Political Economic Digest Series 30

Dear Political Economic Digest Series Participant,

Welcome to the thirtieth issue of Political Economic Digest Series. In the last issue of Political Economic Digest Series we discussed on readings on Immigration and its consequences. This issue will cover readings on Social Cost of Monopoly and Regulation by Franklin M. Fisher.

We hope you enjoy the reading.

The Social Costs of Monopoly and Regulation: Posner Reconsidered

Franklin M. Fisher

Massachusetts Institute of Technology

The traditional analysis of the costs of monopoly concentrates on the deadweight loss involved, monopoly rents being considered merely a transfer to the monopolist from the consumer surplus that would exist under competition. Some years ago, that analysis was challenged by Posner (1975), who presented an ingenious argument that monopoly rents in fact measure the resources lost to society through rent seeking activities and thus should be counted in the costs of monopoly. That argument has recently been used by staff members of the Federal Trade Commission (Long et al. 1982, chap. 3, esp. pp. 77, 97, 104; see also Tollison, Higgins, and Shugart 1983, pp. 23-44) in an attempt to estimate the benefits potentially flowing from the use of the FTC's line-of-business program in antitrust enforcement.

Unfortunately, Posner's argument, while a useful corrective to the traditional proposition that deadweight loss is all that matters, is not correct as a general analysis of the costs of monopoly, and conclusions based on it about the benefits of marginal changes in antitrust activities are likely to be particularly fallacious.

Posner's assumptions and conclusion are as follows:

1. Obtaining a monopoly is itself a competitive activity, so that, at the margin, the cost of obtaining a monopoly is exactly equal to the expected profit of being a monopolist. An important corollary of this assumption is that there are no intra marginal monopolies-no cases, that is, where the expected profits of monopoly exceed the total supply price of the inputs used to obtain the monopoly. I f there were such an excess, competition in the activity of obtaining the monopoly would induce the competing firms (or new entrants) to hire additional inputs in an effort to engross the additional monopoly profits.

2. The long-run supply of' all inputs used in obtaining monopolies is perfectly elastic. Hence, the total supply price of these inputs includes no rents.

3. The costs incurred in obtaining a monopoly have no socially valuable by-products.

The first two assumptions assure that all expected monopoly rents are transformed into social costs, and the third that these costs do not generate any social benefits. [Posner 1975, p. 809; emphasis added]

The problem, I believe, lies with the first assumption and the fact that the last statement therein does not follow and is unlikely to be true. To begin to see why this is the case, consider for a moment the standard result of' competitive theory that profits are reduced to zero in equilibrium. That result follows even when firms are differentially situated, because such differences are defined as rents. Thus, a

manufacturing firm particularly well located ends up earning no equilibrium profits in its manufacturing activity despite its favorable location, because we impute to the location the money that flows from that advantage and treat it as a cost when considering manufacturing. But rents are what Posner's analysis is all about. If firms are differentially situated in terms of' the ease with which monopoly can be obtained, and then they will earn rents that will not represent social costs.

Will firms be differentially situated? Posner plainly means to assume that they are not. His assumptions, even if' true, are insufficient to guarantee this, however, not only because constant costs may involve imputed rents but also because (contrary to Posner's assertion, p. 810) the assumption that inputs are available at constant prices does not imply that costs are constant. That conclusion also requires that the production function-here the production of' monopolies exhibit constant returns to scale, and Posner fails to assume this.

As a matter of fact, such an assumption would not be a plausible one in most contexts. Consideration of what is involved requires a closer examination of what is meant by the assumption that "obtaining a monopoly is itself a competitive activity" so that there is ease of' entry into that activity and profits are competed away.

There are two possible ways to interpret Posner's "production of' monopolies." The "competitive activity" involved is either that of obtaining monopolies generally or that of obtaining a particular monopoly. It is useful to examine both versions.

Suppose first that the activity involved is that of' obtaining monopolies generally. Here the assumption that there is easy entry is plainly plausible; one can readily imagine potential monopolists searching for an appropriate area to monopolize. On the other hand, the assumption of' constant costs-or of' no rents is not easy to maintain in that context. The supply of potential monopolies does not appear infinite. Some industries-the ones with higher entry barriers-are more readily monopolized than others or will yield higher monopoly rents for a given amount of' resources spent in monopolizing them. This means that there are decreasing returns to monopolizing activity and infra marginal monopoly rents to firms that acquire the good monopolies. (I deal below with the fact that higher rents will call forth more effort in the securing of a particular monopoly.)

More important, even were there constant costs in the production of monopolies generally, it would not follow that monopoly rents corresponded to social costs. Consider the process through which profits are driven to zero in an ordinary competitive activity. In such an activity, when profits are being earned, new entrants come in and existing firms expand. The consequent expansion of supply bids prices down, reducing revenues, and the associated increase in the demand for factors bids input prices up, increasing costs. This goes on until profits have disappeared.

Any attempt to describe this process when the activity is that of the general production of monopolies runs into immediate trouble. Even ignoring the fact that Posner assumes that input prices will not be bid up, the desired conclusion will not follow. What is the "supply" of' monopolies generally, the expansion of' which will bring down price? Why should the possessor of a monopoly in one industry have his rents

reduced because others are attempting to secure monopolies in other industries? Why should his costs be increased? Plainly, this interpretation cannot lead to Posner's results.

Suppose, then, that we consider not the obtaining of monopolies in general but rather the obtaining of' a particular monopoly. In this case-even apart from the difficulty of' defining successive units of' "output"-constant costs cannot be a general property, nor can the activity be characterized as "competitive." Competition involves free entry, and monopolies are typically characterized by barriers to entry with incumbents enjoying advantages over potential entrants. This means that the firm that is foresighted enough to enter such a monopolizable area early will be able to monopolize it at a cost lower than that which latecomers would have to expend to wrest the monopoly away. This will result in a rent that will not be competed away by other potential monopolists. Not all of that rent need be the competitive return to investment in information as to the availability of monopoly; some or all of it can perfectly well be traditional monopoly rent. Even where an oligopoly is involved so that the rent-to-entry-investment process is more continuous than in the single-firm monopoly case, entry barriers can relieve incumbents of the necessity of spending all their rents in the effort to protect them from potential rivals.

Monopolies can also be obtained through luck rather than foresight. It is true that, as Posner says (1975, p. 812), if n risk-neutral firms each have an equal chance of obtaining a monopoly with a present value of V, each of them will be willing to spend V/n in an effort to secure the monopoly. Nevertheless, it does not follow that a total of V will in fact be spent (even apart from the question whether risk neutrality is a good assumption). Whether the total is spent depends on the mechanism that produces the monopoly. If the monopoly is achieved before V is spent or if the marginal effect of expenditure on the chance of securing the monopoly falls to zero before V/n is spent, then firms will not in fact spend so much. Only the unsupported assumption of constant returns in the activity of securing a particular monopoly produces a mechanism that leads to Posner's result-and then only if one ignores the dynamics that may lead one firm to shut out others.

Note, however, that the fact that resources are expended on the attainment of monopoly certainly means that there are some cases where what appears as monopoly rent understates the resources spent on rent-seeking activities. Predictions about monopoly profits can overestimate as well as underestimate the amount to be gained, and luck can be bad as well as good. In some cases (private subways in New York City seem a likely example), more will be expended on the rent seeking activity than the actual amount that the rents turn out to be. There is still no mechanism that makes such rents exactly equal the costs and no general presumption that overstatement cases must balance understatement ones across the economy. (Indeed, if monopolies keep on being sought and rent seekers are not risk loving there is a presumption that rents exceed costs.)

The point is that once one starts to think of real examples, Posner's result disappears as a general proposition. The Aluminum Company of America, for example, was well placed to monopolize because of the business it was in, an industry requiring particular mineral resources and cheap energy supply. It was in that business because of the patents it had originally obtained. The fact that it may have been drawn into patent research in aluminum by the possibility of monopoly rents does not alter the fact that

once it was in and had monopolized the business, no further entry into monopolization of aluminum was possible at the same cost, and no entry into the monopolization of other businesses-even businesses with equally attractive monopoly rents-could bid away the monopoly rents already being earned in aluminum. The fact that a risk-neutral company would have been willing to spend the expected present value of all future monopoly rents to obtain the patents in the first place does not imply that they had to spend so much or that they or their potential rivals did so. Once the patents were obtained, at whatever cost, the future monopoly rents were achieved and further expenditure by anyone was pointless.

Much of this can be summarized by considering Posner's statement that "at the margin, the cost of obtaining a monopoly is exactly equal to the expected profit of being a monopolist." If the activity involved is that of obtaining monopolies generally, then that statement is unquestionably true but has no bearing on the issue. If', on the other hand, the activity is that of obtaining a particular monopoly, then the statement is not true. In equilibrium the costs of wresting the monopoly from the incumbent must be at least as great as the monopoly rents to be earned by doing so, but they need not be equal. This means that the incumbent can, in fact, be earning monopoly rents above the costs expended to secure them (the fact that he would have been willing to spend more if necessary has no bearing). Successful monopolists enjoy infra marginal rents, and there is no general mechanism that competes those rents away.

I say no general mechanism, because there clearly are cases in which some such mechanism operates. These are the cases Posner appears to have in mind; they have to do with government-induced monopoly and with regulation.

Potential monopolists are somewhat more likely to be on an equal footing where barriers to entry arise simply through government action than when such barriers arise for other reasons. The picture of resources expended on lobbying for a monopoly license until the eventually successful applicant has spent all the rents to be earned is one of some plausibility. The extent of that plausibility, however, is more limited than may at first appear. Before a monopoly license is given, all applicants may be on an equal basis. Once the license has been granted, however, regulatory authorities may be reluctant to transfer it. The Federal Communications Commission, for example, has almost never failed to renew the television license of an existing station. If incumbents have an advantage over potential replacements in the licensing process, it does not follow that their incumbency rents are no greater than the value of the resources expended to retain them, including the resources expended by unsuccessful applicants.

Furthermore, those rents may exceed even the value of the resources expended to obtain the original monopoly license. It is hard to imagine, for example, that all or most of the originally successful applicants for broadcast licenses in VHF television correctly recognized in the 1940s the size of the rents eventually to be earned or that, if, they did, they had to compete against a large body of unsuccessful applicants who shared that recognition. Moreover, there appears to have been some tendency for successful applicants to have been already involved in radio broadcasting to the extent that the FCC favored such applicants, they earned a monopoly rent even if all applicants recognized the value of television licenses. While it is true that such rent accrued by virtue of the earlier radio license, to

attempt to make it the equivalent of social costs by arguing that radio license applicants all expected and competed for the rents later to be male in television is to strain credulity.

The general point of this example is as follows. Even where government regulation is involved in the production of monopoly, not all potential monopolists will be equally situated. While, in such contexts, Posner is undoubtedly correct that some resources are likely to be expended in getting and retaining the monopoly, and while the resources involved are likely to be greater in such contexts than in those areas that (lo not involve government support, it is still unlikely that the resources expended will match the rents to be earned.

I add one final point related to a use that others have made of Posner's paper rather than directly to the paper itself'. Even were Posner's entire analysis correct and applicable, it would not follow that the benefits of increased or better antitrust enforcement should be taken to include the monopoly rents being earned in those additional industries where the improved enforcement restores competition. The monopoly rents being earned in industries where antitrust cases are brought correspond (in Posner's analysis) to resources already wastefully spent to achieve them. Those costs are investments in monopoly; they are generally sunk costs by the time of antitrust enforcement and cannot be recovered by the removal of the resulting monopoly rents. 3 Only if' the improved enforcement mechanisms apply to attempts to monopolize or if' such attempts are deterred by the improvement can the monopoly rents avoided be said to correspond to social costs that are saved. Whether the deterrent effect of marginal improvements in antitrust enforcement is at all important is, of course, debatable even if that effect is important, decreasing returns to monopolization activity may mean that one catches large-rent monopolies and deters small-rent ones. In any event, the social costs avoided through such deterrence cannot be measured by using the monopoly rents removed in the cases that provide the additional object lessons.

In sum, Posner's analysis does indeed show that the standard analysis of the costs of monopoly as measured only by deadweight loss can understate those costs. While there are thus some circumstances in which some monopoly rents should be included in the construction of such a measure, it is an open question whether those circumstances are so general as to prompt the inclusion of all or nearly all such rents. Broad general theory will not provide the answer here; that answer must rest on a case-by-case analysis.

References

Long, William F.; Lean, David F.; Ravens craft, David J.; and Wagner, C. L., III. Benefits and Costs of the Federal Trade Commission's Line of Business Program. Vol. 2. Staff Analysis. Washington: Fed. Trade Comm., Bur. Econ., September 1982.

Posner, Richard A. "The Social Costs of Monopoly and Regulation."J.P.E. 83 (August 1975): 807-27.

Rogerson, William P. "The Social Costs of Monopoly and Regulation: A Game-theoretic Analysis." BellJ. Econ. 13 (Autumn 1982): 391-401.

Tollison, Robert D.; Higgins, Richard S.; and Shugart, William F., II. Benefits and Costs of the FTC's Line of Business Program: Recommendationos f RobertD . Tollison, Richard S. Higgins, and William F. Shugart II. Washington: Fed. Trade Comm., Bur. Econ., january 20, 1983.