Abuse of Market Power: Government Intervention

RIDLEY COLLEGE

SINCE 1889

Assessment Objectives

Specific Expectations	
AO3	Discuss advantages of large firms with significant market power, including economies of scale and investments in R&D financed by abnormal profits, innovation.
AO3	Discuss risks with respect to output, price, consumer choice in markets dominated by large firms.
AO3	Discuss advantages and disadvantages of government intervention to deal with the abuse of market power including legislation and regulation, government ownership, fines.

Market Power: Advantages & Disadvantages

- Large firms with significant market power offer a number of potential advantages including:
  - Advantages arising from large economies of scale and natural monopoly
  - Ability of such firms to carry out R&D on new product and technology development
- There are also a number of disadvantages and risks in terms of:
  - Allocative inefficiency and welfare loss
  - Higher prices and lower output
  - Loss of consumer surplus to the large firm or firms
  - Negative impact on the distribution of income
  - Higher than necessary average costs due to lack of price competition
  - Possibly less innovation

Government Intervention: Abuse of Market Power

- All market structures other than perfect competition represent market failure, resulting in a price above marginal cost (P>MC), and welfare loss to a lesser or greater degree.
- **Abuse of market power (Anti-competitive practices)** occurs when firms engage in activities that restrict competition.
  - A company can restrict competition if it is in a position of strength on a given market.
  - A dominant position is not in itself anti-competitive, but if the company exploits this position to eliminate competition, it is considered to have abused it.
    - Charging unreasonably high prices prices
    - Depriving smaller competitors of customers by selling at artificially lower prices they can't compete with

Government Intervention: Abuse of Market Power

- Obstructing competitors in the market (or in another related market) by forcing consumers to buy a product which is artificially related to a more popular, in-demand product.
- Refusing to deal with certain customers or offering special discount to customers who buy all or most of their supplies from the dominant company.
- Making the sale of one product conditional on the sale of another product.

- **Monopoly** on the whole have the highest degree of market power which is abusive due to the lack of competition; this is why private, unregulated monopolies are illegal almost everywhere.
- **Oligopoly** may or may not abuse their market power. The market power of a collusive oligopoly is similar to that of a monopoly, and represents a form of abuse.
- **Monopolistic competition** have less market power which for the most part they do not abuse because there is significant competition among firms that produce substitute goods.

Legislation to protect competition

- Most countries have laws to promote competition by preventing collusion between oligopolistic firms, as well as preventing anti-competitive behaviour by a single firm that dominates a market. This is known an **competition policy**.
    - Firms that are found guilty of anticompetitive behaviour are usually asked to pay fines, or may be broken up into smaller firms.
    - Possible difficulties in interpreting the legislation in connection with the behaviour of the offending firms.
    - Laws in a particular country may be enforced to varying degrees, with some governments enforcing them more strictly than others, depending on their priorities or their political and idealogical views.
    - If firms collude, it is difficult to discover evidence of the collusion and to prove it, as collusion occurs secretly, since it is illegal.

Legislation in the case of mergers

- A **merger** is an agreement between two or more firms to join together and become a single firm.
  - Mergers may occur for a number of reasons:
    - Capturing economies of scale (a single large firm may be able to produce at lower average costs)
    - Firm growth (the firm would like to become larger).
    - Acquiring market power
  - Mergers are an issue in competition policy because of the possibility that the single firm created from the merger may have too much market power.
    - Legislation usually involves limits on the size of the combined firms.

Imposition of Fines

- **Fines** are often imposed if a government agency responsible for investigating anti-competitive behaviour discovers some wrongdoing.
  - A problem with fines is that firms will often get their lawyers to calculate whether breaking the la or complying with the law is more costly (or more profitable).
  - Often, the profits of firms that abuse market power are great enough that they are better off illegally abusing their power and paying fines.
  - Large firms often neglect the ethics of wrongful behaviour if they believe that getting caught is not as costly as compliance.

Natural Monopolies: Regulation

- While most countries around the world do not encourage monopoly, an exception is made if there is a natural monopoly, because it is not in society's interests to break it up into smaller firms, as this would result in higher average costs and a waste of resources.

1. **Government ownership of natural monopolies**

    - Natural monopolies may be nationalized, which involves the transfer of ownership from the private sector to the public sector (the government).
    - Government ownership allows the government to regulate natural monopolies, forcing them to lower prices and increase quantities produced in the interests of consumers, thereby reducing allocative inefficiency and welfare loss.
    - Government ownership sometimes leads to inefficiencies and higher than necessary costs of production, as governments are not driven by the goal to maximize profits.

Natural Monopolies: Regulation

2. **Marginal cost pricing**
   - The government can force the monopoly to charge a price equal to marginal cost (P=MC) so the monopolist will achieve allocative efficiency, with prices falling and output increasing to the socially desirable level.
   - However, marginal cost pricing leads to losses for the natural monopolist since P=MC results in a price that is too low for the firm to be able to cover it average costs.
   - As a result, the firm will either go out of business, other the government would have to subsidize it in order to cover its losses.
3. **Average cost pricing**
   - The government can force the firm to charge a price equal to its average costs (P=ATC), meaning the firm earns normal profit.
   - The result is a higher price and lower quantity than marginal cost pricing.

Natural Monopolies: Regulation

- The monopolist makes a normal profit and is not in danger of having to shut down; and it is more efficient than the market solution.
- If, through regulation, it is guaranteed a price equal to its average costs, it loses the incentive to keep its average costs low and there may be an increase in inefficiency.
- Continued regulation provides protection to the firm from new competitors that would have been able to produce more efficiently.