Firms and Markets (2)

Allocative Efficiency

- Market power:

  "Firm's ability to profitably raise price above marginal cost"
- Examples
- Given technologies and internal efficiency:
  - Market power reduces (static) welfare
  - Allocative inefficiency

Rent seeking activities

- Firms may use resources to keep, increase or obtain monopoly power (Posner, 1975)
- Examples: bribes, lobbying costs, etc.
- Monopolist willing to pay the rectangle above marginal costs and below price
- Always bad? (Fisher, 1985)

Productive Inefficiency

"Monopoly… is a great enemy of good management"
Adam Smith, 1776

- Monopolist may produce inside the production frontier because it faces less competitive pressure
- Productive inefficiency increases welfare loss
- Why?
  - Less effort to improve (X-inefficiency)
  - Less market selection
- Empirical evidence
  - More productivity in more competitive markets (Nickell,1996)
  - Competition will increase industry productivity (Olley and Pakes,1996)

Dynamic Inefficiency

- Dynamic efficiency:
  "introduction of new processes or new products"
- Does market power encourages innovation?
  - Mixed empirical evidence (Scherer and Ross, 1990)
  - Monopolies have lower incentives to innovate than competitive firms because they are already making profits
  - But if firms cannot appropriate gains then there are no incentives to innovate (Schumpeter, 1912)
- Is there a way out?

Is Monopoly Necessarily Evil?

- Time consistency problem:
  - Ex-ante efficiency (innovation incentives)
  - Ex-post efficiency (innovation availability)
- Commitment problem
- Optimal design of patents (Tirole, 1988):
  - Breadth
  - Length
- Copyright and trademark laws
- More generally, property rights
- Reputation