

Market Power

BY RENEE HALTOM

Market power is when a firm has the ability to raise prices above the marginal cost of production. In competitive markets, such behavior would drive customers to other firms. Thus, market power is characterized by a lack of competition.

Raising prices above the competitive level transfers wealth from consumers to producers — but this is not what primarily concerns economists. Rather, the problem is that it reduces economic efficiency because it results in too little of the good being produced. That is, firms that exercise market power prevent the good from arriving in the hands of individuals who value it as much as or more than it costs to produce it. In its place, society produces relatively more of goods that are valued less, and society is poorer as a result.

The most extreme case of market power is that of a monopoly, a single seller of a good or service. A firm need not be a monopoly to exhibit market power, however. An oligopoly — a market with a small group of sellers — may also be a source of market power.

Market power can exhibit itself in ways other than higher prices. The Justice Department’s antitrust case against Microsoft in the late 1990s, for example, argued that the computer giant exercised market power by “bundling” its goods — namely, forcing the installation of its Internet browser on any computer that operated the Windows platform — to enhance the market share of its browser.

Cartels are one possible source of market power, though it is rare that firms can get away with colluding to keep prices high, both because cartels are illegal and because they are difficult to sustain due to the incentive to renege. Even within the OPEC oil cartel, member countries have diverging interests and renegeing sometimes occurs.

“Natural monopolies,” another source of market power, occur when it is profitable for only one or a few firms to produce because of large upfront costs that prevent competitors from entering, as with public utilities. Finally, market power is perhaps most often the result of government policy itself, as with occupational licensing or patents.

The nation’s first attempt to limit market power was the Sherman Act of 1890, followed by the 1914 Clayton Act that was more specific about the acts considered to be socially harmful. The latter law includes some types of price discrimination (when firms charge different prices to different consumers), bundling, and mergers that substantially reduce competition. The policymakers supporting these laws had

the traditional notion of monopolies in mind but with little economic justification for how and why monopolies might harm social welfare.

The economics subfield of “industrial organization” emerged in part as a way to analyze how real-world markets depart from the assumption of perfect competition. What was previously perceived as harmful monopoly behavior often proved instead to be the result of departures from the assumptions of perfect competition — assumptions such as perfect information, low transactions costs, and low barriers to entry. This work led to a more nuanced understanding about where inefficiencies resulting from market power truly existed.

One thing this work proved was that such instances are not always obvious. Prices that would prevail under perfect competition are not observable. One method, called the Lerner Index, attempts to measure the difference between price and a firm’s marginal cost. Marginal costs are difficult to measure, however, as are alternative indicators of market power such as demand elasticities, which measure consumers’ responsiveness to changes in price.

Moreover, market power doesn’t always result in socially destructive behavior. Research in industrial organization has shown that bundling can enable innovation and output by allowing the sale of one good to subsidize production of another — as

Microsoft’s attorneys argued. And when competitors collaborate, it can lead to innovation, not necessarily collusion. Industry concentration doesn’t always lead to higher profits, a symptom of market power, and can yield cost reductions. Overall, the influence of the economics profession — along with the increasing complexity of industry generally — has been to increase the extent to which antitrust cases focus on actual losses in social welfare rather than the mere existence of market power itself.

Assuming that socially destructive market power has occurred, it is not always straightforward to address it by, for example, capping prices. Economist Jean Tirole of the Toulouse School of Economics won the 2014 Nobel Prize in economics in part for his theoretical work on this question. In the 1980s, he and the late Jean-Jacques Laffont showed that antitrust policymakers can set optimal prices through a scheme that allows the firm to choose its own pricing solution. But perhaps most importantly, Tirole’s work emphasized the importance of adapting the regulatory response to the industry or market in question — proving that there is no one-size-fits-all method for evaluating or addressing market power. **EF**

