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Market, Competition and Monopoly

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Monopoly: Conceptual differences in law and economics

- In **Economics**: markets are monopolistic or oligopolistic in the absence of perfect competition

Competitive market:

1. A large number of firms
2. Homogeneous products
3. Free entry into and exit from the market
4. Independence of decisions among firms
5. Complete information

- In **Law**: monopoly is used as "a standard of evaluation", designating a situation not in the *public interest*.

Subjective valuation

Where do monopolies come from?

- Monopolies emerge due to a lack of competition created by *barriers to entry.*
- Reasons for high barriers to entry are:
  1. Legal restrictions: Government blocks the entry of more than one firm into a market by granting a patent or copyright, which gives the exclusive right to produce a product or service for a period of time; by granting a firm a public franchise, which makes it the exclusive legal provider of a good or service.
  2. Economies of scale
  3. One firm has control of a key resource material necessary to produce a good.

Legal Restrictions

- One way to prevent new firms from entering a market is to make entry illegal

- Patents, licenses, and other legal restrictions imposed by the government provide some producers with legal protection against competition

- A *patent* awards an inventor the exclusive right to produce a good or service for 20 years
- Patent laws encourage inventors to invest the time and money required to discover and develop new products and processes;

  also provide the stimulus to turn an invention into a marketable product, a process called *innovation*

Licenses and other Entry Restrictions

- Governments often confer monopoly status by awarding a single firm the exclusive right to supply a particular good or service

  - Public Monopoly (RAI)

  - State licensing of hospitals

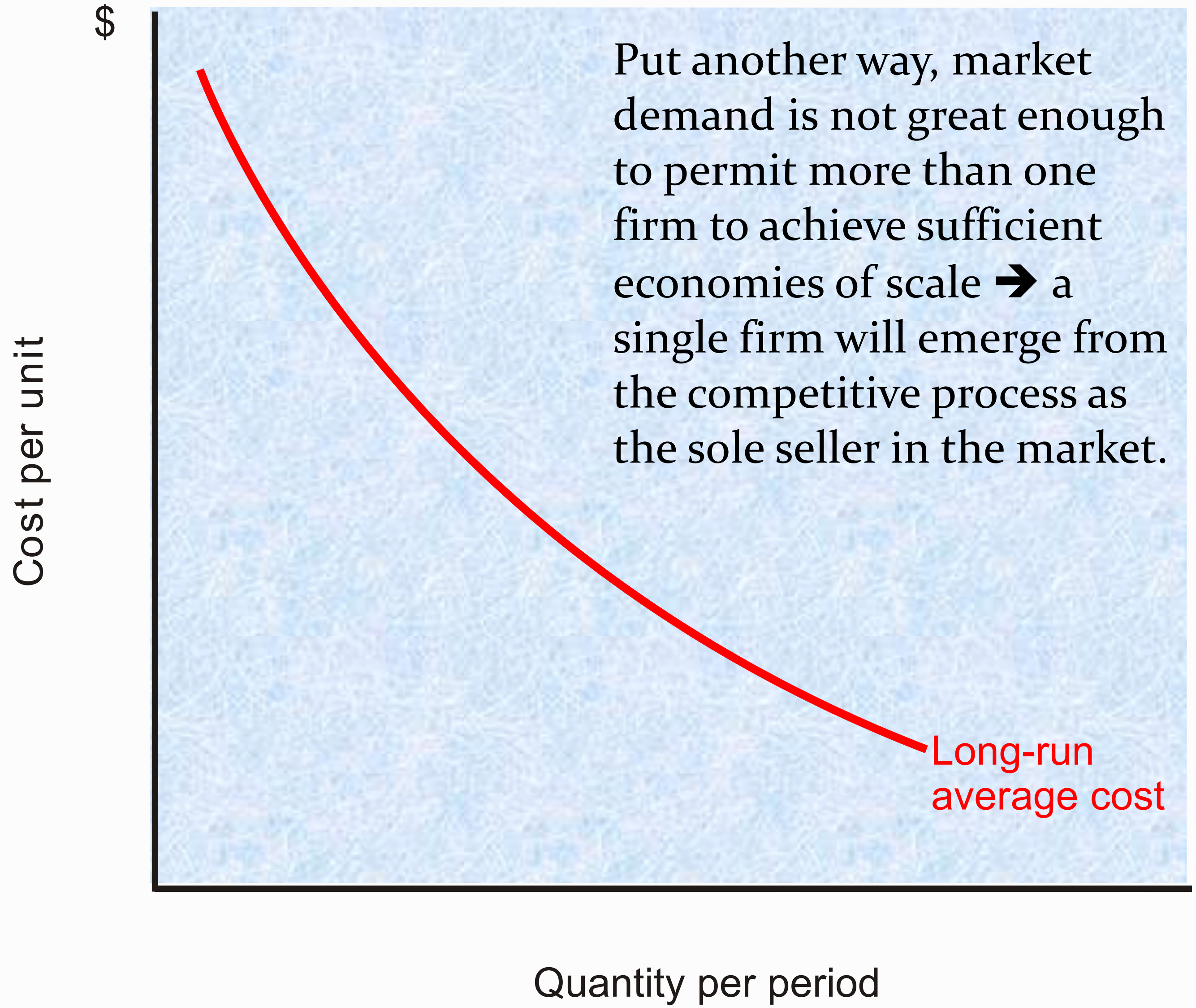
  - Monopoly in distribution,
    special case: tobacco and alcohol

Economies of Scale

- A monopoly sometimes emerges naturally when a firm experiences economies of scale as reflected by the downward-sloping, long-run average cost curve

- In these situations, a single firm can sometimes supply market demand at a lower average cost per unit than could two or more firms at smaller rates of output

Economies of Scale as a Barrier to Entry



Put another way, market demand is not great enough to permit more than one firm to achieve sufficient economies of scale ➔ a single firm will emerge from the competitive process as the sole seller in the market.

Natural Monopoly

- Because such a monopoly emerges from the nature of costs, it is called a *natural monopoly*

- A new entrant cannot sell enough output to experience the economies of scale enjoyed by an established natural monopolist ➔ entry into the market is naturally blocked

Control of Essential Resources

Another source of monopoly power is a firm's control over some nonreproducible resource critical to production

- China is the monopoly supplier of pandas
- DeBeers controls the world's diamond trade

Does monopoly reduce economic efficiency?

- We know that equilibrium in a *perfectly competitive* market results in the greatest amount of economic surplus, or total benefit to society, from the production of a good or service.
- However, a monopoly will ***produce less and charge a higher price*** than would a perfectly competitive industry producing the same good. The effects of monopoly can be summarized as follows:
- Monopoly causes a reduction in consumer surplus;
- Monopoly causes an increase in producer surplus;
- Monopoly causes a deadweight loss, which represents a reduction in economic efficiency; (allocative inefficiency occurs).

Price and Output

- Comparing monopoly with perfect competition
- When there is only one firm in the industry, the industry demand curve becomes the monopolist's demand curve → the price the monopolist charges determines how much gets sold
- If economies of scale are extensive enough, a monopolist may be able to produce output at a lower cost per unit than could competitive firms
- If this is true, the price or at least the cost of production could be lower under monopoly than under competition

Monopoly and innovation

PRO: The market power of the monopolist corresponds to the ability of a firm to charge a price greater than perfect competition one. The introduction of new products requires firms to spend funds on research and development. Because firms with market power are more likely to earn economic profits, they are also more likely to introduce new products.

CONTRA: a competitive market stimulates the competitors to innovate and differentiate the products to charge a higher price

Revenue for the Monopolist

- Because a monopoly, by definition, supplies the entire market, the demand for goods or services produced by a monopolist is also the market demand
- The demand curve for the monopolist's output therefore slopes downward, reflecting the law of demand
- As seen in the following discussion this has important implications for revenues that can be also invested in research

Effects of Monopolies

- For a **economist**: the way in which transactions occur and resources are allocated

Efficiency loss: A firm with monopoly power will produce at a lower output level and charge a higher price than an identical firm in a competitive market

- For a **lawyer**

monopoly means a restriction of the freedom of business to engage in legitimate economic activities

Price Discrimination

A monopolist can sometimes increase economic profit by charging higher prices to customers who value the product more.

The practice of charging difference prices to different customers when the price differences are not justified by differences in cost is called *price discrimination*

The conditions for price discrimination are:

- A firm must possess a market power.
- The firm must know what different consumers are willing to pay
- The firm must be able to divide (segment) the market for the product.

Price discrimination: a case

Airlines: The kings of price discrimination:

- Business travellers - more price inelastic
- Holiday travellers - more price elastic
- Economy, business and first class
- Day and time
- Season

Yield management: continually adjusting prices to take into account fluctuations in demand

The Sherman Act

- Passed by Congress in 1890.
- Regarded as a way to reduce concerns that large business interests dominated industry.
- Private parties may sue.
- The major sections of the Act are so broad that one could find almost any business activity to be illegal.
  - No *restraint of trade*
  - Cannot *monopolize* or *attempt to monopolize*

The history of Antitrust

- SHERMAN ACT(1890)

  “Every contract, combination, or conspiracy **in restraint of trade** among the several states is illegal. Monopolizing trade shall be deemed guilty of a felony and punished”.

  The policy goal of the common law and hence of the Sherman Act: the maximization of consumer welfare

The Clayton Act

- Enacted in 1914
- Wanted government to have the ability to attack a business practice early in its use to prevent a firm from becoming a monopoly.
- Practices are illegal that "substantially lessen competition or tend to create a monopoly."
- Private parties may sue—treble damages.

The history of Antitrust

- CLAYTON ACT(1914): limits undertakings that tend to lessen competition substantially or create a monopoly.

  Section 2 prohibits price discrimination.

  Section 3 makes many tie-in arrangements illegal.

  Section 7 renders corporate mergers and acquisitions illegal if they substantially lessen competition.

The Per Se Rule and The Rule of Reason

- *Per se Rule* means that a certain business agreement, arrangement, or activity will automatically be held to be illegal by the courts.
- *Rule of Reason* means that the court will look at the facts surrounding the business practice before deciding whether it helps or hurts competition.
- Courts consider:
  - Business reasons for the restraint
  - The restraining firm's position
  - Structure of the industry

The Law's conceptual apparatus: Rule of Reason

- "inherent nature" – results in practices illegal per se, which means that there is no defense and that the court need not examine either intent or market power before pronouncing the behavior unlawful. Judging a restraint according to its character instead by its degree.
- "inherent effect" or market power: refers to the inference of bad effects from some fact, e.g. the market share of the parties.
- "evident purpose" or specific intent: proof of an actual intent to inflict the evils of monopoly, that is an intent to gain or maintain monopoly through means other than superior efficiency.

Ways to Monopolize Markets

- Horizontal Mergers and Conglomerates
- Cartels - COLLUSION
  1. Horizontal price fixing
  2. Horizontal market division
- Foreclosing Entry
  1. Vertical Integration
  2. Advertising
  3. Tie-in arrangements

Mergers

Merger: When two or more firms come together to form a new firm.

- **Mergers:** The trade-off between market power and efficiency
  - Sometimes a merged firm is more efficient and has lower costs, and other times it does not.

- **Horizontal merger:** A merger between firms in the same industry.
- **Vertical merger:** A merger between firms at different stages of production of a good.

- Premerger notification to Antitrust Authority.

Horizontal Merger

- Mergers should not be permitted to create or enhance market power, so as to confer on a seller the ability profitably to maintain prices above competitive levels for a period of time.

Analytical process corresponds to the assessment of whether:

- the merger will increase market concentration
- the merger will raise concern about potential adverse competitive effects
- efficiency gains would result that otherwise cannot be achieved

When Mergers Are Allowed

- *Merger guidelines* – Major reason to approve merger is that it will enhance the efficiency in the market, benefiting consumers by better resource allocation.

- *Failing firm defense* – If one of the firms involved in a merger has been facing bankruptcy or circumstances that threaten the firm, the Court will look more favorably upon the merger. The firm must show:
  - not likely to survive without merger
  - no other buyers, or this one will least affect competition
  - tried and failed at all other ways to save firm

Assessment of market power

1. Define the relevant market(s) affected by a firm's conduct

- narrowly defined market: camera selling
- broadly defined: the market is worldwide, and includes not only all cameras, but also portrait artists and possibly transportation media because a painting and a visit are all substitutes for a picture.

2. Calculation of market share, examination of competitive interactions, determination of the conditions of entry, and analysis of other pertinent structural features of the market

Determining Market Power

Product and Geographic Markets – percent of relevant market controlled by the firm

Product Market – a monopoly exists when there is only one firm producing a product for which there is no good substitute

Geographic Market – generally limited to the area where consumers can reasonably be expected to make purchases

Cartels

- **Cartel:** An agreement among firms to charge the same price, or to otherwise not compete.

- The laws usually make it illegal for large firms with market power to collude, and firms wishing to merge or take over another firm must apply for permission to do so.

Information Sharing

Information Sharing as a anticompetitive behaviour

- One problem in antitrust law is deciding whether the trading of information among businesses helps or restrains the competitive process.

In Italy some cases about INSURANCE and BANKS

Boycotts

- Boycott: When a group conspires to prevent the carrying on of business or to harm business.
- Any group can promote this – consumers, union members, retailers, wholesalers or suppliers.
- Act together to inflict damage on a business.
- Boycott is used to force compliance with a price-fixing scheme or other restraint of trade.
- Usually fall under per se rule.

Tying Arrangements (Tie In Sale)

- Agreement by a party to sell a product (the tying product) conditioned that buyer purchases a different (complementary or tied) product.
- If a tie-in creates a monopoly when there are no or few good alternatives, it is likely illegal; if products or service are tied together when there are other competitors, the tie-in will likely pass the *rule of reason* test.
- Supreme Court is likely to impose a *per se* illegality only when three conditions are met:
    - The seller has market power in the tying product
    - Tied and tying products are separate
    - There is evidence of substantial adverse effect in the tied product market

Remedies Available

Government can:

- restrain a company or individual from performing certain actions
- force a company to sell part of its assets
- force a company to let others use its patents or facilities
- cancel or modify existing business contracts
- only plaintiffs suffering injuries caused by *anti*competitive behaviors of firms can recover damages under the law

Remedies in practice

- 1. Conduct remedies: such as mandatory unbundling.
- 2. Structural divestiture: into two parts:
  - the proposed breakup of a huge company would certainly entail substantial direct costs of reorganization.
  - The concern of an increase in pricing

Reading:

The Microsoft Antitrust Case

by

Nicholas Economides (2001)

https://www.stern.nyu.edu/networks/Microsoft_Antitrust.final.pdf