

Eco 188/288: Competitive Strategy and Industrial Organization

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Introductory concepts

- What is industrial organization?
- It is a field in economics which is concerned with the workings of markets and industries and the ways firms compete with each other.
- It differs from microeconomics in two ways:
 - It emphasizes the study of firm strategies that are characteristic of market interaction, such as pricing, advertising, R&D.
 - Instead of the extreme cases of monopoly and perfect competition, we'll focus on the intermediate case of **oligopolies**

Introductory concepts

- Other concepts we'll be dealing with are illustrated in the text through the (dated) example of the pharmaceutical firm Glaxo Wellcome.
- It is a very illustrative case because it involves many issues that this course is concerned with:
 - 1 It is a firm that commands a significant degree of **market power**.
 - 2 The firm resulted from a **merger**.
 - 3 It adopted a **R & D strategy** that enable **entry** into an industry already dominated by another firm.
 - 4 The protected their market position by **patent rights**.
 - 5 When that expired they **differentiated their product**.
- All of these issues are centered around the concept of **market power**.

Introductory concepts

- **Market Power** can be defined as the ability to set prices above marginal costs.
- With this notion defined, we state the aim of i.o. is to address the following four questions:
 - 1 Is there market power in a given industry?
 - 2 How do firms acquire and maintain market power?
 - 3 What are the implications of market power?
 - 4 Is there a role for public policy regarding market power?
- We will informally discuss these questions here, and devote the rest of the course to a more rigorous, analytic approach to answering them

■ Is there Market Power?

- Most important question. If not, then no need for i.o.
- Many empirical studies have attempted to address this from data on prices, output and profit rates.
- From a theoretical perspective, market power is never significant as long as there is free entry into each industry.
- Empirical evidence from particular industries indicate market power may be significant. Examples include the U.S. airline industry, and the market for office supplies.

■ How do firms Acquire and Maintain Market Power?

- One way is through legal protection from competition, so high prices can be set without new competitors entering. I.e. patent new technology.
- Firm strategy to preempt rivals by by creating an early lead through aggressive introductory pricing.
- Maintaining power can be done by, e.g. “predatory pricing”. In other words dramatically lower prices when new firm enters industry until they leave, in order to deter future entry. Examples include the U.S. airline industry.

■ What are the Implications of Market Power?

- From the firms point of view, market power implies higher profits, higher firm value.
- From a policymakers point of view the implication can be more complicated.
- The first-order effect of a high price is a transfer from consumers to firms. Most antitrust policies are aimed at protecting consumers.
- The high price implies an inefficient allocation of resources. For example, high fares imply potential fliers refrain from buying tickets even though the cost of carrying them would be very low. This is an **allocative inefficiency**.
- **Productive Inefficiency** is when firms with greater market power have less incentive to be cost efficient.
- A third type of inefficiency is **rent seeking**- unproductive resources spent by firms attempting to influence policy makers to maintain market power.