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Lecture 5

Market power – part III

micro2
first module
m2

Social costs of monopoly

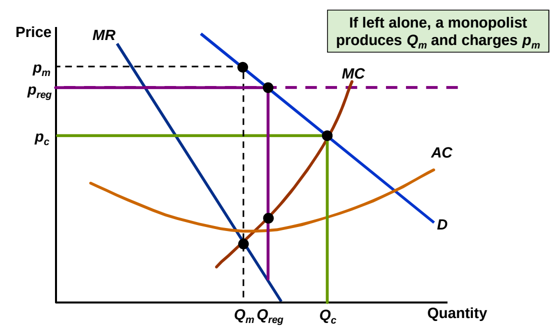
- The ***social cost*** of monopoly is likely to ***exceed*** the deadweight loss
- ***Rent Seeking:*** firms may use resources to gain market power instead of using them in the production process
  lobbying, advertising, building excess capacity
- The ***incentive*** to engage in monopoly practices is determined by the profit to be gained
  the transfer from consumers to the firm

Price regulation

- Government can ***regulate*** market power through price regulation
  - In competitive markets, price regulation ***creates*** a deadweight loss
  - In monopoly, price regulation can ***eliminate*** a deadweight loss
- Lets see the effect graphically…

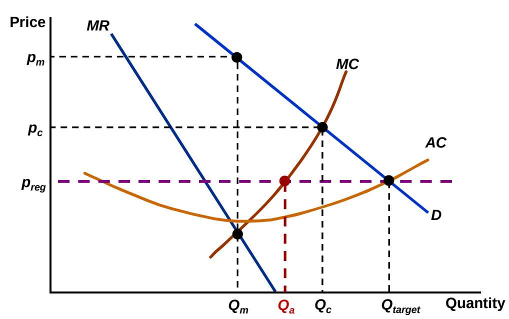
Regulation

Price regulation



Regulation

Price regulation overshooting

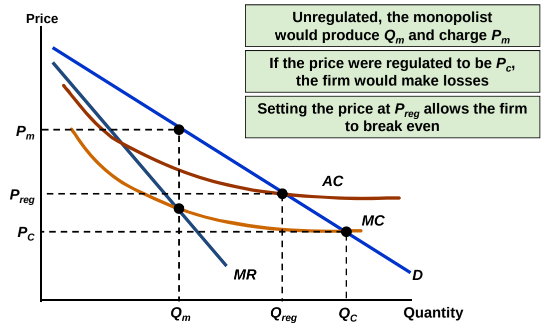


Regulation

Natural monopoly

- In some markets, it is possible that a single firm can produce the entire output at a ***significantly lower cost*** than if there were several firms
  - This happens when there are large ***economies of scale***
  - ***Splitting*** the monopoly into two firms results in considerably higher AC
  - **Examples:** metro, airports, utility companies

Regulating a natural monopoly



Regulation in practice

- Regulation is ***not easy*** in reality
- Government has no clue about the firm's ***cost***
- ***Demand*** may change with evolving market conditions
- Government usually sets price caps based on ***past prices*** taking into account inflation and productivity growth

Monopsony

- A ***monopsony*** is a market in which there is a single buyer
  - an ***oligopsony*** is a market with only a few buyers
- So, buyers may also posses ***market power***
  - the ability to ***affect*** the price of the good and ***pay less*** than the competitive price
- We must derive the ***surplus maximization condition*** for a consumer with market power

Marginal value

- A consumer ***would buy*** an extra unit if

  value of this unit ≥ expenditure for this unit
- That is,

$$MV \geq ME$$

- The ***marginal value (MV)*** of a unit is the additional benefit derived from purchasing this unit
- The valuation for each unit for a consumer is given by the consumer's ***demand curve***
- Therefore, the MV curve ***coincides*** with the demand curve

Marginal expenditure and supply

- ***Marginal expenditure (ME)*** is the additional cost of buying one more unit of a good
- The market ***supply curve*** is not the marginal expenditure curve
- This is because decision to buy an extra unit raises the price ***for all units***
  - you have to ***pay more per unit***, so that the producer ***will produce*** an extra unit (positive sloped supply)

Marginal expenditure

- Expenditure

$$E = p(q) \cdot q$$

  $p(q)$ is the supply curve now
- Then

$$ME = \frac{dE}{dq} = \frac{d(p(q) \cdot q)}{dq} = \frac{dp(q)}{dq} \cdot q + p(q)$$

- Because $p(q)$ has ***positive slope,*** it follows that the ME curve must be ***above it***

Equilibrium

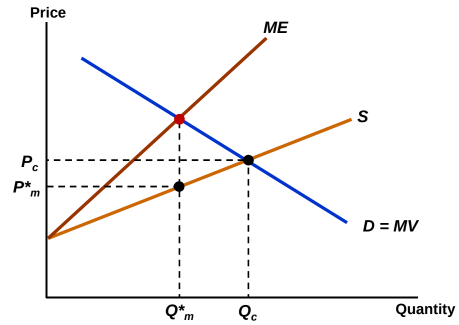
- Equilibrium will be when

$$ME = MV$$

- That is, you ***stop buying when*** the price you need to pay to the producer for a unit more exceeds how much the additional unit is worth to you

  you ***will not buy*** a unit if its price is higher than the value you receive from this unit

Monopsonist buyer



Monopoly vs. monopsony

- Monopsony is easier to understand if we ***compare*** it to monopoly

- Monopolist
  - Faces downward sloping ***demand***
  - ***MR*** below demand
  - Charges ***price*** above MC
  - MR = MC yields less ***quantity*** than PC
- Monopsonist
  - Faces upward sloping ***supply***
  - ***ME*** above supply
  - Negotiates ***price*** below MC
  - MV = ME yields less ***quantity*** than PC

Monopsony power

- You ***do not need*** to be the ***only buyer*** in the market to have monopsony power
- It is common a ***few firms*** to compete among themselves as buyers
  - Each firm has ***some*** monopsony power
  - ***Example:*** super-markets
- ***Monopsony power*** may give them the ***ability*** to pay a ***price less*** than marginal value

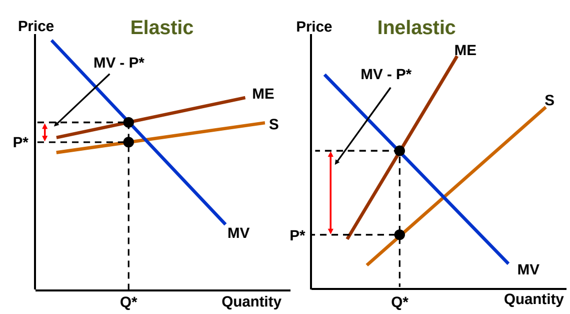
Factors affecting monopsony power

- ***Elasticity*** of market supply
  - Extent to which $p < MV$ depends on ***elasticity of supply***
  - If supply is very elastic, mark-down will be small
  - The more inelastic the supply, the more monopsony power
- ***Number*** of buyers

  fewer buyers make ***total supply less elastic*** and this increases monopsony power
- ***Interaction*** among buyers

  when ***buyers collude*** they can exploit the sellers more effectively

Elastic vs. Inelastic supply

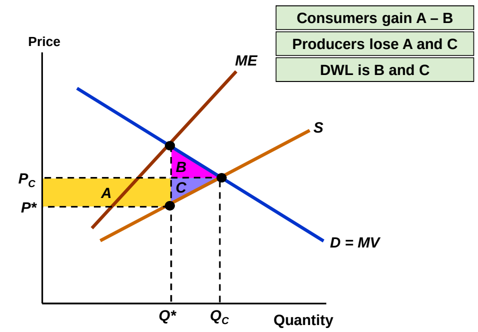


Social costs of monopsony

- Monopsony yields ***lower prices*** and ***lower quantities*** purchased
- We should expect:
  - Sellers to be ***worse off***
  - Buyers to be ***better off***
- We can show the effects of monopsony power ***graphically***

  using ***PS*** and ***CS*** and ***comparing*** them to the PC market

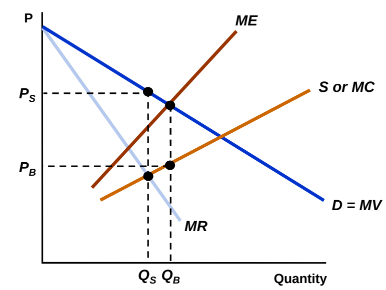
Deadweight loss from monopsony



Bilateral monopoly

- Market with only ***one buyer*** and ***one seller***
  - Pure bilateral monopoly is ***rare***
  - Markets with a ***small number*** of sellers and buyers, both with market power are common
- What is the ***equilibrium*** in a bilateral monopoly?
  - The monopoly equilibrium (MR = MC)?
  - The monopsony equilibrium (MV = ME)?

Bilateral monopoly graph



Limiting market power

- Market power ***harms*** some players in the market – buyer or seller
  - Reduces output
  - Creates ***deadweight loss***
  - Raises issues of ***equity*** and ***fairness***
- It is ***hard to fix*** such failures after the fact

  to ***measure the losses*** and ***find those who lost*** so that the monopolist or monopsonist can compensate them
- It is ***preferable*** to prevent the creation of excess market power from the beginning

  create ***Antitrust*** legislation

Antitrust laws

- ***Rules*** and ***regulations*** designed to promote a competitive economy by
  - Prohibiting ***actions*** that restrain or are likely to restrain competition
  - Restricting the ***forms*** of allowable market structures
- Market power arises in a ***number of ways***, each of which is ***covered*** by the antitrust laws

Antitrust

Sherman Act (1890) – section 1

- Prohibits contracts, combinations, or conspiracies in ***restraint of trade***
  - Explicit agreement to ***restrict output*** or ***fix prices***
  - Implicit collusion through ***parallel conduct***
- ***Example:*** In 1999, four of the world's largest drug and chemical companies were found guilty of fixing prices of vitamins sold in US

Antitrust

Sherman Act (1890) – section 2

- Makes it illegal to "***monopolize***" a market and prohibits conspiracies that result in monopolization
  - It is OK if a firm gets the entire market because of ***superior skill and intelligence*** when nobody else could do it as well as this firm
  - It is not OK if a firm gets the entire market by the ***use of means*** which made it impossible for other firms to engage in fair competition

Antitrust

Clayton Act (1914)

1. Makes it unlawful to require a buyer or lessor ***not to buy*** from a competitor
2. Prohibits ***predatory pricing***
3. Prohibits ***mergers*** and ***acquisitions*** if they "substantially lessen competition" or "tend to create a monopoly"

Antitrust

Federal Trade Commission Act (1914)

1. Created the Federal Trade Commission (FTC)
2. Supplements the Sherman and Clayton Acts by fostering competition through a set of prohibitions against unfair and ***anticompetitive practices***

- Prohibitions against
  - Deceptive ***advertising***
  - Deceptive ***labeling***
  - ***Agreements*** to exclude competing brands from retailing

Antitrust

Robinson - Patman Act (1936)

- ***Prohibits*** price discrimination if it causes buyers to suffer ***economic damages*** and ***competition is reduced***
- Requires that the seller offers the ***same price terms*** to customers at a given level of trade
  - Only for ***tangible goods***, not services
  - Covers ***inputs markets*** only
- Outside of the Act's conditions, ***pricing mechanisms*** can yield wildly different prices for different customers

Antitrust Russia

Antitrust legislation in Russia

- Antitrust issues in Russia are regulated by one law: ***Federal Law No. 135-FZ***, "On the Protection of Competition" (2006)
- The "***3rd antimonopoly package***", which entered into force in January 2012, is indicative of a general trend of liberalization of antimonopoly regulation

  indeed, its ***stated*** aim was to bring Russia more in line with European competition regulations
- The ***Code of Administrative Offences*** includes measures

Federal Law No. 135-FZ

- Defines thresholds for ***excess market power*** (dominance)
  - A company is "presumed dominant" if it has ***more than 50%*** of market share
  - Dominance must be established by Federal Antimonopoly Service (Федеральная антимонопольная служба России, ФАС России) if a company has ***more than 35%*** of market share
  - A company with ***less than 35%*** of market share is generally not considered dominant
- The law places restrictions on ***aids from the government*** that discourage competition

Code of Administrative Offences

- Amended to increase ***liability*** of anti-competitive practices and now includes ***measures*** against such practices
- Company directors can be ***criminally liable*** in cases of a repeated offense (7 years in prison)
- ***Practices*** that are considered illegal include
  - ***Establishing monopoly*** prices
  - Unjustified evasion from the ***execution of contracts*** with individual customers
  - Creation of ***obstacles*** for other entities entering the market

ευχαριστώ!

(thank you!)

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