INEQUALITY AND COMPETITION POLICY

BY BRUCE LYONS [1]

I. INEQUALITY AND COMPETITION

Market power affects inequality in at least two ways. First, monopoly profits disproportionately accrue to the rich, even if some can be captured by employees.[2] Second, the consumption patterns of the poor may be disproportionately biased towards low elasticity products sold in less competitive markets.[3] Inasmuch as competition policy reduces market power, it is therefore an important force for limiting inequality. However, not all sources of competition reduce inequality. In particular, globalization has been a major competitive force in recent decades, but it has also raised inequality in developed countries by affecting incomes at both ends of the income distribution.

At the lower end, foreign competition has exerted downward pressure on the wages of unskilled labor, particularly in concentrated markets where workers could previously demand a share of the profits.[4] At the upper end, globalization has increased the reward for success:

> The relative fall in the incomes to be earned by moderate ability, however carefully trained, is accentuated by the rise in those that are obtained by many men of extraordinary ability… The causes of this change are chiefly two; firstly, the general growth of wealth; and secondly, the development of new facilities for communication, by which men, who have once attained a commanding position, are enabled to apply their constructive or speculative genius to undertakings vaster, and extending over a wider area, than ever before.[5]

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2 An early attempt to capture this was by Comanor & Smiley. They suggest that 93 percent of the population is made worse off by the presence of monopoly power, and that this effect is substantial (e.g. accounting for over half of the wealth of the top 0.27 percent of households who control 18.5 percent of U.S. wealth). However, their methodology makes some very bold assumptions and is based on 1962 data. Comanor & Smiley, "Monopoly and the Distribution of Wealth," *The Quarterly Journal of Economics*, Vol. 89, No. 2 (May, 1975), pp. 177-194.

3 An attempt to link income distribution to consumption patterns and demand elasticities is given by Creedy & Dixon, "The Relative Burden of Monopoly on Households with Different Incomes," *Economica*, Volume 65, Issue 258, May 1998, Pages 285–293. My CCP colleagues Davies & Mariuzzo are currently working on the distributional effects of market concentration using income elasticities of demand.

4 Borjas & Ramey, "Foreign Competition, Market Power, and Wage Inequality," *The Quarterly Journal of Economics*, Volume 110, Issue 4, November 1, 1995, Pages 1075–1110.

5 Marshall, *Principles of Economics* (1890) Book VI ch XII.

Alfred Marshall presumably had the railways, steam shipping and recorded voice in mind when considering the effect of "new facilities for communication" in 1890. The mechanism is the same in the twenty-first century, but global development, international trade, the internet and technology based products have increased the scale of Marshall's "wider area" effect by an order of magnitude.

The stagnation of the majority of personal incomes since the Financial Crisis, academic studies of the growth of inequality[6] and a growing awareness that those at the top of large firms and other organizations have been bucking this stagnation by awarding themselves large pay increases, typically unrelated to performance, has fueled the current political interest in whether there should be an enhanced role for competition policy in addressing inequality.[7]

II. THE RECEIVED ECONOMIC WISDOM ON POLICIES TOWARDS INEQUALITY

Many economists derive their intuitions from the Two Fundamental Theorems of Welfare Economics, which provide a very powerful justification for separating concerns about economic efficiency and inequality. The first states that if there is a complete set of competitive markets (and a few other conditions such as no information asymmetries), then no one can be made better off without making someone else worse off (i.e. Pareto optimality).[8] The second states that any income distribution can be sustained by competitive markets if the appropriate tax and social security instruments are in place (in particular, non-distortive [lump sum] taxation and transfers that do not affect incentives). Put simply, if all these conditions are met, we can use competition policy to achieve efficiency and tax/social security policy to achieve the desired distribution across individuals or households. This view is hard-wired into an economics training and it is why the best economists have cool heads when thinking about efficiency and warm hearts when thinking about distribution.

However, economists are also well aware that the strict conditions for this separation of efficiency and distribution policies does not hold in the real world. Furthermore, practical policy always has a historical context which inevitably includes elements which cannot be changed when considering current policy design and implementation. For example, we cannot assume that taxation and social security policies are always set appropriately. The issue then becomes: to what extent should competition policy be used to address concerns other than economic efficiency?

I deviate briefly into another inequality debate before returning to my answer. Press stories on inequality are often framed in terms of disparities within an organization. For example, the UK press has recently been full of stories about the excessive pay of Vice-Chancellors (i.e. heads of universities), which has been rising far faster than academic salaries. This framing of inequality within the firm offers lawmakers a cheap response that avoids the difficulty of raising taxes on the rich or the cost of subsidizing incomes for the poor. For example, the UK Conservative government recently committed to legislate to require quoted companies to:

> Report annually the ratio of CEO pay to the average pay of their UK workforce, along with a narrative explaining changes to that ratio from year to year and setting the ratio in the context of pay and conditions across the wider workforce; and provide a clearer explanation… of potential outcomes from complex, share-based incentive schemes.[9]

6 Baker & Salop (2015) provide a very helpful guide to the literature, including research by Thomas Piketty, Emmanuel Saez and others. See Baker & Salop, *Antitrust, Competition Policy, and Inequality*, The Georgetown Law Journal Online, Vol. 104.1, 1-28.

7 For an analysis of the corporate governance issues that have allowed this to happen, see Bebchuk & Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation*, (Harvard University Press, 2004).

8 The Fundamental Theorems are proved rigorously in the context of a general model of neoclassical competition (including a focus on the output of given goods). Many competition economists (and lawyers) also have a view of competition as a process, with the objective of competition policy being to keep open the ability of rivals and entrants to challenge existing suppliers. Although there is no equivalent of the First Fundamental Theorem for, say, Hayek's view of competition, it remains that competition is seen as the driving force behind an efficient economy.

9 *Corporate Governance Reform: The Government response to the green paper consultation*, August 2017.

The hope is that this will encourage greater engagement with shareholders and workers, which might result in remuneration committees modifying their policies. What has this to do with competition policy? It provides an example of how inequality-driven policy does not always operate at the macro level. The introduction of inequality concerns into competition policy would similarly have a focus on individual firms, or possibly markets.

Observed inequality depends on a) inherited endowments of wealth and ability; b) individual preferences over how to use those endowments including how much effort to put into education and work; and c) luck. These combine to result in the level of *ex-post* inequality. They also influence how we form our moral judgements of what is fair or unfair, though not always in a straightforward way. For example, the luck of winning a lottery that anyone can enter does not generate the opprobrium of a CEO exploiting a monopoly (think Martin Shkreli for an extreme case). Our view of fairness comes from the process by which inequality has been generated. If the process is considered fair, the observed inequalities are typically considered fair. This provides a possible basis for addressing inequality within the framework of antitrust, because enforcement takes place precisely against those firms who have been acting anticompetitively (i.e. unfairly), and leaves alone firms whose market position was attained by offering good products at attractive prices. However, this is a subtle argument that may not be widely appreciated. Practical policy must also consider the implications of a particular intervention in one market for other apparently similar markets, and there is a danger of a cascade of interventions against all profitable firms, including those who have achieved their profits fairly by greater efficiency and providing consumers with better products at a lower price.

III. BAKER & SALOP'S OPTIONS FOR INTRODUCING INEQUALITY CONSIDERATIONS

Baker and Salop (2015) provide an excellent starting point for considering the possibilities. They offer seven ways in which competition/antitrust policy might be reinforced to address concerns arising from inequality. Their stated aim is not necessarily to advocate the virtues of each but to open up a discussion. In this spirit, I briefly consider their seven suggestions and highlight how some of them have already been applied in the UK, before adding two more of my own. Their first two suggestions are to maintain a focus on the consumer welfare standard, and to increase antitrust agency budgets to facilitate greater enforcement and deterrence. I consider both to be clearly good ideas in the current context, so I move straight on.

Their third suggestion is to prioritize cases that benefit the middle class and the less advantaged. In practice, an agency that becomes aware of a possible cartel must follow the lead, even if that is, for example, suspected price fixing between elite private schools.[10] It is also important to develop a deep deterrence culture across all types of business. Having said that, this prioritization is justified at the margin both to modestly address inequality, and to encourage public opinion to buy into the advantages of a strong competition policy. In the UK, the market investigation regime has been used recently to investigate payday lending (which is a form of credit used only by the poor), domestic energy and personal current accounts (both of which are income inelastic so pricing practices have a disproportionate effect on the poor).

Baker & Salop's fourth suggestion is to design remedies to benefit less advantaged consumers, "for example, this might involve divestitures or price caps placed on certain products and technologies targeted at less advantaged buyers." In the UK, the energy market investigation set a time-limited price cap on pre-payment meter tariffs (which are exclusively used by the poor). This was justified by the lack of competition in this market segment, and not on direct inequality grounds. A concern remains that the price cap will deter entry and innovation in this market segment, and result in little long term benefit to the poor.

Their fifth suggestion is to rebalance regulatory standards in order to worry less about over-deterrence and more about under-deterrence. This seems difficult where independent courts are involved and it could be arbitrary in administrative systems. The basic standard of proof should remain whether the behavior is more likely than not anticompetitive. In any case, it is not clear how this proposal would particularly address inequality issues.

10 As investigated in the UK by the OFT "Independent schools: exchange of information on future fees," (2006).

Baker & Salop's sixth suggestion is to recognize excessive pricing by dominant firms as an antitrust offence. This is seen as more radical in the U.S. than it is in Europe, but even European jurisdictions have found that it is fraught with problems.[11] The first set of problems relates to the (dis)incentives created by prosecuting high prices charged by firms that have broken no law. For example, firms may take fewer risks and invest less in quality or R&D if they fear they will not be able to reap the reward. This may be a particular problem where technology is moving fast (e.g. winner-takes-all technology battles mean that the winners must expect to achieve a high reward that reflects not only their own costs but also the costs of the losers). The second set of problems relates to the huge difficulty of benchmarking prices. Even with homogeneous products and simple linear prices, prices must be compared with those in similar, separate geographic markets or with a measure of costs. There then needs to be a judgement of what gap is "too high." Given the complexity of products and pricing, there is a tendency to fall back on a measure of profitability, but this is also fraught with difficulty. In the UK, the CMA has attempted to use profitability to measure exploitative prices in a number of recent market investigations, but its analysis has been far from convincing. In private healthcare, its price comparison analysis was deeply flawed and withdrawn before appeal. Its substitute profitability analysis could not sustain a case for divestiture, which it had wanted to pursue.[12] In domestic energy, the CMA could not find excessive actual profitability so it argued that the leading firms were inefficient. The CMA consequently made an adjustment to each firm's profitability on the grounds that their measured costs were too high, and concluded that consumers were being ripped off. Although these were not dominant firms in the sense Baker & Salop probably envisaged, these cases do illustrate the extreme difficulty of prosecuting excessive prices both conceptually and evidentially.

Baker & Salop's seventh suggestion is to legislate to adopt inequality as an explicit, additional antitrust goal. An inequality consideration alongside competition would in effect be a public interest test. These have a long history, particularly in merger control, but the trend in recent decades has been to move towards a single focus on competition. The reasons are familiar. In particular, a competition test can be applied by an independent expert competition authority at arm's length from elected politicians. This facilitates a clear economic approach to enhancing the efficiency of the economy, with the associated indirect benefits for reducing inequality. Experts in antitrust enforcement have neither the skills nor electoral mandate to weigh competition against inequality if there is a trade-off, and if there is not, then an inequality objective is redundant.

To this list, I add two further types of intervention for consideration. Both have been applied by UK regulators in the context of their market investigation powers, which allow the CMA to apply strong remedies on markets in which no firm has contravened conventional antitrust laws. Sector regulators can also conduct market studies, though they have different remedy powers.

IV. EMPOWERING CONSUMERS TO GET ACTIVE AND MAKE MARKETS WORK

Traditional competition policy focusses on the supply side – anticompetitive behavior by firms. The fundamental idea is that if there are sufficient firms fighting for customers by offering better products at lower prices, then consumers will choose the product that offers them the best value. However, it is clear that in many markets consumers do not do this. This may be for a variety of reasons. For example, firms may be deliberately obfuscating so as to make comparisons difficult. However, the fundamental problem, whether or not it is deliberately exploited by firms, is a simple lack of engagement by consumers who often make their choices by default or some crude rule of thumb (i.e. "behavioral consumers").[13] This is not necessarily an identifiable group of individuals, because most of us act "behaviorally" in some situations. However, inasmuch as the poor are less likely to have access to the right information to make the best choices, then this may contribute to inequality.

11 See Lyons, *The paradox of the exclusion of exploitative abuse* and other chapters in *The Pros and Cons of High Prices* (2007), published by the Swedish Competition Authority.

12 Declaration of interest: I co-authored an expert report commissioned by the main party on the *CMA's analysis of profitability in the Private Healthcare Market Investigation Remittal Inquiry*; I also advised a leading supplier in the energy market investigation.

13 For an accessible introduction to behavioral consumers, see Kahneman, *Thinking Fast and Slow* (2011).

If there is a single price, the existence of disengaged customers reduces the elasticity of demand because only a part of the market responds to price. This conveys market power to firms unless they are competing so fiercely that elasticity does not matter. The consequences of behavioral consumers for competition change substantially if firms can price discriminate. For example, it may be possible to use information on internet searches or on personal histories of purchase to make individual offers of a higher price to disengaged customers and a lower price to active customers. Another important example is where customers have default contracts (e.g. with energy providers or banks) so "loyal" (i.e. disengaged) customers can be left on expensive or otherwise unattractive contracts, while active switchers can get much better deals. The difference can be substantial, running into hundreds of pounds sterling.[14] High levels of competition in the market may limit profits at the same time as driving firms into widening the gap in prices paid by the active and the disengaged.

What remedies should be applied? The identified problem is with consumer behavior, so it is appropriate to remedy the demand side. The possibilities are often market specific, but they generally fall into three categories: providing consumers with better information (e.g. standardized price comparisons, quality and service metrics); facilitating consumer search (e.g. by combining personal usage data with price and quality information on search websites); and facilitating switching (e.g. phone number portability or compensation for interrupted service). The CMA has used its powers in recent UK market investigations to impose a wide range of such measures (e.g. in energy and retail banking but also many other consumer markets). Information technology is making this type of intervention increasingly possible.

However, their effect on inequality is not unambiguous even if the poorest have least access to the information that would help them get the best deal. For example, suppose a utility provider offers lower priced contracts to new customers to attract them away from rivals, and current customers are left on more expensive tariffs (e.g. that no longer include inducements). The gap in prices will be constrained by the threat of current customers switching to a rival who offers inducements. If a demand side remedy makes all customers willing to switch, then that will reduce the price gap. But if the remedy succeeds in making only the marginal non-switchers more active, then it may leave a rump of those least engaged with the market and widen the price gap. Furthermore, demand-side remedies are not costless as they can impose a considerable regulatory compliance burden on firms.

V. DISTRIBUTIONAL CONSIDERATIONS IN THE ANALYSIS OF PRICE DISCRIMINATION

Public finance economists distinguish between vertical equity and horizontal equity in tax systems. Vertical equity is the principle that higher income individuals should pay more tax than those with lower incomes. A similar principle might be applied to price discrimination. In particular, vertical equity would be violated if price discrimination turns out to favor higher income individuals, but not if the rich pay more. It may be that breaches of vertical equity are hidden in complex pricing. For example, the standard personal bank account in the UK is notionally "free" (i.e. no standing charge), but there are very high charges for unauthorized overdrafts. The poor are much more likely to go into unauthorized overdraft than are the moderately wealthy, so they end up paying more for banking.

It would be relatively straightforward to add the observance of vertical equity as a simple constraint in the competition analysis of price discrimination, though enforcement may be more complex. For example, the rich may buy more of a product and so, in a competitive market, be offered savings due to economies of scale. This does not obviously contravene a moral principle of vertical equity, but it highlights the difficulty of implementation.

Supply-side interventions also have a greater potential for counterproductive effects. Picking up from the example used to illustrate potential problems from demand-side remedies, if the remedy were to require firms to put all existing customers on the same tariff as new customers, it is unlikely that everyone would now benefit from the lower tariff. Instead, firms would find it more profitable to bring tariffs up to the current-customer price or higher, because rivals would have to make an expensive across-the-board price cut in order to attract marginal switchers. Thus an intervention motivated by a concern for inequality could end up reducing the incentive to cut prices, and making everyone worse off (except the suppliers).[15]

14 See recent market investigations by the CMA.

15 For a real example of this effect in the UK domestic energy market, see Hviid & Waddams, *The Economic Journal*.

Horizontal equity is the principle that people with the same income should pay the same taxes. It is usually justified on the grounds that it provides a safeguard against arbitrary discrimination. While attractive in the context of tax setting, horizontal equity considerations do not extend well to price discrimination. For example, individuals of similar income will buy a wide range of products and it seems no great issue if person A buys one half of her shopping basket cheaper than does person B, and the other half more expensively.

VI. CONCLUSION

Market power promotes inequality even if it is not the main cause. This means that a well-funded and vigorously enforced competition policy with a consumer focus is an important adjunct to tax and social security policies in reducing inequality. It is possible to go a bit further in applying inequality considerations to competition case selection, analysis and remedies, but there are no simple solutions. Furthermore, there are many pitfalls, including unanticipated response by firms and misleading precedents for activist intervention. These suggest we should adopt a cautious approach to policy developments that try to bring inequality directly into competition policy.