of goods – predatory pricing / block the market competition

- increase their market share – higher market concentration ratio and thus the market is now oligopoly or can be monopoly if the market share is 100%

Introduction

* Definition of ‘economies of scale’ (EOS)
* State that EOS will affect the form of market structure as it is a source of barriers to entry to influence the structure of the industry

Main Body

**1. Explain how EOS would affect the average cost**

* Explain the type of EOS that will occur in both internal and external EOS
* Internal and External EOS (Diagrams) / set the graph with lower LRAC - can lower price and increase output – increase production

**2. Explain how EOS becomes a source of barriers to entry (BTE) that will shape the market structure / market concentration ratio**

1. EOS🡪↓ average cost 🡪 firms lower price – prevent competition 🡪only for large firms 🡪∴ the industry will become oligopoly or monopoly

**(increase their market share – raise the market concentration ratio - > 50% of market concentration ratio by the top 10 firms – oligopoly)**

* EOS attained at very large output 🡪 a form of natural monopoly
* Small firms are unable to reap EOS exclusively 🡪 no BTE for monopolistic competitive market

1. EOS attained through managerial expertise and technical advantage 🡪 strong BTEs to block competition
2. Diversification of market achieved through EOS 🡪 leads to price discrimination 🡪 only possible for oligopoly and monopoly
3. External EOS🡪 help bigger firms to grow 🡪 some will develop more market power 🡪 formation of oligopoly market

Conclusion

**Essay Question 30**

**(b) Discuss whether monopolies should be disallowed on the basis that they exploit consumers. [15]**

Introduction

* Definition and characteristics of a monopoly

only one firm in the industry, high barriers, product is unique, 100% market concentration ratio

* State that as a sole producer, the monopoly will have exclusive market power to conduct consumer exploitation and thus, there may be a need to disallow it. However, here are other benefits or circumstances that justify the creation of a monopoly

Main Body

**1. Explain how the monopoly set price based on profit-maximisation which will lead to consumer exploitation**

it is a price setter and given the price inelastic demand curve – it will be set price at very high level and the welfare loss is quite extensive

* Draw diagram and description of diagram
* Production based on profit-maximisation 🡪 MC = MR below social equilibrium production level where P=MC – Between Qm and Q­s­ 🡪 welfare loss (DWL) 🡪 partial market failure 🡪↑P, ↓Qty🡪 consumer exploitation
* Price is higher and quantity is lower than other forms of market structure
* extensive DWL – welfare loss to consumer

**2. Explain why such consumer exploitation is undesirable and thus justify the eradication of monopoly**

* Higher price/lower quantity 🡪↓consumer surplus
* DWL
* lesser choice of products – one type of product – the possibility of IPhone in controlling apps market in the IOS 9near monopoly status by defining the usage in one area of use

**3. Other detriments of monopoly that will also justify eradication of the monopoly**

* X-inefficiency 🡪 complacency due to the lack of competition 🡪 produce at higher AC than production efficiency
* no production efficiency in the short-run – when the monopoly produces at profit-maximizing level of output, the production level for the average cost is at excess capacity and not at optimal capacity of production where AC is at minimum level – price will be set higher and cannot benefit the consumers
* Lack of competition for regulation to improve the industry – corruption, lower their quality of goods and services – undermine consumer inetrest
* Greater inequality 🡪 supernormal profits

**4. Why monopoly should not be eliminated?**

* Advantages of large firm
* can reap EOS – lower AC – decrease price – benefit the consumers
* more stable to the growth of the society – essential services that requires large amount of funding – gain extensive EOS as in the case of natural monopoly (the demand of the whole industry is provided by one firm – min AC is very low due to huge fixed cost and minimal variable cost)
* Need for natural monopoly
* Complexity of production of goods 🡪 requires large landspace like water catchment areas for water supply