

Advanced Microeconomic Theory

Chapter 7: Monopoly

Outline

- Barriers to Entry
- Profit Maximization under Monopoly
- Welfare Loss of Monopoly
- Multiplant Monopolist
- Price Discrimination
- Advertising in Monopoly
- Regulation of Natural Monopolies
- Monopsony

Barriers to Entry

Barriers to Entry

- ***Entry barriers***: elements that make the entry of potential competitors either impossible or very costly.
- Three main categories:
 - 1) ***Legal***: the incumbent firm in an industry has the legal right to charge monopoly prices during the life of the patent
 - *Example*: newly discovered drugs

Barriers to Entry

- 2) ***Structural***: the incumbent firm has a cost or demand advantage relative to potential entrants.
 - superior technology
 - a loyal group of customers
 - positive network externalities (Facebook, eBay)
- 3) ***Strategic***: the incumbent monopolist has a reputation of fighting off newcomers, ultimately driving them off the market.
 - price wars

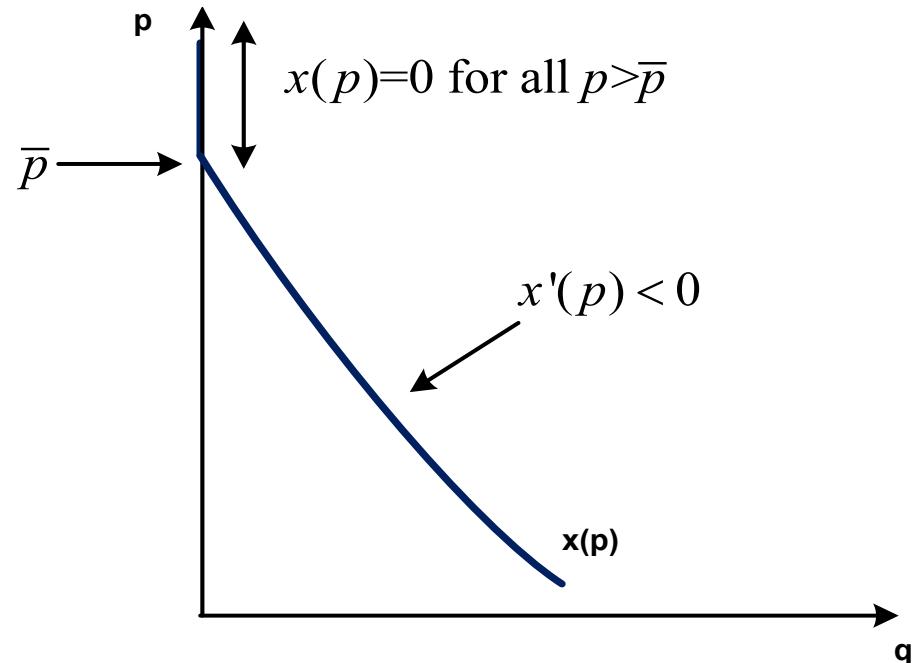
Profit Maximization under Monopoly

Profit Maximization

- Consider a demand function $x(p)$, which is continuous and strictly decreasing in p , i.e., $x'(p) < 0$.
- We assume that there is price $\bar{p} < \infty$ such that $x(p) = 0$ for all $p > \bar{p}$.
- Also, consider a general cost function $c(q)$, which is increasing and convex in q .

Profit Maximization

- \bar{p} is a “choke price”
- No consumers buy positive amounts of the good for $p > \bar{p}$.



Profit Maximization

- Monopolist's decision problem is

$$\max_p px(p) - c(x(p))$$

- Alternatively, using $x(p) = q$, and taking the inverse demand function $p(q) = x^{-1}(q)$, we can rewrite the monopolist's problem as

$$\max_{q \geq 0} p(q)q - c(q)$$

Profit Maximization

- Differentiating with respect to q ,

$$p(q^m) + p'(q^m)q^m - c'(q^m) \leq 0$$

- Rearranging,

$$\underbrace{p(q^m) + p'(q^m)q^m}_{MR = \frac{d[p(q)q]}{dq}} \leq \underbrace{c'(q^m)}_{MC}$$

with equality if $q^m > 0$.

- Recall that total revenue is $TR(q) = p(q)q$

Profit Maximization

- In addition, we assume that $p(0) \geq c'(0)$.
 - That is, the inverse demand curve originates above the marginal cost curve.
 - Hence, the consumer with the highest willingness to pay for the good is willing to pay more than the variable costs of producing the first unit.
- Then, we must be at an interior solution $q^m > 0$, implying

$$\underbrace{p(q^m) + p'(q^m)q^m}_{MR} = \underbrace{c'(q^m)}_{MC}$$

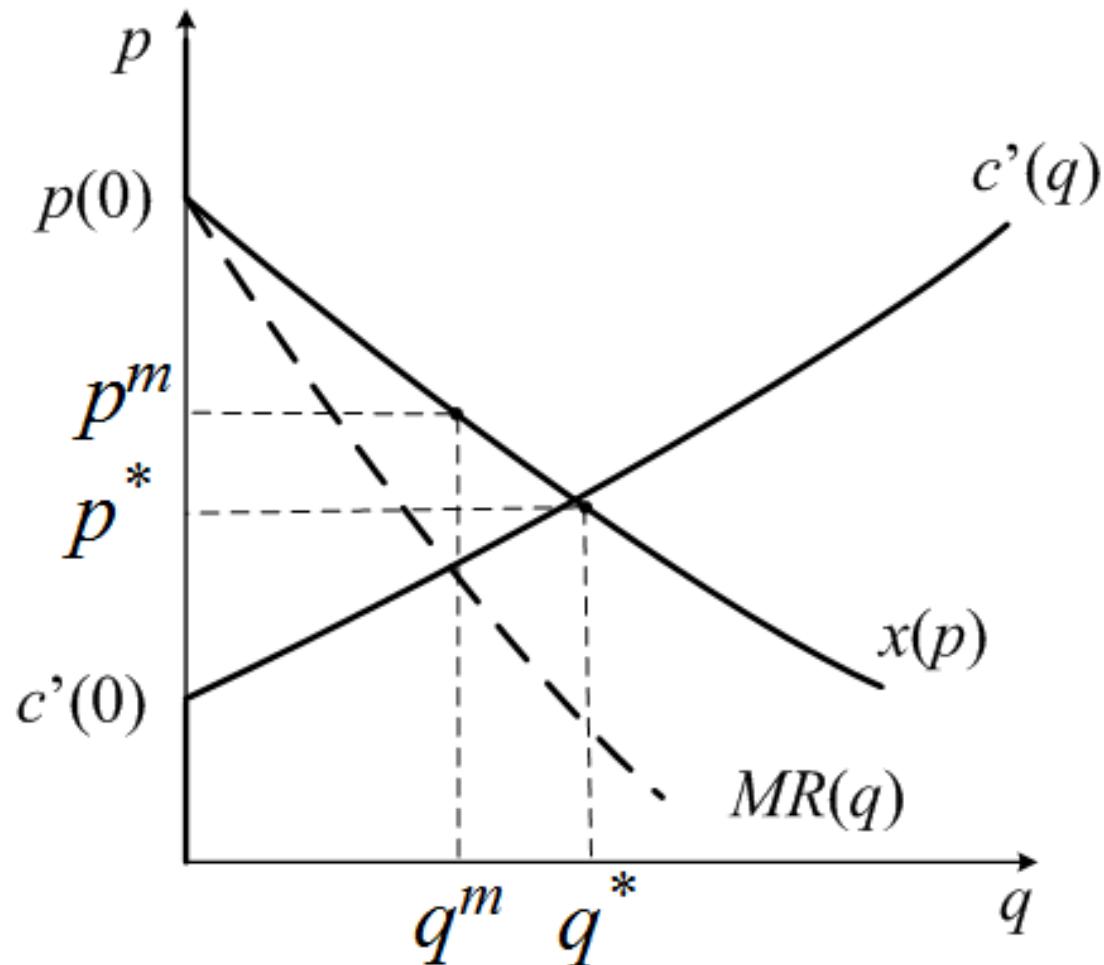
Profit Maximization

- Note that

$$p(q^m) + \underbrace{p'(q^m)q^m}_{-} = c'(q^m)$$

- Then, $p(q^m) > c'(q^m)$, i.e.,
monopoly price $> MC$
- Moreover, we know that in competitive equilibrium $p(q^*) = c'(q^*)$.
- Then, $p^m > p^*$ and $q^m < q^*$.

Profit Maximization



Profit Maximization

- Marginal revenue in monopoly

$$MR = p(q^m) + p'(q^m)q^m$$

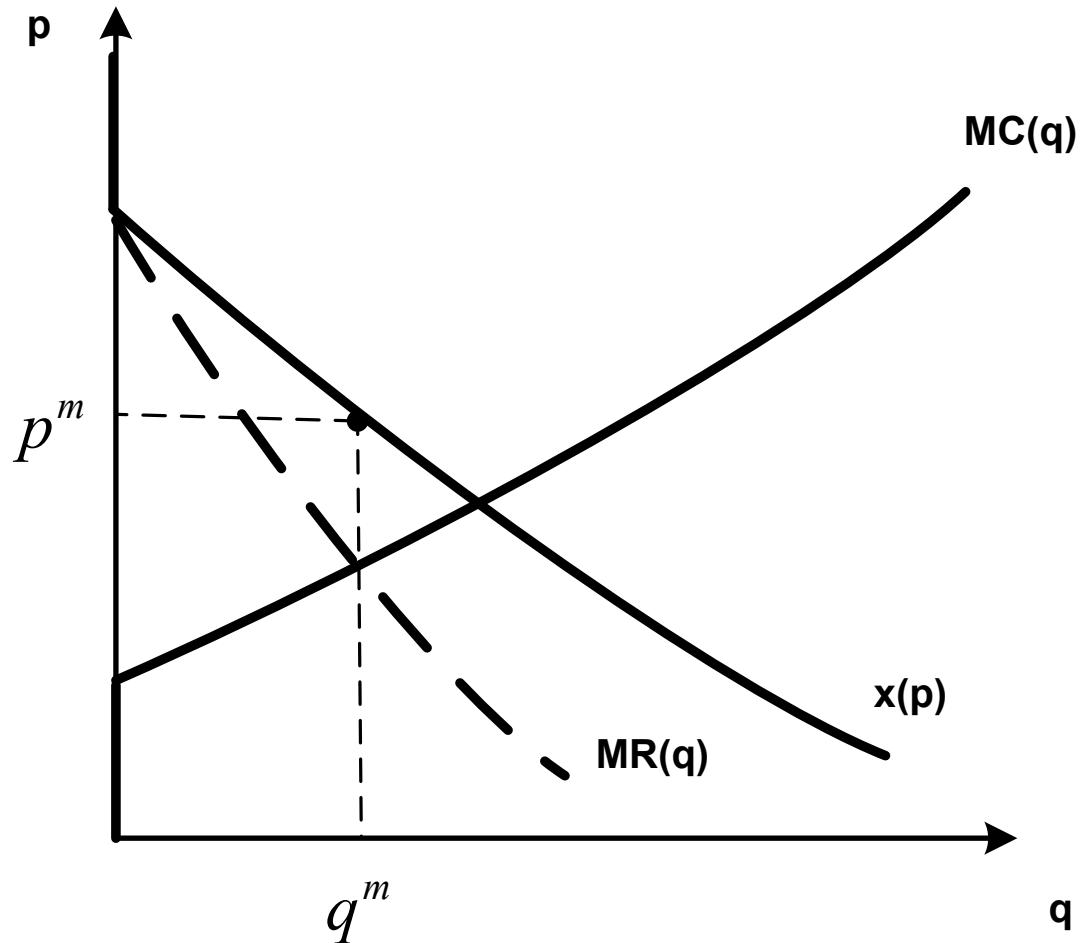
MR describes two effects:

- A ***direct (positive) effect***: an additional unit can be sold at $p(q^m)$, thus increasing revenue by $p(q^m)$.
- An ***indirect (negative) effect***: selling an additional unit can only be done by reducing the market price of all units (the new and all previous units), ultimately reducing revenue by $p'(q^m)q^m$.
 - *Inframarginal units* – initial units before the marginal increase in output.

Profit Maximization

- Is the above FOC also sufficient?
 - Let's take the FOC $p(q^m) + p'(q^m)q^m - c'(q^m)$, and differentiate it wrt q ,
$$\underbrace{p'(q) + p'(q) + p''(q)q}_{\frac{dMR}{dq}} - \underbrace{c''(q)}_{\frac{dMC}{dq}} \leq 0$$
 - That is, $\frac{dMR}{dq} \leq \frac{dMC}{dq}$.
 - Since MR curve is decreasing and MC curve is weakly increasing, the second-order condition is satisfied for all q .

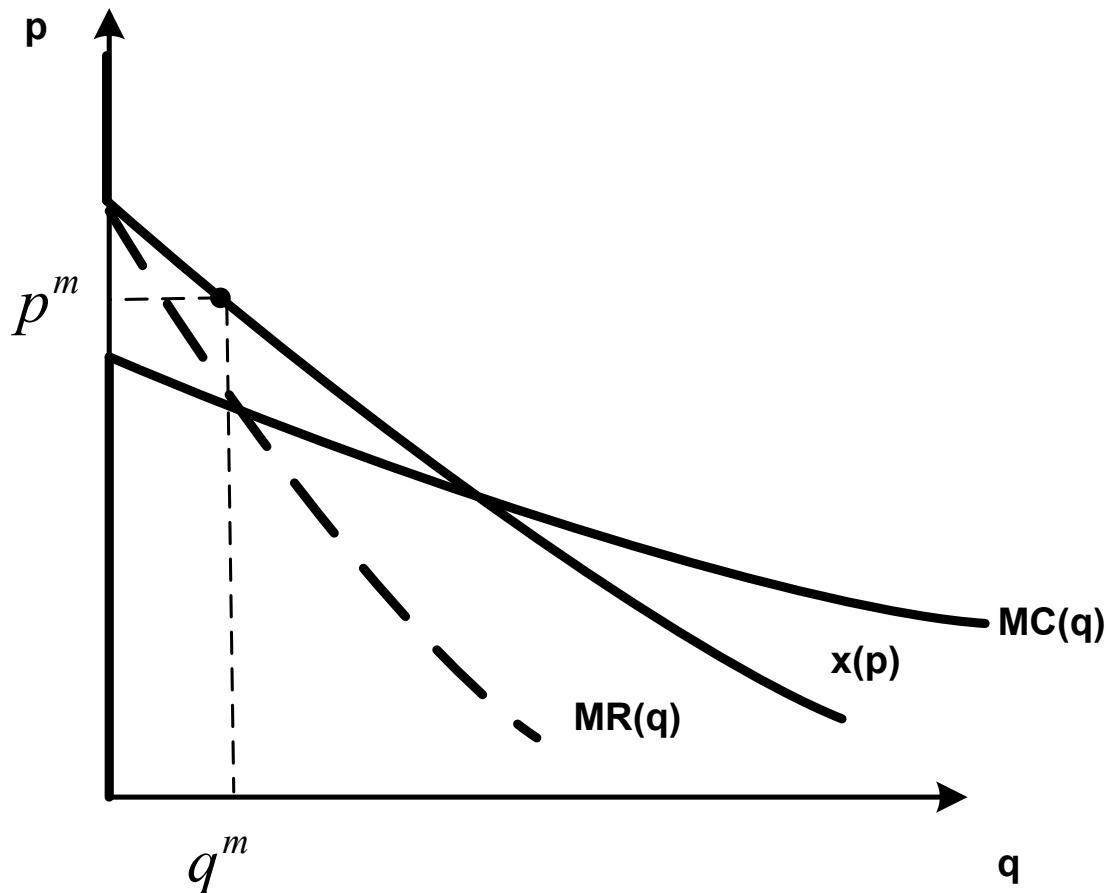
Profit Maximization



Profit Maximization

- What would happen if MC curve was decreasing in q (e.g., concave technology given the presence of increasing returns to scale)?
 - Then, the slopes of MR and MC curves are both decreasing.
 - At the optimum, MR curve must be steeper MC curve.

Profit Maximization



Profit Maximization: Lerner Index

- Can we re-write the FOC in a more intuitive way? Yes.
 - Just take $MR = p(q) + p'(q)q = p + \frac{\partial p}{\partial q}q$ and multiply by $\frac{p}{p'}$,
$$MR = p \frac{p}{p} + \underbrace{\frac{\partial p}{\partial q} \frac{q}{p}}_{1/\varepsilon_d} p = p + \frac{1}{\varepsilon_d} p$$
 - In equilibrium, $MR(q) = MC(q)$. Hence, we can replace MR with MC in the above expression.

Profit Maximization: Lerner Index

- Rearranging yields

$$\frac{p - MC(q)}{p} = -\frac{1}{\varepsilon_d}$$

- This is the **Lerner index** of market power
 - The price mark-up over marginal cost that a monopolist can charge is a function of the elasticity of demand.
- Note:
 - If $\varepsilon_d \rightarrow \infty$, then $\frac{p - MC(q)}{p} \rightarrow 0 \Rightarrow p = MC(q)$
 - If $\varepsilon_d \rightarrow 0$, then $\frac{p - MC(q)}{p} \rightarrow \infty \Rightarrow$ substantial mark-up

Profit Maximization: Lerner Index

- The Lerner index can also be written as

$$p = \frac{MC(q)}{1 + \frac{1}{\varepsilon_d}}$$

which is referred to as the ***Inverse Elasticity Pricing Rule*** (IEPR).

- *Example* (Perloff, 2012):

- Prilosec OTC: $\varepsilon_d = -1.2$. Then price should be $p =$

$$\frac{MC(q)}{1 + \frac{1}{-1.2}} = 6MC$$

- Designed jeans: $\varepsilon_d = -2$. Then price should be $p =$

$$\frac{MC(q)}{1 + \frac{1}{-2}} = 2MC$$

Profit Maximization: Lerner Index

- ***Example 1*** (linear demand):
 - Market inverse demand function is
$$p(q) = a - bq$$
where $b > 0$
 - Monopolist's cost function is $c(q) = cq$
 - We usually assume that $a > c \geq 0$
 - To guarantee $p(0) > c'(0)$
 - That is, $p(0) = a - b0 = a$ and $c'(q) = c$, thus implying $c'(0) = c$

Profit Maximization: Lerner Index

- *Example 1* (continued):
 - Monopolist's objective function

$$\pi(q) = (a - bq)q - cq$$

- FOC: $a - 2bq - c = 0$
- SOC: $-2b < 0$ (concave)
 - Note that as long as $b > 0$, i.e., negatively sloped demand function, profits will be concave in output.
 - Otherwise (i.e., Giffen good, with positively sloped demand function) profits will be convex in output.

Profit Maximization: Lerner Index

- ***Example 1*** (continued):

- Solving for the optimal q^m in the FOC, we find monopoly output

$$q^m = \frac{a - c}{2b}$$

- Inserting $q^m = \frac{a-c}{2b}$ in the demand function, we obtain monopoly price

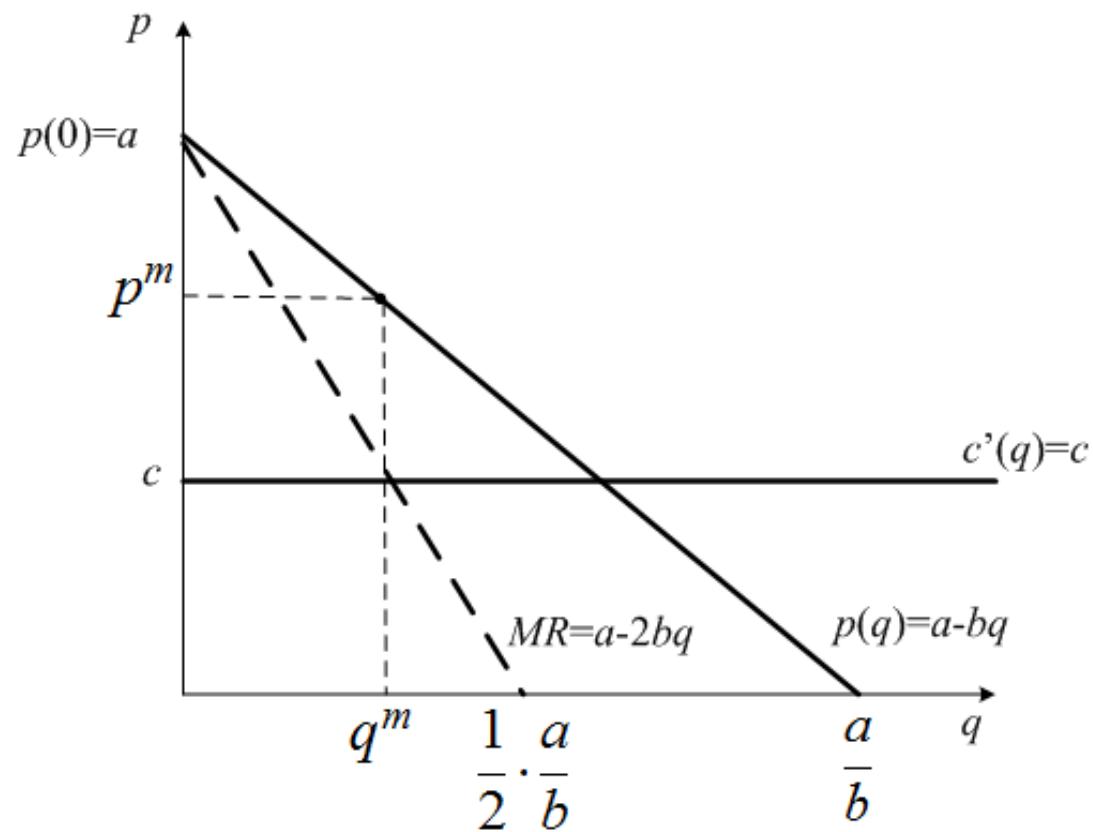
$$p^m = a - b \left(\frac{a - c}{2b} \right) = \frac{a + c}{2}$$

- Hence, monopoly profits are

$$\pi^m = p^m q^m - cq^m = \frac{(a - c)^2}{4b}$$

Profit Maximization: Lerner Index

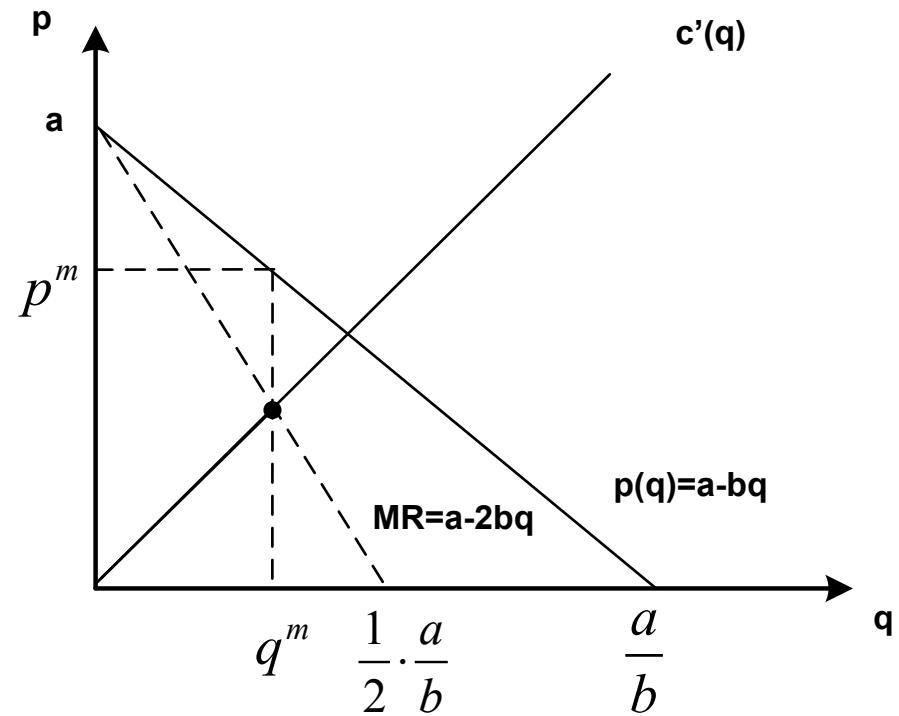
- *Example 1* (continued):



Profit Maximization: Lerner Index

- *Example 1* (continued):

- Non-constant marginal cost
- The cost function is convex in output
 $c(q) = cq^2$
- Marginal cost is
 $c'(q) = 2cq$



Profit Maximization: Lerner Index

- ***Example 2*** (Constant elasticity demand):

- The demand function is

$$q(p) = Ap^{-b}$$

- We can show that $\varepsilon(q) = -b$ for all q , i.e.,

$$\begin{aligned}\varepsilon(q) &= \frac{\partial q(p)}{\partial p} \frac{p}{q} = \underbrace{\frac{(-b)Ap^{-b-1}}{\partial q(p)}}_{\frac{p}{q}} \underbrace{\frac{p}{Ap^{-b}}}_{\frac{p}{q}} \\ &= -b \frac{p^{-b}}{p} \frac{p}{p^{-b}} = -b\end{aligned}$$

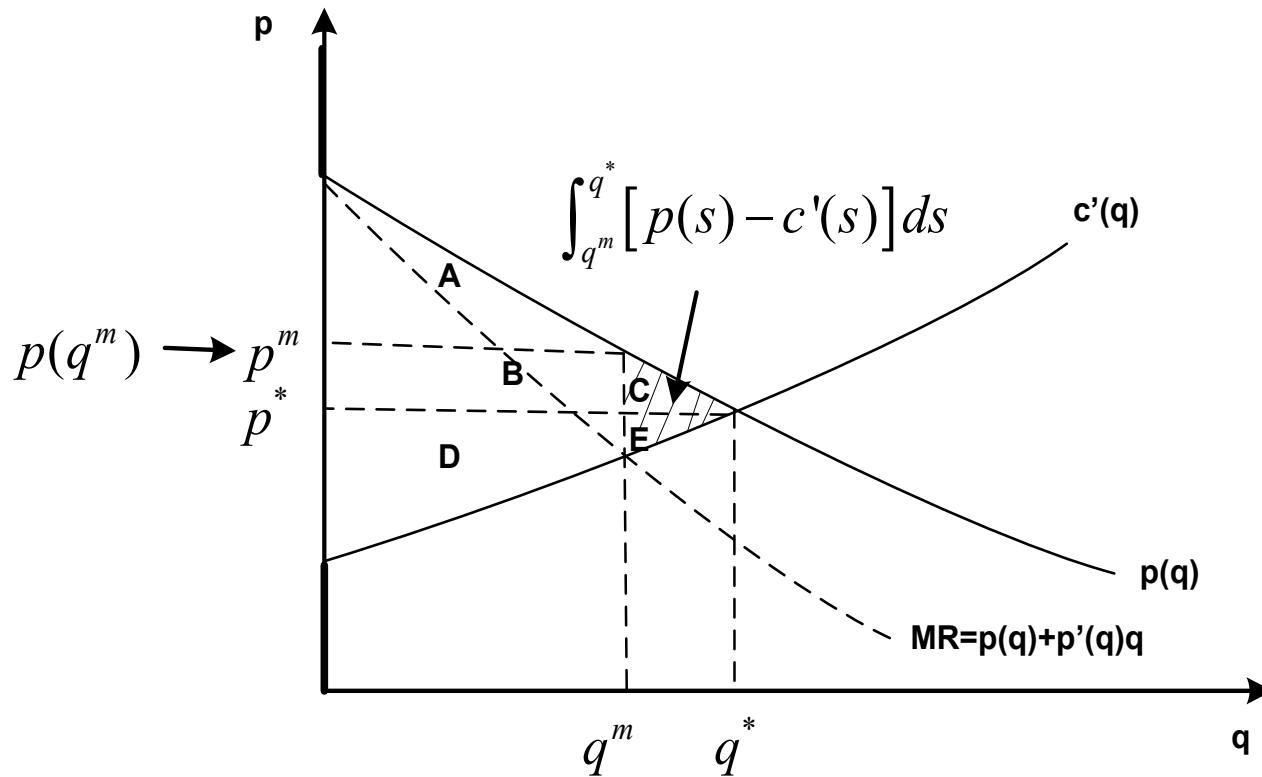
Profit Maximization: Lerner Index

- *Example 2* (continued):
 - We can now plug $\varepsilon(q) = -b$ into the Lerner index,
$$p^m = \frac{c}{1 + \frac{1}{\varepsilon(q)}} = \frac{c}{1 - \frac{1}{b}} = \frac{bc}{b - 1}$$
 - That is, price is a constant mark-up over marginal cost.

Welfare Loss of Monopoly

Welfare Loss of Monopoly

- Welfare comparison for perfect competition and monopoly.

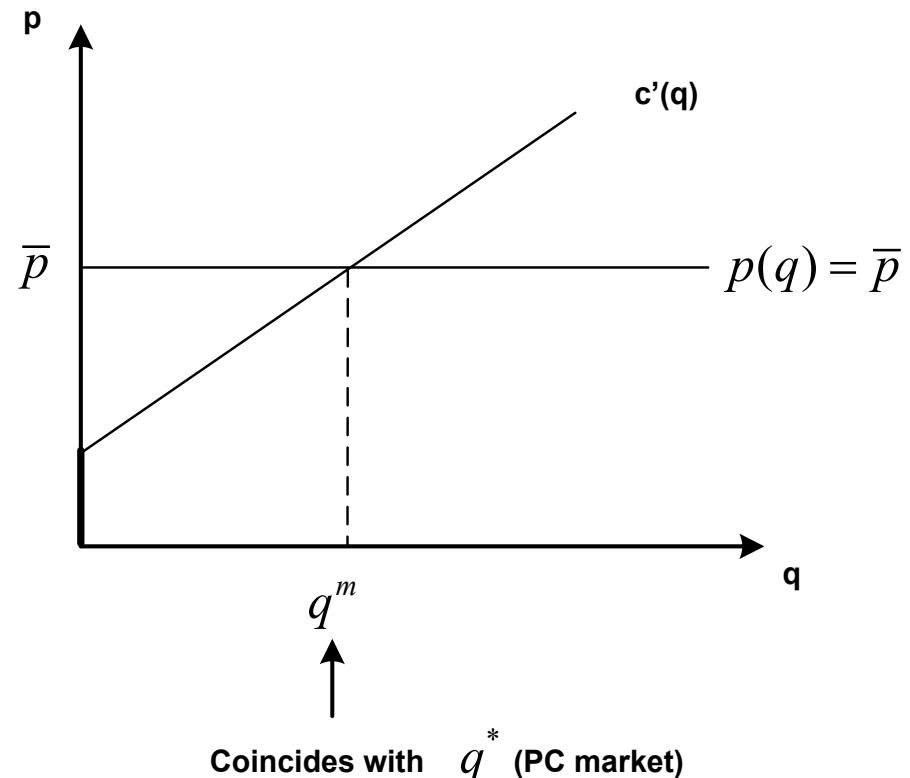


Welfare Loss of Monopoly

- Consumer surplus
 - Perfect competition: $A+B+C$
 - Monopoly: A
- Producer surplus:
 - Perfect competition: $D+E$
 - Monopoly: $B+D$
- Deadweight loss of monopoly: $C+E$
$$DWL = \int_{q^m}^{q^*} [p(s) - c'(s)]ds$$
- DWL decreases as demand and/or supply become more elastic.

Welfare Loss of Monopoly

- Infinitely elastic demand
 $p'(q) = 0$
- The inverse demand curve becomes totally flat.
- Marginal revenue coincides with inverse demand:
$$MR(q) = p(q) + 0 \cdot q = p(q)$$
- Profit-maximizing q
$$MR(q) = MC(q) \Rightarrow p(q) = MC(q)$$
- Hence, $q^m = q^*$ and $DWL = 0$.



Welfare Loss of Monopoly

- ***Example*** (Welfare losses and elasticity):
 - Consider a monopolist with constant marginal and average costs, $c'(q) = c$, who faces a market demand with constant elasticity
$$q(p) = p^e$$
where e is the price elasticity of demand ($e < -1$)
 - Perfect competition: $p_c = c$
 - Monopoly: using the IEPR

$$p^m = \frac{c}{1 + \frac{1}{e}}$$

Welfare Loss of Monopoly

- ***Example*** (continued):

- The consumer surplus associated with any price (p_0) can be computed as

$$CS = \int_{p_0}^{\infty} Q(P)dp = \int_{p_0}^{\infty} p^e dp = \frac{p^{e+1}}{e+1} \Big|_{p_0}^{\infty} = -\frac{p_0^{e+1}}{\underbrace{e+1}_{<0}} > 0$$

- Under perfect competition, $p_c = c$,

$$CS = -\frac{c^{e+1}}{e+1}$$

- Under monopoly, $p^m = \frac{c}{1+1/e}$,

$$CS_m = -\frac{\left(\frac{c}{1+1/e}\right)^{e+1}}{e+1}$$

Welfare Loss of Monopoly

- *Example* (continued):

- Taking the ratio of these two surpluses

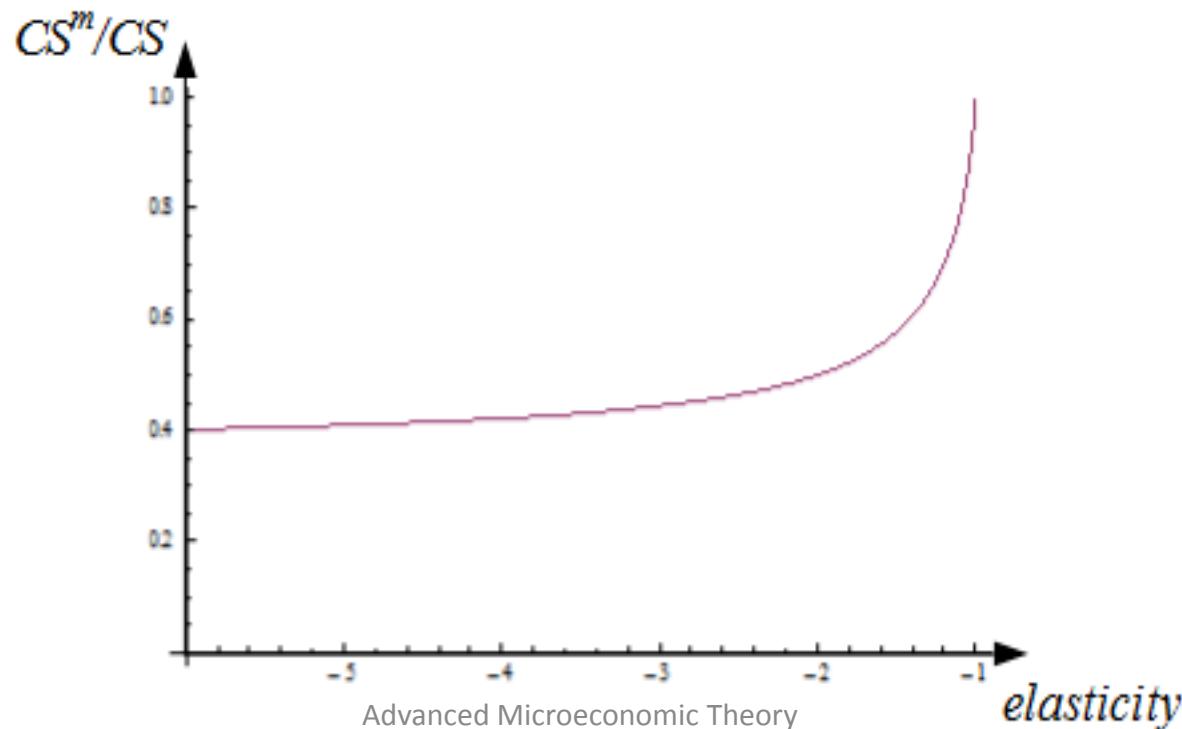
$$\frac{CS_m}{CS} = \left(\frac{1}{1 + 1/e} \right)^{e+1}$$

- If $e = -2$, this ratio is $\frac{1}{2}$
 - CS under monopoly is half of that under perfectly competitive markets

Welfare Loss of Monopoly

- ***Example*** (continued):

- The ratio $\frac{CS_m}{CS} = \left(\frac{1}{1+1/e}\right)^{e+1}$ decreases as demand becomes more elastic (e increases in absolute value).



Welfare Loss of Monopoly

- ***Example*** (continued):

- Monopoly profits are given by

$$\pi^m = p^m q^m - cq^m = \left(\frac{c}{1 + 1/e} - c \right) q^m$$

where $q^m(p) = p^e = \left(\frac{c}{1 + 1/e} \right)^e$.

- Rearranging,

$$\begin{aligned}\pi^m &= \left(\frac{-c/e}{1 + 1/e} \right) \left(\frac{c}{1 + 1/e} \right)^e \\ &= - \left(\frac{c}{1 + 1/e} \right)^{e+1} \cdot \frac{1}{e}\end{aligned}$$

Welfare Loss of Monopoly

- *Example* (continued):
 - To find the transfer from CS into monopoly profits that consumers experience when moving from perfect competition to a monopoly, divide monopoly profits by the competitive CS
$$\frac{\pi^m}{CS} = \left(\frac{e+1}{e}\right) \left(\frac{1}{1+1/e}\right)^{e+1} = \left(\frac{e}{1+e}\right)^e$$
 - If $e = -2$, this ratio is $\frac{1}{4}$
 - One-fourth of the consumer surplus under perfectly competitive markets is transferred to monopoly profits

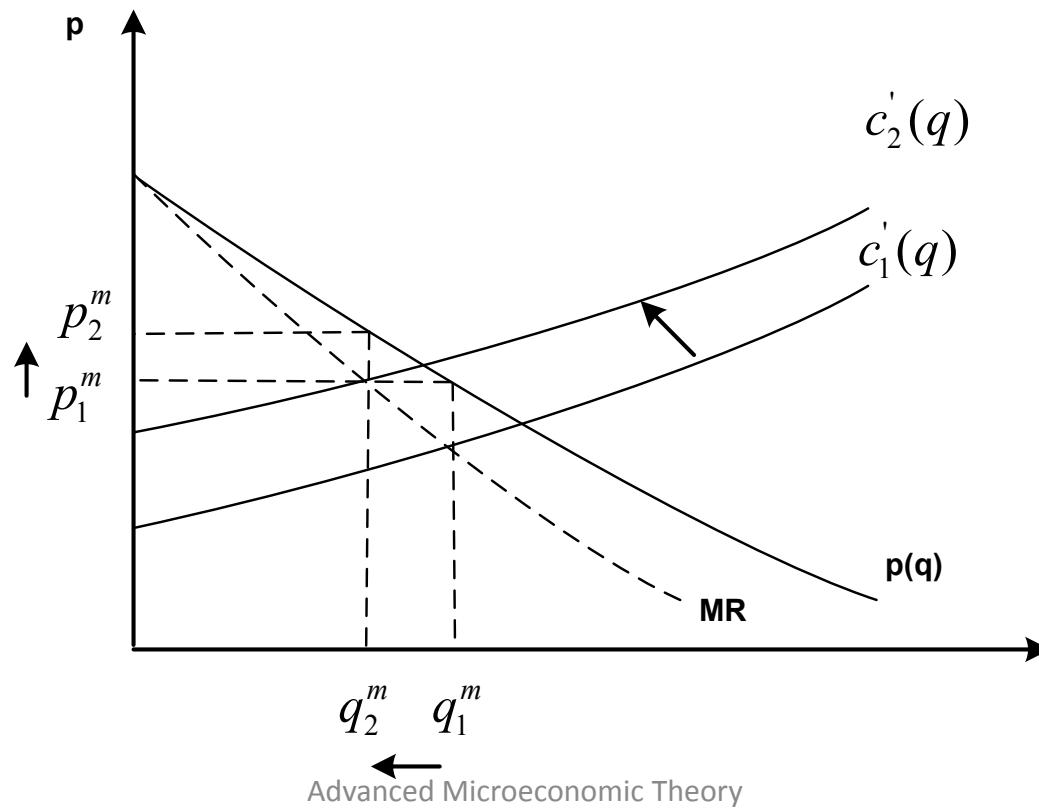
Welfare Loss of Monopoly

- More social costs of monopoly:
 - Excessive R&D expenditure (patent race)
 - Persuasive (not informative) advertising
 - Lobbying costs (different from bribes)
 - Resources to avoid entry of potential firms in the industry

Comparative Statics

Comparative Statics

- We want to understand how q^m varies as a function of the monopolist's marginal cost



Comparative Statics

- Formally, we know that at the optimum, $q^m(c)$, the monopolist maximizes its profits

$$\frac{\partial \pi(q^m(c), c)}{\partial q^m} = 0$$

- Differentiating wrt c , and using the chain rule,

$$\frac{\partial^2 \pi(q^m(c), c)}{\partial q^2} \frac{dq^m(c)}{dc} + \frac{\partial^2 \pi(q^m(c), c)}{\partial q \partial c} = 0$$

- Solving for $\frac{dq^m(c)}{dc}$, we have

$$\frac{dq^m(c)}{dc} = -\frac{\frac{\partial^2 \pi(q^m(c), c)}{\partial q \partial c}}{\frac{\partial^2 \pi(q^m(c), c)}{\partial q^2}}$$

Comparative Statics

- ***Example:***

- Assume linear demand curve $p(q) = a - bq$
- Then, the cross-derivative is

$$\begin{aligned}\frac{\partial^2 \pi(q^m(c), c)}{\partial q \partial c} &= \frac{\partial \left(\frac{\partial[(a - bq)q - cq]}{\partial q} \right)}{\partial c} \\ &= \frac{\partial[a - 2bq - c]}{\partial c} = -1\end{aligned}$$

and

$$\frac{dq^m(c)}{dc} = -\frac{\frac{\partial^2 \pi(q^m(c), c)}{\partial q \partial c}}{\frac{\partial^2 \pi(q^m(c), c)}{\partial q^2}} = -\frac{-1}{-2b} < 0$$

Comparative Statics

- *Example* (continued):
 - That is, an increase in marginal cost, c , decreases monopoly output, q^m .
 - Similarly for any other demand.
 - Even if we don't know the accurate demand function, but know the sign of

$$\frac{\partial^2 \pi(q^m(c), c)}{\partial q \partial c}$$

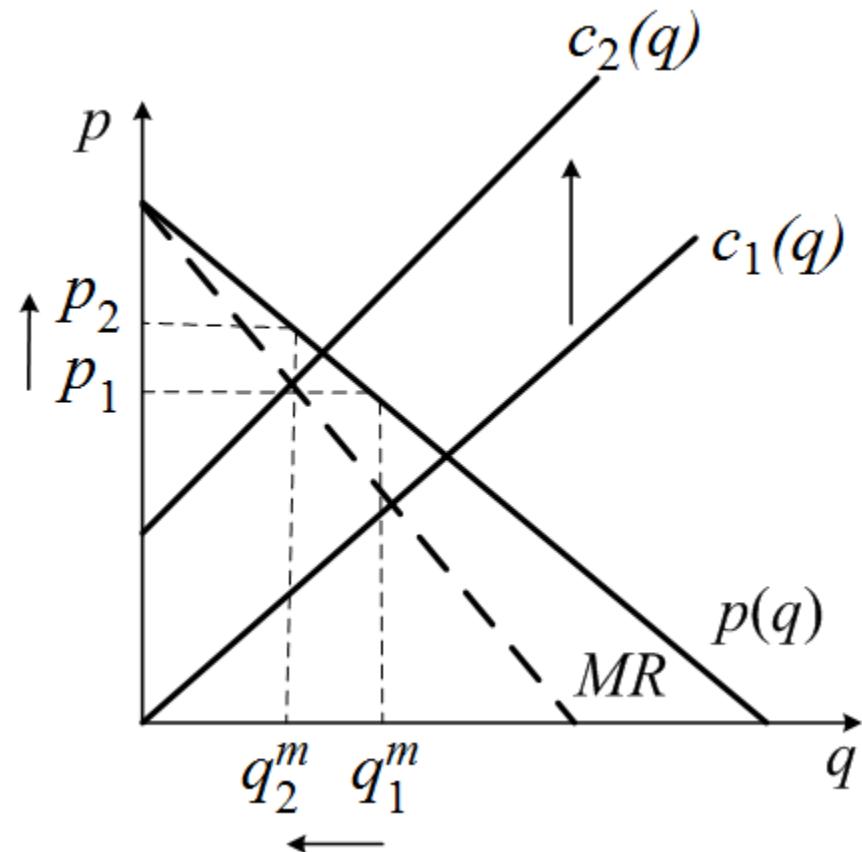
Comparative Statics

- **Example** (continued):

- Marginal costs are increasing in q
- For convex cost curve $c(q) = cq^2$, monopoly output is

$$q^m(c) = \frac{a}{2(b + c)}$$

- Here,

$$\frac{dq^m(c)}{dc} = -\frac{a}{2(b + c)^2} < 0$$


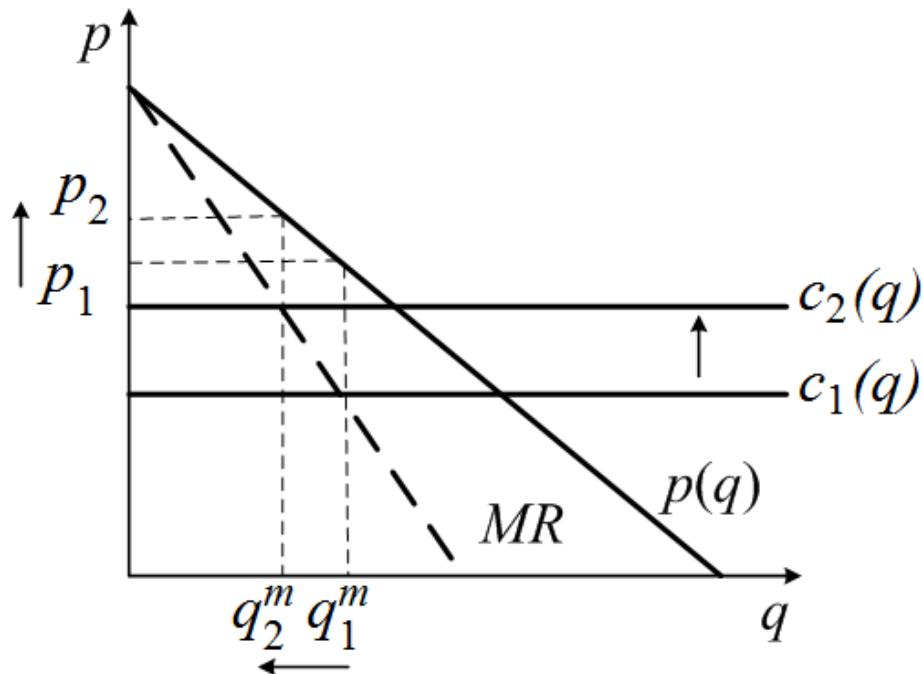
Comparative Statics

- **Example** (continued):

- Constant marginal cost
- For the constant-elasticity demand curve $q(p) = p^e$, we have $p^m = \frac{c}{1+1/e}$ and $q^m(c) = \left(\frac{ec}{1+e}\right)^e$

- Here,

$$\begin{aligned}\frac{dq^m(c)}{dc} &= \frac{e}{c} \left(\frac{ec}{1+e}\right)^e \\ &= \frac{e}{c} q^m < 0\end{aligned}$$



Multiplant Monopolist

Multipiant Monopolist

- Monopolist produces output q_1, q_2, \dots, q_N across N plants it operates, with total costs $TC_i(q_i)$ at each plant $i = \{1, 2, \dots, N\}$.
- Profits-maximization problem

$$\max_{q_1, \dots, q_N} [a - b \sum_{i=1}^N q_i] \sum_{i=1}^N q_i - \sum_{i=1}^N TC_i(q_i)$$

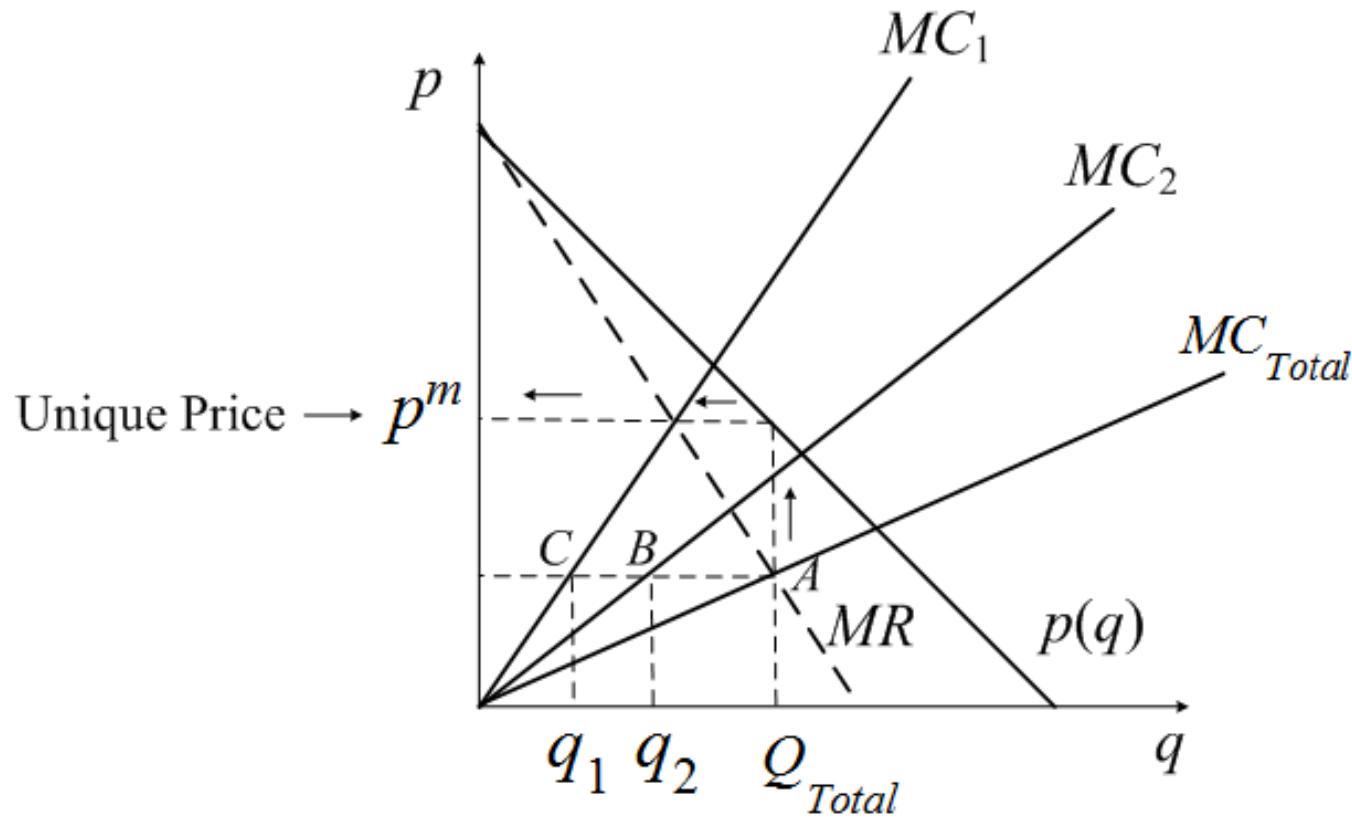
- FOCs wrt production level at every plant j

$$a - 2b \sum_{i=1}^N q_i - MC_j(q_j) = 0$$
$$\Leftrightarrow MR(Q) = MC_j(q_j)$$

for all j .

Multiplant Monopolist

- Multiplant monopolist operating two plants with marginal costs MC_1 and MC_2 .



Multipiant Monopolist

- Total marginal cost is $MC_{total} = MC_1 + MC_2$ (i.e., horizontal sum)
- Q_{total} is determined by $MR = MC_{total}$ (i.e., point A)
- Mapping Q_{total} in the demand curve, we obtain price p^m (both plants selling at the same price)
- At the MC level for which $MR = MC_{total}$ (i.e., point A), extend a line to the left crossing MC_1 and MC_2 .
- This will give us output levels q_1 and q_2 that plants 1 and 2 produce, respectively.

Multipiant Monopolist

- **Example 1** (symmetric plants):
 - Consider a monopolist operating N plants, where all plants have the *same* cost function $TC_i(q_i) = F + cq_i^2$. Hence, all plants produce the same output level $q_1 = q_2 = \dots = q_N = q$ and $Q = Nq$. The linear demand function is given by $p = a - bQ$.
 - FOCs:
$$a - 2b \sum_{j=1}^N q_j = 2cq_j \quad \text{or} \quad a - 2bNq_j = 2cq_j$$
$$q_j = \frac{a}{2(bN + c)}$$

Multipiant Monopolist

- **Example 1** (continued):
 - Total output produced by the monopolist is

$$Q = Nq_j = \frac{Na}{2(bN + c)}$$

and market price is

$$p = a - bQ = a - b \frac{Na}{2(bN + c)} = \frac{a(bN + 2c)}{2(bN + c)}$$

- Hence, the profits of every plant j are

$$\pi_j = \left(\frac{a(bN + 2c)}{2(bN + c)} \right) \frac{a}{2(bN + c)} - c \left(\frac{a}{2(bN + c)} \right)^2 = \frac{a^2}{4(bN + c)} - F$$

- Total profits become

$$\pi_{total} = \frac{Na^2}{4(bN + c)} - NF$$

Multipiant Monopolist

- ***Example 1*** (continued):

- The optimal number of plants N^* is determined by

$$\frac{d\pi_{total}}{dN} = \frac{a^2}{4} \frac{c}{(bN + c)^2} - F = 0$$

and solving for N

$$N^* = \frac{1}{b} \left(\frac{a}{2} \sqrt{\frac{c}{F}} - c \right)$$

- N^* is decreasing in the fixed costs F
 - N^* is decreasing in c as long as $a < 4\sqrt{cF}$, since

$$\frac{dN^*}{dc} = \frac{1}{b} \left(\frac{a - 4\sqrt{cF}}{4\sqrt{cF}} \right)$$

Multiplant Monopolist

- *Example 1* (continued):
 - Note that when $N = 1$, $Q = q^m$ and $p = p^m$.
 - Note that an increase in N decreases q_j and π_j , as

$$\frac{dq_j}{dN} = -\frac{ab}{2(bN + c)^2} < 0$$

$$\frac{d\pi_j}{dN} = -\frac{a^2b}{4(bN + c)^2} < 0$$

Multiplant Monopolist

- ***Example 2*** (asymmetric plants):
 - Consider a monopolist operating two plants with marginal costs $MC_1(q_1) = 10 + 20q_1$ and $MC_2(q_2) = 60 + 5q_2$, respectively. A linear demand function is given by $p(Q) = 120 - 3Q$.
 - Note that $MC_{total} \neq MC_1(q_1) + MC_2(q_2)$
 - This is a vertical (not a horizontal) sum.
 - Instead, first invert the marginal cost functions

$$MC_1(q_1) = 10 + 20q_1 \Leftrightarrow q_1 = \frac{MC_1}{20} - \frac{1}{2}$$

$$MC_2(q_2) = 60 + 5q_2 \Leftrightarrow q_2 = \frac{MC_2}{5} - 12$$

Multipiant Monopolist

- **Example 2** (continued):

- Second,

$$\begin{aligned}Q_{total} &= q_1 + q_2 = \frac{MC_{total}}{20} - \frac{1}{2} + \frac{MC_{total}}{5} - 12 \\&= \frac{1}{4}MC_{total} - 12.5\end{aligned}$$

- Hence, $MC_{total} = 50 + 4Q_{total}$
 - Setting $MR(Q) = 120 - 6Q = 50 + 4Q = MC_{total}$, we obtain $Q_{total} = 7$ and $p = 120 - 3 \cdot 7 = 99$.
 - Since $MR(Q_{total}) = 120 - 6 \cdot 7 = 78$, then

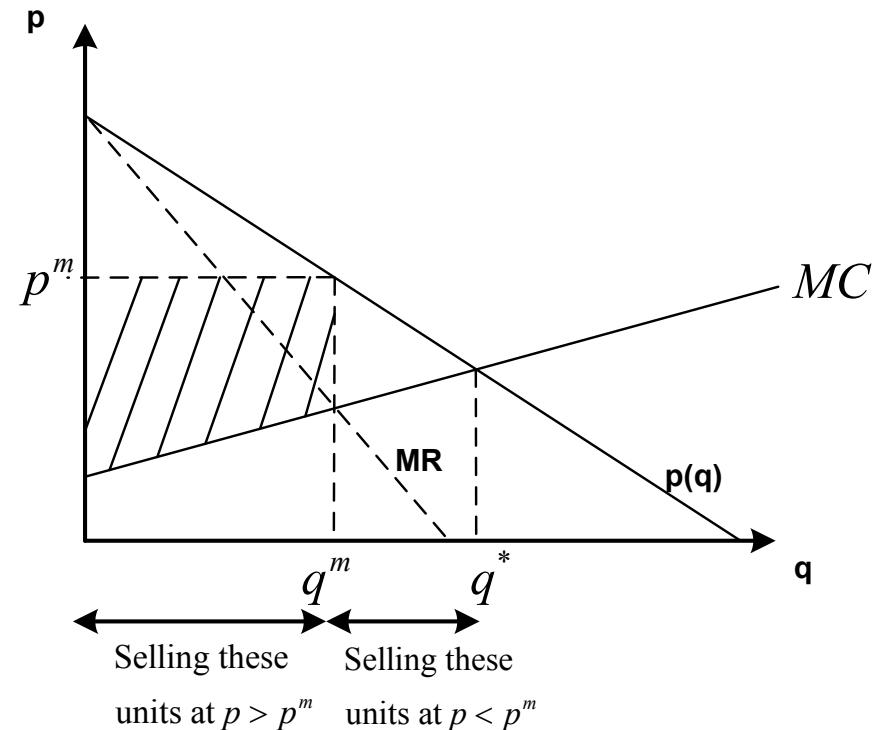
$$MR(Q_{total}) = MC_1(q_1) \Rightarrow 78 = 10 + 20q_1 \Rightarrow q_1 = 3.4$$

$$MR(Q_{total}) = MC_2(q_2) \Rightarrow 78 = 60 + 5q_2 \Rightarrow q_2 = 3.6$$

Price Discrimination

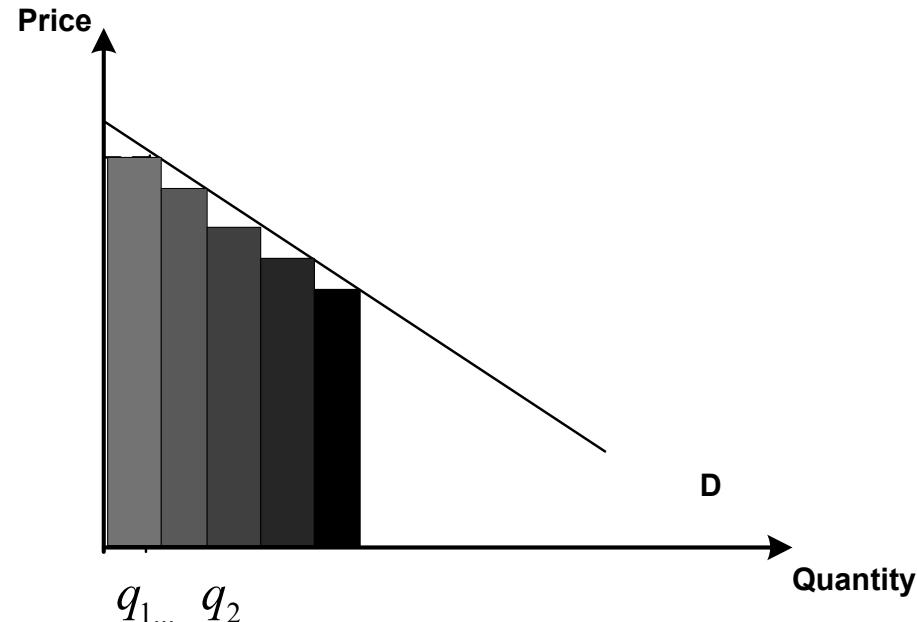
Price Discrimination

- Can the monopolist capture an even larger surplus?
 - Charge $p > p^m$ to those who buy the product at p^m and are willing to pay more
 - Charge $c < p < p^m$ to those who do not buy the product at p^m , but whose willingness to pay for the good is still higher than the marginal cost of production, c .
 - With p^m for all units, the monopolist does not capture the surplus of neither of these segments.



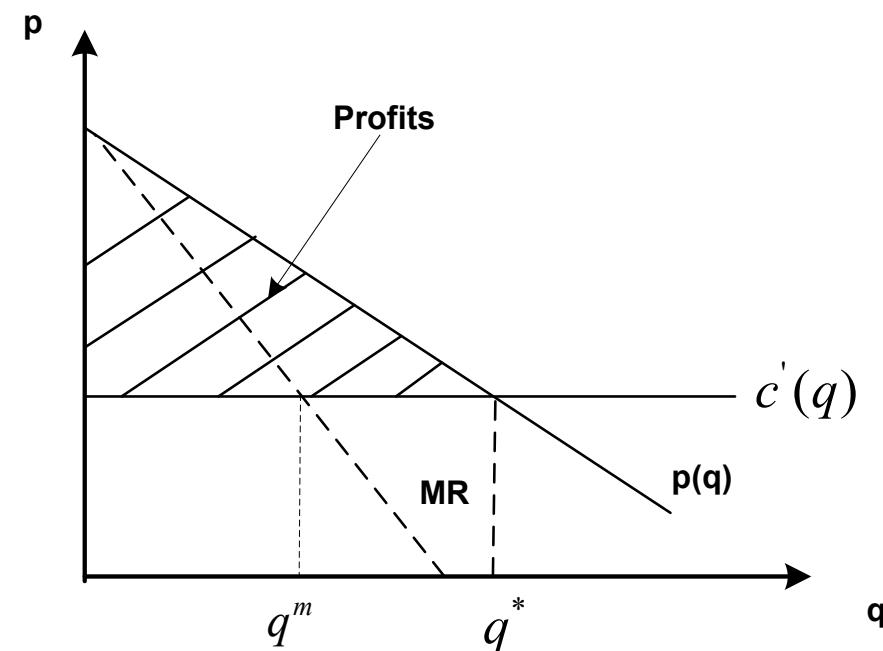
Price Discrimination: First-degree

- ***First-degree (perfect) price discrimination:***
 - The monopolist charges to every customer his/her maximum willingness to pay for the object.
 - *Personalized price:*
The first buyer pays p_1 for the q_1 units, the second buyer pays p_2 for $q_2 - q_1$ units, etc.



Price Discrimination: First-degree

- The monopolist continues doing so until the last buyer is willing to pay the marginal cost of production.
- In the limit, the monopolist captures all the area below the demand curve and above the marginal cost (i.e., consumer surplus).



Price Discrimination: First-degree

- Suppose that the monopolist can charge a fixed fee, r^* , and an amount of the good, q^* , that maximizes profits.
- PMP:

$$\begin{aligned} & \max_{r,q} r - cq \\ & \text{s.t. } u(q) \geq r \end{aligned}$$

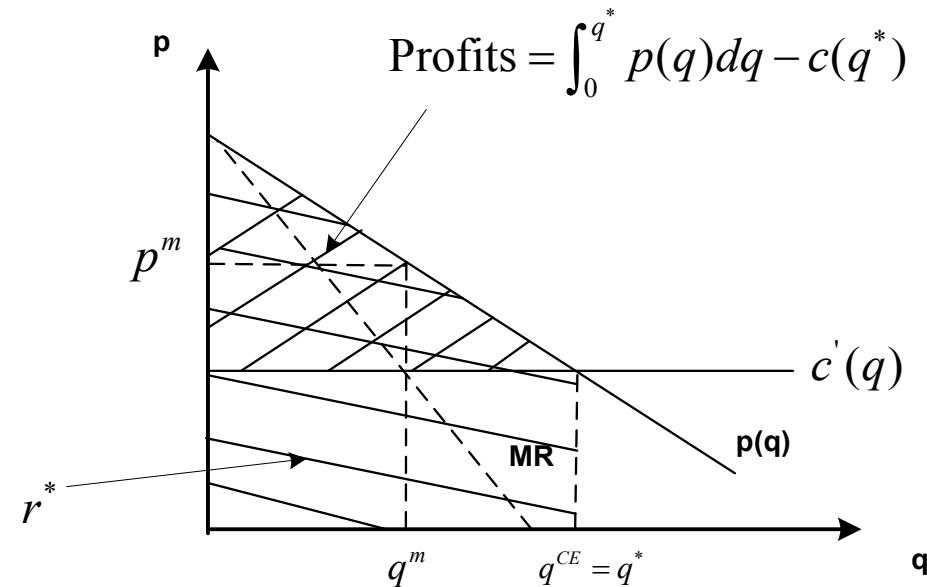
- Note that the monopolist raises the fee r until $u(q) = r$. Hence we can reduce the set of choice variables

$$\max_q u(q) - cq$$

- FOC: $u'(q^*) - c = 0$ or $u'(q^*) = c$.
 - *Intuition:* the monopolist increases output until the marginal utility that consumers obtain from additional units coincides with the marginal cost of production

Price Discrimination: First-degree

- Given the level of production q^* , the optimal fee is $r^* = u(q^*)$
- Intuition:* the monopolist charges a fee r^* that coincides with the utility that the consumer obtains from consuming q^* .

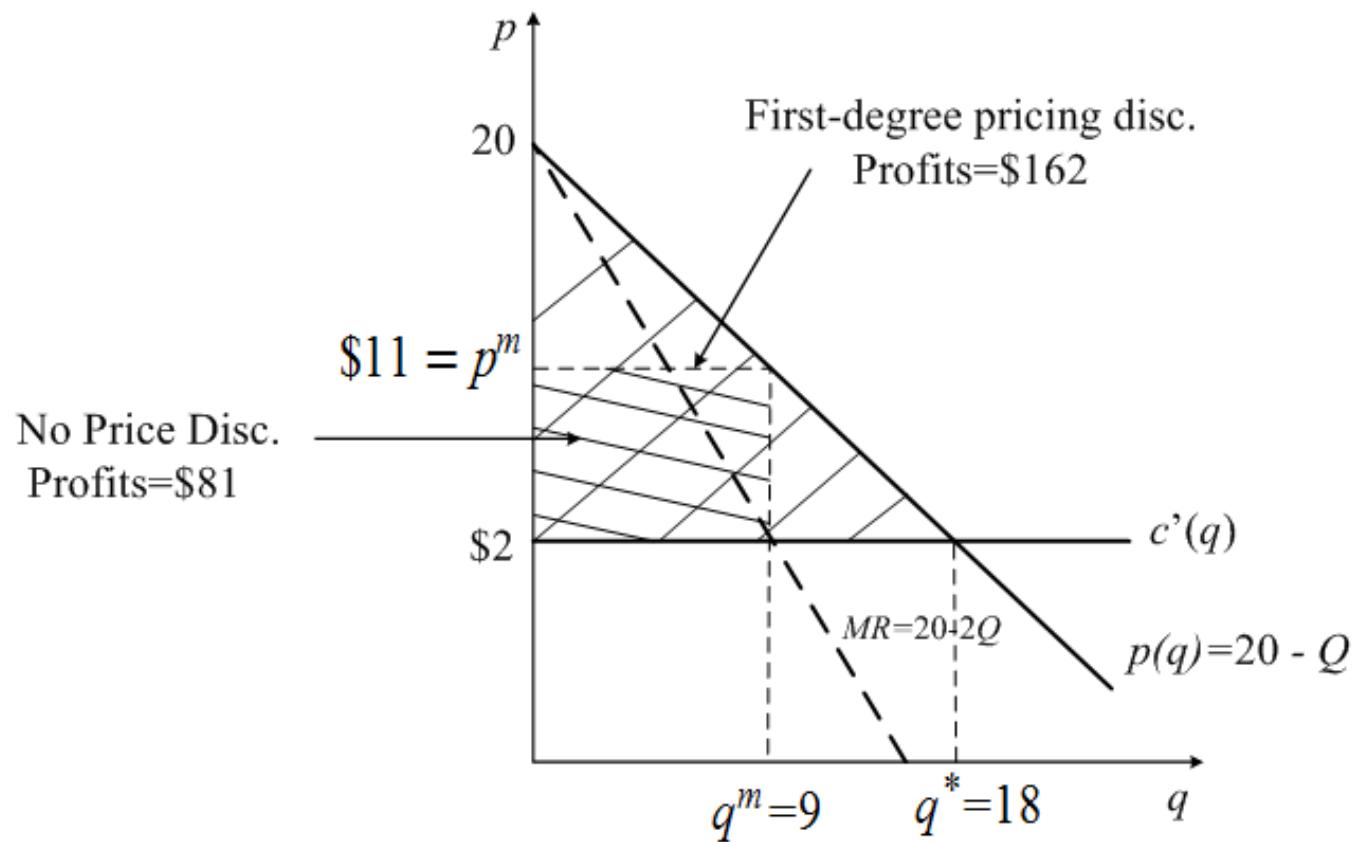


Price Discrimination: First-degree

- *Example:*
 - A monopolist faces inverse demand curve $p(q) = 20 - q$ and constant marginal costs $c = \$2$.
 - No price discrimination:
$$MR = MC \implies 20 - 2q = 2 \implies q^m = 9$$
$$p^m = \$11, \quad \pi^m = \$81$$
 - Price discrimination:
$$p(Q) = MC \implies 20 - Q = 2 \implies Q = 18$$
$$\pi = \frac{18 \times (20 - 2)}{2} = \$162$$

Price Discrimination: First-degree

- *Example* (continued):



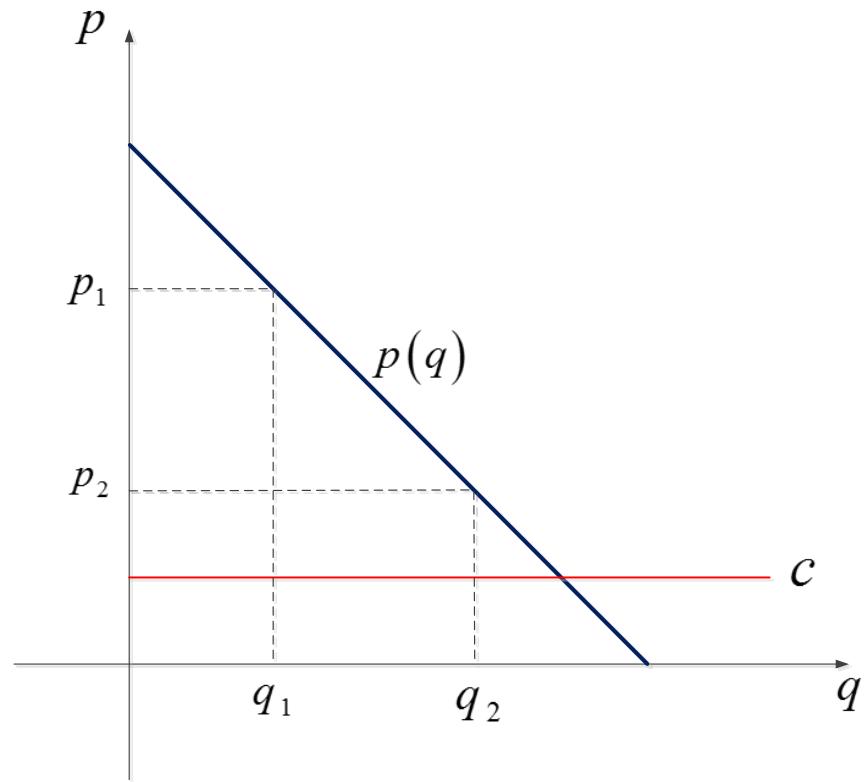
Price Discrimination: First-degree

- Summary:
 - Total output coincides with that in perfect competition
 - Unlike in perfect competition, the consumer does not capture any surplus
 - The producer captures all the surplus
 - Due to information requirements, we do not see many examples of it in real applications
 - Financial aid in undergraduate education (“tuition discrimination”)

Price Discrimination: First-degree

- ***Example*** (two-block pricing):

- A monopolist faces a inverse demand curve $p(q) = a - bq$, with constant marginal costs $c < a$.
- Under two-block pricing, the monopolist sells the first q_1 units at a price $p(q_1) = p_1$ and the remaining $q_2 - q_1$ units at a price $p(q_2) = p_2$.



Price Discrimination: First-degree

- *Example* (continued):

- Profits from the first q_1 units

$$\pi_1 = p(q_1) \cdot q_1 - cq_1 = (a - bq_1 - c)q_1$$

while from the remaining $q_2 - q_1$ units

$$\begin{aligned}\pi_2 &= p(q_2) \cdot (q_2 - q_1) - c \cdot (q_2 - q_1) \\ &= (a - bq_2 - c)(q_2 - q_1)\end{aligned}$$

- Hence total profits are

$$\begin{aligned}\pi &= \pi_1 + \pi_2 \\ &= (a - bq_1 - c)q_1 + (a - bq_2 - c)(q_2 - q_1)\end{aligned}$$

Price Discrimination: First-degree

- *Example* (continued):

- FOCs:

$$\frac{\partial \pi}{\partial q_1} = a - 2bq_1 - c - a + bq_2 + c = 0$$

$$\frac{\partial \pi}{\partial q_2} = -b(q_2 - q_1) + a - bq_2 - c = 0$$

- Solving for q_1 and q_2

$$q_1 = \frac{a - c}{3b} \quad q_2 = \frac{2(a - c)}{3b}$$

which entails prices of

$$p(q_1) = a - b \cdot \frac{a - c}{3b} = \frac{2a + c}{3} \quad p(q_2) = \frac{a + 2c}{3}$$

where $p(q_1) > p(q_2)$ since $a > c$.

Price Discrimination: First-degree

- ***Example*** (continued):

- The monopolist's profits from each block are

$$\begin{aligned}\pi_1 &= (p(q_1) - c) \cdot q_1 \\ &= \left(\frac{2a + c}{3} - c \right) \cdot \frac{a - c}{3b} = \frac{2}{b} \left(\frac{a - c}{3} \right)^2\end{aligned}$$

$$\begin{aligned}\pi_2 &= (p(q_2) - c)(q_2 - q_1) \\ &= \left(\frac{a + 2c}{3} - c \right) \cdot \left(\frac{2(a - c)}{3b} - \frac{a - c}{3b} \right) = \frac{1}{b} \left(\frac{a - c}{3} \right)^2\end{aligned}$$

- Thus, $\pi = \pi_1 + \pi_2 = \frac{(a-c)^2}{3b}$, which is larger than those arising from uniform pricing, $\pi^u = \frac{(a-c)^2}{4b}$.

Price Discrimination: Third-degree

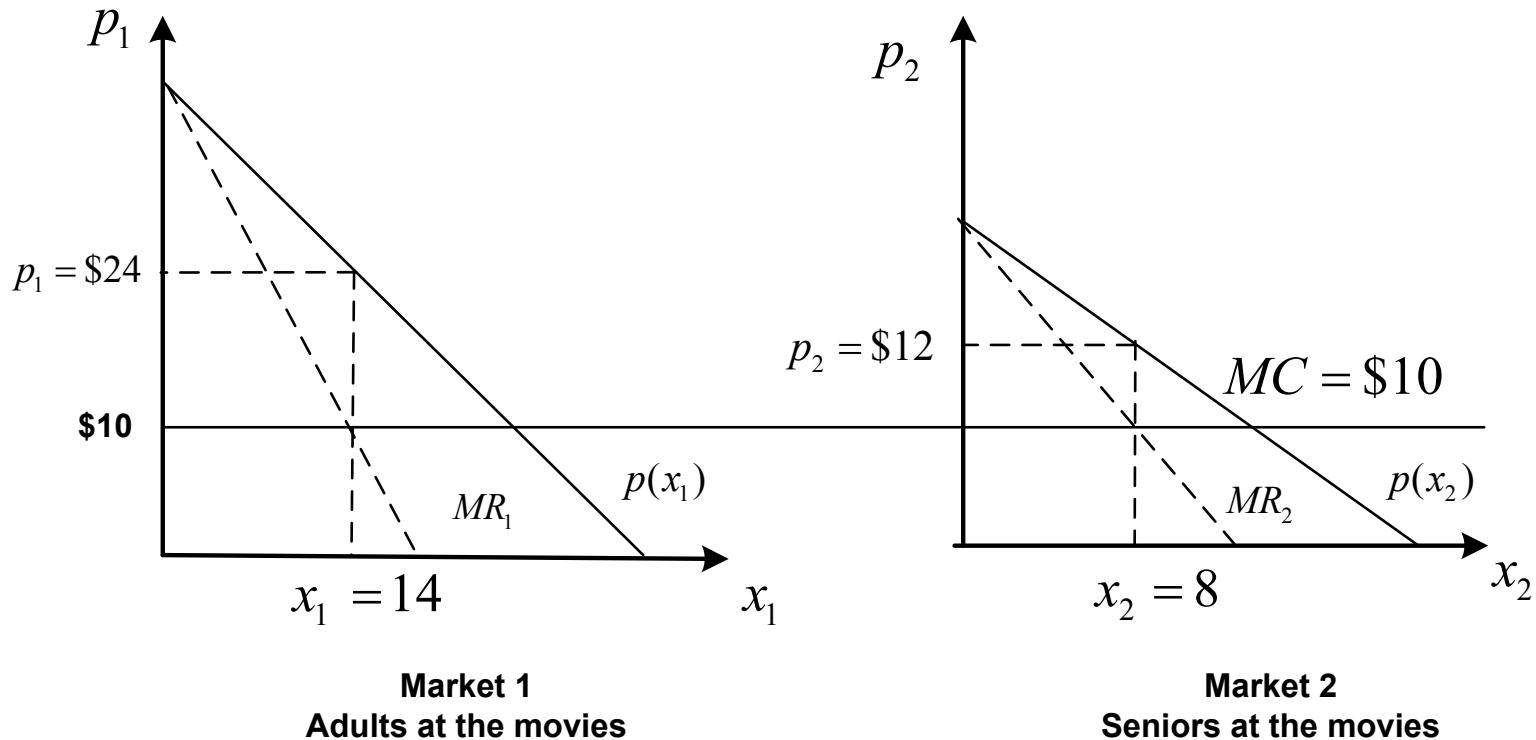
- ***Third degree price discrimination:***
 - The monopolist charges different prices to two or more groups of customers (each group must be easily recognized by the seller).
 - *Example:* youth vs. adult at the movies, airline tickets
 - Firm's PMP:
$$\max_{x_1, x_2} p_1(x_1)x_1 + p_2(x_2)x_2 - cx_1 - cx_2$$
 - FOCs:
$$p_1(x_1) + p'_1(x_1)x_1 - c = 0 \implies MR_1 = MC$$
$$p_2(x_2) + p'_2(x_2)x_2 - c = 0 \implies MR_2 = MC$$
 - FOCs coincides with those of a regular monopolist who serves two completely separated markets practicing uniform pricing .

Price Discrimination: Third-degree

- **Example:** $p_1(x_1) = 38 - x_1$ for adults and $p_2(x_2) = 14 - 1/4x_2$ for seniors, with $MC = \$10$ for both markets.

$$MR_1(x_1) = MC \Rightarrow 38 - 2x_1 = 10 \Rightarrow x_1 = 14 \quad p_1 = \$24$$

$$MR_2(x_2) = MC \Rightarrow 14 - 1/2x_2 = 10 \Rightarrow x_2 = 8 \quad p_2 = \$12$$



Price Discrimination: Third-degree

- Using the Inverse Elasticity Pricing Rule (IERP), we can obtain the prices

$$p_1(x_1) = \frac{c}{1+1/\varepsilon_1} \text{ and } p_2(x_2) = \frac{c}{1+1/\varepsilon_2}$$

where c is the common marginal cost

- Then, $p_1(x_1) > p_2(x_2)$ if and only if

$$\begin{aligned} \frac{c}{1+1/\varepsilon_1} &> \frac{c}{1+1/\varepsilon_2} \Rightarrow 1 + \frac{1}{\varepsilon_2} < 1 + \frac{1}{\varepsilon_1} \\ \Rightarrow \frac{1}{\varepsilon_2} &> \frac{1}{\varepsilon_1} \Rightarrow \varepsilon_2 < \varepsilon_1 \end{aligned}$$

- Intuition:* the monopolist charges lower price in the market with more elastic demand.

Price Discrimination: Third-degree

- ***Example*** (Pullman-Seattle route):
 - The price-elasticity of demand for business-class seats is -1.15, while that for economy seats is -1.52
 - From the IEPR,

$$p_B = \frac{MC}{1 - 1/1.15} \Rightarrow 0.13p_B = MC$$

$$p_E = \frac{MC}{1 - 1/1.52} \Rightarrow 0.34p_E = MC$$

- Hence, $0.13p_B = 0.34p_E$ or $p_B = 2.62p_E$
 - Airline maximizes its profits by charging business-class seats a price 2.62 times higher than that of economy-class seats

Price Discrimination: Second-degree

- ***Second-degree price discrimination:***
 - The monopolist cannot observe the type of each consumer (e.g., his willingness to pay).
 - Hence the monopolist offers a menu of two-part tariffs, (F_L, q_L) and (F_H, q_H) , with the property that the consumer with type $i = \{L, H\}$ has the incentive to self-select the two-part tariff (F_i, q_i) meant for him.

Price Discrimination: Second-degree

- Assume the utility function of type i consumer

$$U_i(q_i, F_i) = \theta_i u(q_i) - F_i$$

where

- q_i is the quantity of a good consumed
- F_i is the fixed fee paid to the monopolist for q_i
- θ_i measures the valuation consumer assigns to the good, where $\theta_H > \theta_L$, with corresponding probabilities p and $1 - p$.

- The monopolist's constant marginal cost c satisfies $\theta_i > c$ for all $i = \{L, H\}$.

Price Discrimination: Second-degree

- The monopolist must guarantee that
 - 1) both types of customers are willing to participate (“***participation constraint***”)
 - the two-part tariff meant for each type of customer provides him with a weakly positive utility level
 - 2) customers do not have incentives to choose the two-part tariff meant for the other type of customer (“***incentive compatibility***”)
 - type i customer prefers (F_i, q_i) over (F_j, q_j) where $j \neq i$

Price Discrimination: Second-degree

- The participation constraints (PC) are

$$\theta_L u(q_L) - F_L \geq 0 \quad PC_L$$

$$\theta_H u(q_H) - F_H \geq 0 \quad PC_H$$

- The incentive compatibility conditions are

$$\theta_L u(q_L) - F_L \geq \theta_L u(q_H) - F_H \quad IC_L$$

$$\theta_H u(q_H) - F_H \geq \theta_H u(q_L) - F_L \quad IC_H$$

Price Discrimination: Second-degree

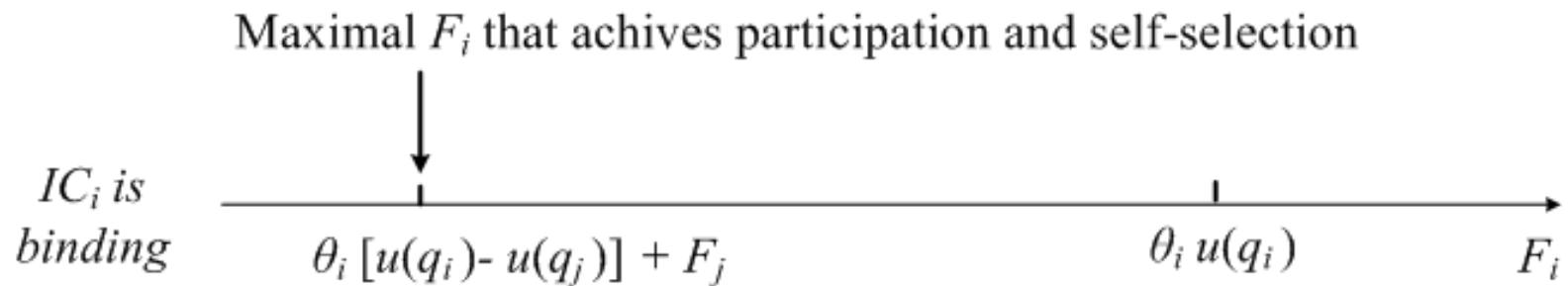
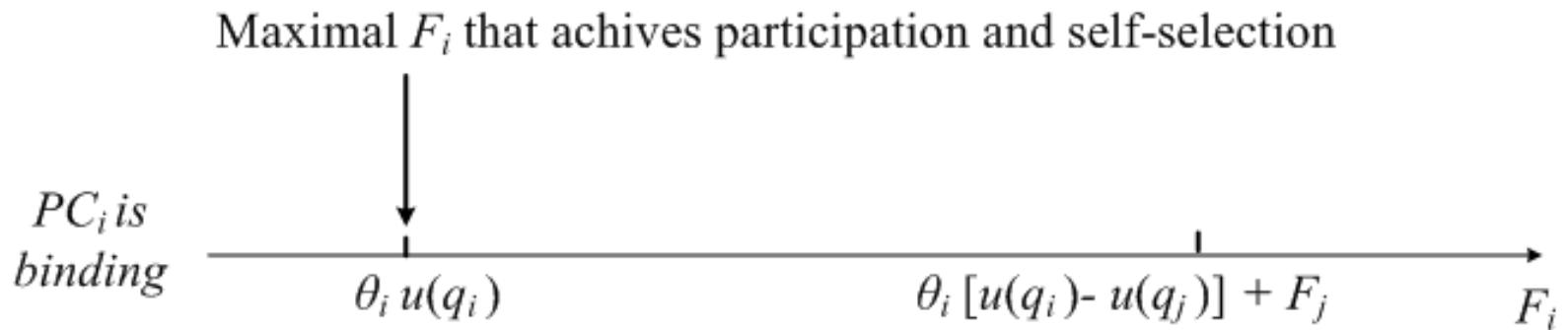
- Rearranging the four inequalities, the monopolist's profit maximization problem becomes:

$$\begin{aligned} \max_{F_L, q_L, F_H, q_H} \quad & p[F_H - cq_H] + (1 - p)[F_L - cq_L] \\ & \theta_L u(q_L) \geq F_L \\ & \theta_H u(q_H) \geq F_H \\ & \theta_L [u(q_L) - u(q_H)] + F_H \geq F_L \\ & \theta_H [u(q_H) - u(q_L)] + F_L \geq F_H \end{aligned}$$

Price Discrimination: Second-degree

- Both PC_H and IC_H are expressed in terms of the fee F_H
 - The monopolist increases F_H until such fee coincides with the lowest of $\theta_H u(q_H)$ and $\theta_H[u(q_H) - u(q_L)] + F_L$ for all $i = \{L, H\}$
 - Otherwise, one (or both) constraints will be violated, leading the high-demand customer to not participate

Price Discrimination: Second-degree



Price Discrimination: Second-degree

- ***High-demand customer:***
 - Let us show that IC_H is binding
 - An indirect way to show that
$$F_H = \theta_H[u(q_H) - u(q_L)] + F_L$$
is to demonstrate that $F_H < \theta_H u(q_H)$
 - Proving this by contradiction, assume that
$$F_H = \theta_H u(q_H)$$

Price Discrimination: Second-degree

- Then, IC_H can be written as

$$\begin{aligned} F_H - \theta_H u(q_L) + F_L &\geq F_H \\ \Rightarrow F_L &\geq \theta_H u(q_L) \end{aligned}$$

- Combining this result with the fact that $\theta_H > \theta_L$,

$$F_L \geq \theta_H u(q_L) > \theta_L u(q_L)$$

which implies $F_L > \theta_L u(q_L)$

- However, this violates PC_L

- We then reached a contradiction
- Thus, $F_H < \theta_H u(q_H)$
- IC_H is binding but PC_H is not.

Price Discrimination: Second-degree

- ***Low-demand customer:***

- Let us show that PC_L binding
 - Similarly as for the high-demand customer, an indirect way to show that

$$F_L = \theta_L u(q_L)$$

is to demonstrate that $F_L < \theta_L[u(q_L) - u(q_H)] + F_H$

- Proving this by contradiction, assume that

$$F_L = \theta_L[u(q_L) - u(q_H)] + F_H$$

Price Discrimination: Second-degree

- Then, IC_H can be written as

$$\begin{aligned}\theta_H[u(q_H) - u(q_L)] + \theta_L[u(q_L) - u(q_H)] + F_H &= F_H \\ \Rightarrow \theta_H[u(q_H) - u(q_L)] &= \theta_L[u(q_H) - u(q_L)] \\ \Rightarrow \theta_H &= \theta_L\end{aligned}$$

which violates the initial assumption $\theta_H > \theta_L$

- We reached a contradiction
- Thus, $F_L < \theta_L[u(q_L) - u(q_H)] + F_H$
- PC_L is binding but IC_L is not

Price Discrimination: Second-degree

- In summary:

- From PC_L binding we have

$$\theta_L u(q_L) = F_L$$

- From IC_H binding we have

$$\theta_H [u(q_H) - u(q_L)] + F_L = F_H$$

- In addition,

- PC_L binding implies that IC_L holds, and
 - IC_H binding entails that PC_H is also satisfied,
 - That is, all four constraints hold.

Price Discrimination: Second-degree

- The monopolist's expected PMP can then be written as unconstrained problem, as follows,

$$\begin{aligned} \max_{q_L, q_H \geq 0} \quad & p [F_H - cq_H] + (1 - p)[F_L - cq_L] \\ &= p \left\{ \underbrace{\theta_H [u(q_H) - u(q_L)] + F_L}_{F_H} - cq_H \right\} \\ & \quad + (1 - p) \left\{ \underbrace{\theta_L u(q_L)}_{F_L} - cq_L \right\} \\ &= p \left\{ \theta_H [u(q_H) - u(q_L)] + \underbrace{\theta_L u(q_L)}_{F_L} - cq_H \right\} \\ & \quad + (1 - p) \{ \theta_L u(q_L) - cq_L \} \\ &= p[\theta_H u(q_H) - (\theta_H - \theta_L)u(q_L) - cq_H] \\ & \quad + (1 - p)[\theta_L u(q_L) - cq_L] \end{aligned}$$

Price Discrimination: Second-degree

- FOC with respect to q_H :

$$p[\theta_H u'(q_H) - c] = 0 \implies \theta_H u'(q_H) = c$$

- which coincides with that under complete information.
- That is, there is no output distortion for high-demand buyer
- Informally, we say that there is “**no distortion at the top**”.

- FOC with respect to q_L :

$$p[-(\theta_H - \theta_L)u'(q_L)] + (1 - p)[\theta_L u'(q_L) - c] = 0$$

which can be re-written as

$$u'(q_L)[\theta_L - p\theta_H] = (1 - p)c$$

Price Discrimination: Second-degree

- Dividing both sides by $(1 - p)$, we obtain

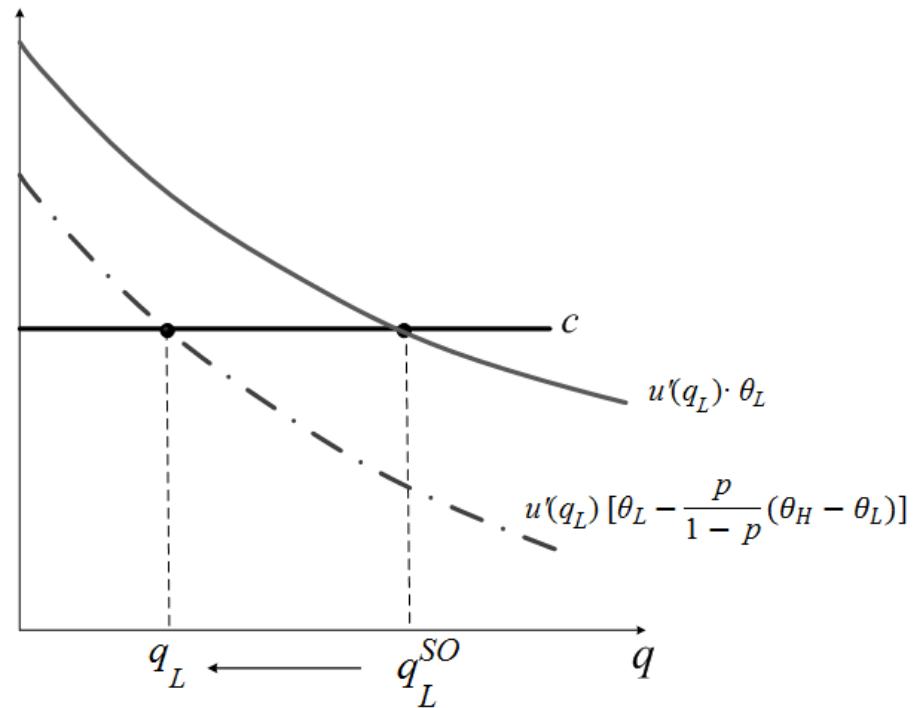
$$u'(q_L) \left[\frac{\theta_L - p\theta_H}{1-p} \right] = c$$

- The above expression can alternatively be written as

$$u'(q_L) \left[\theta_L - \frac{p}{1-p} (\theta_H - \theta_L) \right] = c$$

Price Discrimination: Second-degree

- $u'(q_L) \cdot \theta_L$ depicts the socially optimal output q_L^{SO} , i.e., that arising under complete information
- The output offered to high-demand customers is socially efficient due to the absence of output distortion for high-type agents
- The output offered to low-demand customers entails a distortion, i.e., $q_L < q_L^{SO}$
- Per-unit price for high-type and low-type differs, i.e., $F_H \neq F_L$
 - Monopolist practices price discrimination among the two types of customers.



Price Discrimination: Second-degree

- Since constraint PC_L binds while PC_H does not, then only the high-demand customer retains a positive utility level, i.e., $\theta_H u(q_H) - F_H > 0$.
- The firm's lack of information provides the high-demand customer with an "information rent."
 - Intuitively, the information rent emerges from the seller's attempt to reduce the incentives of the high-type customer to select the contract meant for the low type.
 - The seller also achieves self-selection by setting an attractive output for the low-type buyer, i.e., q_L is lower than under complete information.

Price Discrimination: Second-degree

- ***Example:***
 - Consider a monopolist selling a textbook to two types of graduate students, low- and high-demand, with utility function

$$U_i(q_i, F_i) = \frac{q_i^2}{2} - \theta_i q_i - F_i$$

where $i = \{L, H\}$ and $\theta_H > \theta_L$.

- Hence, the UMP of type i student is

$$\max_{q_i} \quad \frac{q_i^2}{2} - \theta_i q_i - F_i \quad \text{s. t. } pq_i + F_i \leq w_i$$

where $w_i > 0$ denotes the student's wealth.

Price Discrimination: Second-degree

- *Example* (continued):
 - By Walras' law, the constraint binds
$$F_i = w_i - pq_i$$
 - Then, the UMP can be expressed as
$$\max_{q_i} \frac{q_i^2}{2} - \theta_i q_i - (w_i - pq_i)$$
 - FOCs wrt q_i yields the direct demand function:
$$q_i - \theta_i + p = 0 \quad \text{or} \quad q_i = \theta_i - p$$

Price Discrimination: Second-degree

- ***Example*** (continued):
 - Assume that the proportion of high-demand (low-demand) students is γ ($1 - \gamma$, respectively).
 - The monopolist's constant marginal cost is $c > 0$, which satisfies $\theta_i > c$ for all $i = \{L, H\}$.
 - Consider for simplicity that $\theta_L > \frac{\theta_H + c}{2}$.
 - This implies that each type of student would buy the textbook, both when the firm practices uniform pricing and when it sets two-part tariffs
 - Exercise.

Advertising in Monopoly

Advertising in Monopoly

- **Advertising**: non-price strategy to capture surplus
- The monopolist must balance the additional demand that advertising entails and its associated costs (A dollars)
- The monopolist solves

$$\max_A p \cdot q(p, A) - TC(q(p, A)) - A$$

where the demand function $q(p, A)$ depends on price and advertising.

Advertising in Monopoly

- Taking FOCs with respect to A ,

$$p \cdot \frac{\partial q(p,A)}{\partial A} - \underbrace{\frac{\partial TC}{\partial q}}_{MC} \cdot \frac{\partial q(p,A)}{\partial A} - 1 = 0$$

Rearranging, we obtain

$$(p - MC) \frac{\partial q(p,A)}{\partial A} = 1$$

- Let us define the advertising elasticity of demand

$$\varepsilon_{q,A} = \frac{\% \text{ increase in } q}{\% \text{ increase in } A} = \frac{\partial q(p,A)}{\partial A} \cdot \frac{A}{q}$$

Or, rearranging,

$$\varepsilon_{q,A} \cdot \frac{q}{A} = \frac{\partial q(p,A)}{\partial A}$$

Advertising in Monopoly

- We can then rewrite the above FOC as

$$(p - MC) \varepsilon_{q,A} \cdot \frac{q}{\frac{\partial q(p,A)}{\partial A}} = 1$$

- Dividing both sides by $\varepsilon_{q,A}$ and rearranging

$$p - MC = \frac{1}{\varepsilon_{q,A}} \cdot \frac{A}{q}$$

- Dividing both sides by p

$$\frac{p - MC}{p} = \frac{1}{\varepsilon_{q,A}} \cdot \frac{A}{p \cdot q}$$

Advertising in Monopoly

- From the Lerner index, we know that $\frac{p-MC}{p} = -\frac{1}{\varepsilon_{q,p}}$.

Hence,

$$-\frac{1}{\varepsilon_{q,p}} = \frac{1}{\varepsilon_{q,A}} \cdot \frac{A}{p \cdot q}$$

- And rearranging

$$-\frac{\varepsilon_{q,A}}{\varepsilon_{q,p}} = \frac{A}{p \cdot q}$$

- The right-hand side represents the *advertising-to-sales ratio*.
- For two markets with the same $\varepsilon_{q,p}$, the advertising-to-sales ratio must be larger in the market where demand is more sensitive to advertising (higher $\varepsilon_{q,A}$).

Advertising in Monopoly

- *Example:*
 - If the price-elasticity in a given monopoly market is $\varepsilon_{q,p} = -1.5$ and the advertising-elasticity is $\varepsilon_{q,A} = 0.1$, the advertising-to-sales ratio should be
$$\frac{A}{p \cdot q} = -\frac{0.1}{-1.5} = 0.067$$
 - Advertising should account for 6.7% of this monopolist's revenue.

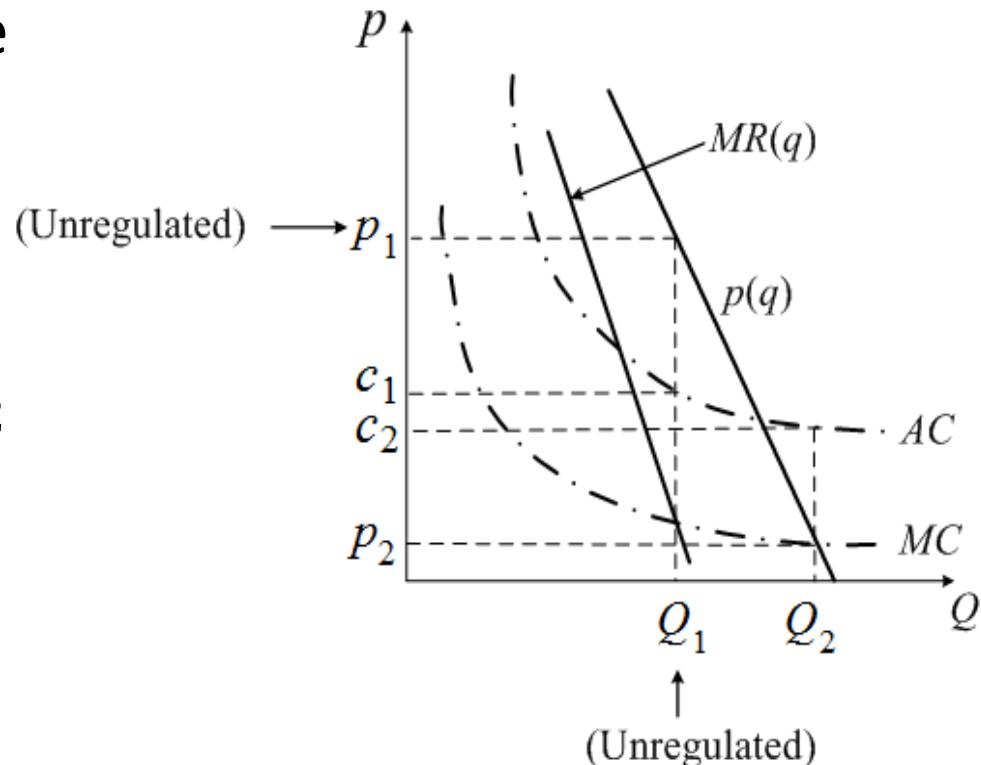
Regulation of Natural Monopolies

Regulation of Natural Monopolies

- ***Natural monopolies***: Monopolies that exhibit *decreasing* cost structures, with the MC curve lying below the AC curve.
- Hence, having a single firm serving the entire market is cheaper than having multiple firms, as aggregate average costs for the entire industry would be lower.

Regulation of Natural Monopolies

- Unregulated natural monopolist maximizes profits at the point where $MR=MC$, producing Q_1 units and selling them at a price p_1 .
- Regulated natural monopolist will charge p_2 (where demand crosses MC) and produce Q_2 units.
- The production level Q_2 implies a loss of $p_2 - c_2$ per unit.

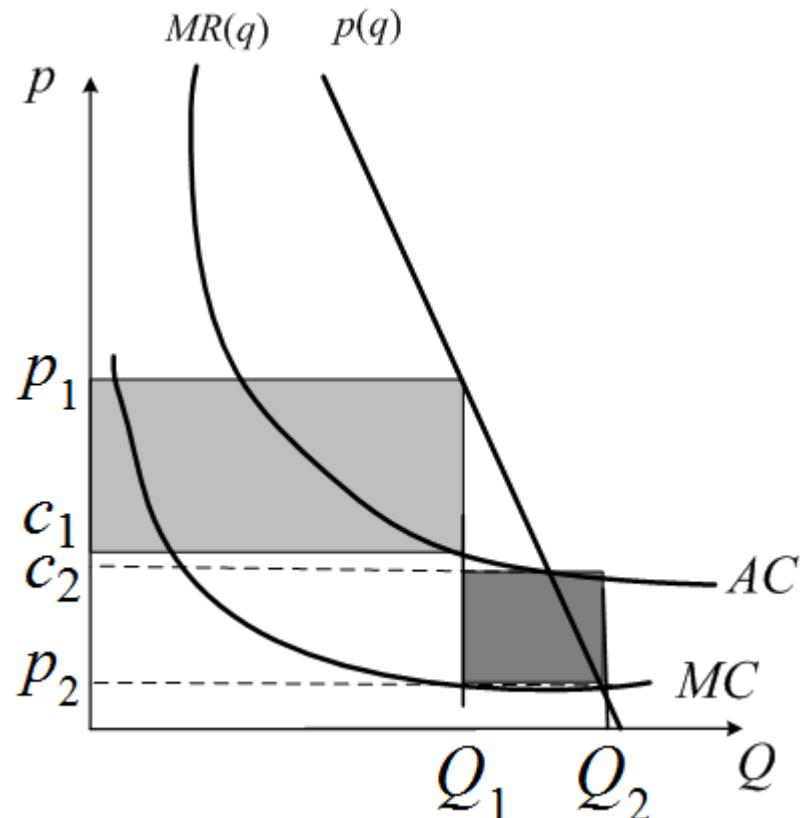


Regulation of Natural Monopolies

- Dilemma with natural monopolies:
 - abandon the policy of setting prices equal to marginal cost, OR
 - continue applying marginal cost pricing but subsidize the monopolist for his losses
- Solution to the dilemma:
 - A multi-price system that allows for price discrimination
 - Charging some users a high price while maintaining a low price to other users

Regulation of Natural Monopolies

- Multi-price system:
 - a high price p_1
 - a low price p_2
- *Benefit*: $(p_1 - c_1)$ per unit in the interval from 0 to Q_1
- *Loss*: $(c_2 - p_2)$ per unit in the interval $(Q_2 - Q_1)$
- The monopolist price discriminates iff
$$(p_1 - c_1)Q_1 > (c_2 - p_2)(Q_2 - Q_1)$$



Regulation of Natural Monopolies

- An alternative regulation:
 - allow the monopolist to charge a price above marginal cost that is sufficient to earn a “fair” rate of return on capital investments
- Two difficulties:
 - what is a “fair” rate of return
 - overcapitalization

Regulation of Natural Monopolies

- *Overcapitalization of natural monopolies:*
 - Suppose a production function of the form $q = f(k, l)$. An unregulated monopoly with profit function $pf(k, l) - wl - rk$ has a rate of return on capital, r . Suppose furthermore that the rate of return on capital investments, r , is constrained by a regulatory agency to be equal to r_0 .

Regulation of Natural Monopolies

- PMP:

$$L = pf(k, l) - wl - rk + \lambda[wl + r_0k - pf(k, l)]$$

where $0 < \lambda < 1$.

- FOCs:

$$\frac{\partial L}{\partial l} = pf_l - w + \lambda(w - pf_l) = 0$$

$$\frac{\partial L}{\partial k} = pf_k - r + \lambda(r_0 - pf_k) = 0$$

$$\frac{\partial L}{\partial \lambda} = wl + r_0k - pf(k, l) = 0$$

Regulation of Natural Monopolies

- From the first FOC:

$$pf_l = w$$

- From the second FOC:

$$(1 - \lambda)pf_k = r - \lambda r_0$$

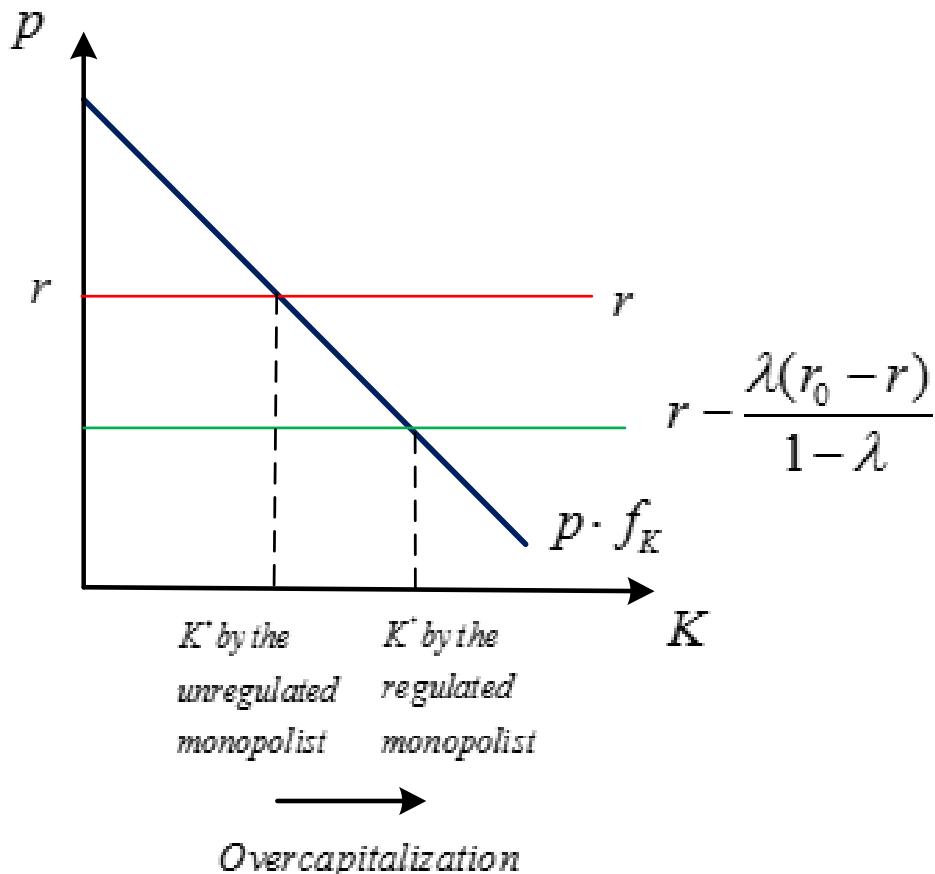
and rearranging

$$pf_k = \frac{r - \lambda r_0}{1 - \lambda} = r - \frac{\lambda(r_0 - r)}{1 - \lambda}$$

- Since $r_0 > r$ and $0 < \lambda < 1$, then $pf_k < r$.
- Hence, the firm would hire *more capital* than under unregulated condition, where $pf_k = r$.

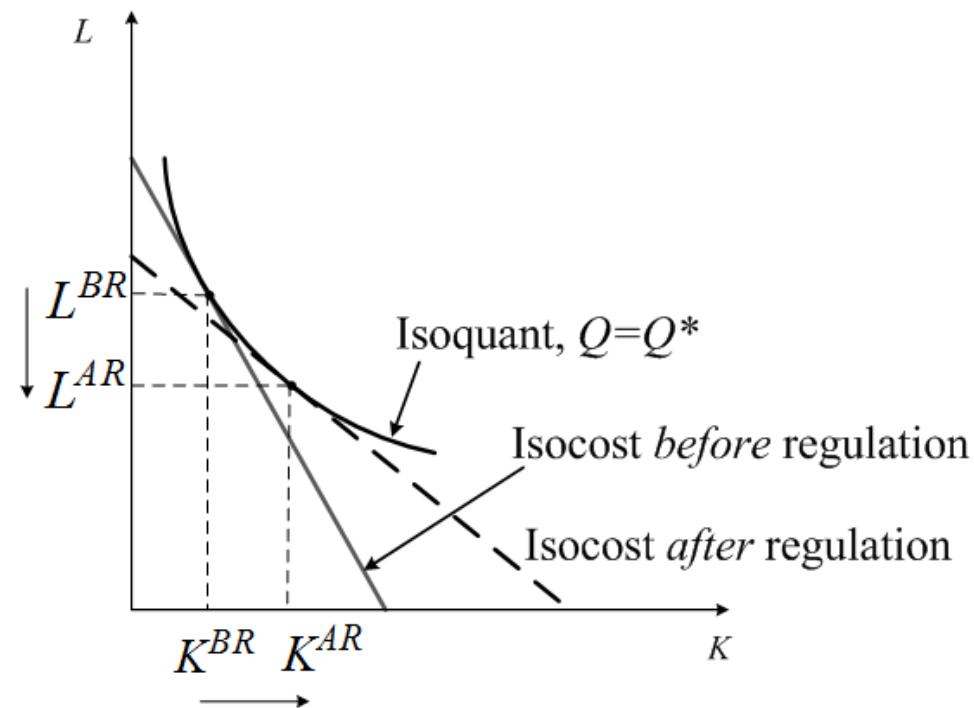
Regulation of Natural Monopolies

- $p f_k$ is the value of the marginal product of capital
 - It is decreasing in k (due to diminishing marginal return, i.e., $f_{kk} < 0$)
- r and $r - \frac{\lambda(r_0 - r)}{1 - \lambda}$ are the marginal cost of additional units of capital in the unregulated and regulated monopoly, respectively
- $$r > r - \frac{\lambda(r_0 - r)}{1 - \lambda}$$
- *Example:* electricity and water suppliers



Regulation of Natural Monopolies

- An alternative illustration of the overcapitalization (*Averch-Johnson effect*)
- Before regulation, the firm selects (L^{BR}, K^{BR})
- After regulation, the firm selects (L^{AR}, K^{AR}) , where $K^{AR} > K^{BR}$ but $L^{AR} < L^{BR}$
- The overcapitalization result only captures the substitution effect of a cheaper input.
 - Output effect?



Monopsony

Monopsony

- **Monopsony**: A single buyer of goods and services exercises “buying power” by paying prices below those that would prevail in a perfectly competitive context.
- Monopsony (single buyer) is analogous to that of a monopoly (single seller).
- *Examples*: a coal mine, Walmart Superstore in a small town, etc.

Monopsony

- Consider that the monopsony faces competition in the product market, where prices are given at $p > 0$, but is a monopsony in the input market (e.g., labor services).
- Assume an increasing and concave production function, i.e., $f'(x) > 0$ and $f''(x) \leq 0$.
 - This yields a total revenue of $pf(x)$.
- Consider a cost function $w(x) \cdot x$, where $w(x)$ denotes the inverse supply function of labor x .
 - Assume that $w'(x) > 0$ for all x .
 - This indicates that, as the firm hires more workers, labor becomes scarce, thus increasing the wages of additional workers.

Monopsony

- The monopsony PMP is

$$\max_x \quad pf(x) - w(x)x$$

- FOC wrt the amount of labor services (x) yields

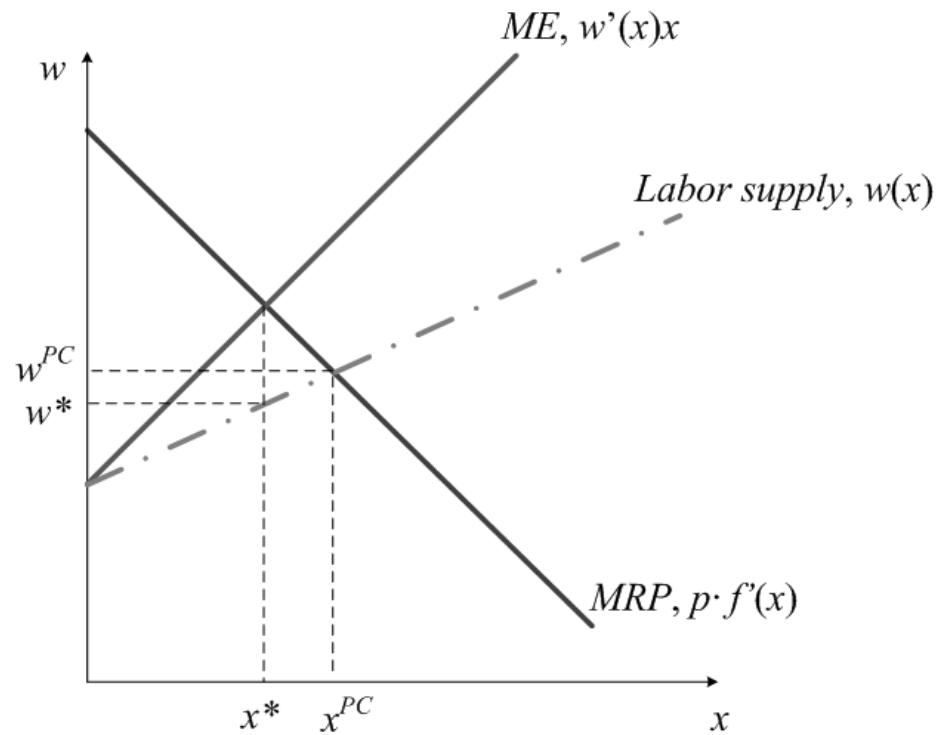
$$pf'(x^*) - w(x^*) - w'(x^*)x^* = 0$$
$$\Rightarrow \underbrace{pf'(x^*)}_A = \underbrace{w(x^*) + w'(x^*)x^*}_B$$

- A : “marginal revenue product” of labor.
- B : “marginal expenditure” (ME) on labor.
 - The additional worker entails a monetary outlay of $w(x^*)$.
 - Hiring more workers make labor become more scarce, ultimately forcing the monopsony to raise the prevailing wage on all inframarginal workers, as captured by $w'(x^*)x^*$.

Monopsony

- Monopsonist hiring and salary decisions.

- The marginal revenue product of labor, $p f'(x)$, is decreasing in x given that $f''(x) \leq 0$.
- The labor supply, $w(x)$, is increasing in x since $w'(x) > 0$.
- The marginal expenditure (ME) on labor lies above the supply function $w(x)$ since $w'(x) > 0$.
- The monopsony hires x^* workers at a salary of $w(x^*)$.



Monopsony

- A deadweight loss from monopsony is

$$DWL = \int_{x^*}^{x^{PC}} [pf'(x) - w(x)]dx$$

- That is, the area below the marginal revenue product and above the supply curve, between x^* and x^{PC} workers.

Monopsony

- We can write the monopsony profit-maximizing condition, i.e., $pf'(x^*) = w(x^*) + w'(x^*)x^*$, in terms of labor supply elasticity, using the following steps:

$$\begin{aligned} pf'(x^*) &= w(x^*) + \frac{\partial w(x^*)}{\partial x^*} x^* \\ &= w(x^*) \left(1 + \frac{\partial w(x^*)}{\partial x^*} \frac{x^*}{w(x^*)} \right) \end{aligned}$$

- And rearranging,

$$pf'(x^*) = w(x^*) \left(1 + \frac{1}{\frac{\partial x^* w(x^*)}{\partial w} x^*} \right)$$

Monopsony

- Since $\frac{\partial x^*}{\partial w} \frac{w(x^*)}{x^*}$ represents the elasticity of labor supply ε , then

$$pf'(x^*) = w(x^*) \left(1 + \frac{1}{\varepsilon}\right)$$

- Intuitively, as $\varepsilon \rightarrow \infty$ (labor supply becoming perfectly elastic), the behavior of the monopsonist approaches that of a pure competitor.

Monopsony

- The equilibrium condition above is also sufficient as long as

$$pf''(x^*) - 2w'(x^*) - w''(x^*)x^* < 0$$

- Since $f''(x^*) < 0$, $w'(x^*) > 0$ (by assumption), we only need that either:

- a) the supply function is convex, i.e., $w''(x^*) > 0$;
or

- b) if it is concave, i.e., $w''(x^*) < 0$, its concavity is not very strong, that is

$$pf''(x^*) - 2w'(x^*) < w''(x^*)x^*$$

Monopsony

- *Example:*
 - Consider a monopsonist with production function $f(x) = ax$, where $a > 0$, and facing a given market price $p > 0$ per unit of output.
 - Labor supply is $w(x) = bx$, where $b > 0$.
 - The marginal revenue product of hiring an additional worker is

$$pf'(x) = pa$$

- The marginal expenditure on labor is

$$w(x) + w'(x)x = bx + bx = 2bx$$

Monopsony

- *Example* (continued):
 - Setting them equal to each other, $ap = 2bx^*$, yields a profit-maximizing amount of labor:
$$x^* = \frac{ap}{2b}$$
 - x^* increases in the price of output, p , and in the marginal productivity of labor, a ; but decreases in the slope of labor supply, b .
 - Sufficiency holds since
$$pf''(x^*) - 2w'(x^*) = p0 - 2b < 0 = w''(x^*)x^*$$