Economic Note

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IEM Institut Economique Molinari

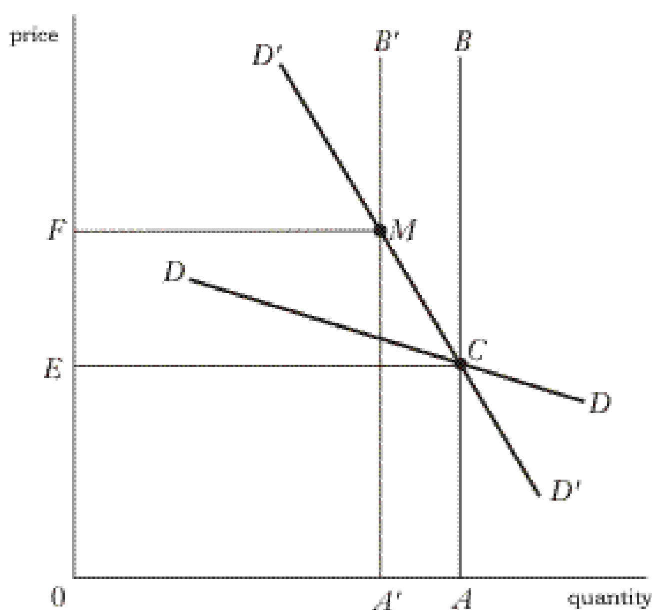
The shaky foundations of antitrust policy

Monopoly price theory

"We can confidently say that we share the same goals and pursue the same results on both sides of the Atlantic: namely to ensure effective competition between enterprises, by conducting a competition policy which is based on sound economics and which has the protection of consumer interest as its primary concern". Mario Monti declared three years ago when he was still European Competition Commissioner[1]. He was summing up in a sentence the stated aims of anti-trust policies from their creation in the United States at the end of the 19th century up to the present day through their introduction in Europe at the end of the second world war. Mr Monti was also underlining the predominant position economic theory holds in their justification.

It is true that economists have often helped politicians by providing them with a sophisticated array of concepts upholding the idea that political action can defend the interests of consumers against greedy producers. The neo-classical theory of monopoly price is certainly one of the rationalisations that has overwhelmingly convinced researchers. However, the fact that it is considered obviously true by most economists cannot be a proof of its validity. This essay will demonstrate that this analysis is flawed and that an anti-trust policy, based on this, is unfounded.

Economists often suggest as one of the main tools of an anti-trust policy the monopoly price theory which outlines why and under what conditions monopolistic companies harm consumers. One of its most important conclusions is that by letting the market operate, one can obtain a sub-optimal situation for consumers and this is why this theory can be used as a justification for an interventionist competition policy. A detailed analysis of these justifications requires a close look at this model.



Graph 1 : Monopoly price and competitive price

The monopoly price theory is shown on graph 1. To begin with, let's imagine a competitive price identifiable as OE at which a certain quantity OA of a good can be sold. The preferences of buyers (which determine the shape of the demand curve D'D') can be such that at the price OF, higher than the competitive price, people will be ready to spend more (OA'MF>OACE) despite lower quantities sold (OA'<OA). This means that the total monetary income for sellers is higher at the superior price. If there is only one seller, the situation is referred to a monopoly. It is in the interest of this unique seller to limit the quantity of the product available and to sell at the highest price to maximise his revenue. The OF price is a monopoly price[2]. If the preferences of buyers are such that the price maximising the income of the monopoly is the competitive price (if demand is DD rather than D'D'), it will be at the OE price that transactions occur.

If several sellers are dealing at demand

[1] Antitrust in the US and Europe : a History of Convergence, General Counsel Roundtable American Bar Association, Washington DC, 14 November 2001.

[2] This terminology might be confusing because a monopoly is not a sufficient condition to obtain a monopoly price. The necessary condition is what economists call the "inelasticity" of demand at the competitive price, or when buyers are ready to spend more at higher prices than the competitive price.

D'D', the situation is the same because the monopoly price and the extra revenue can be obtained through an agreement or entente. Without an agreement, sellers attempting to maintain high prices would see their efforts undermined by competitors able to attract clients at lower prices until all players on the market align with the competitive price. The monopoly price implies that buyers will obtain fewer goods at a higher price per unit. They are at a disadvantage compared to a competitive situation. Laissez-faire would therefore harm consumers[3] by letting agreements happen and the monopoly have its effect. An interventionist policy could defend their interests by preventing agreements, the appearance of monopolies and monopoly prices.

> "By definition anyone is free to enter a free market. By fixing the number of sellers present on the market, the model is avoiding the deep impact that free entry has on the market.."

Often overlooked is the fact that the model considers the number of sellers as fixed which is the reason why a monopoly price can appear. The same deduction cannot be made quite so easily regarding laissez-faire. To do this, all assumptions of the model would have to conform to the nature of a free market. However, it is obvious that by definition anyone is free to enter a free market. By fixing the number of sellers present on the market, the model is avoiding the deep impact that free entry has on the market. If entry is free, how can the monopoly benefit from the situation? Why don't new entrants recuperate clients by selling at a lower price? Doesn't this process end when the competitive price has been reached?

Economists are of course aware of this problem. Over the last twenty years, several books and articles have been devoted to this and have shed new light on the monopoly price question. This is how the theory of "contestable markets" has appeared, substituting the free entry criterion to the number of sellers[4]. If free entry exists, sellers must be competitive not only compared to those already present but also compared to competitors likely to enter the market. It is the potential competition which makes a monopoly or a cartel contestable. When a market is contestable, even a monopoly cannot shift from the competitive price without seeing its position weakened by new entrants.

Contrary to what one might think, this theory does not necessarily mean that a free market guarantees perfect "contestability" of a monopoly that might emerge. The expression "free entry" as it has been used in this text corresponds to the individual right to produce and sell goods to whoever might want to buy them. By contrast, most economists understand that an entry is "free" if it is easy. In other words, a market is all the more contestable if the entry and exit costs are low. Even in the case of the free market - without legal obstacles to entry by definition - potential entrants may face "entry barriers", enabling a cartel or monopoly to fix its price over the competitive one. Barriers to entry might include "predatory" price policies such as forcing new entrants to operate at a loss, companies of the sector benefiting from lower costs thanks to their experience, risking heavy losses for new entrants because of irretrievable costs if they were forced to exit the market or the necessity to find considerable capital to start a company.

> "The concept of competition without "barriers to entry" is totally absurd. The common characteristic of all these non-legal obstacles is that they highlight the threat of losses for potential entrants."

These difficulties can indeed be called "barriers to entry" but imagining that they do not exist in an ideal competition would lead to strange conclusions as illustrated below. In the automobile industry, the equipment needed to produce at a very low cost per unit can only be bought at high levels of investment, which are required to compete with firms already present

[3] Strictly speaking, this is true for all buyers and not just for consumers of a finished product. An investor renting the services of a worker might also be victim of the monopoly. Anyone tempted to interpret a criticism of the monopoly price theory as a defence of "big capital" must realise that such a criticism could also be a justification for a "restrictive" attitude from a worker, limiting his services to obtain a monopoly salary.

[4] Baumol, Panzar and Willig, Contestable Markets and the Theory of Industry Structure, New York, Basic Books, 1982.

on the market. There would not be such a barrier to entry if anti-trust legislation had prevented these companies from reaping the benefits of economies of scale by imposing for instance a size limit on production units. Costs per unit would be much higher but the necessary capital to compete would be lower. Would this result in more competition and cheaper cars? Barriers would of course be overcome but, thanks to this increased "contestability", only the wealthiest or most passionate consumers could afford to buy a car since the production costs would have increased to a point higher than what the majority of buyers are willing to pay. However this would result in a "monopoly price" lower than the competitive price!

Moreover, the concept of competition without "barriers to entry" is totally absurd. The common characteristic of all these non-legal obstacles is that they highlight the threat of losses for potential entrants. Investors expect that the difference between the selling price of goods and the purchase price of production factors will be negative or so small that they are reluctant to invest in a new company. Why do investors expect losses or rather, what is the significance of these losses? An investor cannot obtain reduced prices for production factors because usually their owners have decided that they can be rented or sold at a better price within the same industry or another. Competing investors are ready to buy these resources at a higher price because they expect a selling price for their products, which is determined by the valuations of consumers, so that the sales margin will be acceptable. In other words, the fear of financial losses is the barrier which blocks resources being allocated for the fulfilment of less "urgent" consumer needs. In order for the allocation of resources not to be totally arbitrary, some barriers are necessary. Without them, consumer satisfaction, the main concern of anti-trust policies defenders, is in for a rough ride[5].

[5] See the essay Profit and Loss by Ludwig von Mises for more on the nature of profit and loss.

Up to now all the theoretical problems faced by anti-trust policies that have been examined presupposed the validity of the distinction between monopoly price and competitive price. Under closer scrutiny, this is actually wrong[6]. Let's take the example of an investor considering to start the production of a certain good and that nobody else has had the same idea so that he finds himself in a monopolistic position. The person must decide what quantity to produce based on the price for equipment rental, personnel costs etc and sales prices clients will be willing to pay. The choice of quantity produced and allocation of production factors will obviously tend towards the maximum net revenue[7], which the investor will obtain if he does not make mistakes. If this is the case, he will obtain the expected price, revenue and margin. We are in the presence of a monopoly but this is not a sufficient condition to have a monopoly price according to the usual theory. The question is then: is this a monopoly price or a competitive price?

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The criterion of restricted sales in order to benefit from a higher price and increase profit does not allow the distinction between the two prices because, in either case, the monopoly will try to obtain the highest price to maximise revenue. There is no higher price allowing further revenue, which means that both situations are impossible to differentiate as the seller is in the same position vis-à-vis demand. Consequently one can reformulate the monopoly price theory in a way, which reveals its illusory nature. Price (OP in graph 2) is a result of the interaction between supply (SS) and demand (DD) and there is no higher price, which might be advantageous for the monopoly. It is up to economists to determine whether

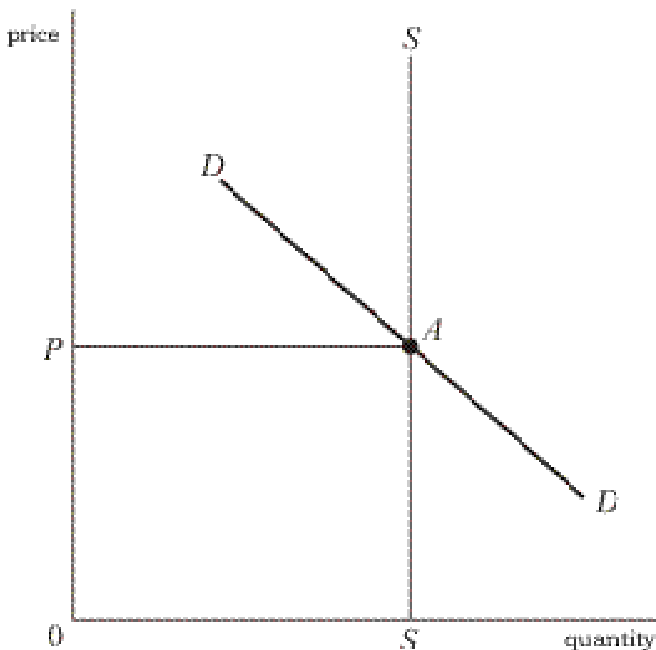
[6] This criticism was made for the first time in 1962 by Murray Rothbard in Man, Economy and State, (chapter 10). The reasoning in that paragraph is based on this original contribution to economic science, contribution which is completely ignored by most economists.

[7] For the sake of clarity, we will ignore the possibility that the person's choice might also be based on non-monetary reasons. Taking them into consideration does not change any of the conclusions reached.

it is a competitive price or whether a lower price, arbitrarily, can be qualified as competitive as opposed to the existing monopolistic one. There is no other distinction criteria available and one can assume if no difference is visible between two things, there is in fact only one. Prices can therefore hardly be monopolistic or competitive, they are only market prices. As a result, a policy aimed at preventing the appearance of monopoly prices is unfounded.

"The erroneous concepts of monopoly and competition prices do not allow the possibility to identifying a situation in which consumers are abused as a result of voluntary transactions with producers. It follows that a whole section of anti-trust policy has no economic justification."

In the free market, it is impossible to tell whether transactions take place at a monopoly or competitive price. A clear distinction does exist in certain cases such as murder where one is clearly within or outside the reach of the law. Such a boundary is impossible to find in the case of market prices. Anti-trust legislation can be described as arbitrary in so far as it is based on this distinction. Unlike a murderer, a seller cannot know what action might be criminal or whether the price at which he wants to trade changes him into a delinquent. The only reliable information is that the higher the market share, the more suspect he becomes. Nevertheless, the erroneous concepts of monopoly and competition prices do not allow the possibility to identifying a situation in which consumers are abused as a result of voluntary transactions with producers. It follows that a whole section of anti-trust policy has no economic justification.



Graph 2: Determination of the market price

Institut Economique Molinari

rue Luxembourg, 23 bte 1
1000 Bruxelles
Belgique
Tél. +32 2 506 40 06
Fax +32 2 506 40 09
e-mail:
cecile@institutmolinari.org
www.institutmolinari.org

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