

Lack of Competition: Where It's Found and How Much It Costs

*By Timothy Hannan**

The government's long-standing concern over noncompetitive pricing is front-page news again. One widely publicized case is being argued over whether the cereal industry constitutes a shared monopoly for the purpose of deterring market entry by would-be competitors. Another case involves the possibility of AT&T's divestiture of Western Electric. IBM also is enmeshed in a divestiture case, and calls for antitrust actions against the oil companies are being heard from many quarters.

Large amounts of resources are devoted to the competition issue. The IBM and AT&T cases alone will involve millions of dollars and thousands of people over a period of several years. Other efforts in the antitrust area also call for heavy expenditures of

money and time.

The object of these efforts is to weaken the pricing power and other effects often associated with the behavior of traditional monopolies—manufacturing firms large enough to dominate a whole industry. But traditional monopolies are not the sole producers of these effects. While the cases that steal the headlines may involve manufacturing industries, it now appears that service industries subject to government regulation may be especially likely to originate these effects. If so, policymakers may be able to get a better return on their consumer-protection dollars by concentrating more of their attentions on the regulated service sector.

A LONG-STANDING BATTLE FOR COMPETITION

The use of government policy to combat noncompetitive behavior has been part of the American political landscape for almost

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ninety years. It all started in 1890 with passage of the Sherman Act—an act which served as the legal foundation for trust busting in the years following its passage. Later, Congress passed the Clayton Act in an effort to restrain the growth of traditional monopolies in their incipiency instead of waiting for them to become full blown. The Trade Commission Act, which set up the Federal Trade Commission, focused on “unfair methods of competition,” leaving to policy-makers the task of determining what those methods were. These three acts together form the basis of our antitrust laws, and continuing concern has led to important amendments to these laws as new kinds of noncompetitive situations have appeared.

With this concern heating up once again, it's useful to ask what accounts for the resiliency of the issue. A lot of resources have been devoted to the various policy approaches to noncompetitive behavior. Is there a way to evaluate the effectiveness of these approaches and to find out whether other approaches may be even more effective?

TRADITIONAL MONOPOLIES

'Monopoly' means 'one seller'. In a monopoly situation, the supplying individual or firm has no competitors to get in the way of its pricing and sales strategies. While noncompetitive effects can be produced in other ways—where there are so few sellers that they're able to collude in setting prices, or where prices are set by government regulation—it's still useful to consider the case of the traditional monopoly; it provides a familiar point of departure for dealing with other sources of noncompetitive behavior.

The characteristic behavior of traditional monopolies can be seen in the prices they charge for their products and in the amounts they offer for sale. Free from competitors, monopolists find it in their interest to charge a higher price and offer less for sale than they would if competition prevailed.

Fortunately for consumers and policy-

makers, traditional monopolies usually are hard to maintain for any length of time because their higher prices and profits tend to encourage new competitors to set up shop. In a sense, then, consumers and policy-makers have a natural ally in the actions of would-be competitors, and the situation probably would be much more troublesome without this inherent weakness in the position of many temporary monopolies.

Would-be competitors cannot be counted on, however, to save every situation. In some cases, it may be impossible to compete with an established monopolist that controls the supply of a basic input required to manufacture a given product. The classic example of this is the prewar aluminum industry, where the Aluminum Company of America (Alcoa) controlled practically every source of bauxite in the United States. Since bauxite is a necessary input for the production of aluminum, Alcoa was able to remain the sole producer of aluminum for many years. Inability to compete with established monopolies may result also from certain industry production processes which make small competitors much less efficient than a large established firm.

Government regulation may produce an analogous situation by prohibiting market entry—as it has in the airline industry, for instance, where would-be competitors have been excluded from profitable markets. (Such barriers may be falling, given the current trend toward deregulation in the airline industry.) Where entry by new competitors is difficult, whatever the reason, noncompetitive behavior can persist.

SOCIAL CONSEQUENCES OF NONCOMPETITIVE BEHAVIOR

The ability to raise prices (and profits) and to reduce amounts offered for sale has been thought to have an adverse impact on the political process, on the distribution of income, and (of particular importance to economists) on economic efficiency.

Its political consequences are hard to assess with certainty and probably are impossible to quantify. But many believe that economic power unchecked by competition can lead to an undue influence on the political process, perhaps through lobbying or other efforts. Worry over such political influence may have played a role in the passage of antitrust legislation.

The fairness of the income redistribution occasioned by noncompetitive behavior is another concern. Some argue that artificially high profits represent a redistribution of income from the consuming public at large to the producers who set prices; and since those producers may be richer on average than consumers at large, income may be transferred from the less affluent to the more affluent. Others argue that the income redistribution caused in this way is insignificant.

Concern over what happens to the incomes of different people is fundamental to many public issues, and this issue is no exception. Even though it's quite difficult to determine the extent of income redistribution occasioned by noncompetitive pricing, many clearly regard the issue as a potentially significant one.

Further, such pricing can result in economic inefficiency. While inefficiency may not be the primary reason for popular concern, it has received the most concentrated study. Among the different kinds of inefficiency that have been thought to result, allocative inefficiency has struck economists as especially important.

To illustrate: Suppose for a moment that the economy is divided into two sectors, one of which is competitive while the other is characterized by lack of competition. Since firms in a noncompetitive setting tend to produce less and offer less for sale than firms in a competitive environment (something they must do in order to maintain a higher price), too few resources are allocated to the sector they control. As a result, too many resources are allocated to the competitive

sector. In such a situation, if resources (scarce land, labor, and other things necessary for production) could be taken out of the competitive sector and put into the noncompetitive sector, society as a whole would be better off. Because noncompetitive behavior does not allow this transfer to happen, it brings about a real economic cost. It leads to an allocation of resources which is inefficient because it satisfies consumer demand with less than maximum effectiveness.

Thus it's clear that while noncompetitive behavior could have an undesirable effect on political life and income distribution, it also could impose real efficiency costs on society.

HOW MUCH DOES IT COST?

Attempts actually to estimate the economic cost of noncompetitive behavior have come only recently. This delay may have been caused by the late development of the theory that makes such estimates possible, or perhaps it was caused by the paucity of appropriate data in earlier periods. Whatever the reasons, empirical estimates of the economic burden now occupy the attention of many economists.

The Harberger Analysis. The first study to provide an estimate of this loss was conducted by Arnold Harberger in the 1950s.¹ In an attempt to measure how much allocative inefficiency it causes in the manufacturing sector, Harberger estimated price increases that he believed could be attributed to monopoly power. Using these estimates and industry sales data, along with an assumption about how consumer buying patterns change when prices change, Harberger came up with a result that probably surprised a lot of people. His calculations suggested that the net loss from the exercise of monopoly power in the manufacturing sector came to no more than one-tenth of one percent of the Gross National Product—only enough to give

¹See Arnold C. Harberger, "Monopoly and Resource Allocation," *American Economic Review* (May 1954), pp. 77-87.

every family in America a good steak dinner, by one economist's figuring. Similar studies using different data and slightly different methods soon followed, but most found pretty much the same things. Measured in this way, the net loss appeared to be too small to get excited about.

Some Additional Considerations. While many critics suggested that the Harberger analysis understated the true cost of monopoly, two attacks on his kind of analysis seem especially pertinent to policy. The first concerns the possibility that traditional monopolies cause appreciable economic losses in addition to the misallocation of resources that Harberger worried about. The second asks whether Harberger, in examining the manufacturing sector, really was looking in the right spot.

It's possible that traditional monopolists just plain waste resources, especially if, as many believe, they are less diligent than competitive firms in controlling their costs. There is reason to believe also that they have to use substantial amounts of resources to obtain and maintain monopoly power. Firms that agree to collude have to spend a lot of time and effort coordinating their activities and guarding against attempts to cheat on the agreement. Even the act of getting a monopoly may involve large expenditures to obtain crucial patents or government-bestowed franchises.

Resources used for these purposes are being used in a socially wasteful way, and if their amount is substantial, then the true economic cost may be substantially greater than that calculated by Harberger.

In an attempt to account for some of this additional cost, Richard Posner recently has calculated that monopoly power in mining and manufacturing accounts for a net loss of about 0.6 percent of the Gross National Product.² While this too is not a shocking

figure, it suggests that the loss from monopoly is many times larger than indicated by the earlier estimates.

The second pertinent criticism of Harberger's analysis is that, while his original estimates were confined solely to the manufacturing sector, more evidence is coming to light that noncompetitive pricing may occur in its severest form in other sectors. In Harberger's sample of manufacturing industries, the average increment in prices caused by monopoly power came to little more than six percent, with some increments much smaller. Figure 1 shows some examples. While not all economists may agree on the precise method for calculating such price increases, those, like Harberger, who have attempted the calculations usually have come up with rather small figures. Even the celebrated electrical equipment conspiracy, for instance, which is one of the most durable and successful conspiracies on record in the manu-

FIGURE 1

**MONOPOLY PRICE DISTORTIONS
ARE RELATIVELY LOW
IN MANUFACTURING INDUSTRIES***

Industry	Percentage Increment in Price
Bakery Products	5.6
Packaged Foods	3.5
Knit Goods	2.0
Furniture	2.2
Paints	3.4
Wire and Nails	1.2
Scientific Instruments	13.1

*Figures adjusted to yield the percentage price increase over the competitive price.

SOURCE: Harberger, p. 80.

²Richard A. Posner, "The Social Cost of Monopoly and Regulation," *Journal of Political Economy* 83 (August 1975), pp. 807-827

facturing sector, apparently succeeded in raising prices by less than 10 percent on average.³

Where then are the worst offenders? Strange as it seems, service industries that are subject to government regulation may be more successful at boosting prices and restricting output to noncompetitive levels than the unregulated industries in the manufacturing sector. Regulatory controls over advertising, market entry, and pricing can drive prices up appreciably. Figure 2 presents estimates of the degree by which prices in a number of such industries exceed competitive levels. Taken from several different sources, these estimates vary in reliability and should not be accepted as definitive. They suggest, however, that large monopoly-like price distortions do occur in regulated industries, with prices estimated to be more than 60 percent above competitive levels in some cases.

Why this relatively poor performance on the part of regulated industries? Apparently because entry by new firms is restricted, price competition in the industry is discouraged, and efforts to agree on a mutual price are not subject to antitrust enforcement. This is a situation in which prices might be expected to be artificially high, since noncompetitive pricing is punished neither through the entry of new competitors nor through strong antitrust enforcement.⁴

Posner calculates the economic cost of noncompetitive behavior in the regulated sector to be in the neighborhood of 1.7 percent of the Gross National Product. This is appreciably greater than his estimate for

³U.S. Congress, Joint Committee on Internal Revenue Taxation, *Staff Study of Income Tax Treatment of Treble Damage Payments under the Antitrust Laws*, Washington, Government Printing Office, 1965, p. 39.

⁴In most respects, regulation of the banking industry is not of this type. While there are some regulatory restrictions on the establishment of new banks, antitrust laws are enforced vigorously in an effort to keep banking markets competitive.

FIGURE 2

**MONOPOLY-LIKE DISTORTIONS
ARE HIGHER
IN REGULATED INDUSTRIES**

Industry	Percentage Increment in Price
Physicians' Services	40*
Eyeglasses	34†
Motor Carriers	62‡
Airlines	66§
Taxicabs	16¶

*R. A. Kessel, "Higher Education and the Nation's Health: A Review of the Carnegie Commission Report on Medical Education," *Journal of Law and Economics* 15 (1972), p. 119.

†L. Benham, "Price Structure and Professional Control of Information," mimeograph, University of Chicago Graduate School of Business, 1973, p. 19.

‡Average of estimates in U.S. Department of Agriculture studies cited in T.G. Moore, *Freight Transportation Regulation* (Washington: American Enterprise Institute, 1972), and R.N. Farmer, "The Case for Unregulated Truck Transportation," *Journal of Farm Economics* 46 (1964), pp. 398-409.

§Average of estimates computed from R.E. Caves, *Air Transport and Its Regulators* (Cambridge: Harvard University Press, 1972), p. 372; W.A. Jordan, *Airline Regulation in America* (Baltimore: Johns Hopkins University Press, 1979), pp. 110-111, 124-125; and "Is Regulation Necessary?" *California Air Transportation and National Regulatory Policy*, *Yale Law Journal* 74 (1965), pp. 1435-1436. (This and the three previous estimates were taken from a table compiled by Posner, p. 818.)

¶Computed from estimates for Chicago presented in E.W. Kitch, M. Isaacson, and D. Kasper, "The Regulation of Taxicabs in Chicago," *Journal of Law and Economics* 14 (October 1971), p. 301.

the mining and manufacturing sectors. Calculations such as these are speculative and may miss the mark in the case of some industries. They do suggest, however, that lack of competition in the American economy may carry an appreciably higher price tag than previously believed and that a good chunk of the excess may occur in regulated industries.

POLICY EMPHASES

Findings of this kind are useful in devising an appropriate policy response because they help indicate the magnitude of the loss caused by noncompetitive behavior and they point to the areas of the economy which are especially vulnerable to it. Put differently, they identify the gains that may result from devoting scarce resources to corrective efforts. The question is how these gains can be captured most efficiently.

Policymakers can focus on either the behavior of individual firms in an industry or on the structure of the industry overall. The behavioral approach is designed to punish price fixing and other kinds of anticompetitive conduct after they have occurred, and its most frequently used device is the antitrust suit. The structural approach has a different rationale—to maintain industries more or less free of anticompetitive behavior by keeping enough firms in the industry to insure competitive behavior. Suits are used in this approach, too, but usually to prevent a merger that would eliminate a strong competitor and thereby reduce competition.

Whatever the underlying rationale, though, antitrust suits tend to be expensive. Huge amounts of resources may be required to pursue just one antitrust case through the courts. An example is the ongoing AT&T case, where just one part of the litigation is expected to cost about \$100 million dollars on the AT&T side alone.⁵ Both the Federal

Trade Commission and the Justice Department's Antitrust Division, with 1978 budgets estimated at \$66 million and \$46 million, respectively, also devote substantial resources to such cases.⁶ And then there's the time factor: cases such as these can require many years of litigation.

Because of the cost, policymakers have to be rather picky in choosing their cases and in determining the most appropriate method of attack. The governing principle is to put policy resources where they are likely to produce the largest return. While in some cases the largest return may come from bringing actions such as the highly publicized antitrust cases currently in the courts, in other situations the most effective way of reducing the burden of noncompetitive behavior may involve another approach.

One new twist on the structural approach can be seen in recent legislative proposals which, if enacted, could prohibit mergers of firms with \$2 billion or more in assets unless those firms could show that the mergers would produce significant competitive benefits. Another new twist is apparent in efforts to roll back rules that restrict entry or set prices in the regulated sector. Deregulation could be an effective procompetitive tool and could offer a relatively cheap way of getting a big reduction in monopoly-like pricing behavior. It already has shown real promise in the airline industry, for example, where the lifting of anticompetitive regulations has lowered fares for consumers. And the trucking industry may offer another opportunity for increasing competition through deregulation.

There are many ways to attack the effects of noncompetitive behavior, and the most efficient ones are those that yield the most benefit for the least cost. Recent experience suggests that increased emphasis on regulatory change may pay the biggest dividends.

⁵Statement by William C. Cashel, *Wall Street Journal*, December 1, 1977, p. 26.

⁶*Budget of the United States Government, 1979, Appendix*, Washington, Government Printing Office, 1978.

SUMMARY

The largest antitrust cases currently in the news reflect a long-standing concern over traditional monopoly. The reason for this concern is that noncompetitive behavior imposes costs on society, and the antitrust suit is an attempt to reduce those costs. But traditional monopoly is not the only source of noncompetitive behavior, and the antitrust suit is not the only weapon in the arsenal.

Picking the most desirable array of weapons to use in the battle requires information on how significant the costs of monopoly-like behavior are and in what sectors of the economy those costs are likely to be the largest. Based on the most recent research, it seems that several different methods of eliminating noncompetitive behavior are worthwhile and that regulatory changes may offer a particularly large payoff.

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