COMPETITION POLICY AND INTERNAL FIRM EFFICIENCY

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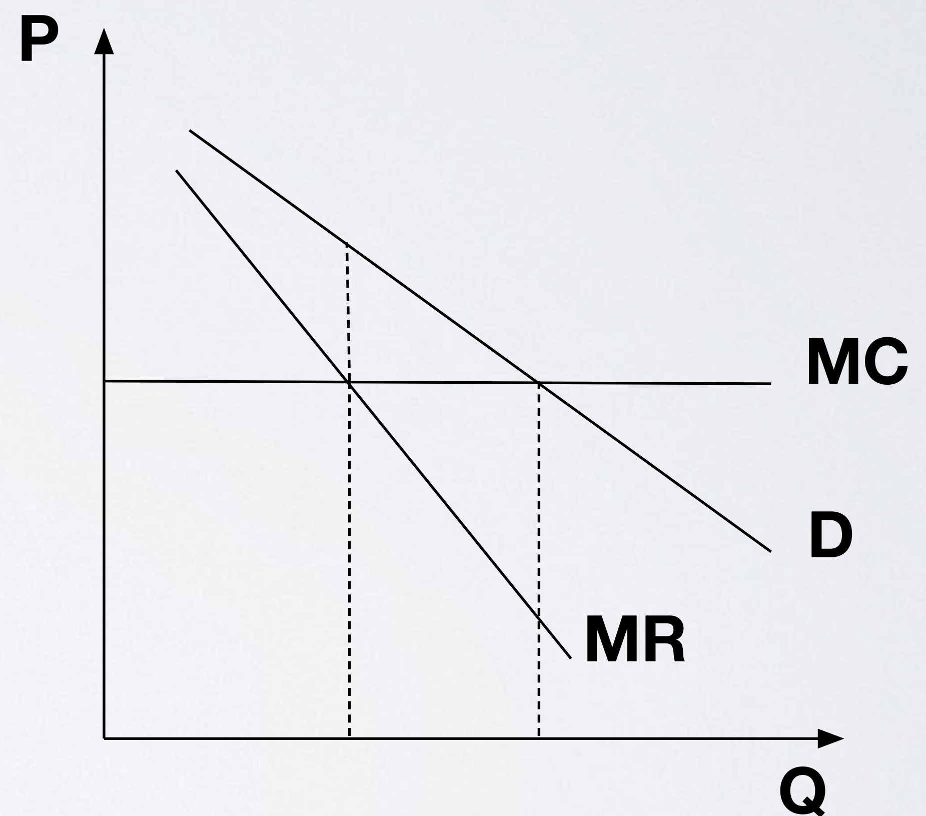
THE STANDARD VIEW

- Standard economic view of why monopoly (more generally, market power) is bad=reduces allocative efficiency



THE STANDARD VIEW

- Incredibly important
- Makes fairly sharp predictions and has clear policy implications
- If $p > MC$ then…

SOME CAVEATS

- I'm just an economist
- Not going to say anything about what the law *is*
- Perhaps say something about what it should be, could be,…
- Or at least why it is the way it is

X-EFFICIENCY

- But only part of the story
- What about the internal efficiency of firms?
- To businesspeople and practitioners an obvious concern
- But not to economists until 1980s (with roots in 1930s)

X-EFFICIENCY

- Neoclassical version of the firm: a black box limited only by technology—the "production possibilities frontier"
- Agency view: modern firms typically run by non-owner managers w/ different preferences and incentives than owners
- Berle and Means: "The Separation of Ownership and Control"

X-EFFICIENCY

- In 1960s and 70s Harvey Leibenstein at Harvard pushed the idea of "X-efficiency"
- The welfare loss from internal inefficiencies might be larger than from allocative inefficiencies
  - Transfers versus welfare losses
- X-efficiency v. Pareto efficiency
- Key question: how does X-efficiency intersect w/ product market competition

SEPARATION OF OWNERSHIP & CONTROL

- Need to have a model of how firms operate
- Agency theory
- Principal=owner(s) of firm; Agent=manager(s) of firm

AGENCY THEORY

- A's action (e.g. effort) probabilistically affects P's payoff (e.g. profits)
- P doesn't observe A's action, just a noisy signal of it
- So can only write incentive contracts based on the signal
- And hence A won't take the action P wants (e.g. will put in less effort)
- This is the welfare loss from the separation of ownership and control

AGENCY THEORY

- Optimal incentive contracting is all about how to mitigate this loss
- But incentives come from many sources: pecuniary, career concerns, intrinsic motivation…
- …and product market competition
- Hicks: "The best of all monopoly profits is a quiet life"

WHAT ECONOMICS HAS TO SAY

- More intense product market competition can increase or decrease managerial effort
- Even more complicated when thinking about the welfare loss (first-best minus second-best), since FB changes with PMC
- Depends on the nature of competition
    - More "Cournot" (quantity competition) or more "Bertrand" (price competition)
    - Fixed costs an important determinant (e.g. airlines versus retail)

COMPETITION LAW & POLICY IMPLICATIONS: MARKET DEFINITION

- Standard view of market definition (roughly): who are your competitors and customers?!
- To address internal efficiency need to know the *nature* of competition
- Not just additional information—might suggest alternative market definition

COMPETITION LAW & POLICY IMPLICATIONS: ANTI-COMPETITIVE PRACTICES

- A practice that is anti-competitive in terms of allocative efficiency could be pro-competitive in terms of internal/x-efficiency

- Less PMC can *increase* the marginal returns to cost reduction by manager/agent

- Depends on the nature of product market competition

COMPETITION LAW & POLICY IMPLICATIONS: GOVERNANCE AND EXECUTIVE COMPENSATION

- Corporate governance and incentives from executive compensation increase internal/x-efficiency
- Governance and competition as strategic substitutes
- "We have strong governance so it's ok that we…"

SUMMARY

- Standard economic view of competition law & policy is about allocative/ Pareto efficiency
  - Is $p>MC$?
- A complementary view is to focus on *internal firm efficiency*
- Need different (richer?) facts to assess pro- or anti-internal efficiency claims
- Arguably more subtle than allocative efficiency issues
- But welfare costs could be as large or larger