

Microeconomics

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To my mother, Mimi Perloff

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11.6 GOVERNMENT ACTIONS THAT CREATE MONOPOLIES

Governments create many monopolies. Sometimes, governments own and manage monopolies. In the United States, as in most countries, the postal service is a government monopoly. Indeed, the U.S. Constitution explicitly grants the government the right to establish a postal service. The European Commission's 1995 draft directive to liberalize European postal services allows countries to "reserve" letters lighter than 350 grams (12 ounces) for delivery by national post offices until at least the year 2000. Many local governments own and operate public utility monopolies that provide garbage collection, electricity, water, gas, phone services, and other utilities.

Frequently, however, governments create monopolies by preventing competing firms from entering a market. For example, when a government uses a patent to limit entry, it allows a firm to earn a monopoly profit from an invention—a reward to the firm for developing the new product.

Barriers to Entry

By preventing other firms from entering a market, governments create monopolies. Typically, governments create monopolies in one of three ways: by making it difficult for new firms to obtain a license to operate, by granting a firm the rights to be a monopoly, or by auctioning the rights to be a monopoly.

Frequently, firms need government licenses to operate. If governments make it difficult for new firms to obtain licenses, the first firm may maintain its monopoly. Until recently, many U.S. cities required that new hospitals or other inpatient facilities demonstrate the need for a new facility to obtain a certificate of need, which allowed them to enter the market.

Government grants of monopoly rights have been common for public utilities. Instead of running a public utility itself, a government gives a private company the monopoly rights to operate the utility. Often, there are strings attached to such grants of monopoly rights. One possibility is that the government captures some of the monopoly profits. The State of Louisiana granted Harrah's Jazz Company a 30-year pact in 1994, guaranteeing the firm a monopoly on land-based gambling. Under state law, if other firms enter, the casino can refuse to pay the state its share of the proceeds, which were (optimistically) estimated at the time of passage to be at least \$100 million a year.²³ Similarly, as discussed in the application on airport monopoly concessions, a government may capture some of the monopoly profits by charging a high rent to the monopoly. Alternatively, government officials may capture the rents for monopoly rights by means of bribes.

Governments around the world have privatized many state-owned monopolies in the last several decades. By selling its monopolies to private firms, a government can capture the value of future monopoly earnings today. However, for political or other reasons, governments frequently sell at a lower price that does not capture all future profits.

²³Sayre, Alan, "Louisiana's Gambling Industry Is Faltering," *San Francisco Chronicle*, September 6, 1994:B1.

14.4 ADVERTISING

Thirty-five percent of Americans say that they would be in favor of printing ads on dollar bills if it would result in lower taxes.²⁴

In addition to setting prices or quantities, choosing investments, and lobbying governments, firms engage in many other strategic actions to boost their profits. One of the most important is advertising.

Consumers are constantly exposed to advertising. When MCA/Universal Home Video released its *Jurassic Park* videotape at the end of 1994, it blitzed the market with ads designed to reach 98% of the adult population in the United States 25.2 times each.²⁵

Promotional Activities

Advertising is only one way to promote a product. Other promotional activities include providing free samples and using sales agents. Some promotional tactics are subtle. For example, grocery stores place sugary breakfast cereals on lower shelves so that they are at children's eye level. According to a survey of 27 supermarkets nationwide by the Center for Science in the Public Interest, the average position of 10 child-appealing brands was on the next-to-bottom shelf, while the average position of 10 adult brands was on the next-to-top shelf.²⁶

Before 1991, media advertising (television, radio, newspaper, and magazine ads) absorbed the major share of marketing budgets. Since 1991, consumer promotions—giveaways, tie-ins, coupons, contests, and the like—have taken the larger share. For example, in the summer of 1994, Frito-Lay put all its marketing dollars into sponsoring country singer Reba McEntire's concert tour.²⁷

We begin this discussion by examining advertising (or other promotional activities) by a monopoly, which has no rivals. Then we consider strategic advertising in a duopoly, in which a firm advertises to attract customers from its rival.

Monopoly Advertising

A monopoly advertises to raise its profit. A successful advertising campaign shifts the market demand curve by changing consumers' tastes or informing them about new products. The monopoly may be able to change the tastes of some consumers

²⁴Garchik, Leah, "Personal," *San Francisco Chronicle*, November 6, 1995:D10 (citing a poll reported in the *New Republic*).

²⁵"*Jurassic Park* Video Due in Stores in October," *San Francisco Chronicle*, May 27, 1994:C14.

²⁶Adult cereals contain an average of 10% sugar, while the kids' products average 44% sugar. *The Washington Post*, "Sugary Cereals Tempt the Tots," *San Francisco Chronicle*, April 11, 1990:Food 3.

²⁷"Wilma! What Happened to the Plain Old Ad?" *Business Week*, 3375, June 6, 1994:54.