MARKET POWER AND EFFICIENCY AND THEORIES OF (ANTITRUST) HARM

Market power

- Market power: the ability of one or more firms to price above the perfectly competitive level

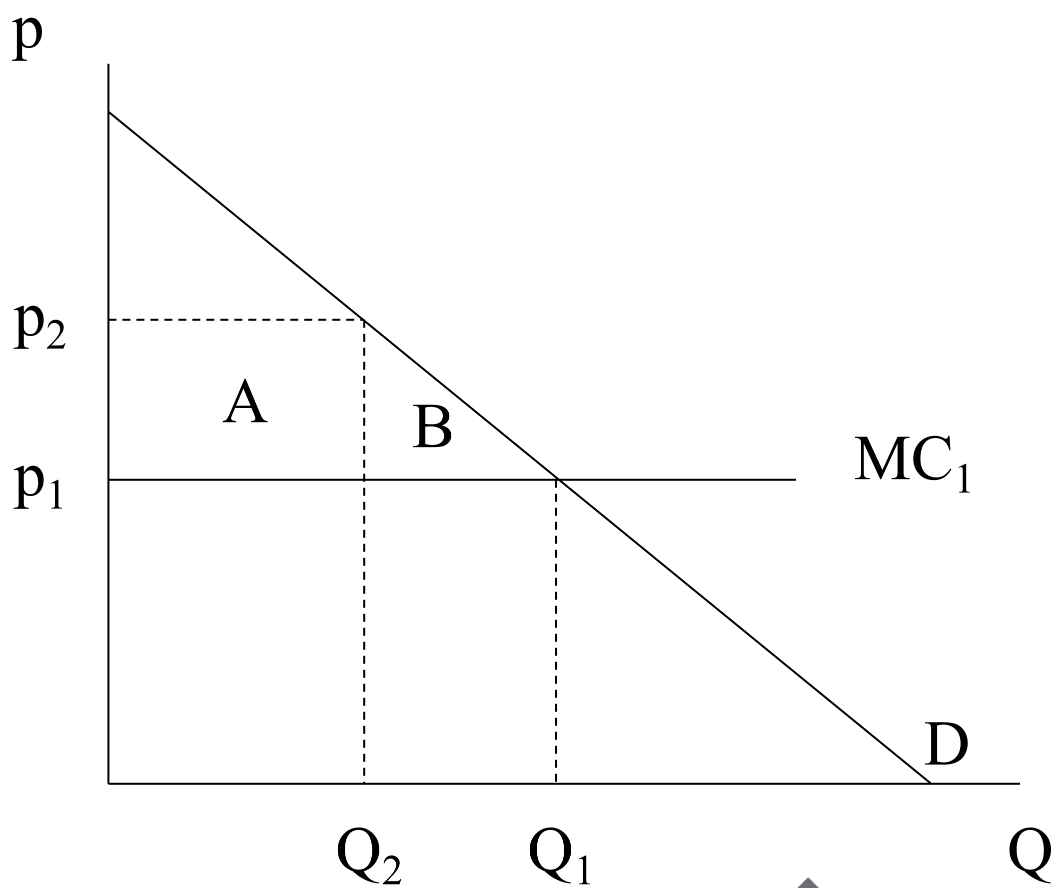
- Lerner Index

$$L = \frac{p - mc}{p}$$

- L = 0 (perfect competition); L = 1 (maximum market power)

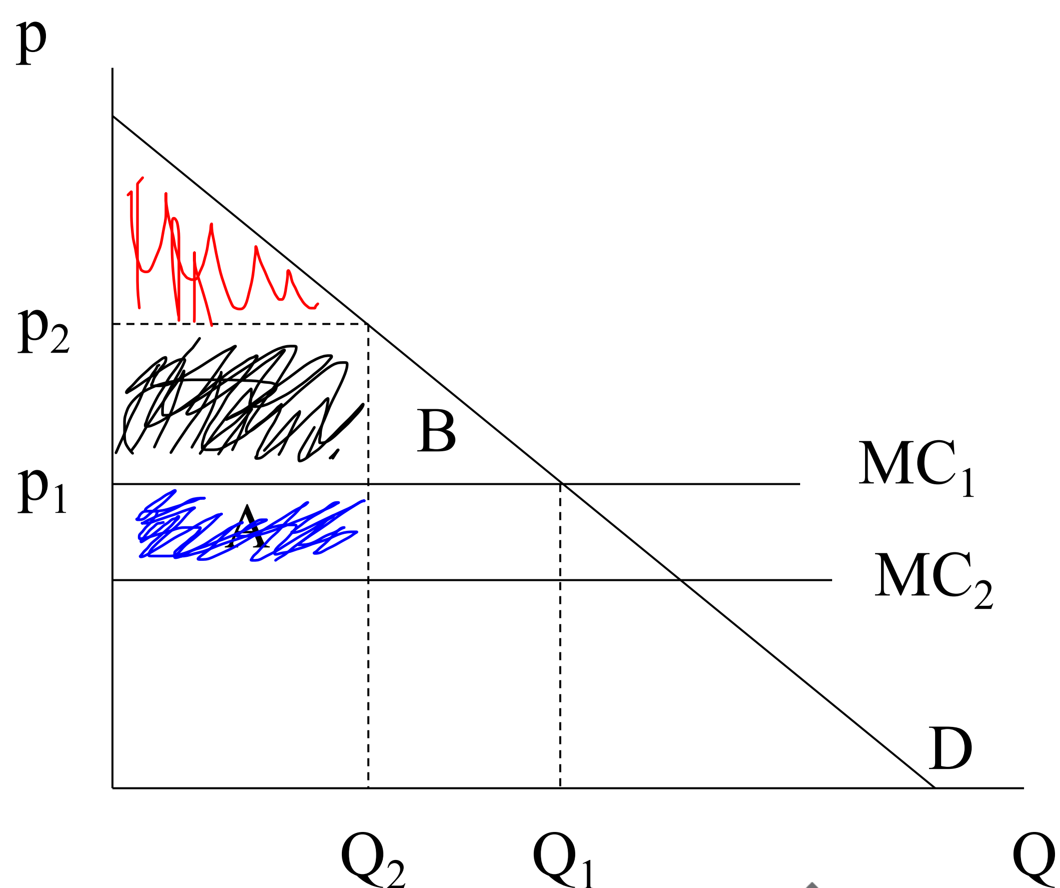
Market power and allocative efficiency

- Competition and productive efficiency
- A is a transfer of surplus form consumers to producers
- B is a deadweight loss



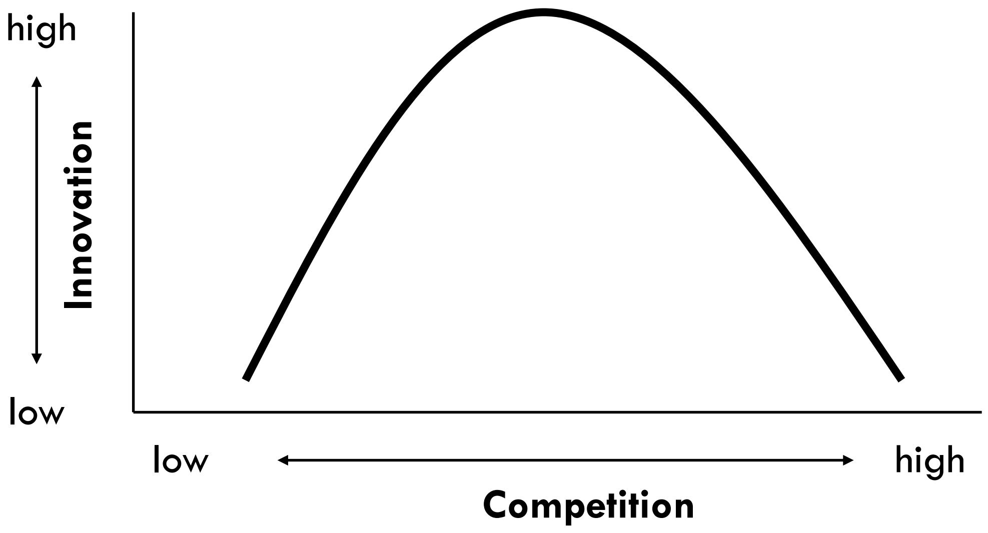
Market power and productive efficiency

- Competition and productive efficiency
- Economies of scale
- More efficient to concentrate production within "few" firms, possibly one (natural monopoly)



Market power and dynamic efficiency

- Competition and dynamic efficiency
- Two effects of competition
  - Escape competition effect
  - Schumpeterian effect
- Innovation depends on incentives
- Inverted-U relationship



A framework for assessing market power

- Market power can exist in a variety of contexts:
  - in some markets, a single undertaking may possess market power (unilateral effects)
  - in other markets, a number of undertakings may collectively possess market power (coordinated effectcs)

- It is necessary to have a conceptual framework to assess <u>whether</u> and to what <u>extent</u> market power exists

The "old" economic assessment framework

- The traditional approach for assessing market power relied on the causal link between **structure–conduct–performance**

- Main focus on structural factors

Structural analysis: steps

- Step 1: Define a relevant market (product and geographic)
- Step 2: Analyse the supply-side structure of the market
  - Number of competitors
  - Market shares and concentration indexes
  - Vertical integration; etc.
- Step 3: Assess barriers to entry (potential competition)
- Step 4: Assess countervailing buyer power (if any)

Modern economic approach: developing a theory of harm

- In the latest years, antitrust authorities focused on articulating a "*theory of harm*" behind a competition concern
- The theory of harm is a story that explains why an agreement between two or more firms or a practice engaged by a firm may harm competition and adversely affect consumers
- It does not only take into account the structural features of the market but also the incentives and the ability of the firms involved

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Theory of harm: elements

A well developed theory of harm:

- should articulate how competition and, ultimately, consumers will be harmed by the practice under exam relative to an <u>appropriately defined counterfactual</u>
- should be consistent with the <u>incentives</u> and the <u>ability</u> of the parties involved
- should be consistent with the available <u>economic theory</u>
- should be consistent with the available <u>empirical evidence</u>

Theory of harm: statements

A theory of harm and the justifications of the various nodes of the story will make emerge two categories of statements:

1. **Factual assertions**: description – and possibly quantification – of an economic phenomenon
   - e.g. X and Y are the closest competitors; consumers face high switching costs; demand price elasticity is 1.6

2. **Logical propositions**: a reasoning that, on the basis of a set of premises, (i.e. some factual assertions), derives a conclusion

- e.g. switching costs would prevent a new entrant from reaching an efficient scale and would impede entry

Theory of harm: testing the statements

- In general a factual assertion can be either **true** or **false**
  - When a factual assertion contains estimates it is impossible to express such a clear-cut opinion and the judgement it can only concern the **reliability** or **robustness** of the estimates

- A logical proposition is **valid** or **invalid**
  - internal consistency: conclusions must logically follow from the premises
  - economic theory: conclusion are related to the premises by an established or sound economic theory

Efficiency justifications

- An efficiency justification is an <u>alternative story</u> that explains a certain practice engaged by a firm will ultimately enhance competition and positively affect consumers

- An efficiency justification contains all the elements of a theory of harm

  - Factual statements
  - Logical propositions

Theory of harm: broad categories

- Individual theories of harm are numerous and specific to the case at stake
- However, most draw on a limited number of common potential sources of competitive harm:
  - **Softening competition/unilateral market power**

    One or more firms have a lower incentive to compete aggressively and can unilaterally exercises market power
  - **Collusion**

    Two or more firms coordinate to jointly exercise market power
  - **Foreclosure**

    A firm reinforces or protects its market power by excluding equally efficient competitors from the market

Softening competition

- One or more firms undertake a practice such that lowers their incentives to compete aggressively

- Examples
  - Merger between to close competitors: unilateral effects

  - Best pricing policies
    - Price Matching Guarantee
    - Parity clause

  - Softening competition theory of harm is based on an alteration of a static game

Collusion

- Coordination of market strategies (prices, output etc.) such as to raise profits and harm consumers

- Coordination occurs through a dynamic interaction (repeated game)

- 3 Problems:
  - Coordination problem: finding the terms of coordination
  - Enforcement problem: curbing firms' incentive to deviate through a punishment mechanism
  - External stability: impeding disruptive actions by fringe competitors and/or buyers

Foreclosure

- Raising rivals' costs strategy - RRC
  - the dominant firm impedes the access to an essential input or to a more efficient input
- Lowering rivals' demand strategy - LRD
  - the incumbent reduces the demand that is available to new entrants till is no longer profitable entering the market
- Output strategy
  - the dominant firm does not affect neither the cost or the demand of competitors, but might choose its output level so as to bring price at a level that would make entry unprofitable