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)
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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
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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
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IMPLICATIONS: GOVERNANCE AND EXECUTIVE COMPENSATION

• Corporate governance and incentives from executive compensation increase internal/external 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