Microeconomics with Ethics

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Chapter 16

Ethics of Market Competition

This course is unique among microeconomics courses because it has ordered the presentation of market structure from fewer to greater participants. The first market in Chapter 3 involved just two participants, Smith and Jones, trading apples and oranges. In Chapter 7, when we introduced the market demand function, we expanded the consumer side of the market to many consumers of a product, rather than just one. In Chapter 10, we analyzed a market with a single monopoly firm supplying many consumers. In Chapter 11, we introduced competition on the supply side with a duopoly market consisting of just two firms and discussed the likely outcomes when there is an oligopoly market consisting of a small number of firms. Finally, in Chapters 12-14, we considered a market of perfect competition with many suppliers and many consumers of a product.

The models used in our investigations so far focus almost exclusively on the price and quantity decisions of firms and consumers and ignore many real world complications that will be considered later in this chapter. Nevertheless, we were able to highlight some very important conclusions about market competition. As more profit-seeking firms enter a market and compete to sell their products, the price of the product will decrease, total market supply will increase, and individual firm profits will fall. These outcomes have important implications. Consumers of the product will become better-off because they can buy more at a lower price and this raises total consumer surplus. New firms that enter the market and make a profit also do better than previously, for if not, they would not have entered. However, incumbent firms that were already producing the product suffer a decrease in profit and a loss of producer surplus. The analysis of market welfare shows that total surplus value accruing to consumers and producers combined, increases with an increase in competition. Thus, competition is good for consumers, new entrants, and the market overall, but bad for incumbent firms.

Because some market participants benefit from greater competition while other participants lose, economists will often describe this as a redistribution of income. Even though income is not expressly being measured in these evaluations, nonetheless, income is an alternative measure of well-being and so it is common to refer to gains and losses in a market in this way.

It is also worth pointing out that movements in the opposite direction, namely market changes in which competition is reduced, will result in a redistribution of income away from consumers and towards the incumbent firms. A reduction in competition will also cause a reduction in overall market welfare. Because there is an interest group, namely incumbent firms, who stand to benefit from less competition, we do see mechanisms arise in real world markets that are intended to reduce competition and secure greater monopoly power for the incumbent firms. The many creative ways that firms use to achieve this outcome is the topic of this chapter.

16.1 Is Competition Ethical?

Learning Objectives

1. Learn why actions taken by businesses to restrict competition may be viewed as unethical.

In Chapter 4 we argued that, in order to guarantee that two parties will mutually benefit from trade in a market, it is important that market participants constrain their self-interest with a set of ethical principles; most importantly that they refrain from using any sort of coercion, theft, violence or fraud to obtain benefits for themselves. Instead, market participants should agree to cooperate with each other in markets and only engage in trade that is mutually voluntary and with information that is accurate and true. If market participants behave in this way, then market outcomes will be efficient, thereby assuring the maximum total social benefit accrues, at lowest possible cost.

In this chapter we address another situation that pits the self-interest of market participants against what is best for the social or common good. Markets serve its participants best when many firms compete against each other in the production and sale of goods and services. This is just another way of saying that economic efficiency is highest under perfect competition. However, from the perspective of one market group, namely businesses or firms, their specific interests are best served when competition is restricted. The ideal market for a firm would be to have a monopoly and face no competition from others at all. Thus, there is a basic economic truth, or an economics lesson, that everyone should know: business interests and consumer interests are opposed to each other. What is best for businesses or firms is not what's best for consumers, nor is it typically what's best in the aggregate. Society, or the citizenry, is best served when there is a lot of competition among independent firms.

Restrictions on competition are similar to ethical violations such as the use of force or fraud, because they have the effect of raising the well-being of one group at the expense of others and at the expense of the larger whole. Since most societies have put into place social, moral, and religious norms that encourage ethical behavior, we might also wish there existed similar social pressures, (should we call them ethical norms?), to encourage the promotion of competition. Indeed, there is some such pressure and it comes in the form of promoting the freedom for anyone to participate in markets. However, there are also many restrictions to market participation that legally restricts access by new firms. More on that later in the chapter. There are also modern laws such as antitrust policies (a.k.a. competition policies) that regulate mergers and acquisitions and prevent the formations of near monopolies.

Relative to the ethical and moral norms constraining force and fraud, norms preventing the restriction of competition are less prevalent. For example, I know of no historical children's stories warning against the dangers of business collusion or the fixing of prices. For this reason, it may be too bold to argue that promotion of competition is an "ethical" principle. However, perhaps it should be. Perhaps this is simply the next logical step in our ethical and moral development and we should take further actions to promote these principles to a broader population. This is an issue worthy of further reflection.

What follows in this chapter is a review of the multitude of methods used by businesses to respond to increases in competition in their market. Some methods involve adaptation to a

more competitive market. Others involve blatant actions to prevent other firms from gaining a foothold in the market. Sometimes the actions involve collusions among firms, other times it involves collusions between firms and government. Sometimes governments implement laws encouraging competition, but other times governments prevent competition from thriving.

In most examples, we must step outside the models to discuss the much more complex situations that arise in the real world. Firms do not compete only on the basis of price and quantity as in our simple models. Instead they respond with a variety of strategies that adjust the nature of the products being sold and the methods used to produce them. Sometimes these adjustments work in favor of consumers and have a positive effect on market welfare. Measurement of these effects would require constructing a more complicated model to include these elements. An example is the monopolistic competition model that incorporates product differentiation, but we will not take that step in this book.   Instead, we'll merely introduce some of these real world responses informally and suggest when firm actions are likely to be supportive of market efficiency and when they are likely to be detrimental.

Key Takeaways

1. Restrictions that prevent competition from occurring in a market has similar impacts to the market behaviors such as the use of force and deception highlighted in Chapter 4, thus these restrictions may be considered similarly unethical.
2. Many countries have promoted the freedom to compete in markets by instituting competition policies or antitrust laws.

16.2 Business Responses to Competition

Learning Objectives

1. Learn the variety of methods incumbent firms often use to respond to increases in competition in their industry.
2. Learn how some methods serve to enhance market efficiency, some methods reduce market efficiency and some have ambiguous impacts.

We will outline five major methods firms use when they face an increase in competition from new entrants: 1) product differentiation, 2) process innovation, 3) barriers to entry, 4) government interventions and 5) unethical responses. The first two categories are mostly positive responses in that they involve making a unique and better product or reducing the costs of producing the product. These responses are likely to improve the well-being of consumers in the market as well as improving the outcome for the incumbent firm. The remaining three methods are mostly techniques that put roadblocks in the way of the competition and make it more difficult for others to compete in the existing marketplace. As such these techniques serve to improve the monopoly power of the incumbent firms and raise their own profits at the expense of other firms in the industry. By preventing competition from occurring they also tend to raise the prices consumers pay and reduce market welfare. These are the methods that society ought to be both aware of and wary of.

Product Differentiation

One simple way an incumbent business can respond to new firms selling similar products is to try to improve the consumer appeal of their own product relative to the others on the market. To do so, a firm would have to make their product a little bit different from its competitors. Perhaps using more vivid and attractive colors, or changing the design of the product in a way that makes it more stylish or easier to use. This process is called product differentiation because the product is made differently enough to become unique in the marketplace. In contrast, in the standard market model we assumed that all products sold were homogeneous, meaning they were identical in all respects. The homogeneity assumption was made to simplify the model and assure that the only relevant consideration for a consumer was the price of the product. Once that assumption is relaxed, firms are able to compete with each other across a more varied spectrum by selling products of different colors, designs, and qualities, all while fulfilling the same basic needs for the consumer.

Consumers can benefit from this type of competition because presumably every consumer has a unique set of likes and dislikes. For example, some people like the color pink, and if by chance one firm differentiates its product to offer pink versions, then this consumer would be happier buying from this firm than some other firm that only sells blue products. Firms that research their own customers desires can more effectively satisfy the particular needs in the market. In so doing, firms not only become more profitable in the industry but their success will occur largely because it is serving its customers better. This is a win-win situation for both firms and consumers.

There are some other ways firms can offer a better product to its customers most notably by bundling other services on top of the product itself. For example, suppose a firm selling refrigerators decides to offer a one-year warranty on its product. In this case the product is no longer just a refrigerator, but is a refrigerator bundled with an insurance policy that will replace the product if it fails within the first year. Some other firm might respond to this offer, noting that refrigerators are reliable enough that they rarely break down in a year, and offer a five-year extended-warranty that bundles the product with an even better insurance package. These are just a couple of examples of how innovative firms can compete by offering more complex products. In so doing, firms are trying to more effectively satisfy the needs and concerns of their customers and hope that by providing a better bundle of goods and services they will attract more customers and increase their own profit. Firms that do not copy the innovators and offer similar bundled products are likely to lose customers and eventually may be forced out of the business.

This is the healthy dynamic competitive process that was suggested by the economist Josef Schumpeter who coined the phrase creative-destruction. In his explanation of the competitive process it is natural for innovative firms to enter market with new ideas and new products that better serve customers (this is the creative process). At the same time, incumbent firms who have been in the business a long time and have lost their creative tendencies tend to fall behind and go bankrupt (this is the destruction process). This process recognizes that business losses are an expected outcome over time and highlights the necessity for this to happen so that new firms can step in and better serve the consumers in the market. What really drives the competitive process is always seeking to better serve the consumer's desires and needs and those firms that can successfully do that will succeed, whereas those that do not satisfy the consumer

as effectively will lose. Ideally, this is how markets should work, and sometimes they do. There is nothing inherently counter to promoting economic efficiency in this mechanism and thus there is little worry that these firm behaviors are unethical. However, there are other situations, some of which are described below, where competition does not work exactly in this way and where firms can take advantage of its customers.

Process Innovation

When competitor firms enter the market, the higher market supply pushes the product price down and lowers profits for incumbent firms. One way to maintain higher profit is to try to reduce the average costs of production. Innovation is often inspired by pressure. To understand why, imagine this example. Consider a firm that has been operating in a market for a long period of time and has faced little competition. The firm supplies a product, maybe screws, to hardware stores who are generally satisfied with the product provided and continually return to purchase again. Suppose the firm makes a small profit and knows from experience that the profit is always there as long as the process remains pretty much the same. This market might be described as stable or stagnant and there is nothing wrong with this equilibrium. As long as the participants on both sides are reasonably happy, it might continue for a very long time.

Contrast this story with a more dynamic market in which hardware stores and their customers are continually searching for the best floor tiles to be used in new construction. Suppose there has been substantial scientific innovation that has brought new tile products made of new materials into the market. In response to these new substitute products, established tile companies, rather than trying to produce with new materials, may instead respond by searching for ways to reduce the costs of producing their product. This might involve investing in new machinery or hiring a consulting firm to help it adjust its production process to reduce waste. If the average cost of producing its product can be reduced as fast or faster than the market price is falling, then profits can be maintained or even increased. The incentive to make these sort of changes are always present for firms in an industry, as long as they are continually seeking more profit. However, the competitive pressure from new firms producing innovative products will surely serve as extra motivation to make such cost reductions more quickly.

If firms respond to greater competition by reducing production costs, this is a good market outcome that will ultimately carry over to lower prices for consumers, as long as the competitiveness in the market remains. Thus, with some creative effort, both firms and consumers in the market can benefit.

It is worth pointing out that there are some losers in this process as well. When a firm reduces costs it means they will not be demanding some of the inputs they used earlier. For example, if the consulting firm determines that the same output can be achieved with a third fewer workers, then some workers will lose their jobs in this industry. Although this will cause some discomfort for those who must transition, it enables the economy to ultimately expand overall production because these resources are freed up to be used in their next best alternative use. Persistent cost reductions allow an economy to produce on the basis of what it has a comparative advantage in at the moment, and therefore is an overall positive effect for an economy.

Process Innovation with Trade Secrets

Stalwart proponents of free markets will often use the above market descriptions to suggest that profit seeking behavior by firms will always lead to innovations and cost-cutting measures that

can only have positive effects in the overall market. Undoubtedly, these processes often do occur and the positive effects are often realized. However, there are instances where firms can prevent these processes from proceeding in the manner described above.

Consider a perfectly competitive market for boxes with many box producing firms competing such that the market price is equal to minimum average cost. Suppose the machines used to cut and shape the cardboard into various box sizes frequently jam, causing production delays which adds to the average cost of production. All box firms face the same dilemma and have similar amounts of down time clearing their jammed machines. Suppose a manager at one of the firms notices that the jams typically happen at the beginning of each workday, but not as often during the end of the day. This inspires an idea. What if the cardboard cutting machines are turned on an hour before the production line workers begin their day, enabling the machines to "warm-up." Suppose after testing this new procedure the firm discovers that jams occur much less frequently and that average costs are reduced by 20%. This would be a significant improvement in technology arising from a simple procedural change inspired by the creative thinking of one production worker. What would happen next?

In the market model described in Chapter 14, we assumed that firms had perfect information about the best production techniques available to produce a product. In this case, the manager's innovation would be immediately made available to all firms in the industry thereby reducing average and marginal costs and resulting in positive short-run profits for all firms. Moving to the long-run, positive profit would inspire entry by new firms which would cause the market price to fall thereby reducing firm profit to zero at a new price equal to the new lower minimum average cost of production. This outcome is good for consumers who will pay less for boxed products and it is good for overall economic efficiency

But now let's tell the adjustment story differently. The innovating firm that discovered the cost-cutting production technique has no incentive to share this information with other firms in the industry. Doing so will set off the process described above and eventually it will see its profits return to zero. The alternative is to keep the production information secret. This is known as a *trade secret*.

According to the World Intellectual Property Organization (WIPO), a *trade secret* is any information that is commercially valuable, known to a limited number of people, and has had reasonable steps taken to maintain its secrecy. Unauthorized acquisition or disclosure of trade secrets is considered an unfair trade practice. WIPO encourages companies to take measures to protect trade secrets including the use of non-disclosure agreements (NDAs), non-compete agreements (NCAs), strong information technologies (IT) systems, and using internal controls on access to critical information.

Non-disclosure agreements are meant to prevent employees from sharing critical knowledge about a company's production processes with others outside the company. What knowledge is critical? Anything that is valuable, meaning it enhances the firm's profit, and which is not possessed by its competitors. This may include recipes that distinguish the company's product from near substitutes, such as the recipe for Coca-Cola. Or, it may include knowledge about cost-saving production processes such as the warming-up procedure in the box factory example above. Non-compete agreements go a step further and prevent an employee from quitting and starting their own firm producing a similar product at least for some period of time after separation. Strong IT protections and internal controls are meant to prevent external and internal cyber theft of company secrets.

Although these are commonly used business practices it is worth reflecting why companies engage in these practices and whether it is appropriate for them to do so. Keeping valuable information secret clearly is advantageous for the firms themselves because it reduces competitive pressures and helps to maintain their profit. Information can be thought of as an input used in the production process, much like a diamond mine is a necessary input in the production of diamonds. If a company can take control of all the diamond mines in the world, then by preventing competition they can earn much more profit for themselves. The same is true if valuable information is monopolized and prevented from dissemination. Thus, the negative effect of trade secrets is that by preventing the widespread dissemination of information, it will prevent consumers from enjoying the benefits of lower prices caused by the information-induced cost reductions. In a sense, these actions redistribute income from consumers to firms and, according to the market model, would also reduce overall economic efficiency.

For these reasons, many market advocates are often opposed to the use of NDAs and NCAs. While beneficial to, and widely supported by, businesses, these agreements clearly have anticompetitive effects that may be damaging to many individuals in the broader economy.

Barriers to Entry: Intellectual Property Protections

Suppose the cost-reducing innovation was not an idea that a manager has, but instead is an invention created by the research and development team at the company, perhaps a new machine design that rapidly speeds up production so that there is greater output in less time. In this case, the company can file for a patent with the Trademark and Patent office. In the US, patents and copyrights are protected in the Constitution itself and thus intellectual property rights (IPRs) have a long history of support.

In a patent application, information about the new invention is revealed, rather than kept secret. In exchange for the revelation though, a patent recipient is legally granted exclusive rights to use the invention for a 20-year period. This is an example of the government granting monopoly privileges to a business. If any other firm copies the design and tries to use the invention in their own production, the patent holder can use the government judicial process to sue the violator and force cessation and recovery of damages.

The granting of these monopoly rights has some economic justifications. The intention is that by securing positive monopoly profit for innovative firms for an extended period, more firms will seek to innovate. With greater innovation will come a stream of long term technological improvements that may make up for the protective monopoly effects in the shorter-term. Innovative businesses such as pharmaceutical companies and technology firms certainly promote this logic to argue for the necessity of intellectual property rights (IPRs).

While arguments supporting IPR have mostly won out in countries around the world, support is not 100%. Economic empirical investigations that have sought to verify the positive effects of IPR have often fallen short. The economic literature sometimes refers to this as the patent puzzle. For example, a 2013 meta-analysis (this is a study that looks at all the studies on a particular subject) argued that there is no empirical support across numerous studies that patents have a causal effect on innovation and productivity. They concluded that while weak patent protection in a country may mildly increase innovation with few side-effects, strong patent protection tends to retard innovation and have damaging side-effects. (Boldrin and Levine, Journal of Economic Perspectives,2013).

The damaging side-effects likely occur because of the anticompetitive effects induced by the lengthy period of monopoly profit. By avoiding competition, a firm with IPR protections has some breathing space, a time period where monopoly returns are secure even if no new innovation occurs. In a sense, a protected firm can rest on their laurels, which may in turn reduce short-term incentives for innovation. For some products though, such as pharmaceutical drugs, the 20 year protection may be too short, largely because lengthy government approval processes may prevent sales of the product until years after the initial patent is registered. Thus, the effectiveness of IPR may vary greatly across industries.

Also some intellectual property protections such as trademarks and copyrights, provide valuable information to consumers about the source of a product. Part of the appeal of product differentiation is to make a product distinct from one's competitors and then build a loyal set of consumers who know your product and prefer it over others. Once a positive reputation is established, it is clearly unfair for another producer to market a similar product using your company name or registered trademark. To do so would be deceptive to consumers who would be led to think that are getting a product from the reputable company when instead they may be getting an inferior substitute. Thus, IPR helps to convey truthful information about product sources and helps to establish positive reputation effects that can make a market work more efficiently.

Geographical indicators (GIs) are another type of IPR protection that can be more controversial because it involves claims of ownership over product names associated with specific locations. For example, champagne is a type of sparkling white wine that can now only be sold with that name if it was produced in the Champagne region of France. If you make a similar sparkling wine with the same grape but in a different part of the world you may not market it as champagne. Since champagne has a reputation as a celebratory beverage, French producers of champagne gain a competitive advantage over sparkling wine producers elsewhere. Champagne producers in France are happy with this GI designation, but producers of similar products produced elsewhere are not. Consumers may have different preferences on this issue. Some may believe the geographic designation is important and are happier when the name indicates the sparkling wine is surely from France. Other consumers might like to celebrate with "Champagne" but would also prefer to spend less and use a similar tasting beverage produced elsewhere.

In conclusion, IPR represents a government granted monopoly to use a particular invention, name or marking. To the extent that these protections convey useful information to consumers, IPR may improve economic efficiency and market outcomes. To the extent IPR prevents competitor firms from entering and being able to market similar products, it may reduce economic efficiency. If the extra profits earned via temporary monopoly rights spurs more innovation, then the long-term effects of IPR may be positive. The fact that there are numerous positive and negative tradeoffs to consider, makes IPR a continually controversial issue.

Barriers to Entry: Mergers and Acquisitions

Suppose a firm innovates and receives a patent on machinery, or, effectively maintains a trade secret that helps it to produce its product cheaper than competitors. This will enable it to be more profitable than other firms in the industry and one thing it could do with the extra profit, is to buy out competitor firms. By doing the firm could spread the usage of its patented invention, or trade secret, across many more production facilities, and make even greater profit. If the company becomes large enough to be able to control the price, it could use its monopoly

power to reduce market output and raise the price, thereby increasing its profit even further. A firm could also use its monopoly profit to conduct more research and development to develop additional innovations that could be patented and prevent usage by other companies. Processes such as these may enable one firm, or several firms, to dominate an industry in a way that makes it almost impossible for new firms to enter the market and compete. A similar outcome can be accomplished via licensing. Rather than taking over competitor firms, an innovator can license the use of, say, cost-cutting machinery to other firms. This would enable those firms to make extra profit, a share of which will be transferred to the innovating firm with the license fee. Although this is great for the dominant firms themselves, and these same firms will argue why this is a good way to spur innovation and improve economic efficiency, it can also have a detrimental effect upon consumers in that market and ultimately reduce market efficiency.

Because of these anticompetitive effects of mergers, many countries have implemented antitrust policies, also known as competition policies. In general, these laws prevent an industry from becoming too concentrated by requiring that large firms who wish to merge receive government approval to do so. The government agency that conducts the investigations, this is the Federal Trade Commission in the US, evaluates the likely effects of any merger to see if the industry will become too concentrated (meaning too few firms competing), and have a negative impact on consumers in that market. Government would not allow a merger to occur if the effect is too anticompetitive. Government can also use these policies to break apart firms that have become too dominant. More than a century ago this was known as trust-busting, trusts being another word that means monopoly. When the US first introduced antitrust laws, it began by breaking up the oil, railroad, and steel trusts, among others, that had developed in the middle stages of US industrialization. Today there is less trust-busting but some regulators have talked recently about whether the large internet and social media giants like Facebook, Google, Amazon and Twitter should be broken apart to promote competition.

Businesses, along with merger and acquisition lawyers, often argue that these actions can promote economic efficiency in the long-run because larger firms can take advantage of economies of scale and thereby produce higher output at lower costs and pass this on to consumers in the form of lower prices. This is a valid argument if the industry has the characteristics of a natural monopoly whereby the most efficient production can only occur at a scale large enough to fulfill the entire market demand. If the market does not have these characteristics, then the arguments are more likely used to distract attention from a monopoly power grab by the firm.

Nevertheless, one of the problems with a little monopoly power, like the kind that might come from trade secrets and patent protection, is that the extra profit can be used to establish greater monopoly power. To learn more about a rising trend towards greater market concentration and the growth of monopoly power, especially in the United States, see Thomas Philippon's The Great Reversal: How America Gave up on Free Markets (2019). This book offers a substantial amount of recent empirical evidence suggesting that American markets have become much more concentrated in the past few decades, relative to Europe, much to the detriment of the average household's standard of living. Many economists, including Nobel prize winner Joseph Stiglitz, have argued that it is this expansion of monopoly/oligopoly power in business that has been a major contributor to the rise of income and wealth inequality.

Barriers to Entry: Exclusivity Contracts

One common business practice that aims to mildly prevent competition is the inclusion of exclusivity clauses in contracts between buyers and sellers. For example suppose a university enters into a contract with a major soft drink manufacturer to supply its vending machines with their products. In the contract, the soft drink manufacturer is likely to include a clause requiring that the university not to enter into any other contract with a competing soft drink manufacturer. This prevents direct competition with another soft drink producer within university properties. The university has little reason to object since they presumably want to supply the major soft drink on their campus. However, consumers who prefer the alternative brands, will be prevented (slightly) from exercising their choice and may be forced to pay slightly higher prices due to the monopoly in the soft drink market.

Another example is in the sales of food in movie theaters and sports venues. These establishments generally forbid a paying customer from bringing in their own food or drink. By establishing a monopoly on these accompanying services, these businesses can and do charge prices that are much higher than one would pay in the surrounding area. Indeed, most live entertainment businesses like these make most of their profit on food and drink sales rather than on the entry fees. This pricing strategy essentially enables them to underprice the entry fee, and make up the lost revenues on food and drink sales. The prevalence of this pricing model suggests that it is the most effective way for these businesses to maximize their profits. But the practice requires restrictions on free entry by competing sources of food and drink for these consumers.

Businesses would argue that these kinds of exclusivity agreements are absolutely essential for them to compete successfully. Just be aware that the basis of their success in these cases is the implementation of mild levels of entry restrictions on alternative competing supplies.

Barriers to Entry: Licensing Requirements

Another method that can be used to restrict competition in an industry is by implementing licensing requirements for professional inputs in the market. For example, to work as a lawyer or a physician, a person must satisfy a set of requirements and receive a license to practice in that profession. There is a strong argument supporting licensing. Licensing is intended to provide quality control and assure consumers that the person they have hired is competent in providing their services. But there is also a conflict that can easily arise. Licensing that is too restrictive can also be used to prevent the entry of competent individuals, thereby increasing the monopoly power of the group who are able to acquire licenses. What is “too restrictive” is of course subject to interpretation. Different observers are likely to have different opinions about it.

For example, suppose a foreign trained and licensed physician who has practiced for many years in their own country wants to practice medicine in the US. US licensing requires that individuals have completed a pre-med course curriculum leading to a bachelor’s degree that includes basic courses in biology, chemistry and calculus. Many foreign training programs do not have these same requirements, but the foreign trained physician would still need to complete these to practice medicine in the US. Some may view these requirements in his special circumstance as too cumbersome and believe it acts as a barrier to entry by competent foreign doctors. Others would argue that these high standards is essential to maintain the high quality of US medical care.

Perhaps in the area of medicine, high entry requirements do serve the interests of consumers and raises economic efficiency by providing better information. However licensing requirements have been incorporated for many profession where health and safety is not as critical. In cases of licensing for cosmetologists, barbers, taxidermists, sheet metal workers, travel guides, bartenders and locksmiths, one may wonder whether these regulations, often promoted by State governments rather than private certification boards, have the consumers' best interests at heart or whether these are intended more to erect barriers to prevent the free entry of others and acquire some monopoly power.

Government Interventions

There is another way innovative firms can use their monopoly profit to improve their monopoly positions besides merging with competitor firms; they can spend the profit on lobbying activities to convince legislators to enact regulations that work to the advantage of their firm. Although governments have implemented many regulations to promote competition, they have also implemented regulations that restrain competition or that favor particular firms or industries. Possibly, these anticompetitive regulations that disproportionately favor large businesses over small ones, are much more prevalent than the other regulations promoting competition.

One simple way to prevent competition is to induce the government to levy higher tariffs on imported goods that compete directly with your product. Imports are goods produced by foreign firms but sold domestically. As we will see in Chapter 18, an expansion of international trade resulting in higher imported goods, also expands the degree of competition in that sector. The incumbent domestic firms are generally harmed because of the expanded number of firms supplying the domestic market. An import tariff is a way to thwart the competition by forcing a tax be paid by the foreign firms but not by the domestic firms. As we will see in Chapter 18 though, the tax is unlikely to be paid for by the foreign producers but will instead be paid by domestic consumers of the product. Thus, domestic consumers are harmed by tariff increases and overall economic efficiency is likely to be reduced as well.

Another method to restrict competition using government rules is to insert business-friendly regulations into new legislation. Oftentimes these regulations are extremely subtle and unlikely for anyone but insiders to understand how it favors a particular firm. Often legislators will provide some explanation, for example that this is the best procedure to achieve some objective over the other alternatives, or perhaps it will help to create more jobs. These explanations are typically cover designed to hide the true intent, which is to provide a favored outcome to particular firms usually by either directing business to those favored firms or by preventing competitors from participating in certain markets.

A growing concern among many is the issue of regulatory capture by industries. This refers to the ability of industry lobbyists to affect or control the decisions made by regulatory agencies. For example, if a firm intends to merge with another firm in the industry to increase its monopoly power, it also knows that the merger will be reviewed by the FTC. However, if the firm's lobbyists can convince the regulatory officials that this merger is not a threat to competition in the industry, they might be able to prevent an investigation from taking place. This is a simple example of how regulatory decisions can be captured by the large industry interests. Some US legislators, such as Elizabeth Warren, a Senator from Massachusetts, have warned that this process is rampant in Washington DC especially within financial regulatory bodies like the Securities and Exchange Commission, and has proposed measures to reduce the ability of firms to capture these agencies. However, these measures are very difficult to pass

because threats to change the ability to influence is met with lobbying funds directed at the legislators to convince them not to make such changes.

Look back to this page later for more examples of this process. In the meantime take note that sometimes when governments work with business or industry, the outcomes are often in the direct interest of the businesses themselves and often in a way that enhances their monopoly power in an industry. This is one of the valid reasons many people are suspicious of a greater role for government. Although government can be used to promote fair and just outcomes which enhances overall economic efficiency, because of the way the decision process works in democratic societies, oftentimes governments don't enact such laws and rules. We will talk more about the lobbying process in Chapter 21.

Unethical Responses: Deception

The most damaging and worrisome examples of business attempts to respond to greater competition, or to restrict it, arises when the firms are willing to blatantly violate commonly accepted ethical principles and use violence, threats, and deceptive practices. Let's consider several examples.

One method that could be used to respond to new substitute products sold by competitor firms is to badmouth or disparage the new competitor's product. One could use advertising to highlight faults or problems of a competitor's product and argue why your product is better.

See this ad for Google Chromebook as an example: https://www.youtube.com/watch?v=DS0H0XDDotI .

Alternatively, one could be more malicious and raise doubts about the safety or effectiveness of competitor products. One could even proclaim that the other products will cause physical harm or disease. If the competition is from a foreign source, especially a developing country, one might appeal to patriotism and argue that it is best to help your own people. Or, one could allude to the poor working conditions, low wages, and poor environmental policies of the countries and argue that you shouldn't condone these policies by purchasing their products. The central feature of this approach is to announce that there is something bad about the competitors' products and therefore you should buy our product instead. This is especially unethical when pure falsehoods or lies about the competitor products are used to discourage consumers from buying. Efficient outcomes in markets requires that consumers have accurate information about the products they consider buying and if firms are floating inaccuracies this diminishes the chance that efficient outcomes will arise.

Misleading advertising is a common way to thwart competition and it leads to the bad image that many people have about advertising in general. Advertising can be a positive force and help consumers make better choices, but only if it provides true and accurate information about products for sale. For example, ethical advertising could involve simple descriptions of the features of a company's products together with the suggestion that this will satisfy consumer needs. Or, if a comparison with other products is made, a company could compare the features of competitor products accurately but again argue that their products' features would be more satisfying. Advertising becomes unethical when it either inaccurately embellishes the qualities of one's own product, or, falsely disparages the features of the competitor products.

Often the types of advertisements that cross the ethical line are obvious, but quite often it can be hard to tell and there may be differing opinions. For example, online hotel booking sites are

common today. Many of them will list a collection of hotel rooms available in a location and sometimes will add a note about the cheapest rooms saying something like, “only 2 rooms left at this price.” One might certainly wonder if these are actually true statements. Surely budget-conscious consumers might be worried enough about losing a low price on a room that hearing that the offer might soon be unavailable would spur them to hit the “Reserve Now” button. Companies that recognize this psychological fear of missing out might choose to add “only 1 room left” buttons even when it is not factually correct. The purpose is to induce quicker purchases for your product rather than a competitor. Is this going too far? I leave it to you to consider and decide for yourself.

Unethical Responses: Organized Crime

A much more malicious response to competition is possible for someone willing to use violence or threats of violence. This is a common practice historically used by mafia organizations or other organized crime syndicates. As an example, during the Prohibition period in the US during the 1920s, it was common for different mafia groups to control well-defined territories within major cities as the sole supplier of illegal alcohol. If other producers tried to sell alcohol in the same region, they might be threatened or killed by the controlling interest. These same methods have been used in other illicit activities including illegal drug sales, prostitution, and gambling.

To avoid arrest and imprisonment from both the sale of alcohol and the violence used to secure monopoly power, the high monopoly profit was used to bribe law enforcement officials to turn a blind eye to these illicit activities. This is similar to regulatory capture but is better described as outright corruption. Indeed with enough power in a community an organized crime syndicate can even begin to take over the functions of the local police and earn even greater profit using extortion. For example, in organized crime communities, many small businesses producing legal goods are required to pay “protection money” to the syndicate. These businesses have no choice but to pay because failure to do so could result in injury or death to oneself or one’s family members. In this way, an organized crime syndicate can extend its profits from its illegal activities and also acquire the profits earned from legitimate businesses as well.

None of these activities are compatible with a free market competitive system. Organized crime syndicates use force, and threats of violence to acquire monopolies in a wide range of businesses and to effectively prevent the entry of competitor businesses whose presence would erode their monopoly profit. With less profit they would have less money to bribe government officials and their protection from the law could evaporate. Although corrupt business models such as these are extremely lucrative for those in the business, it comes at a cost to the consumers, the potentially competitive innovative firms, and to members of the community whose health and safety is continually threatened because of the high level of violence necessary to maintain the system.

Key Takeaways

1. Acceptable, or market-friendly responses, include process innovations that reduce the costs of production and product enhancements, such as product differentiation, product quality adjustments, and bundling the product with other services such as warranties.
2. Unacceptable, or market-unfriendly, or unethical, responses to competition are those that reduce overall market efficiency by restricting or eliminating competition and enhancing the

monopoly power of incumbent businesses to the detriment of consumers who receive lower quality products at a higher price.
3. Clearly unethical business practices include the use of force, violence or deception to solidify an incumbent's position in a market.
4. Ambiguous business methods to restrict competition, meaning it is uncertain if market efficiency is reduced, include the use of intellectual property rights, trade secrets, and mergers and acquisitions.

16.3 Ethics of Competition Summary

Learning Objectives

1. Learn why the perfect competition result of zero profit for firms is unrealistic and why small or temporary profit may be justified.
2. Learn why high market concentration is not sufficient to conclude that firms are using their monopoly power
3. Learn the differences between a free market advocate's and a free market critics' vision of competition in markets.

This chapter provides a very brief summary of some of the techniques incumbent businesses use to respond to competition by new entrants. Acceptable, or market-friendly responses, include process innovations that reduce the costs of production and product enhancements, such as product differentiation, product quality adjustments, and bundling the product with other services such as warranties. These are market friendly because they improve overall market efficiency by supplying better products to customers at lower prices.

In contrast, unacceptable, or market-unfriendly, or unethical, responses to competition are those that reduce overall market efficiency by preventing or eliminating competition and enhancing the monopoly power of incumbent businesses to the detriment of consumers who receive lower quality products at a higher price.

Some anticompetitive actions are obviously unethical, as when businesses use force, violence or deception to solidify their position in a market. Other anticompetitive actions are somewhat controversial with some observers promoting them, usually the business interests themselves, while others oppose them. The controversial actions include mergers, intellectual property protections, and government regulations favoring business interests. Business advocates will argue, with some justification, that many of these controversial actions are absolutely necessary for business success and can have positive long-term effects for society. However, whenever some firms are able to prevent other firms from competing in the market, it is likely to reduce total output, raise prices and reduce overall economic efficiency. Only when possible long term effects are substantial enough, can it outweigh the anticompetitive effects of entry restrictions.

One thing to recognize though, is that the perfect competition model suggesting that competition will push firm profit to zero is unrealistic for several reasons. First, for simplicity the model assumes away many aspects of real-world competition such as the possibility that firms can produce many different unique products by bundling goods and services together in creative ways. The possibility to continually differentiate products and to redesign the production process with cost-saving measures will enable dynamic firms to earn positive profit

for lengthy periods before other competitors can catch up. Second, the existence of adjustment costs, for example the inability of workers to quickly find other jobs when a business reduces output, may require positive profit to provide a cushion so that firms need not respond to every small negative market shock by quickly downsizing. In other words, some profit may be needed to provide stability in an industry suffering periodic shocks so that the creative destruction process is not so damaging to long-term economic success.

Also, market concentration, meaning a small number of firms operating in an industry, does not always result in monopolistic pricing and a reduction in market efficiency. One reason is the previously mentioned presence of economies of scale in some industries. Another reason arises if the entry costs by potential competitors is relatively low. For example, suppose an airline establishes a monopoly on service between two cities that has regular demand for one flight each way, every day. Suppose further that demand is relatively inelastic because employees of a major company must travel regularly between its headquarters and its production facilities located in the two cities. Having a monopoly, the airline might be expected to raise its price considerably and make monopoly profit since the passengers have no other option to travel between the cities. However, if it were to do that, suppose other airlines could quickly and cheaply open up a competing service between the cities and try to take away some of the monopoly profit. Thus, recognizing this likely outcome prevents the original firm from charging excessive prices despite being a monopoly.

Economist refer to this situation as a contestable market. It highlights why it is important to evaluate the workings of a market completely before determining if high firm concentration is really leading to anticompetitive effects. This is the argument that the internet and social media firms would use to argue that despite having a high market share in their respective industries, consumers are not being forced to pay higher prices for their services. They would also argue that there are network effects causing economies of scale. The point though is that monopoly power does not always result in monopoly pricing and a reduction in economic efficiency.

Philippon (2019) in the Great Reversal, illustrates this point by comparing the airline industry with the retail industry. Both industries in the US have seen an increase in market concentration in recent decades. The airline industry is dominated by just a few major airlines and in the retail industry there is the giant firm Walmart, that accounts for 60% of retail sales. However, while prices for airlines flights have risen considerably in the past 20 years, the prices of products in the retail industry have not. Two industries with similar market concentration levels will not necessarily have the same market outcome.

The main point of this discussion is to highlight that the issue is complicated and thus can be expected to be contentious. Some market observers will point to the high concentration in an industry, like in social media, and argue that the industry should be made more competitive. Others will argue that despite market concentration market efficiency is still being attained and thus there is no need to break them up. Some observers will argue for the expansion of intellectual property rights for say pharmaceutical companies because it is necessary to spur on research and development into new drugs. Others will argue that it is precisely the monopoly privileges given to the drug firms by governments that causes the high prices of medicines and prevents access to life saving drugs for many needy individuals around the world. Some observers will argue for the need for an expanded government to control the exploitation of consumers by big business. Other observers worry that an expansion of government will result

in even greater control of the regulatory processes by big business who already use their monopoly profit to influence outcomes in their favor.

Market advocates, those who say they favor free markets and open competition, imagine profit seeking firms competing freely with each other by innovating products and processes while adjusting to market shocks by easily moving workers and resources between industries on the basis of shifting comparative advantages. In contrast, market critics, those who are highly suspicious of business practices and free markets, imagine that profit seeking firms will naturally bind together into large conglomerates, raise prices and gouge consumers while deceiving them as to the true qualities of the products they are selling. They will also capture the regulatory processes of government thereby securing their monopoly positions all to the detriment of the average citizen.

Who's right? Well, market advocates and market critics are both right, because all of the processes are always active in every market economy in the world. Some firms are actively innovating and reducing costs to better compete in their markets. Workers and resources are being shifted between industries and market conditions change with differing degrees of suffering due to the adjustments. Some firms are integrating with each other or preventing free entry of new firms and forming larger conglomerates to the detriment of their consumers. Some businesses are using their monopoly profits to influence public policy in their favor. Some government regulations are helping to promote free and fair competition within markets. Other government regulations have been surreptitiously inserted into legislation and is helping powerful firms become even more powerful. And finally in some markets firms are deceiving their customers or are using strong-armed tactics to prevent free and fair competition from prevailing.

An ethical competitive market is one that realizes the vision of the free market advocates while simultaneously preventing the common business practices that worry the free market critics. The solution cannot be more or less government though, because although government regulations can prevent monopolization from occurring in some instances, government regulations are also responsible for causing greater monopolization in other instances. This is why when free market advocates, like former US President Ronald Reagan, claim that government is the problem, while free market critics, like US Senator Bernie Sanders, claim that government is the solution, both can be right! Government policies are both a problem and a potential solution. Thus, for a government solution to work, it must also prevent the possibility of regulatory capture at some point in the future.

Key Takeaways

1. In real world markets firms may be justified to make positive profit to maintain a reasonable level of market security in the face of periodic market shocks.
2. Contestable markets and economies of scale are two justifications for high concentration in some industries that will not lead to high consumer prices and market inefficiencies.
3. Market advocates imagine profit seeking firms competing freely with each other by innovating products and processes while adjusting to market shocks by easily moving workers and resources between industries on the basis of shifting comparative advantages.
4. Market critics imagine that profit seeking firms will naturally bind together into large conglomerates, raise prices and gouge consumers while deceiving them as to the true qualities of the products they are selling. They will also capture the regulatory processes of

government thereby securing their monopoly positions all to the detriment of the average citizen.

5. An ethical competitive market is one that realizes the vision of the free market advocates while simultaneously preventing the common business practices that worry the free market critics.