MARKET FAILURE

Market Power

Market Failure: Syllabus Points

Market failure and government policies

- the concept of market failure

Public goods and common resources

- the classification of goods, i.e. based on rivalry and excludability
- public goods and the free rider effect
- common resources and the tragedy of the commons
- **policy options** to reduce market failure associated with public goods and common resources

Externalities

- the concept of externalities, i.e. positive and negative externalities
- the influence of externalities on market efficiency, i.e. a deadweight loss
- **policy options** to correct for externalities, including the use of taxes and subsidies

Market power

- the characteristics of an imperfectly competitive market
- the concept and causes of market power
- how market power can influence market efficiency, i.e. a deadweight loss
- **policy options** to influence market power, including regulation/deregulation and legislation

Market Power

- **What is Market Power?** - Market power is the ability of a business to insulate itself from competition.
- It also refers to the ability of a firm (or group of firms) to raise and maintain price above the level that would prevail under competition; this is referred to as market or monopoly power.
- ***The exercise of market power leads to reduced output and loss of economic welfare.***

Market Power: A Competitive market

- **Competition** is generally understood to be a process in which rivals compete in order to achieve some objective.
- Competition in microeconomics occurs when there are many buyers and sellers acting independently, so that no one has the ability to influence the price at which a product is sold in the market.
- This should be contrasted with market power, also known as monopoly power, which refers to the control that a seller may have over the price of the product it sells.
- The greater the market power, the greater is the control over price.
- On the other hand, the greater the degree of competition between sellers, the smaller their market power, and the weaker is their control over the price.

Market Power: Markets

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Market Power: Imperfect markets

- *A **competitive market** is characterized by a large number of small firms free entry and exit and very little product differentiation*. **[IMPT]**
- When one or more of these **conditions** is **NOT MET** - **the market is said to be 'imperfect'**

An imperfect market exists when:

1. *There are relatively small number of firms*
2. *Firms have market power*
3. *Firms use product differentiation*
4. *Barriers to entry are used to restrict competition*

Market Power: Imperfect markets

- The best examples of imperfect competition are monopoly and oligopoly markets.
- A monopoly is a market with just one firm - Synergy and Australia Post are government regulated monopolies.
- An oligopoly is a market with a few large dominant firms - Coles and Woolworths dominate the grocery market in Australia.

Market Power: A Monopoly

- **Monopoly** is a type of market structure where there is
  - a single firm dominating the market for a product, and
  - where **high barriers to entry** (*factors making it difficult for other firms to enter the industry*) ensure that the monopoly position of the single seller can be preserved.
- **Monopoly power**, also known as **market power**, refers to the ability of a firm or a group of firms to control the price of the product they sell.
- Monopoly power can be exercised not only by monopolies, but also by firms in o**ligopolies**, where there are a **few large sellers**.

Market Power: A Monopoly

- **Monopoly power is considered to be socially undesirable** because it leads to:
  - a welfare loss, as social surplus is less than maximum
  - allocative inefficiency - there is an underallocation of resources to the good
  - **lower output** and a **higher price** of the industry than the output and price of a more competitive market

Market Power: Imperfect markets

- In imperfect markets firms are said to have market or monopoly power which means that they can set price.
- In imperfect markets, prices are higher because there is less competition.

Market Power: Barriers to Entry

- Barriers to entry are an important feature of imperfect markets.
- A barrier to entry is anything that restricts or blocks the entry of new firms into an industry or market.
- [IMPT] They may include government regulation, patents, technology barriers, startup costs and licensing requirements.

Barriers to Entry - Examples

Examples of entry barriers:

- **Controlling a scarce resource** – if a mining company secured the only diamond mine in the country, it would have sole rights to mine the gems.
- A **government licence** granting a legal monopoly e.g. Australia Post
- A **technological advantage** – e.g. Microsoft has considerable market power because it supplies the operating system used in most computers.
- A **patent** on an invention gives protection from competition (up to 17 years in Australia) eg pharmaceutical firms

Barriers to Entry - Examples

Examples of entry barriers:

- Extensive **product differentiation**, **brand proliferation**, **large advertising budget**, **controlling retail outlets**.
- **Economies of scale** – only a few firms can compete in the market because of the large set up costs
- **Collusive behavior** – when firms agree to share markets, to fix prices or quantities or to otherwise seek to reduce competition and / or prevent new firms entering the market

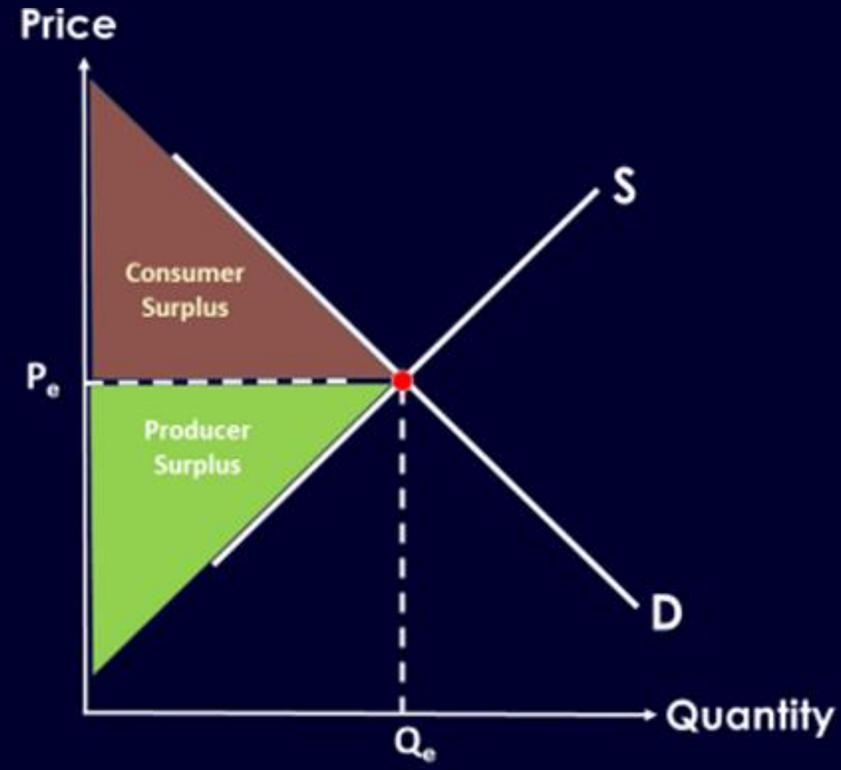
Market Power

- In an imperfect market, such as a monopoly or oligopoly, firms can use their market power to 'exploit' the market.
- A firm has market power if it can affect the market price by varying its output.
- Monopoly and oligopoly firms have substantial market power because they operate in markets with little effective competition – Hence, firms with market power will attempt to profit maximize.
- *Their private interest will not necessarily coincide with society's interest and therefore the socially optimal level of output in unlikely to be produced.*
- This **will result in higher prices and reduced output**, ***decreasing economic welfare for society***.

Market Power: Barriers to Entry

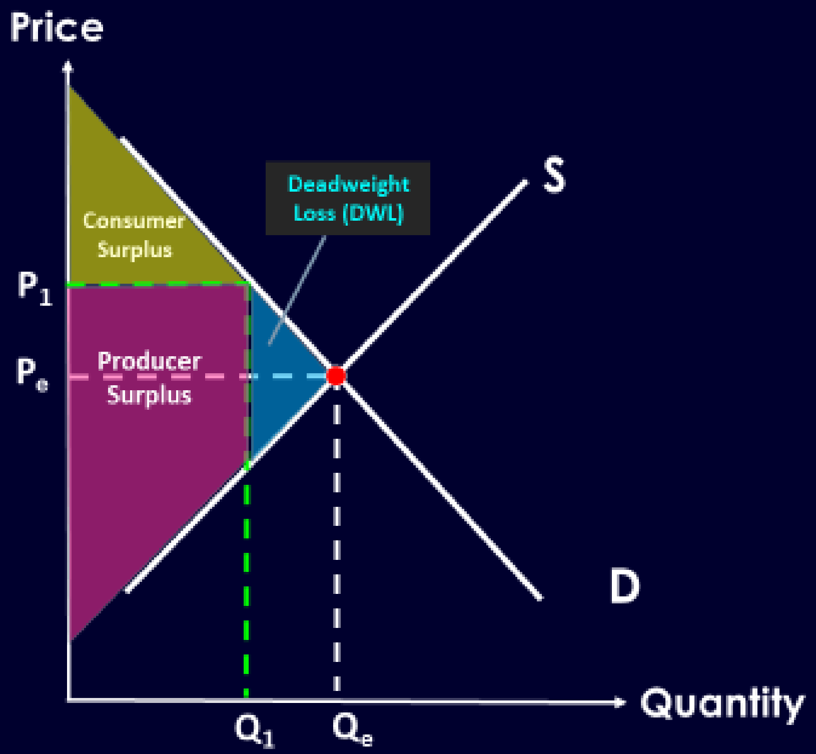
- The figure illustrates the effects of market power on price and quantity.
- A competitive market will produce where demand equals supply.
- The equilibrium price (Pe) and quantity (Qe) is efficient.
- At the equilibrium, total surplus (the sum of consumers and producer surplus) is maximized.

CS + PS = Total Surplus maximised



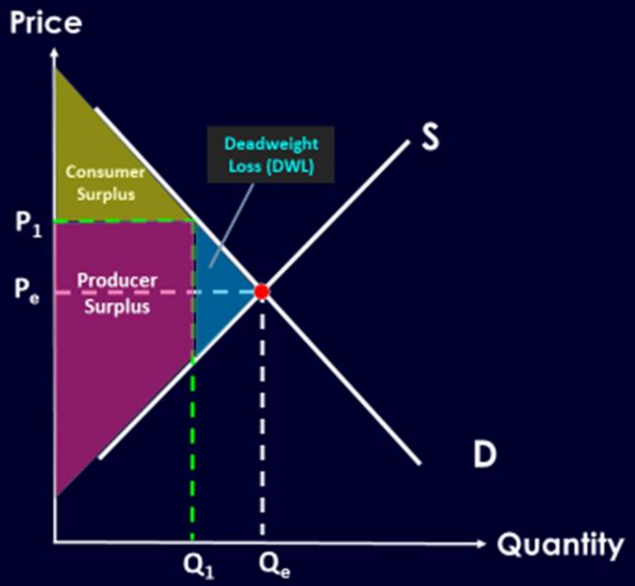
Market Power: Barriers to Entry

- The figure below shows the effect of market power. In this case the monopolist reduces output to Q1 in order to increase price to P1.
- Notice that the consumers are now worse off – they pay a higher price and consume a lower quantity. Consumer surplus decreases.
- The monopoly on the other hand gains – producer surplus (Revenue and possibly profit) increases.



Market Power: Barriers to Entry

- But society is now worse off because total surplus decreases by the area DWL.
- There is deadweight loss in economic welfare because the market has been restricted.
- This is the classic case against monopoly and why monopolies and oligopolies are criticized for being inefficient.
- Most countries now have government legislation which promotes a competitive business environment and tries to prevent firms with market power from exploiting the market.



Market Power – Anti Competitive Behaviour

- **Competition** provides the spur for businesses to improve their performance, develop new products and respond to changing circumstances.
- **Competition** also offers the promise of lower prices and improved choice for consumers and *greater efficiency, higher economic growth and increased employment opportunities.*

Market Power – Anti Competitive Behaviour

- Firms with market power have the incentive to reduce competition – by either reducing price competition or by reducing he number of firms competing in the market.
- The term **anti-competitive behavior** refers to any agreements or arrangements between firms that seek to restrain competition and thereby remove the automatic regulation that competitive markets achieve.
- Any agreement between firms in an industry to fix prices to divide the market, or to prevent the entry of new.
- Business practices that try to reduce competition will result in market failure and will lead to a deadweight loss.

Market Power – Anti Competitive Behaviour

Business Practices that reduce competition	
Cartel	When firms agree to act or collude together instead of competing with each other – includes both price fixing and market sharing
Collusion	General term describing agreement between firms - either price or market sharing – to reduce competition and increase profits
Market sharing	A market is divided into a series of smaller markets. Each supplied by one of the firms , thus reducing competition
Collusive Tendering	Firms agree to submit exorbitant tenders which ensure high profits and the sharing of work between collusive members
Predatory pricing	When a comp[any with substantial market power sets its prices at a sufficiently low level with the purpose of eliminating or substantially damaging a competitor.
Resale Price Maintenance	The suppliers sets the price at which a retailer must sell its products. The manufacturer may refuse to sell to any retailer which may resell their products at a discount.
Exclusive dealing	When one person trading with another imposes some restrictions on the other's freedom to choose with whom or where they deal
Collective Boycott	When a group of competitors agree not to acquire goods or services from , or not to supply goods or services to, a business with whom the group is negotiating
Merger	Two or more firms join together to form one larger firm – prohibited if it substantially reduces in the market.

Market Power: Government Policy

- Market Power is prominent in imperfect markets such as monopoly and Oligopoly markets.
- Market power is inefficient because it reduces competition and decreases total surplus
- Government policy to address market power includes regulation/ deregulation as well as specific legislation.
- **An example of government legislation in Australia that attempts to prevent market power is the Competition and Consumer Act 2010.**

Market Power: Government Policy

- This Act is administered by the Australian Competition and Consumer Commission (ACCC) and contains *rules against anti competitive conduct to ensure that there is fair and effective competition within Australia.*
- The Act also contains consumer protection rules, known as the Australian Consumer Law, which businesses must abide by in their dealing with consumers.
- **The role of the ACCC is to protect, strengthen and supplement the way competition works in Australia markets and industries to improv efficiency of the economy and to increase the welfare of Australians.**

Market Power: Government Policy

- This means that the ACCC tries to ensure that the benefits of increased competition flow through to consumers in the form of lower prices and better service.
- It does this prohibiting anti-competitive conduct by firms with market power such as price fixing and collusion.
- Listed below are some examples of business practices in Australia that are against the Law because they limit or prevent competition.

Market Power: Government Policy

- **Cartels:** A cartel exists when firms agree to act or collude together instead of competition with each other. Typical cartel behavior includes price fixing and market sharing.
- **Misuse or market power:** A business that has a substantial degree of power in a market (eg monopoly) is prohibited from taking advantage of that power for the purpose of eliminating or substantially damaging a competitor or preventing the entry of a firm into any market.
- **Exclusive dealing:** this occurs when one firm trading with another imposes some restrictions on the others freedom to choose with whom , in what or where they deal. Most types of exclusive dealing are against the law only when they substantially lessen competition.

Market Power: Government Policy

- **Resale price maintenance:** Suppliers manufactures and wholesalers are prohibited from specifying a minimum price below which goods or services may not be resold or advertised for resale. A supplier may recommend a resale price for goods provided that it is a recommended price only.
- **Predatory pricing:** this occurs when a company with substantial market power sets its prices at a sufficiently low level with the purpose of eliminating or substantially damaging a competitor or preventing the entry of a competitor into that or any other market,
- **Collective boycotts:** This occurs when a group of competitors agree not to acquire goods or services from, or not to supply goods or services to, a business with whom the group is negotiating , unless the business accepts the terms and conditions offered by the group.

Market Power: Government Policy

- **Mergers and acquisitions:** Mergers may be deemed to be in the public interest if they lead to benefits for consumers.

  However, if they have the effect of substantially lessening competition in a market then they are prohibited.

Market Power: Government Policy

- The Competition and Consumer Act provides for heavy penalties where firms have engaged in anti competitive behavior.
- In 2008, for example, Visy was fined $36 million by the federal court for its role int eh cardboard packaging cartel which overcharged thousands of firms and millions of consumers.
- In 2016, Colgate Palmolive was ordered to pay an $18 million fine for colluding with rival companies to fix the price of detergents in Australian supermarkets.

Market Power: Government Policy

- Governments need to be careful when using regulation to achieve certain social objectives that they don't reduce the level of competition in an industry.
- The types of regulations that restrict competition are those that
  - Limit the number of types of businesses
  - Limit the ability of businesses to compete
  - Reduce the incentive for businesses to compete
  - Limit the choices and information available to consumers

Market Power: Government Policy

- The taxi market is a good example where government regulation led to reduced competition, high prices and relatively poor service.
- In this case the answer is **deregulation** – remove the unnecessary restrictions on the market and allow increased competition.
- In certain cases, such as the sale of firearms and explosives. Then regulation is necessary to protect the public.