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Lecture 23

Industrial policy

Industrial Economics

Mergers

* *Horizontal* mergers
  rise in market share
* *Vertical* mergers
  cut off competition's access to vital resources or outlets
* Most mergers do **not** have a significant ***effect*** on competition
* Some other mergers may be necessary for the ***survival*** of the industry
* Some improve ***efficiency*** (present or future)

Merger policy

* Authorities will ***prevent*** certain mergers when the rationale is the creation of ***additional market power***
* The policy has ***two stages***:
  1. ***Rules:*** legislation specifies ***criteria / thresholds*** a merger must satisfy in order for it to be ***contestable***
  2. ***Discretion:*** authorities ***look into*** cases that exceed the pre-specified thresholds

Justifiable market power

* When it provides ***efficiency gains***
  * Lower average ***costs***
  * More efficient ***management***
  * Improved ***R&D*** capabilities
  * Alleviation of the ***double marginalization*** problem
* When it is imposed by ***market conditions***
  * Economic ***crisis***
  * One of the firms will otherwise go ***out of business***
* If there exists ***monopsony power***
  * Allows firms to ***match*** the power of the monopsony
  * It might create ***weird*** market structures

Horizontal agreements

* Horizontal agreements (explicit or tacit) are in general ***prohibited***
  they are ***not defensible*** on efficiency grounds
* Exceptions:
  * Cooperation in ***R&D***
  * Cartels that have the purpose of reducing capacity in ***declining industries***

Detection in horizontal agreements

* Detection is the ***main difficulty*** regarding horizontal restrictive practices
* It is not easy to ***distinguish*** between collusive and non-collusive behavior based on ***data***
* Similarity of ***prices*** (and price changes) is not sufficient for concluding that collusion exists
* Detection is easier in ***secondary agreements*** that may facilitate collusion
  exchange information on prices, costs, etc.

Exchange of info

- Exchange of information can ***facilitate collusion***
- ***But*** it may also improve the knowledge of market conditions and thus ***promote competition***
- Exchanges of ***individual*** firm data are suspected of being used to sustain collusion
- Dissemination of ***aggregate*** industry data is not considered suspect

Abuse of dominant position

- Mere existence of market power is ***not a major concern***
- Using market power to eliminate, restrict or distort competition is a concern
- Authorities will ***intervene*** to control firm conduct whenever there is ***abuse***
  - "Excessive" prices
  - Strategies that deter entry or expansion of rivals
  - Price discrimination or tying
  - Predatory pricing
  - Vertical restraints

Rent-seeking may be ambiguous

- Price discrimination or vertical restraints, can have ***ambiguous welfare effects***
- Some rent-seeking practices can be ***legitimate competitive actions*** even if they also deter entry
  - Introducing ***new products***
  - Building ***excess capacity*** in anticipation of a rise in demand
  - ***Advertising*** might have informative value

Practice in abuse of dominant position

- Prosecuted firms have a ***two-level defense*** to cases brought against them

1. Show that the practice does not alter the ***market outcome***
2. Show that the practice does not entail ***abuse***

- For example applying RPM or exclusive territories might be defended by ***poking holes*** to the prosecution's case in either level:

1. RPM is a ***reasonable markup***
2. The efficiency gains ***offset*** the DWL

Price discrimination: EU vs. US

- Europe:
  - Prohibition of ***geographic*** price discrimination
  - Prohibition of ***agreements*** between ***producers*** and ***distributors***, barring the distributor from selling the goods to customers in other countries
- US:
  - ***Some hostility*** against PD for social, political and economic reasons (in particular, to protect small distributors)
  - Often authorities have been ***reluctant*** to attack PD

Refusal to sell essential input

- ***Refusal*** to sell ***essential input*** to competitive firms
  - It is a ***barrier*** to entry but…
  - Firms also have the ***right to profit*** from their investments – otherwise investment is ***discouraged***
- So, there is sometimes a ***dilemma*** for competition authorities

Exclusive dealing

* ***Exclusive dealing*** to hinder or prevent entry by rivals
  * It is a ***barrier*** of entry but…
  * It can also lead to ***efficiency gains***
* The competition authorities must ***assess*** its effect in each ***particular case***
* There is ***presumption*** that both exclusive dealing arrangements and exclusive territories are ***normally not anticompetitive***

Predatory pricing

* ***Predation*** exists when a firm sets a ***price lower than AVC***
  AVC is a ***proxy*** for short-run marginal cost
* Predatory pricing is ***difficult to prove***
  * Costs are not ***straightforward***
  * ***Intentions*** of price cuts are not clear ex ante
* There might be ***policies preventing*** predatory actions based on rules
* However, ***prosecution*** of predation is done in a ***discretionary manner***, case by case

Prices below MC

* There exist ***circumstances*** where a firm may set a price below MC ***without*** being involved in predation:

1. Cost may be ***dynamic*** instead of static
   for example, in markets with significant '***learning by doing***' selling a lot today reduces production costs in future periods
2. Predation does not certainly ***require*** pricing below MC
   a predator firm may enjoy a ***cost*** or ***brand advantage*** over rivals

Policy towards R&D

* ***Unusual*** for the market to equilibrate on the ***socially optimal*** amount of ***investment*** on R&D
* This is a ***market failure***, thus ***policy*** towards R&D is necessary
* The ***target*** of policy is to ***protect*** the investment on R&D to ***maintain the incentive*** for innovation
  firms should appropriate ***fair returns*** from their innovations

Protection of R&D

Policy tries to protect R&D from various aspects:

1. ***Imitation:*** some products are ***easier to imitate*** and need more protection than others
   beverages vs. medicine
2. ***Liquidity:*** some projects require ***massive investment*** even large firms cannot undertake
   public funding may be an option (ex: weapon industry)
3. ***Risk:*** development policies might provide research ventures with certain cash flows
   for instance, ***pre-orders***

Government subsidies

* The state often ***finances*** R&D performed by particular firms
  this is an attempt to increase total R&D ***expenditure***

1. Horizontal financing
   * For instance, ***tax breaks*** based on total R&D spending
   * ***Drawbacks: limited effect*** on firms' R&D decisions; may encourage firms to undertake ***unworthy projects***
2. Selective financing:
   * For instance, ***grants*** targeted towards ***particular sectors***, technologies or projects
   * ***Drawbacks: asymmetric info*** for the likelihood or the value of discovery; ***corruption***; ***lobbying***

Joint R&D ventures

- They may be ***welfare-enhancing*** because:
  - Prevent needless ***duplication*** of R&D expenditures
  - Allow firms to exploit ***complementarities***
  - Resolve ***financing*** problems
  - Reduce the ***appropriation*** problem (shares are predetermined)
- Almost everywhere are ***legal***
- In the US, EU and Japan, R&D cooperation has not only been allowed but often is also ***subsidized***

Joint R&D and competition

- Joint research ventures do ***reduce competition*** in later stages of the market
- They provide a legal ***communication channel*** between rival companies
  - it can be used to ***facilitate*** illegal collusion
- Collusion might become a ***disincentive*** for performing research for further development of the product
- The ***empirical evidence*** on the effectiveness of these policies is ***mixed***

Thank you!

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