Government intervention in response to abuse of market power

Advantages and risks of large firms （AO3）

Advantages:

1. Large economies of scale and natural monopoly
2. The ability to carry out R&D on new product and technology development.

Disadvantages:

1. Allocative inefficiency and welfare loss
2. Higher prices and lower output
3. Loss of consumer surplus to the large firms
4. Negative impact on the distribution of income
5. Higher than necessary average costs due to lack of price competition
6. Possibly less innovative.

Abuse of market power

- **Market Power** (monopoly power) refers to the control that a seller may have over the price of the product it sells; it is the ability of a firm to charge a price greater than marginal cost, or P>MC.
- **Abuse of market power**, also known as **anti-competitive practices**, refers to situations where firms engage in activities that result in reduced competition.

Abuse of market power

- **Examples of abusing market power:**
  - Charging unreasonably high prices
  - Depriving smaller competitors of customers by selling at artificially low prices they can't compete with
  - 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.
  - Collusion: the agreement between firms with market power to set higher prices
  - Refusing to deal with certain customers or offering special discounts 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

For different market structures

- **Monopolies** have the highest degree of market power which is abusive due to the lack of competition.
- Firms in **oligopolies** may or may not abuse their market power.
  - Collusive oligopoly represents a form of abuse
  - Non-collusive oligopolies may or may not abuse their market power.
- Firms in **monopolistic competition** have less market power. for the most parts they do not abuse because there is significant competition among firms that produce substitute goods.

Government responses

Possible government responses to the abuse of monopoly power(to prevent the market failing to reach an optimal allocation of resources) include:

- Legislation and regulation
- Fines
- Government ownership

→ Making monopolized industries more competitive.
→ Regulating the behavior of the monopolies (price, output)
→ Turning some private monopolies into public enterprises.

Anti-trust (competition) laws

- Anti-trust laws are laws aimed at curbing **monopoly power**.
- Anti-trust laws tries to promote competition:
  - They allow government to prevent mergers.
  - They allow government to break up companies.
  - They prevent companies from performing activities that make markets less competitive.
  - They impose fines to firms that are found guilty of anticompetitive behavior.

Legislation to protect competition

- **Competition Policy**: Laws to promote competition by preventing collusion between oligopolistic firms, as well as preventing anti-competitive behavior by a single firm that dominates a market.
  - Antitrust law (Competition law) Prevent the abusement of market power of monopoly and Oligopoly

- Firms that are found guilty of anticompetitive behavior are usually asked to pay fines or maybe broken up into small firms.

Legislation to protect competition

- **Difficulties:**
  - Possible difficulties in interpreting the legislation in connection with the behavior of the offending firms.
  - Laws in a particular country maybe enforced to varying degree, with some governments enforcing them more strictly than others, depending on their priorities or their political and ideological views.
  - If firms collude, it is difficult to discover evidence of the collusion and to prove it.

Legislation in the case of mergers

- A **merger** is an agreement between two or more firms to join together and become a single firm.
- **Purposes of merger**:
  - Interest in firm growth: gain access to a larger market and customer base
  - Interest in acquiring market power → reduce competition
  - Interest in capturing economies of scale.
- **Government response**: It involves the possibility that the single firm created from the merger have **too much market power**. So, it **limits on the size** of the combined firms.

Legislation in the case of mergers

Difficulties:

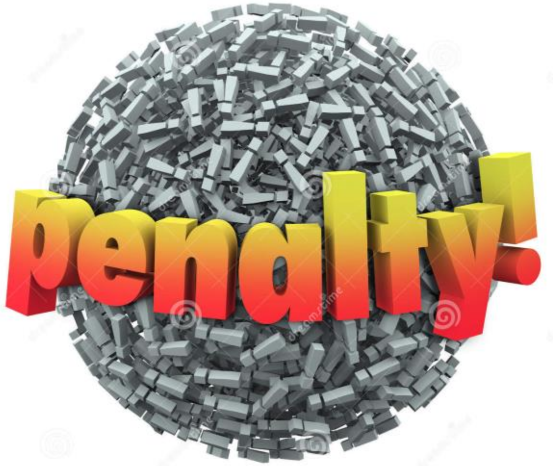
- Sometimes companies merge not to reduce competition but to lower costs through more efficient joint production (synergies-benefits from merger)
  - E.g. many U.S banks merged, by combining operations, have been able to reduce administrative staff.
- It is difficult to decide what firms should be allowed to merge and what firms should not. Which mergers are desirable, and which are not.
  - Different interpretation of the legislation, as well as the ideological differences among different governments on the desirability or not of a high degree of market power.

The imposition of fines

Fines will be imposed to firms if a government agency responsible for investigating anti-competitive behavior discovers some wrongdoing.

Problems: Firms will calculate whether breaking the law or complying with the low is more costly (or more profitable)

- The profits of firms that abuse market power are greater enough that they are better off illegally abusing their power an paying fines, than not abusing their power and not paying fines.
- Often they are not caught for anti-competitive behaviour



In the case of Monopoly

- **Antitrust law**
  - Imposition of fine
  - Break up company
  - E.g. The imposition of fine for Microsoft and Google
  - E.g. In 1984, US government split up AT&T, the large telecommunications company, into eight smaller companies.
  - E.g. the split up of Standard Oil Co. (owned by Rockefeller petroleum, the origin of Trust) into 34 regional companies in 1911.

In the case of Oligopoly

- Antitrust law
  - It prevent oligopolists from acting together in ways that would make their markets less competitive.
- Imposing fines for firms that found guilty of Collusion behaviour (Price fixing)
  - Formal collusion
  - Informal collusion
- Prevent merge and acquisition → collusion, acting like a monopoly

In the case of natural monopoly

- Natural monopoly is an exception. It is not in society's interests to break it up into small firms.
- **Government's action**:
  - Government ownership of natural monopolies
    - Nationalize the natural monopoly → transfer of ownership from the private sector to the public sector (the government)

    →Lower prices and increase quantities produced in the interests of consumers

    →Reducing allocative inefficiency and welfare loss.
    - Problems: sometimes government ownership leads to inefficiencies and higher than necessary costs of production

In the case of natural monopoly

Government's action:

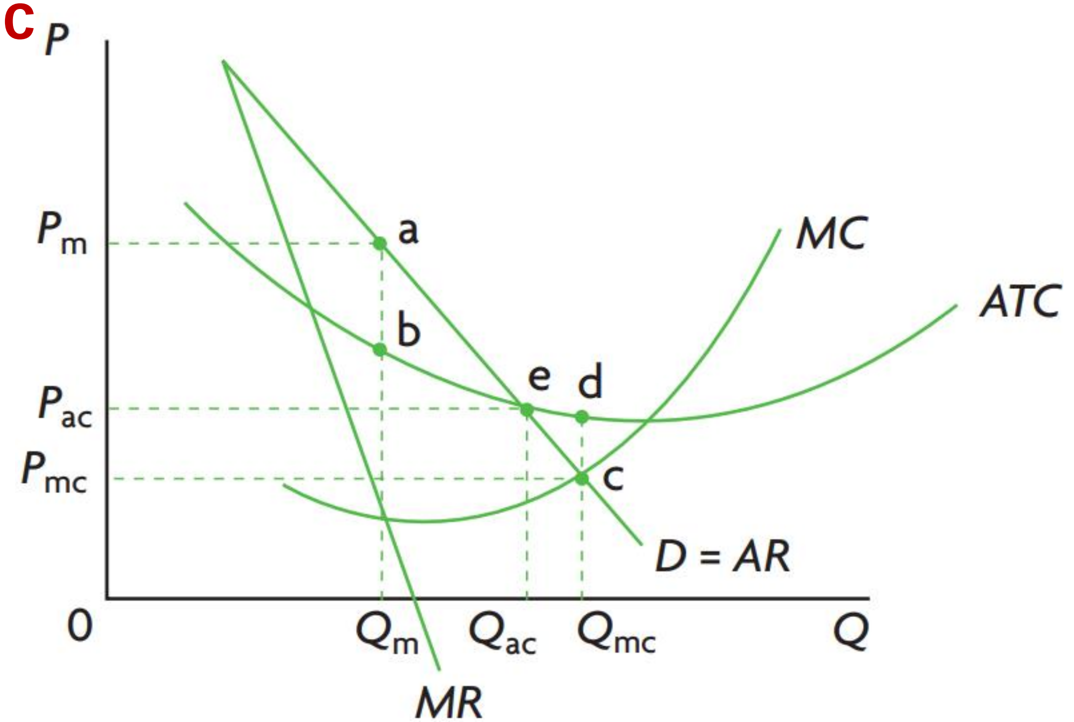
- **Government regulation of natural monopolies** to ensure more socially desirable price and quantity outcomes.
  - Marginal cost pricing
  - Average pricing
- Without competitors to offer choices, the government is the only option to ensure that a quality product at a reasonable price is delivered to consumers. So it may not be profitable, the government will often **subsidize** the firm's operations.

Price control for natural monopoly

1. Marginal cost pricing

- **P=MC** at **d** → **allocative efficiency**
- Produce **Q**mc and sell it at **P**mc.
- Marginal cost pricing forces an **efficient allocation of resources**, and quantity of the good produced increases to the **socially desirable level.**
- **Drawbacks**: at Qmc, Pmc<ATC → **loss of dc**
- As long as the demand curve cuts the ATC curve to the left of minimum ATC, as in a natural monopoly, it is not possible for the MC curve to cut the demand curve at a point above ATC.

→ It is impractical since the losses forced on the monopolist would make it go out of business in the long run.



Price control for natural monopoly

2. Average cost pricing

- **P=ATC** at **e** → **Fair return pricing**
- Produce **Q_{ac}** and sell it at **P_{ac}**.
- $Q_{ac}<Q_{mc}$, $P_{ac}>P_{mc}$, less efficient than marginal cost pricing.
- the monopolist is forced to earn **normal profit**.

- Allocative inefficiency & Productive inefficiency
- **Advantages:**
  - ✓ the monopolist makes normal profit and is not in danger of having to shut down;
  - ✓ It is more efficient than the market solution.
- **Disadvantages:**
  - x Loses of incentive
  - x Continued regulation provides protection to the firm from new competitors that would have been able to produce more efficiently.