

# Industrial Organization, Week 1

## Market power and Efficiency

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# Agenda

- 1 Power
- 2 Efficiencies
- 3 Examples

# Nuts and bolts: Market power and formal market power

- ▶ **Power:** The ability to acquire goods below their market price
- ▶ **Market power:** Market power is the ability to set prices above cost.
- ▶ **Memo on cost:** Costs subjective, depends on the uneasiness of the process of creation(think actors/writers)
- ▶ **Formal Market power:**  $r = (R-C)/C$  or if costs proportional to output then:  
 $r = (P - UC)/UC$
- ▶ **Effects for firms:** More profits
- ▶ **Effects for consumers:** Value transfer from consumer to firm

## Nuts and Bolts 2: Static/Dynamic and Sources of market power

- ▶ **Static effects:** Effects that happen outside of time(axiomatic)
- ▶ Example: {What is the equilibrium? How is the equilibrium affected by X }
- ▶ **Dynamic:** Effects that happen over time(empirical)
- ▶ Example: {How do we get to equilibrium? How do profits change over time?, }
- ▶ **Intellectual property:** Gives a legal monopoly over 20 years
- ▶ Gives market power in the short run, but good in the long run(investment)
- ▶ **Regulation:** Limiting prices or quantities or product variety
- ▶ Limits investments and allocations
- ▶ *Both of these are special cases of barriers to exit and entry*

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# Types of efficiencies

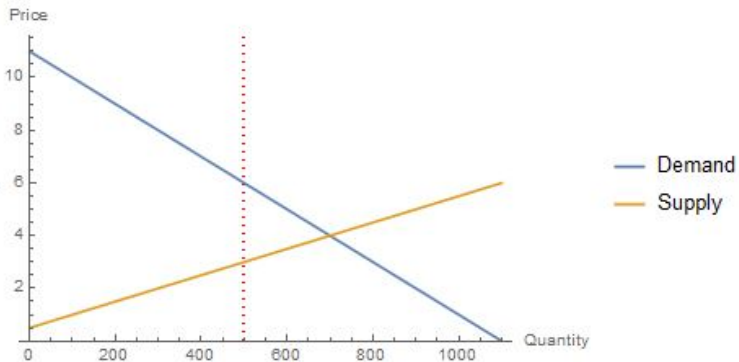
- ▶ **Allocational efficiency:** The highest valuation person gets the item
- ▶ **Investment efficiency:** Bringing goods into existence/market
- ▶ **Production efficiency:** Lower costs
- ▶ **Rent-seeking efficiency:** Unproductive use of resources(think bureaucracy)

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# Occupational Licensing

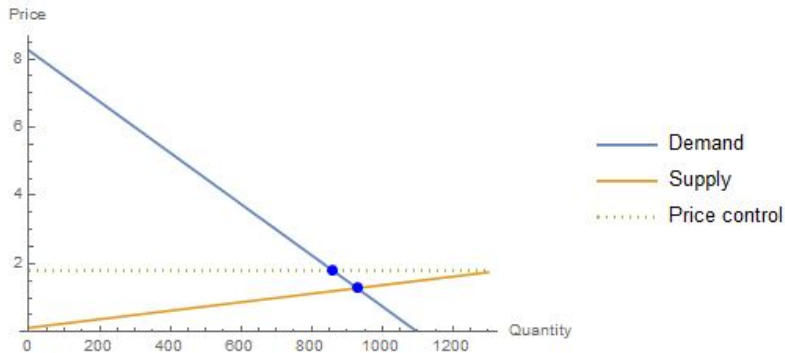
- ▶ - Allocational efficiency
- ▶ ↓ Investment
- ▶ ↓ Production





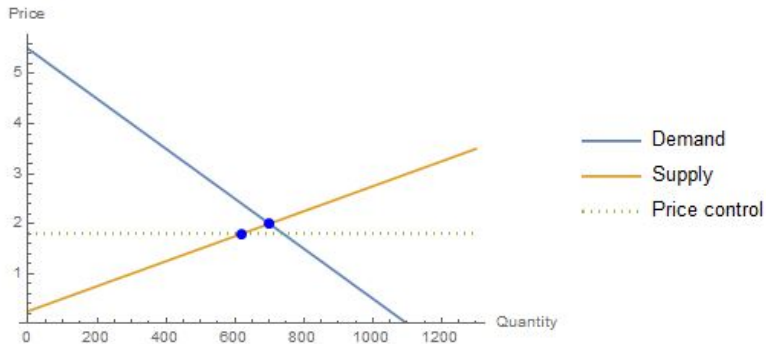
# Price control(min)

- ▶ - allocational
- ▶ ↓ investment



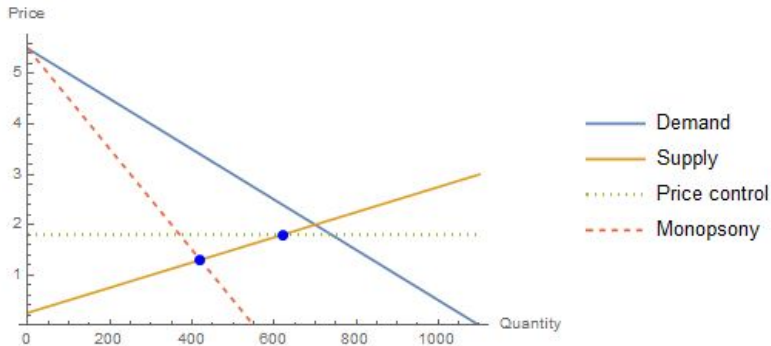
# Price control(max)

- ▶ ↓ allocational
- ▶ ↓ investment



# Monopsony

- ▶ - allocational
- ▶ ↑ investment



# How do we do industrial organization?

- ▶ Describe a market structure: Who are the buyers and sellers, what are the characteristics of the good and how does that affect their interaction. What are the strategies of the buyers and sellers?
- ▶ Does the environment cause the strategy of vice versa?
- ▶ How much can we explain with positing a market structure?
- ▶ **Economics is more about what we cannot say:**
- ▶ Supply and Demand: We cannot reason from a price change
- ▶ Bertrand Paradox: We cannot measure competition from the number of players

## Some notes on homework

- ▶ Step 1: Equalize quantity demanded with quantity supplied
- ▶ Step 2: Solve for price
- ▶ Step 3: Plug the price into the equations to get the quantity
- ▶ Step 4: Draw a graph
- ▶ Step 5: If there is a tax, compute the amount collected( $\text{tax} \times \text{quantity}$ )
- ▶ Step 6: Compute the area of the upper triangle(consumer surplus)
- ▶ Step 7: Compute the area of the lower triangle(producer surplus)
- ▶ Step 8: Add 5, 6, 7 for total surplus
- ▶ Step 9: Deadweight loss: is the surplus difference with and without taxation