Factors Influencing Monopoly Revenue & Profits

Monopoly profits are generated when profits are maximized at a level ABOVE the average total cost! A monopoly with low costs can potentially enjoy massive profits indefinitely!

Factors Influencing Monopoly Profits and Revenue

- x-inefficiency
- elasticity of demand
- price discrimination
- excise taxes

X-inefficiency

Monopolies can grow inefficient due to lack of competition. X-inefficiency will increase costs, which will in turn reduce profits.

X-inefficiency: Is the failure to use resources in the most economically efficient way.

Note: This is different than standard inefficiency.

X-efficiency is the effectiveness with which a given set of inputs are used to produce outputs. If a firm is producing the maximum output it can with its given resources, and the best technology available, then it is said to be x-efficient.

X-inefficiency occurs when x-efficiency is not achieved. The concept of x-efficiency was introduced by Harvey Leibenstein in his paper Allocative efficiency v. "x-efficiency" in American Economic Review 1986.
In a perfectly competitive market, x-inefficient cannot occur because if a firm is less efficient than its competition then it will not survive in the market.

However, it may be possible for a monopoly to be x-inefficient, because the lack of competition makes it possible to use inefficient production techniques and still stay in business.

X-inefficient is not the only type of inefficiency in economics. Other types of efficiencies we can consider include:

- Pareto Efficiency: Pareto efficiency is achieved when no party can be made better off without another party being made worse off.
- Allocative Efficiency: Occurs where marginal benefit is equal to marginal cost. Since price is always based on "marginal benefit" (consider the "water-diamond paradoxs"), price always represents marginal benefit. Therefore, allocative efficiency is attained when price is equal to marginal cost.
- Productive Efficiency: At the macroeconomic level, this considers how close a society is to producing the most output that it can with its resources (closest to the PPC); at a microeconomic level, this considers whether a firm is producing at the bottom of its average total cost curve.
- Economic Efficiency: Producing the most value of output for the least value of input. Thus, we needed a new term to describe the distinct phenomenon of X-inefficient.
Price Discrimination

If a monopolist could discriminate perfectly (charge everyone as much as they are willing to pay) then their marginal revenue would not fall any faster than their demand curve. Thus their demand curve would become their marginal revenue curve...

Price Discrimination

If a monopolist could discriminate perfectly (charge everyone as much as they are willing to pay) then their marginal revenue would not fall any faster than their demand curve. Thus their demand curve would become their marginal revenue curve... and their equilibrium would shift to the right.

Degrees of Price Discrimination

1st degree: → Price varies on a customer by customer basis (i.e. car dealers).
   → This is also known as "perfect" price discrimination, where each customer pays their own personal maximum price.
   → In perfect price discrimination the consumer surplus is completely eliminated.

2nd degree: → Price varies based on quantity sold.
   → Quantity discounts ensure that customers who are willing and able to buy more product will pay a lower per unit price.

3rd degree: → Price varies based on market segment.
   Examples:
   → age segmentation in movies, public transport, and admissions to parks;
   → gender segmentation for haircuts;
   → segmentation based on business versus private citizens for phone and banking services.

Excise Tax

If an excise tax of 4.00 was placed on a monopoly's product, then it would shift the marginal costs up by 4.00 across all levels of output.

This would shift the equilibrium price up slightly, and reduce the equilibrium output. Note that the increase in price is far less than the tax!

Excise Tax

Q: Why not just increase the price by the amount of the tax?

A: If you do this, then demand will fall to a non-profit maximizing level!

You will sell less, and anything you do sell will have higher marginal costs!

Hey, if you have to pay tax, then it's far better to pay the tax out of maximum profits!