EC2001 Intermediate Microeconomics

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Is competition necessarily beneficial for consumers?

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Introduction.

Throughout economics, it is a time honoured assumption that monopolies are theoretically less efficient than competitive counterparts. I will show, through the comparison of examples of theory and through examples of real world economic conditions how it is that in some particular cases monopoly can be shown to be more efficient than competitive behaviour. This essay compares examples of real world economics found in three studies written in 1996 with examples of commonly taught 'textbook' economics to come to the conclusion that some monopolies have displayed lower prices, an absence of adverse selection, and other beneficial characteristics than competitive firms could possibly do, given that these firms operate in the same type of markets.

Background: competition and price.

To begin with, a definition of 'competition' is required in order to approach the answer from the correct angle. Competition:

> The situation when anybody who wants to buy or sell has a choice of possible suppliers or customers. With perfect competition there are so many suppliers and customers, with such good contact between them, that all traders ignore the effects of their own supplies or purchases on the market, and act as price-takers, able to buy or sell any quantity at a price which they [alone] cannot influence. Such intense competition is rather unusual in real life. The more usual condition is monopolistic or **imperfect competition**, with a limited number of buyers or sellers. In this case buyers or, more usually, sellers realize that the amount they can trade is affected by the price they offer. With **monopoly** there is only one seller...

> Monopolistic competitors have some monopoly power, but this is [or may be] limited in the long run by potential competition from possible entrants to a market...[1]

What is beneficial to consumers?

Agreeably, factors of influence in this regard which consumers will find either beneficial or not will be factors regarding non-price competitive aspects of a particular product/service[2]. Characteristics include those such as quality of product, guarantee of product performance and reliability/track record of the supplying company. More primarily, consumers are looking for the lowest price for similar or same products. A consumer faced with two choices for two identical products produced by two different companies, indistinguishable in terms of quality, guarantees, public opinion and the suchlike, will choose whichever good is the lowest in price. This follows, simply, from the principle of opportunity cost: if the opportunity cost of having to buy something worth £1 is buying something exactly the same for £0.50, then you/I would obviously buy that worth £0.50 (which would make you a net saving of £0.50 in comparison to spending the £1).

In this sense, purely perfect competition is in the consumers interests, although, as I have quoted above, firms in perfect competition are theoretically price takers, but this is not always so in real life.[3] Therefore, the existence of a perfectly competitive market, with prices ruled by the demand and supply mechanism is, admittedly, unreal. In a monopoly situation we have, by definition only one supplier of a good, and in keeping with the *assumption* that perfect competition acts in the consumers' interests, then we might expect that a monopoly would not act in the consumers'

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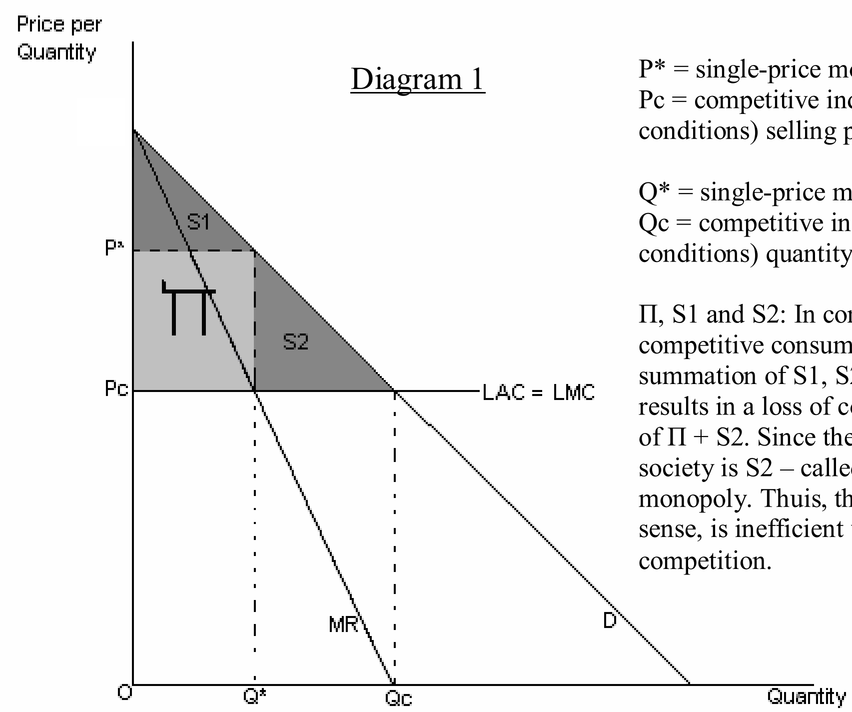
[1] John Black, 2002 (see online bibliography for complete reference).
[2] From hereon in, the word 'product' will be used instead of the term 'product/service'.
[3] "Even this more limited condition [of the assumption of perfect and easily accessible information] will fail in many cases." Frank, 2003, p.375 and "…economists recognize that no industries strictly satisfy the four requirements for perfect competition…" Frank, 2003, p.400.

interests (such as it does not adhere to the perfect competition idea). However, the findings of Thomas von Ungern-Sternberg[4], Stefan Felder[5], Karl Epple and Reinhard Schäfer[6], respectively, claim that moving out of a state-controlled monopolistic situation, to one of *imperfect,* and thus realistic *non-assumptive* competition (which necessarily include non-state controlled/financed actors) we find a detrimental effect on the prices paid by the consumers of these services.

Theory: Efficiency and welfare loss in competition and monopoly.

Diagram 1 shows the graphical theory of the welfare loss (and the inefficiency of) a single price monopoly[7]:



P* = single-price monopolist's selling price.
Pc = competitive industry (operating under same cost conditions) selling price

Q* = single-price monopolist's quantity produced.
Qc = competitive industry (operating under same cost conditions) quantity produced

Π, S1 and S2: In comparision with the perfectly competitive consumer surplus, (identified by the summation of S1, S2 and Π) single-price monopoly results in a loss of consumer surplus equal to the area of Π + S2. Since the monopolist earns Π, the cost to society is S2 – called the deadweight loss from monopoly. Thuis, theoretically, monopoly, in this sense, is inefficient when compared with perfect competition.

Diagram 1 above shows a monopolist (assuming a single price is being charged) will produce Q* units (where MR=LMC). The competitive producer on the other hand, would produce Qc, and

[4] von Ungern-Sternberg, T., 1996.
[5] Felder, S, 1996.
[6] Epple and Schäfer, 1996.

charge Pc – a greater quantity for a lesser price. According to this theory monopoly is inefficient as well as causing a welfare loss.

Under the conditions above, the monopolist charges a single price at a single quantity produced, however, in the case of the regional monopolies in von Ungern-Sternberg's findings. The prices applied in reality will be priced according to the value of that which is to be insured[8].

Theory: Adverse selection.

Adverse selection: -

> The pattern in which insurance tends to be purchased disproportionately by those who are most costly for companies to insure.[9]

This often results in insurance companies having to raise their premiums making buying insurance even less attractive to lower risk people.

Three controversial studies.

In 1996 The European Economic Review published three papers on state run monopoly insurance markets in Switzerland and Germany. One article dealt with the situation in Switzerland after a change in the system from a state run arrangement to one allowing the existence of competition.

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[7] Frank, 2002, p. 439.
[8] This follows from his first graph "*Comparison of Premium rates*" in von Ungern-Sternberg, 1996.

The limits of competition.[10]

This study presents the case of the Swiss system for housing insurance up until 1992/4.[11] The system before this time was run partially as a state run monopoly market (in certain areas) and partially as a competitive market (in other areas). The main arguments that von Ungern-Sternberg has are that the state monopolies charged lower 'premia' (essentially prices) for similar products to the competitive companies' products. His reasons here are that the state run monopolies do not need to spend as much money on advertising and administration as the competitively run companies. The conclusion is that the state monopolies 'outperform'[12] the private sector firms.

von Ungern-Sternberg's paper, whilst suggesting that "the state run monopolies are considerably cheaper than the private insurance companies"[13], also shows that there is a lack of choice for the consumer. Whilst there are overall lower premia on the state side, there also exists a lack of choice due to the state companies being "single product companies".[14] This lack of choice is not necessarily a bad thing. In the paper, von Ungern-Sternberg shows how less competition may benefit consumers through the removal of all competition in order to provide these low price levels. Where innovation is concerned, we should be aware that of all markets, housing insurance markets have a level of innovation that is surprisingly low. So low that we can call such markets "static markets" – and this is apparent from over the past 100 years.[15]

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[9] Frank &Bernanke, 2004, p. 316, & G-1.
[10] von Ungern-Sternberg, 1996 (title).
[11] Op. Cit., Footnote 8.
[12] von Ungern-Sternberg, 1996
[13] Op. Cit., p. 1114.
[14] Op. Cit., p. 1116.
[15] Op. Cit., p. 1118.

Lastly, what would letting the private companies compete against the state run monopolies mean for the consumer? Firstly, this would only work in a 'situation of complete information'[16] As we have seen, it would mean a raising of premia prices and, due to the static situation of insurance markets it would not mean any increase in the quality or range of products available.

The transition from Monopoly to Competiton:[17] Epple and Schäfer, 1996

A second study of a particular and similar market for housing insurance related to the company Gebäudeversicherung Baden-Württemberg (GVBW) operating in the German Federal State of Baden-Württemberg. This study was compiled by Epple and Schäfer (1996), and looks more specifically at the outcomes of a transition from monopolistic market structure to one of competition.

Under monopoly, say Epple and Schäfer, compulsory purchase eliminates the dangers of adverse selection.[18] When all consumers in a market do buy a product then the risk of only those who are higher risks, or only those who are lower risks buying the insurance is, as claimed, eliminated. This is beneficial to the consumer in that the elimination of adverse selection will, in the extreme prevent rising premia prices due to only bad risks buying a product. A second point is that under competitive conditions adverse selection can mean not everyone gets comprehensive insurance.[19] This is due to the fact that:

> competitive insurers 'negotiate' insurance coverage and must, as a result of market-related adverse selection, limit the risk and tailor their product. They have to incorporate

[16] Op. Cit., p. 1119.
[17] Epple and Schäfer, 1996, (title).
[18] Op. Cit., p. 1125.

specific risks into their basic insurance package by means of risk mark-ups, exclusion of liability, sum limitations, and if necessary high deductibles; they therefore automatically and unavoidably provide narrower insurance coverage.[20]

Furthermore, Epple and Schäfer corroborate what von Ungern-Sternberg has said, showing that "premium rates for house-owners have increased by 84% to 117% since June 1992"[21]

Finally, we have the case of Stefan Felder's *Fire insurance in Germany*.[22]

Felder is concerned with the consequences of different types of market (either monopoly or competition) on the price performance of insurance companies. Firstly, Felder's evidence is greatly in favour of the two preceding papers, showing monopolies to have 22% lower markup[23] on damage payments in comparison to those of competitively operating companies. Felder also gives the average premium rates of competitive and monopolistic firms showing the competitive companies to have a definite higher average than monopolistic firms. As well as confirming the findings of the other two studies, Felder also says that economies of scale exist in both markets, but the *more* scalar economies are monopolistic ones. Furthermore, these monopolistic economies of scale are even *too small*[24], thus it follows that if the monopolies were in fact kept, and competitive companies were to be declined, we would see greater economies of scale in the monopolistic firms as contrasted against the possible economies of scale from competitive firms.

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[19] A non-benefit for consumers who want to be insured but cannot do so due to prices that are too high.
[20] Op. Cit., p. 1128.
[21] Op. Cit., p. 1130.
[22] Felder, 1996, (title).
[23] Op. Cit., p. 1133.

Conclusions.

When we contrast these three studies' finding with the normal models of monopoly we have considered, we see the outcomes are quite contrary to those we would normally expect. Theory tells us that monopoly situations are less efficient than perfectly competitive situations, however, reality shows us that in some cases when we look at situations involving a move from monopoly into competition, we find lower premium prices throughout, less spending on advertising and administration leading to the performance of monopolies surpassing that of competitive firms. The lack of choice on behalf of the consumer is more than compensated for by these better criteria of performance. The lack of profits does not hinder the industry due to its status as a static market for over a century. Furthermore, the dangers of adverse selection are forgone in a system where purchase is mandatory, as all consumers must participate. This helps with the prevention of rising prices due to bad risks. Finally, these specific types of monopolies can be described as having better economies of scale for exploitation than competitive firms operating in similar markets. Overall then, we have shown that competition *is not necessarily beneficial for the consumers*.

[24] Op. Cit., p. 1137.

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