

Chapter 17

Competition policy

Learning objectives

In this chapter, students will:

- consider the various public policies aimed at solving the problem of monopoly
- consider how competition laws try to foster competition in oligopolistic markets
- examine various business strategies such as resale price maintenance and tying
- consider why competition laws are often controversial.

Key points

- 1 Policymakers can respond to the inefficiency of monopoly behaviour in four ways. They can use the competition laws to try to make the industry more competitive. They can regulate the prices that the monopoly charges. They can turn the monopolist into a government-run enterprise. Or, if the market failure is deemed small compared with the inevitable imperfections of policies, they can do nothing at all.
- 2 Policymakers use competition laws to prevent oligopolies from engaging in behaviour that reduces competition. If firms in an oligopoly form a cartel to reduce competition and raise profits, then authorities, such as the ACCC, can prosecute those firms under the competition laws.
- 3 The application of these competition laws and competition policy more generally can be controversial. Some behaviour that may seem to reduce competition may in fact have legitimate business purposes.

Chapter outline

Monopoly and oligopoly can lead to deadweight loss. Governments around the world have responded to this by enacting laws that restrict the behaviour of monopolies and oligopolies. They also have policies that aim to improve the efficiency of oligopolistic and monopoly markets. (See text page 347)

- Definition: *competition laws* – laws that restrict the behaviour of firms with market power, such as monopolists or firms in a small oligopoly.
- Definition: *competition policy* – the laws and policies that aim to improve social efficiency in oligopolistic and monopolistic markets.

Public policy toward monopolies

Using the law to increase competition

- Definition: *Trade Practices Act* – Australia's main competition laws.
- The Trade Practices Act is the main law in Australia preventing anti-competitive behaviour. It is used to control mergers and to prevent those with substantial market power from using that power to restrict or harm competition.
- Competition laws are designed to raise social welfare so the government must be able to determine which mergers are desirable and which are not. Measuring and comparing the social benefit from merger synergies with the social costs of reduced competition is difficult.

Regulation

- Regulation is often used when the government is dealing with a natural monopoly. Most often, regulation involves government limits on the price of the product.

See text Figure 17.1, page 350

- While we might believe that the government can eliminate the deadweight loss from monopoly by setting the monopolist's price equal to its marginal cost, there are 2 major obstacles to this.
- 1st if the firm is a natural monopoly, its average total cost curve will be declining because of its economies of scale. When average total cost is falling, marginal cost must be lower than average total cost. Therefore, if the government sets price equal to marginal cost, the price will be below average total cost and the firm will earn a loss, causing the firm to eventually leave the market.
 - Governments sometimes subsidise the monopolist in this situation – but that is funded by taxes that have their own deadweight losses.
 - Therefore, governments may choose to set the price of the monopolist's product equal to its average total cost. This gives the monopoly zero profit, but assures that it will remain in the market. Note that there is still a deadweight loss in this situation because the level of output will be lower than the socially efficient level of output.
- 2nd marginal cost pricing gives the monopolist no incentive to reduce costs.
- In practice governments deal with both problems by allowing monopolists to keep some of the benefits of lower costs, even if only for a fixed period of time.

Public ownership and privatisation

- Rather than regulating a monopoly run by a private firm, the government can run the monopoly itself.
- Monopolies run by private firms have incentives to:
 - Reduce costs if they think they will get some of the benefit in the form of higher profits.
 - Abuse market power if it raises profits.
- The government's ownership choice will depend on which of these incentives are stronger and have the biggest effect on economic wellbeing and on whether the government can effectively control the actions of a private owner or a public bureaucrat.
- Governments have been tending to rely more on private ownership and regulation and less on public ownership to control natural monopolies.
- Definition: *privatisation* – the sale of a government-owned business to private owners.

Doing nothing

- Sometimes the costs of government regulation outweigh the benefits.
- Therefore, some economists believe that it is best for the government to leave monopolies alone.

Case study: The ACCC – Australia's competition regulator

- The ACCC has two categories of responsibilities – consumer protection and competition protection. The competition protection areas are largely covered by the Trade Practice Act and deal with different aspects regulating mergers, the creation of monopolies and other anti-competitive conduct.

In the news: Should merging be easier?

- Business often argues that the restrictions on mergers in Australia are too tight and that the Trade Practices Act needs to be updated. In this article Ross Gittins considers the arguments for relaxing merger laws in Australia.

Public policy toward oligopolies

Restraint of trade and competition laws

- Section 45 of the Trade Practices Act makes it illegal for corporations to make a contract or arrangement that would substantially lessen competition.
- Section 45A extends this by making it illegal for firms to agree to fix, control or maintain prices.

Case study: An illegal phone call

- This is an example highlighting the strong incentive for oligopolies to collude to reduce production, raise prices and increase profit.

In the news: Cracking cartels

- This article discusses recent developments around the world in the use of competition laws to break cartels.

Controversies over competition policy

- Competition laws have been used to condemn some business practices whose effects are not obvious.
- Definition: *resale price maintenance* – when a wholesaler requires that its retailers do not sell its products to their customers below a specified retail price.
- This practice appears anti-competitive at first glance as it prevents the retailers from competing on price. However some economists defend it on two grounds:
 - 1 They deny the practice is aimed at reducing competition. If the wholesaler had market power they could exert it through the wholesale price. Plus the wholesaler has no incentive to discourage competition among its retailers – if its retailers were a cartel they would sell less.
 - 2 Economists have argued that this policy has a legitimate goal. Customers often go to one retailer with good service, knowledgeable sales people, and higher prices for information on a product and then turn around and buy the product at a discount retailer. Resale price maintenance limits the discounter's ability to 'free ride' on the service provided by other retailers.
- Definition: *predatory pricing* – when a firm sells its product at an artificially low price in order to drive out an efficient competitor and reduce long run competition.
 - Economists debate whether this is ever a profitable business strategy and whether courts are capable of telling which price cuts are competitive and which are predatory.
- Definition: *tying* – when a firm will only sell customers one product if they also buy another product. Tying is also called bundling.
 - Economists are sceptical of this as a simple mechanism for expanding market power because people will not be willing to pay more for two products sold together than they would if the goods are sold separately. Tying probably exists more as a method of price discrimination. The argument that tying allows a firm to extend its market power to other goods is not yet well founded in its simplest form.
- Transparent pricing has been used by competition authorities in different countries. Under it firms must report their prices to the regulator and make them publicly known.
 - The benefit is meant to come from customers being able to compare prices and shop for the cheapest deal.
 - However it appears that published transparent prices may also make it easier for firms to collude. This is because it makes successful cheating on the other members of a cartel much harder.

Adjunct teaching tips and warm-up activities

- 1 Ask the students if any of them have heard of any recently completed or proposed mergers. Have the students think about the potential efficiency arguments for and against the merger.

Solutions to text problems

QZ *Describe the ways policymakers can respond to the inefficiencies caused by monopolies. Give a potential problem with each of these policy responses. (page 354)*

Policymakers can respond to the inefficiencies caused by monopolies in one of four ways: (1) by trying to make monopolised industries more competitive; (2) by regulating the behaviour of the monopolies; (3) by turning some private monopolies into public enterprises; and (4) by doing nothing at all. Competition laws prohibit mergers of large companies and prevent them from coordinating their activities in ways that make markets less competitive, but such laws may keep companies from merging to gain from synergies. Some monopolies, especially natural monopolies, are regulated by the government, but it is hard to keep a monopoly in business, achieve marginal-cost pricing, and give the monopolist incentive to reduce costs. Private monopolies can be taken over by the government, but the companies are not as likely to be well run. Sometimes doing nothing at all may seem to be the best solution, but there are clearly deadweight losses from monopoly that society will have to bear.

QZ *What kind of agreement is illegal for businesses to make? Why are competition laws controversial? (page 362)*

It is illegal for businesses to make an agreement about reducing quantities and raising prices. The competition laws are controversial because it isn't always clear what kinds of behaviour the competition laws should prohibit, such as resale price maintenance, predatory pricing, and tying. It is also unclear whether requirements like transparent pricing are, on balance, pro-competitive.

Questions for review (page 363)

- 1 The government has the power to regulate mergers between firms because of competition laws such as the Trade Practices Act. Firms might want to merge to increase operating efficiency and reduce costs, something that is good for society, or to gain monopoly power, which is bad for society.
- 2 When regulators tell a natural monopoly that it must set price equal to marginal cost, two problems arise. The first is that, because a natural monopoly has a constant marginal cost that is less than average cost, setting price equal to marginal cost means that the price is less than average cost, so the firm will lose money. The firm would exit the industry unless the government subsidised it, but getting revenue for such a subsidy would cause the government to raise other taxes, increasing their deadweight loss. The second problem is that it gives the monopoly no incentive to reduce costs.
- 3 Resale price maintenance occurs when a wholesaler sets a minimum price that retailers can charge. This might seem to be anticompetitive because it prevents retailers from competing on price. But that's doubtful because: (1) if the wholesaler has market power, it can exercise such power through the wholesale price; (2) wholesalers have no incentive to discourage competition among retailers since doing so reduces the quantity sold; and (3) maintaining a minimum price may be valuable so retailers provide customers with good service.
- 4 A firm trying to use predatory pricing to eliminate a competitor could face a tricky situation. For a price war to drive out a rival, prices have to be driven below cost. This is likely to spur demand and it is possible that the firm will suffer large losses.
- 5 Tying can be used to raise profits as it is a form of price discrimination. If different buyers value the two tied products differently then tying allows the seller to increase profit by charging a combined price closer to the buyers' total willingness to pay.

Tying remains a controversial business practice as there are arguments that it can be used to extend market power in one market to another market.

- 6 Rules that create transparent pricing may make cartels easier to sustain. With transparent pricing any cheating on the cartel is easier to uncover and punish effectively. The prospect of few benefits and substantial costs from cheating will tend to make it easier for cartels to maintain discipline with transparent pricing.

Problems and applications (page 363)

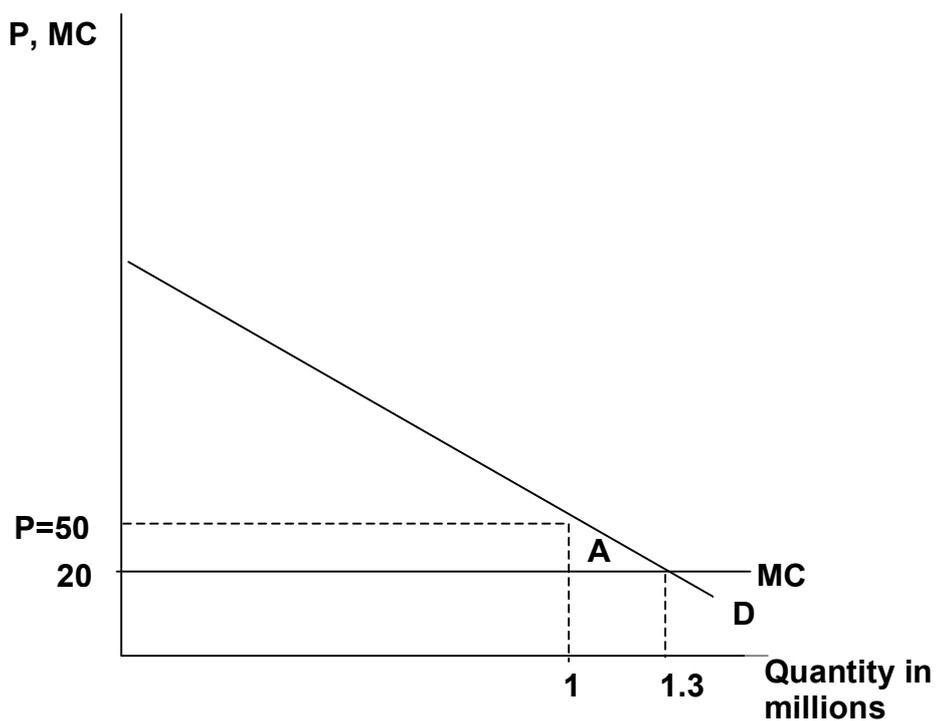
- 1 a Long-distance phone service was originally a natural monopoly because installation of phone lines across the country meant that one firm's costs were much lower than if two or more firms did the same thing.
 b With satellites, the cost is no different if one firm supplies them or if many firms do so.
 c It is efficient to have competition in long-distance phone service and regulated monopolies in local phone service because local phone service remains a natural monopoly (being based on land lines) while long-distance service is a competitive market (being based on satellites).
- 2 a Regulators might believe that forcing a monopoly to charge price equal to average cost is a good outcome because the monopolist will earn zero economic profit yet not want to exit the industry. This price regulation does not maximise social welfare as it leads to deadweight losses, because the monopolist's price does not reflect the marginal cost of producing the good. In addition to the deadweight losses this form of regulation may give the regulated firm an incentive to misrepresent its costs.
 b Average cost pricing gives a monopolist no incentive to reduce costs. The monopolist knows that it will not benefit from reduced costs.
 c Price cap regulation allows the regulated firm to keep all of the benefits from lower costs for a fixed period of time. This is more encouraging of innovation than simple average cost pricing.
- 3 Though Britney Spears has a monopoly on her own concerts, there are many other singers in the market. If she was to raise the concert price too much, people would substitute to other singers and other forms of entertainment. So there is no need for the government to regulate the price of her concerts.
- 4 a The decision matrix for this game is:

Braniff's Decision 17.1 below.

		Price \$100	Price \$200
		American's Decision	Price \$100 Low profits for Braniff Low profits for American
	Price \$200	High profits for Braniff Very low profits for American	Medium profits for Braniff Medium profits for American

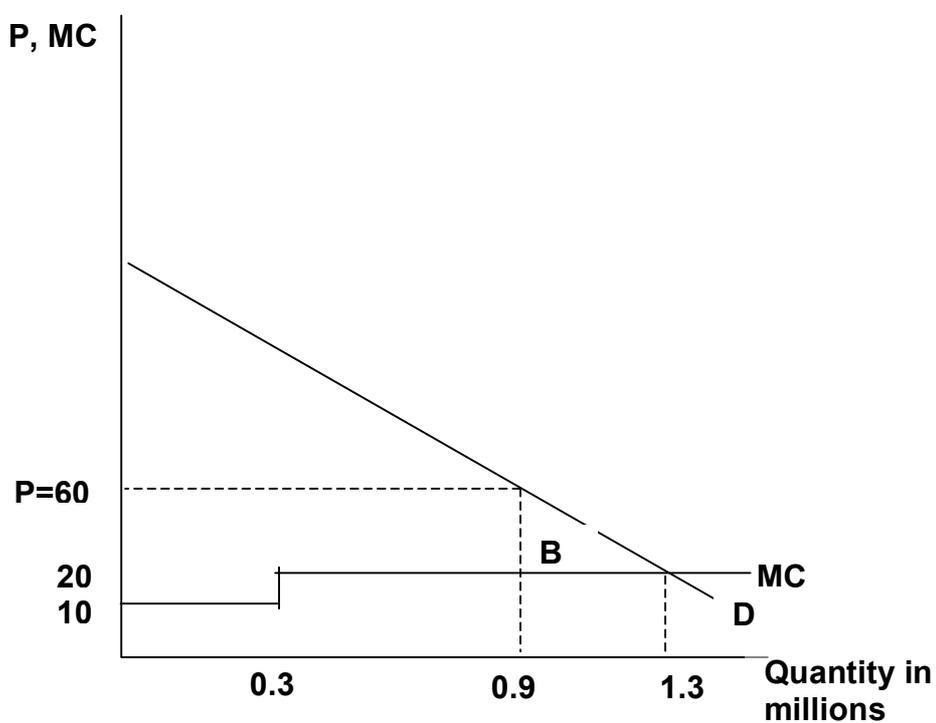
- b If Braniff sets a low price, American will set a low price. If Braniff sets a high price, American will set a low price. So American has a dominant strategy to set a low price. If American sets a low price, Braniff will set a low price. If American sets a high price, Braniff will set a low price. So Braniff has a dominant strategy to set a low price. Since both have a dominant strategy to set a low price, the Nash equilibrium is for both to set a low price.
- c A better outcome for the airlines would be for both airlines to set a high price; then they would both get higher profits. But that outcome could only be achieved by cooperation, that is, by colluding. If that happened, consumers would lose because prices would be higher and quantity would be lower.
- 5 a The deadweight loss associated with this oligopoly is the area A in Figure 17.1 below, the area below the demand curve and above the marginal cost curve between $Q=1M$ and $Q=1.3M$.

Figure 17.1



b The deadweight loss will change to area B as shown in Figure 17.2.

Figure 17.2



An estimate of the size of the change in deadweight loss is the area of B less the area of A = $\frac{1}{2} (1.3 - 0.9) (60 - 20) - \frac{1}{2} (1.3 - 1) (50 - 20) = 3.5$ M

c The cost savings generated by the merger are $10 \times 0.35 = 3.5$ M. This assumes that none of the decrease in industry quantity is from the merged Allcar and Bootstone, who now have a lower

marginal cost than the other producers. That is, the merged Allcar and Bootstone continue to produce 350 000 tyres per year.

The total size of these cost savings would be directly affected by any change in quantity produced by the merged Allcar and Bootstone. For example, the reduction in marginal cost they achieve may be due to the retirement of more expensive capacity. The merged group may reduce its quantity produced as part of the industry decrease in production. Or the change in cost position of the merged group may allow it to try and steal more market share from the other producers, increasing the size of their cost savings.

- d** The estimated increase in deadweight loss is exactly offset by the cost savings made by the merged entity. This outcome would change if the merged entity changes its quantity produced.
- 6** It is likely that pricing below marginal cost would be predatory pricing rather than simply vigorous competitive pricing. Firms that are pricing below marginal cost are not maximising profit, as they are making a loss on items priced this way. The firm could choose not to produce units that are priced below marginal cost and its profits would increase. So a profit-maximising firm would only price below marginal cost if it expected to drive the rival firm out and be able to recoup its losses then.

It is possible that a firm might set a price below marginal cost but not be predatory pricing. For example a firm could use a temporarily very low price as a form of advertising to raise awareness of its product. A firm could be temporarily cash constrained and need to raise cash in a hurry. A firm could be simply making a mistake and mispricing the product. None of these situations would be likely to continue for long as the firm would be losing money.

- 7** Bundling could be good for consumers and business. For consumers it can allow a saving versus the purchase of items separately. It can also make consumers more confident that the parts of the bundle will work together than if they were purchased separately. Businesses might benefit from the price discrimination possibilities of bundling and it may actually be cheaper to produce and deliver many items as bundles rather than as separate offerings.
- One situation where bundling could create competition concerns is when a firm has a monopoly in a product and uses bundled prices to extend that market power into a complementary product. For complementary products, competitors may not be able to match the bundled price as this would result in a return below their marginal cost.
- 8 a** Having the petrol prices easily visible made it easier for cartel members to monitor each other, making cheating on the cartel more difficult to hide.
- b** Banning the advertising of petrol prices might not stop this sort of collusion, although it would make it more difficult for cartel members to detect and punish any cheating by other cartel members.
- c** The chief benefit of banning the advertising of petrol prices is that it would reduce the ability of a cartel to monitor itself, making the survival of cartels less likely. The costs of such a policy are that customers would find it harder to shop around for the best deal.