The VOTE Textbook
Student Notes
Chapter 16: Market Power

Opening Story: Desert Pete

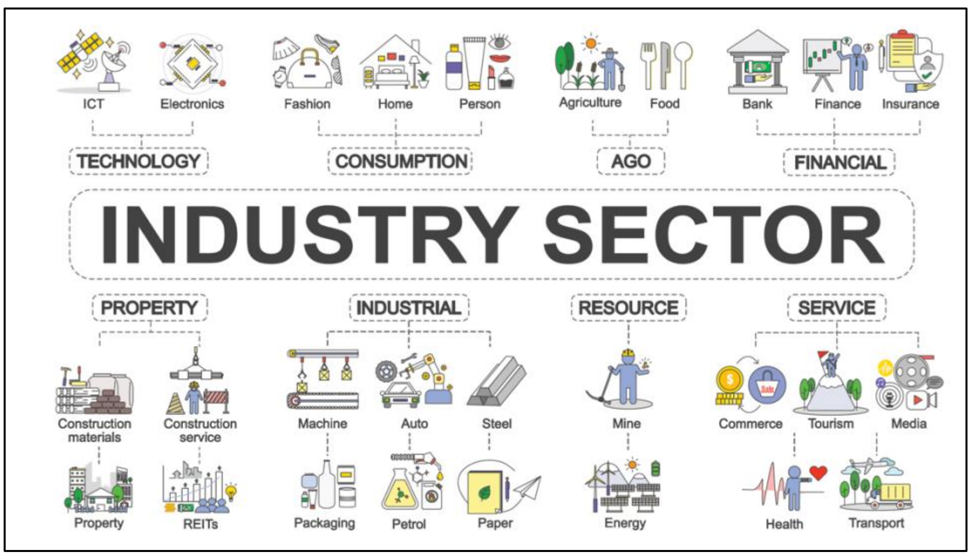
Entrepreneur: A person who takes on greater-than-normal risk and invests the most energy to start, organize, grow, or operate a business.

Market Power is the ability of a business to set prices above the level that would exist if the firm had competitors.

The Golden Moment

Shared Problem: Large firms can abuse their market power

Shared Goal: The best products at reasonable prices



Market Structure

It is the relationship between firms in an industry characterized by the number of firms and pricing power, product differentiation, and barriers to entry and exit.

Four Types of Market Structures

1. Perfect Competition
   Huge number of firms; price takers; homogeneous products; no barriers to entry/exit
2. Monopolistic Competition
   Many firms; some pricing power; differentiated products; limited barriers to entry/exit
3. Oligopoly
   Few firms; substantial pricing power; no close substitutes; substantial barriers to entry/exit
4. Monopoly
   One firm; price maker; no substitutes; total barrier to entry/exit. A near-monopoly means one company controls nearly all of the market.

"Natural" Monopoly

- One firm dominates the market because it makes a substantial initial investment to create the infrastructure.
- When it grows bigger, it gains a market advantage over would-be competitors, because with growth, the cost to supply goes down.
- This cost advantage creates a "natural" barrier that keeps smaller firms out of the market and prevents new firms from gaining a foothold.
- Government may permit firms to maintain their natural monopoly power if it is determined that society benefits, but then government regulates price.

Positive Competition (the goal of all perspectives)

Opponents focus on bringing their A game to everything they do because they challenge themselves to continually improve and perform at the peak of their abilities.

Negative Competition (rejected by all perspectives)

The focus of the rivalry is to obliterate opponents, not to do one's best. Cheating, bullying, and other underhanded tactics are destructive and antisocial.

<u>Shared Tools: Accounting Profit and Economic Profit</u>

Firms combine resources with technology to produce something that is more valuable than the individual factors of production.

Inputs		<	**Output**
• Fish	➢ Variable input		Fish tacos
• Avocados	➢ Variable input		
• Chefs	➢ Fixed inputs		
• Assistants	➢ Variable inputs		
• Grills	➢ Fixed inputs		
• Square footage	➢ Fixed input		

Short Run: When production occurs with at least one fixed input. A fixed input is one that can't easily be changed today. A variable input is one that can easily be changed today.

Whether inputs are fixed or variable depends on the production process and what is being produced.

All production happens in the short run.

Long Run: All inputs are variable.

All three perspectives care about profit and well-being, but the conventional approach is to see profit as the pathway to well-being, while radicals see well-being as the pathway to profit.

In either case, the equation for profit is the same:

Profit = Total Revenue (TR) – Total Cost (TC)

TR	TC
Price x Quantity	Fixed Costs + Variable Costs

Accounting Profit Is Not the Same as Economic Profit

Accounting profit is

Profit = Total Revenue – Total Cost

Economic profit expands on that equation to include opportunity cost, which is the potential gain that could have been made by choosing to do or make something else.

Profit = Total Revenue – (Total Cost + Opportunity Cost)

EXAMPLE

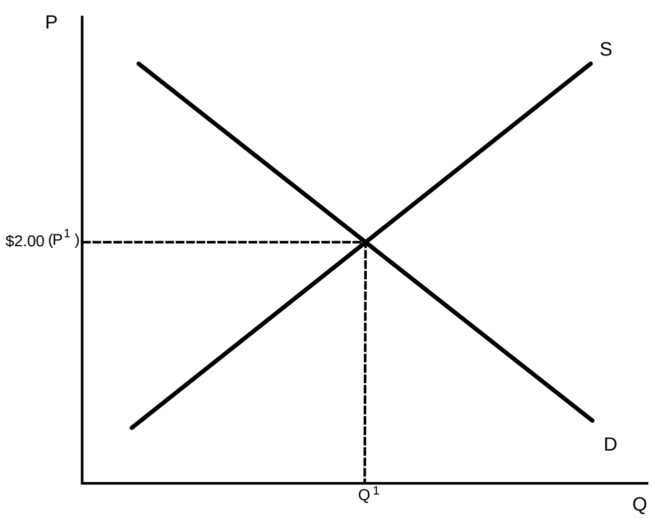
- A jewelry designer makes $200,000 per year.
- Wages = $60,000
- Costs for the raw materials, rent and equipment = $90,000.
- The designer could make $250,000 per year working for another firm.

Accounting Profit = **$50,000**

Economic Profit = **–$200,000**

Conventional Tools: Perfect Competition Versus Monopoly

All market graphs used so far have assumed perfect competition.



Soap Market

Stop #1: Prices and Quantity in Perfect Competition in the Short Run

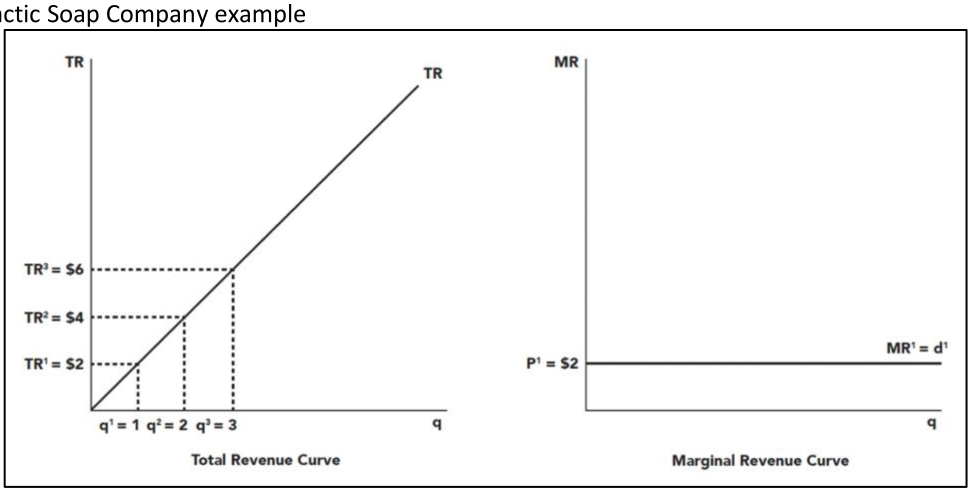
Firms maximize their profit when their marginal revenue equals their marginal cost.

Galactic Soap Company example

Market price of a bar of soap	\$2.00 per bar
Fixed input (land):	2 acres
Fixed input (capital):	2 machines, 1 factory
Variable input (labor):	0-7 workers
Total fixed costs:	\$200/day
Total variable costs:	\$50/day per worker
Total costs:	\$200 + number of workers at \$50/day (Opportunity cost included)

Total Revenue

Galactic Soap Company example



The MR curve is the same as the market price in perfect competition. An individual firm is so small that it can sell as much as it wants without ever impacting market price. So, the MR curve is also the demand curve that the perfectly competitive individual firm faces.

Total Cost

Fixed costs on average go down as more is produced, but average total costs, average variable costs, and marginal costs go up as more is produced.

Think about what happens when too many workers (variable input) crowd around the equipment (fixed input) and get in one another's way.

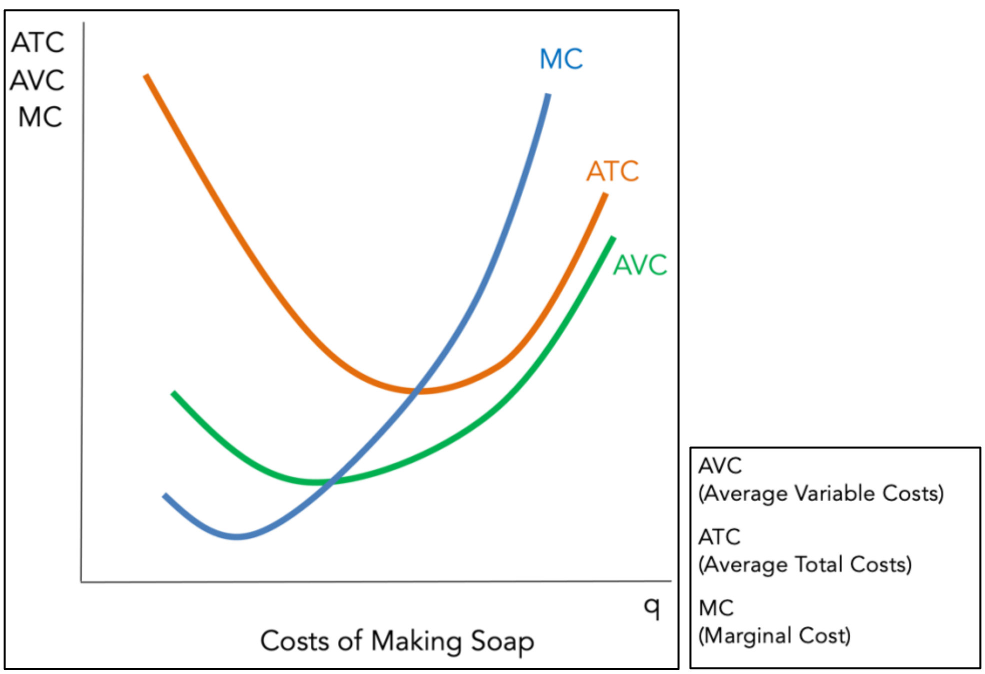
The Law of Diminishing Marginal Returns: As more and more of a variable input is added to a set of fixed inputs, the additional output for each additional unit of input decreases.

Galactic Soap Company example

Workers	1	2	3	4	5	6	7
Total Output	50	150	220	270	300	325	330
Marginal Output	50	100	70	50	30	25	5

The law of diminishing marginal returns occurs at the 3rd worker.

Because output decreases per worker after the 3rd worker (yet each continues to earn $50 per day), costs per unit go up as more is produced.



Profit Maximization

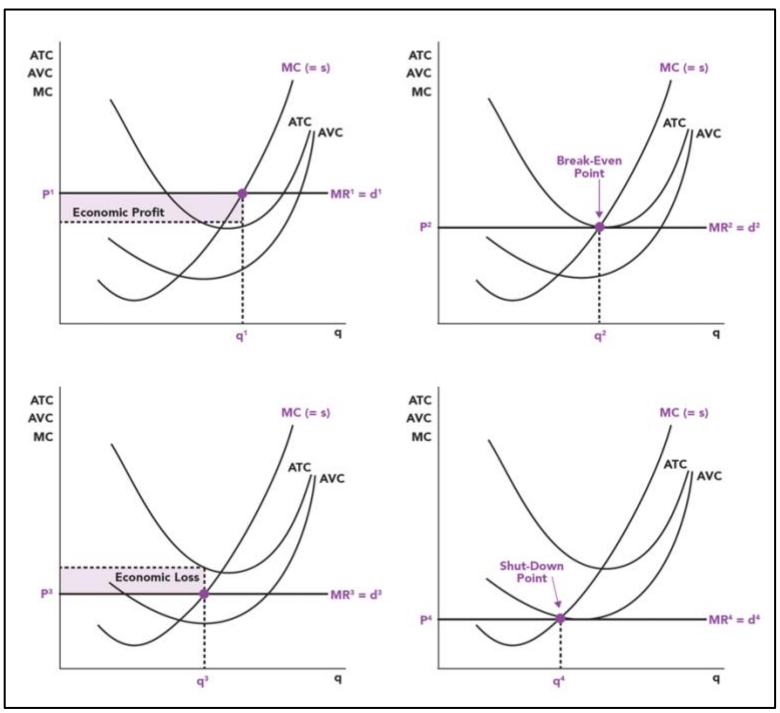
Firms succeed by maximizing their profit. They use *marginal analysis* to decide how much to produce. Marginal analysis compares the additional benefits of an activity to the additional costs of that activity.

Galactic Soap Company example

Quantity	Marginal Cost (MC)	Marginal Revenue (MR)	Produce? Y/N
220	$0.71	$2	Yes! MC < MR
270	$1.00	$2	Yes! MC < MR
325	**$2.00**	**$2**	**Yes! MC = MR**
> 325	> $2.00	$2	No! MC > MR

To maximize profit, firms should produce until

MC = MR



Break-even may not seem like great news, but it is a very strong, very positive position for a firm because economic profit includes opportunity cost.

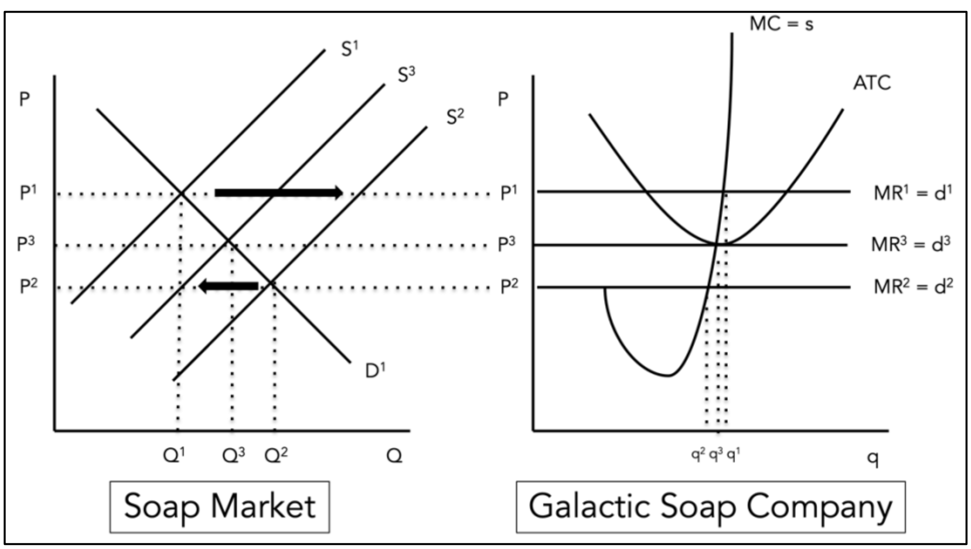
Stop #2: Price and Quantity in Perfect Competition in the Long Run

In the long run, in perfect competition, firms make the profit-maximizing quantity using the fewest resources.

In perfect competition in the long run, with no barriers to entry, new firms are attracted by economic profit and enter the market. The market supply curve shifts to the right and the market price for falls below the break-even point. With no barriers to exit, firms shut down, leaving the market. The market supply curve shifts to the left and the market price rises.

Firms continually enter and exit the market, drawn by profit and repelled by loss, until the market price settles at the break-even point. Existing firms are motivated to stay, while new firms have no incentive to enter.

At the break-even point, MC = MR at the bottom of the ATC curve. In the long run, in perfect competition, firms make the profit-maximizing level of output using the fewest resources.

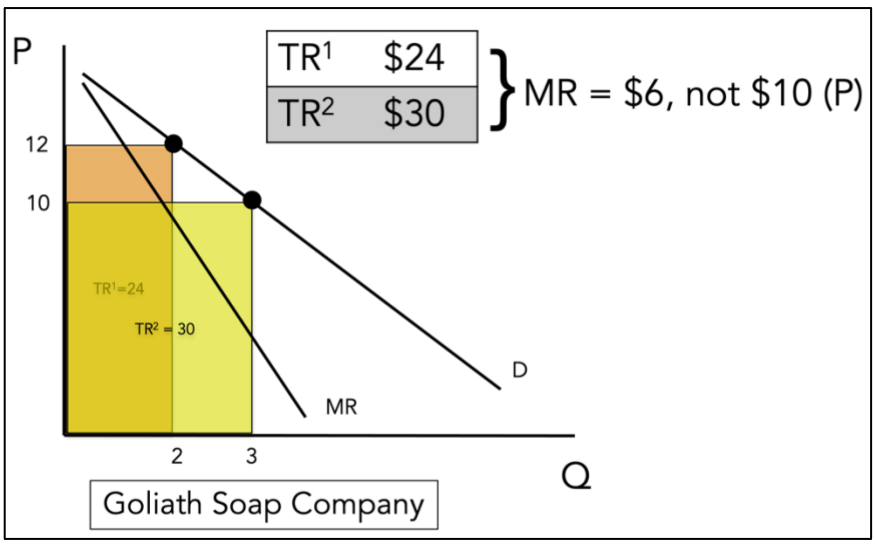


Stop #3: How Firms with Monopoly Power Manipulate Price and Quantity

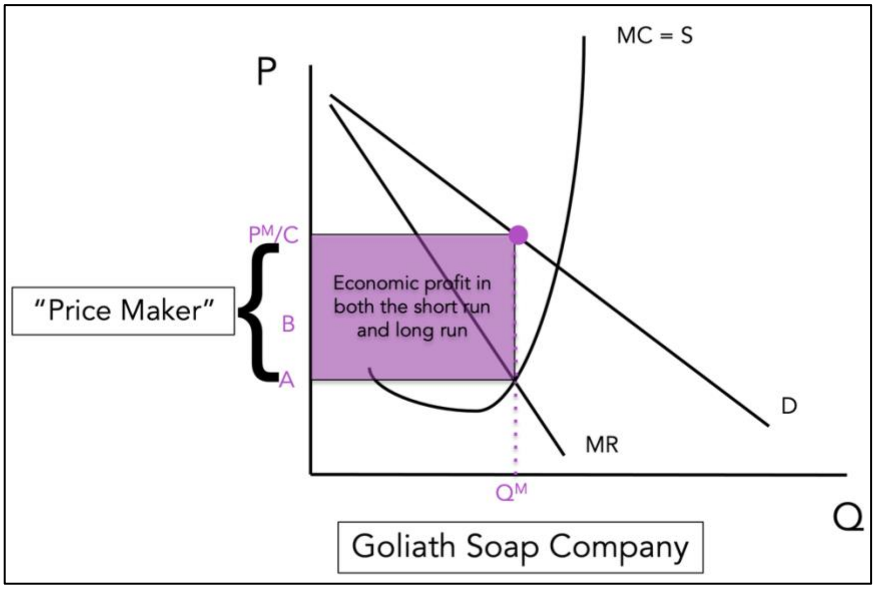
A monopoly abuses its power by restricting output so it can raise prices. Society gets higher prices and lower quantities. Profit maximization still occurs where MR = MC, but the demand curve is not the MR curve, as it was in perfect competition.

(In perfect competition, individual firms are too small to affect the price—they are price takers—so they sell as much as they want at the given market price.)

But a monopoly is a price maker, so the demand curve (D) it faces is the market demand curve. In other words, it can't sell as much as it wants at any price. That's why D is not the same as the MR curve.

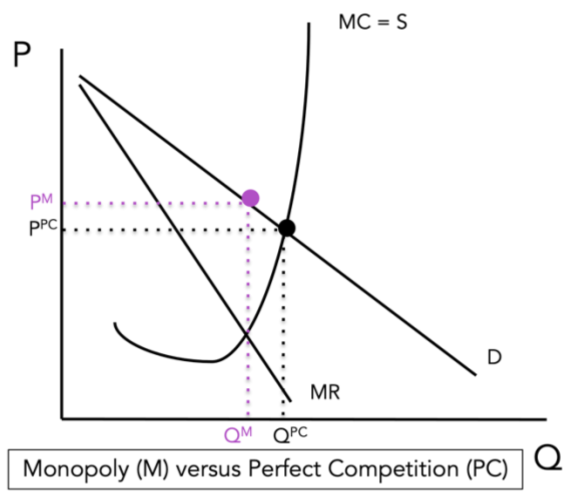


- In a monopoly, the MC curve is the same as in perfect competition and profit maximization is still MC = MR.
- Q^M is Goliath's profit-maximizing quantity.
- It could charge price A, B, or C, but not price D because there is no demand for the profit-maximizing quantity at that price. It will charge the highest price it can command (C, which is the monopoly price, P^M).

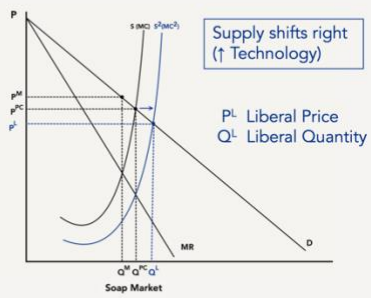


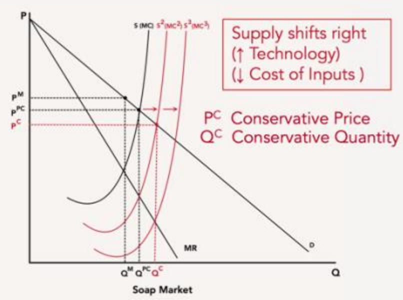
Conservative & Liberal Conclusion

Compared to perfectly competitive firms, monopolies (M) abuse their power by restricting output to raise prices, resulting in higher prices and lower quantities for society.



Liberal	Conservative
1. **Strengthen market power regulations.** 2. Government prevents firms from gaining monopoly power. 3. Competition brings new technologies.	1. **Reject market power regulations.** 2. Drawn to profitable production, competitors develop new technologies. 3. Larger firms are more efficient, so cost of inputs go down.





Market Power Policies	
Liberal	**Conservative**
Liberals want ***market power regulations.***	Conservatives want ***free-market competition.***

Radical Tools: Production for Profit and Production for Use

Radicals use the six core points as tools to analyze economic issues.

- Ownership
- Governance
- Meeting people's basic material needs
- Production
- Sustainability
- Communities

Radicals select the core point that makes the most sense for a particular issue. For market power, it is production.

Drill down into production in capitalism:

Workplace Exploitation

+

Capitalist Competition

} The Pressure for Bad leads to The Visible Suffering

… and is represented by the Six-Core Cube of capitalism, which can never be solved.

The Unsolvable Six-Core Cube of Capitalism

1. Private Ownership
2. Top-Down Governance
3. Individuals at Risk
4. Production for Profit
5. Unsustainable Growth
6. Unhealthy Communities

Why unsolvable?
It is built around six core points that are rotten to the core!

Production for Profit: Firms make things that bring them the most profit, regardless of whether those products are necessary, useful, or beneficial.

Production for Profit

- The primary goal of production is to make money.
- The success of every endeavor is measured in profit, not well-being.
- Win-lose competition is normalized and celebrated.

The Visible Suffering of Capitalism

- Hunger and malnourishment
- Harmful products
- Mass poverty
- Homelessness
- Extreme income inequality
- Pollution and climate crisis
- Inaccessible, low-quality health care
- **Destructive market domination**
- Impoverished elders
- Exploding public and private debt
- Damaging trade relationships
- High prices and no jobs

Drill down into production in democratic socialism:

Workplace Justice

\+

Coordination Among Competitors

The Pressure for Good leads to The Invisible Synergy

…and is represented by the Six-Core Cube of democratic socialism, which can be solved.

The Solvable Six-Core Cube of Democratic Socialism

1. Cooperative Ownership
2. Participatory Governance
3. Social Safeguards
4. <u>Production for Use</u>
5. Sustainable Development
6. Healthy Communities

Why solvable?

It is built around six core points that are beneficial to the core!

Production for Use: Firms make things that improve people's lives, rather than producing only to make a profit.

Production for Use

- The primary goal of production is to make products that are necessary, useful, and beneficial.
- The measure of success of every endeavor is the increased well-being of society, not profit.
- Win-win solutions are normalized and celebrated.

Market Power Policy: Radical

Prosocial Competition Laws

Activities and behaviors that benefit society. These laws remove the pressure from firms to compete in ways that hurt society. For example:

1. Democracy in the Workplace

   Each worker-owner in a firm has only one vote. This protects against a few individuals manipulating the larger group and causing the firm to abuse its market power.

2. Anti-price-gouging laws

   When the price is unreasonably or unfairly high, community councils are empowered to rein in firms' pricing power and restore reasonable prices in the market.

The Invisible Synergy of Democratic Socialism

- Abundant, healthy food
- Safe and helpful products
- Prosperity
- Housing for all
- Equitable income distribution
- Clean environment
- Universal, first-rate health care
- **Fair and positive competition**
- Secure and dignified retirement
- A thriving, debt-free society
- Mutually beneficial trade relationships
- Jobs and stable prices

THE BLAME GAME What causes large firms to abuse their power?		
Conservative	**Liberal**	**Radical**
Too much government interference in capitalism	Not enough government intervention in capitalism	The drive for profit in capitalism
We need free-market capitalism.	We need fair-market capitalism.	We need democratic socialism.

<u>Discussion Story: MCI versus AT&T</u>

<u>Understanding Market Power</u>

In 2018, the 100 richest entities in the world included 29 countries and 71 corporations.

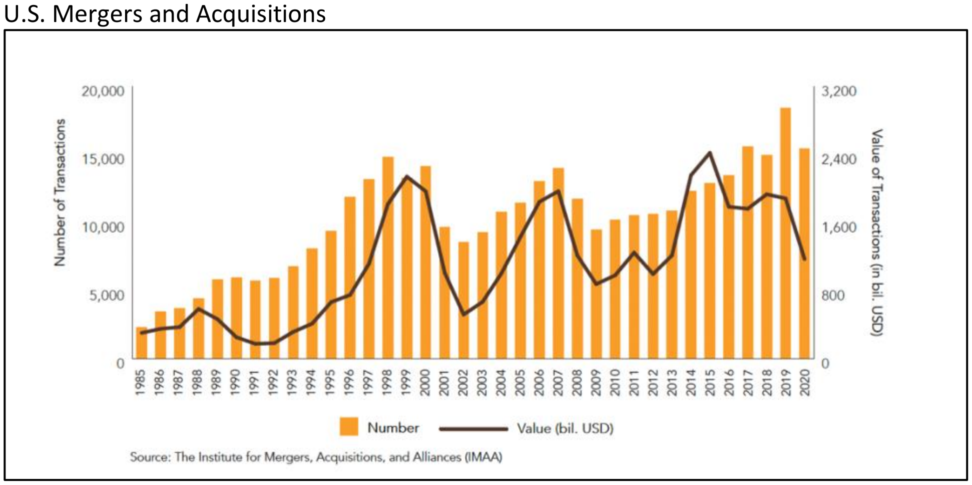
FIRM	ANNUAL TOTAL REVENUE	NATION	GDP
Walmart	$500 billion	**Austria**	$455 billion
TOYOTA	$272 billion	**Egypt**	$250 billion
Apple	$265 billion	**Czech Republic**	$249 billion
amazon	$142 billion	**Kuwait**	$141 billion
Alphabet	$110 billion	**Ecuador**	$108 billion

Market Power

The following terms are used interchangeably but have distinct meanings.

- **Monopoly**: One firm controls the market
- **Big Business**: Group of firms run by one Board of Directors
- **Trust**: Umbrella term for large corporations
- **Cartel**: Group of firms that make the same product and act together to set price and quantity

U.S. Mergers and Acquisitions



U.S. Mergers and Acquisitions

Types

- Conglomerate ➔ Merge unrelated products
- Vertical ➔ Merge along supply chain
- Horizontal ➔ Merge competing products

Measuring Market Concentration

Herfindahl–Hirschman Index (HHI)

A measure of the size of one firm in relation to the entire industry, used to gauge the level of competition.

Gaining Market Power, Part I

Lawful barriers to entry

- No close substitute
- Cost advantage
- Control over key resources
- Advertising
- Network effects

Gaining Market Power, Part II

Unlawful barriers to entry

- Price fixing
- Predatory pricing
- Fraudulent advertising
- Frivolous lawsuits
- Corporate espionage and sabotage

Copyrights, Patents, Trademarks, and Licenses

All perspectives agree that government should protect intellectual property rights and have a role in professional licensing and allocation of shared resources, but they disagree on the methods, time period, regulatory authority, ownership, and control.

- Liberal: Strong government oversight.

- Radical: Participatory governance.
- Conservative: Free-market solutions with limited government.

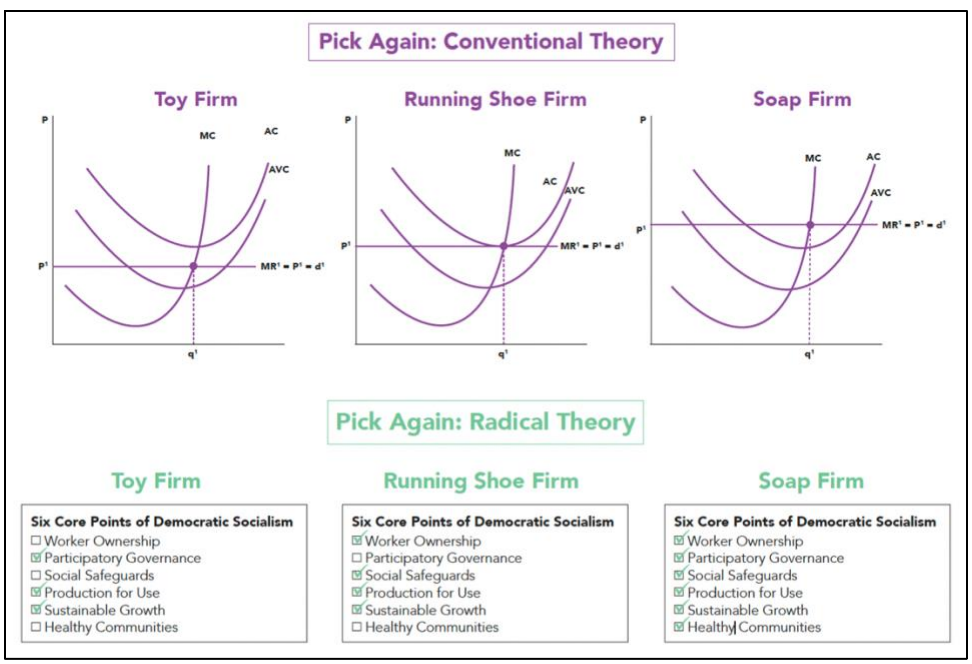
Antitrust Legislation

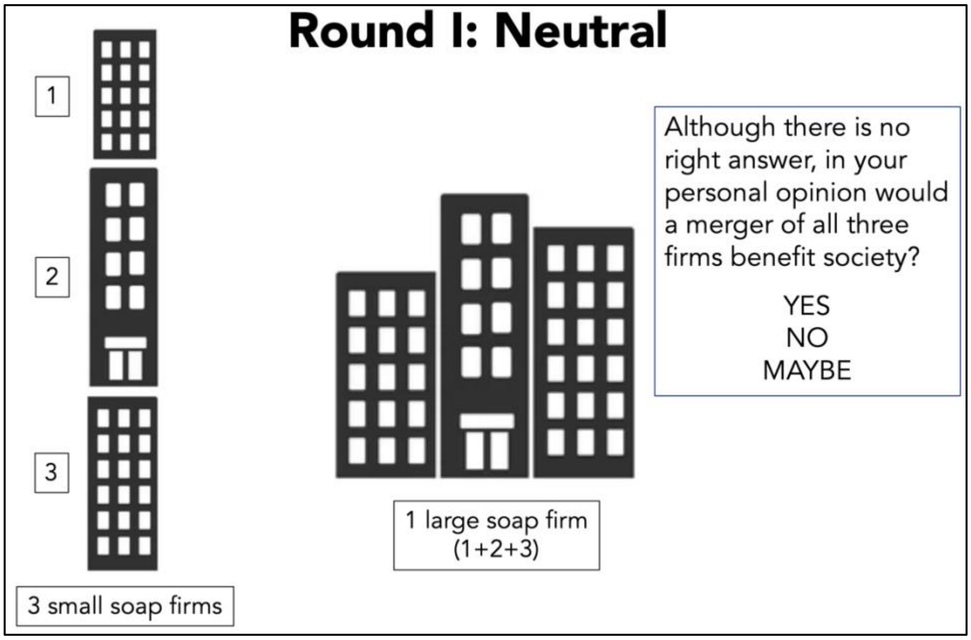
Laws intended to promote competition by breaking up monopoly and near-monopoly firms and blocking firms from getting too big in the first place.

The Antitrust Division of the U.S. Department of Justice and the Federal Trade Commission (FTC) in the U.S. Department of Commerce implement those laws and take legal action against firms that violate the statutes.

- 1890: Sherman Antitrust Act
- 1914: Clayton Antitrust Act
- 1936: Robinson-Patman Act
- 1946: Lanham Act
- 1950: Celler-Kefauver Act
- 1976: Hart-Scott-Rodino Antitrust Improvement Act
- Big Tech Antitrust Cases—early 2000s

<u>Three-in-One Activity: "To Merge or Not to Merge, That Is the Question"</u>



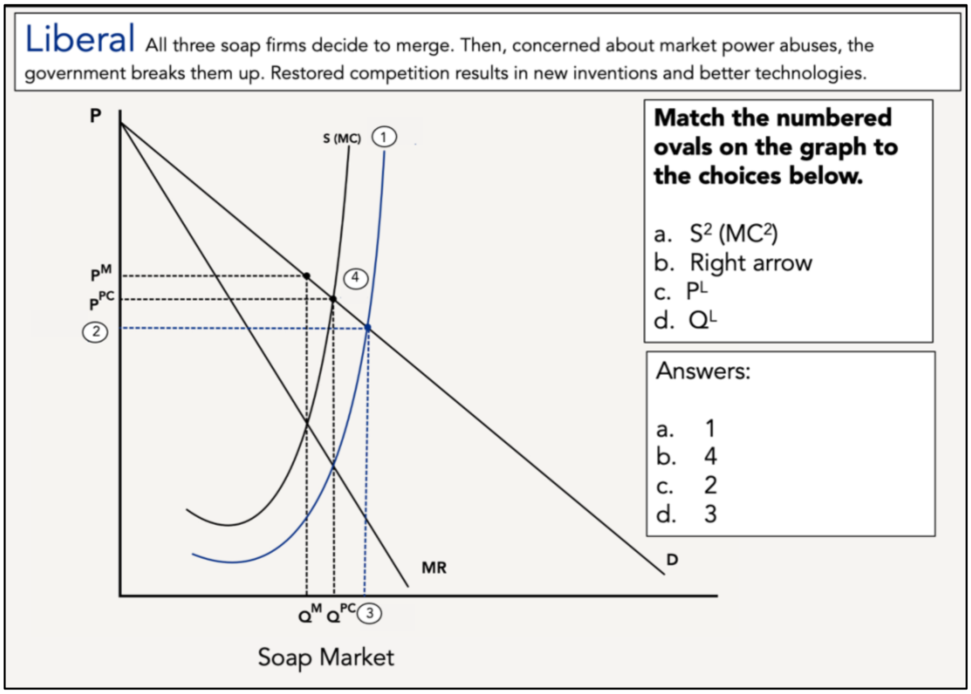


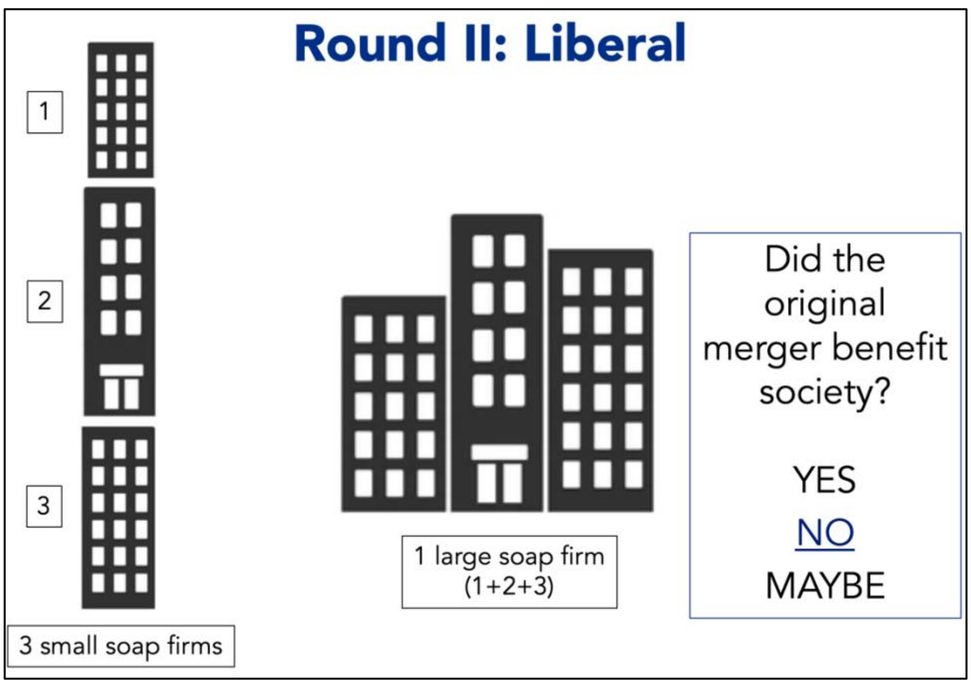
<u>Voices on Market Power</u>

Liberal

Response to discussion story: Government wisely allocated resources by giving AT&T regulated monopoly power. When technology changed, it broke up the monopoly.

Voice: Pages 708-712
Summary: Page 713
Talking Points: Page 714



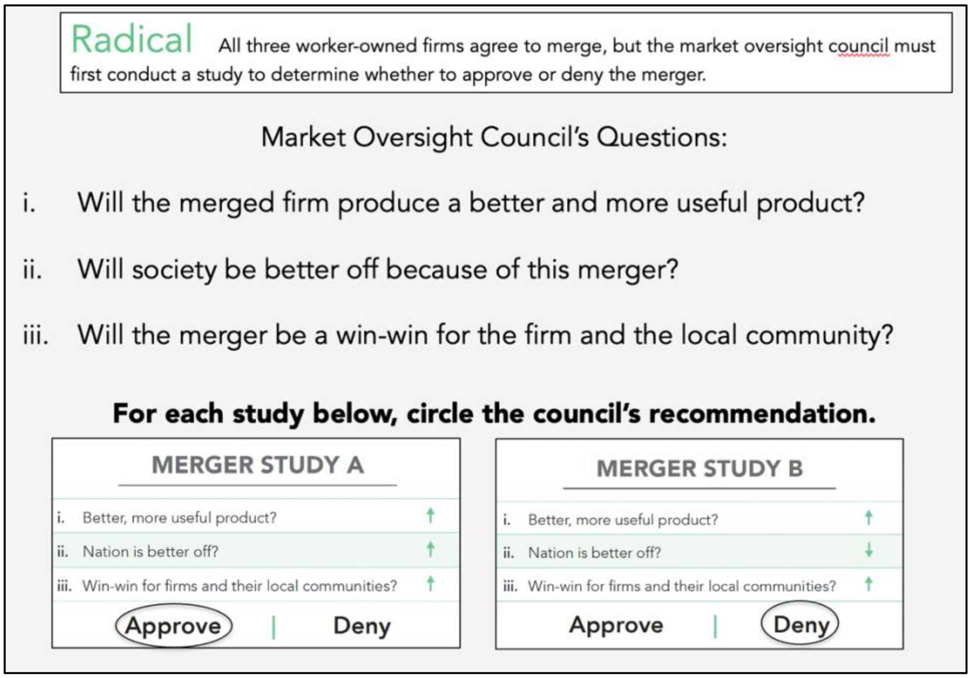


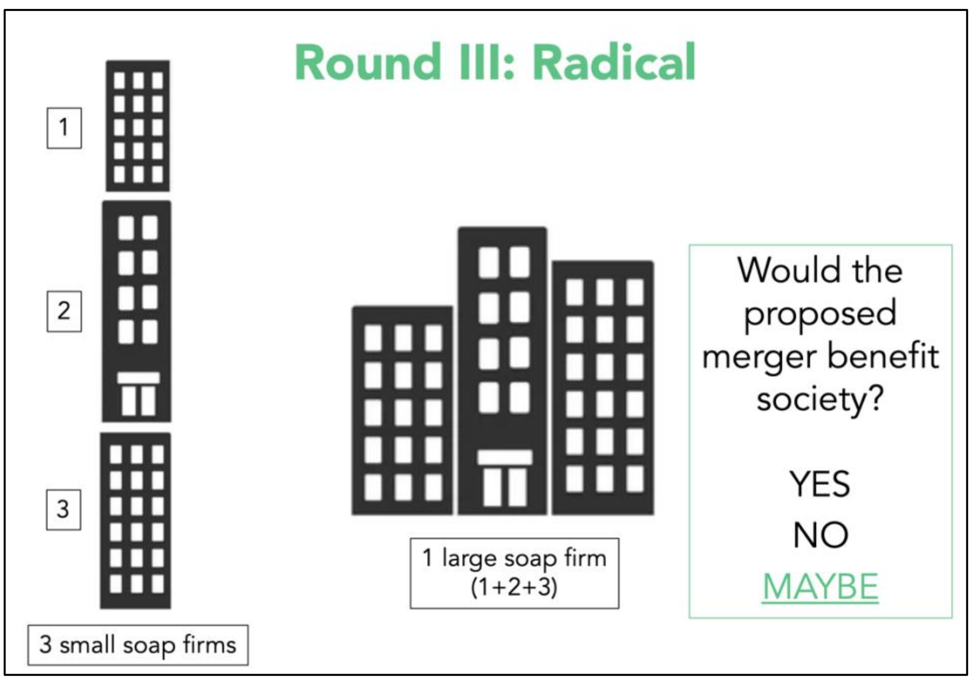
Radical

Response to discussion story: Products should benefit society, but AT&T's relentless drive for profit blocked life-changing technology, and government was its accomplice.

Voice: Pages 715-719

Summary: Page 720
Talking Points: Page 721

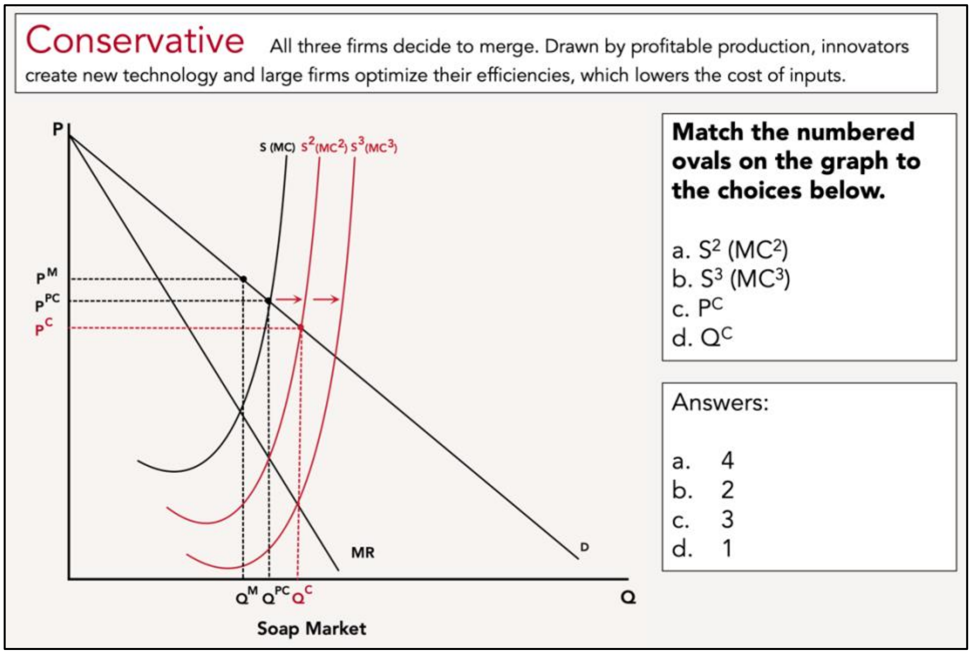


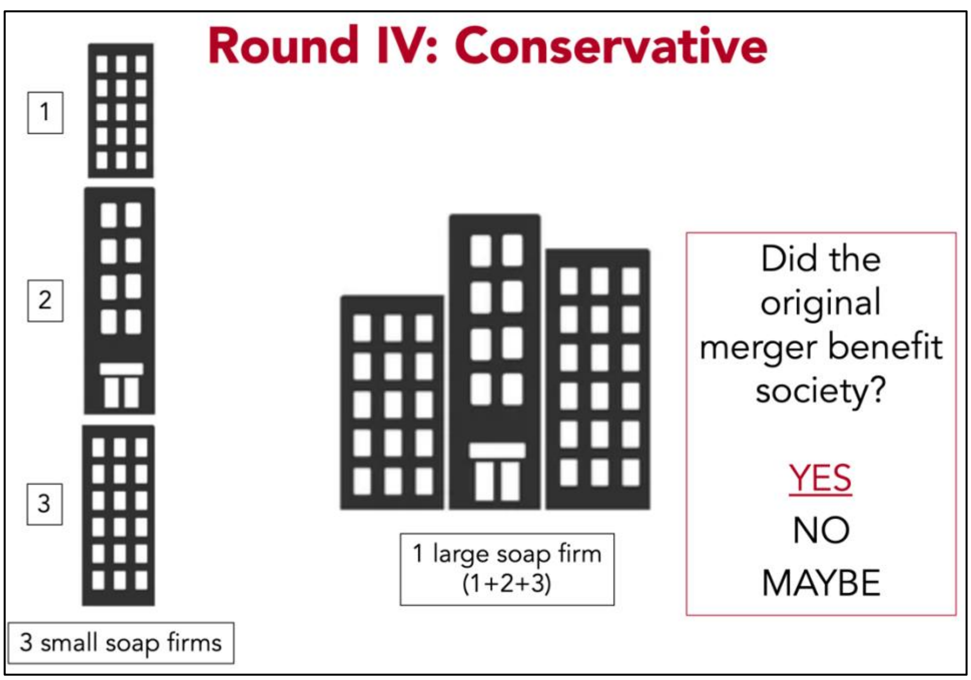


Conservative

Response to discussion story: The lure of profit brings us new technologies. But the government allowed AT&T to block innovation, which delayed progress for decades.

Voice: Pages 722-726
Summary: Page 727
Talking Points: Page 728





Shared Outcome: The best products at reasonable prices.