

*Market power fosters creative production.*

# In Defense of Monopoly

BY RICHARD B. MCKENZIE

*University of California, Irvine*

**W**ith renewed dedication, antitrust enforcers on both sides of the Atlantic appear intent on saving the world from the evils of monopoly. Microsoft has been the poster child for targeted antitrust investigation and enforcement in the United States since the early 1990s. The Clinton Justice Department took the software giant to court in 1998 for using its considerable dominance of the operating system market, protected by the so-called “applications barrier to entry,” to “bolt” its Internet Explorer web browser to its Windows operating system and thus to destroy browser competitor Netscape and undercut competition and consumer welfare — supposedly. After a rough ride through the federal district court (in which the presiding judge discredited himself by revealing a private animus toward Microsoft in a secret media interview while the trial was underway), an appeals court agreed that Microsoft was a “monopoly,” but it found no anti-competitive fault with Microsoft’s enhancing Windows with Internet Explorer. (Besides, by the time of Microsoft’s trial, all other available operating system developers had integrated browsers because of the growing importance of the Internet.)

The European Commission has not been so charitable to Microsoft. In 2004, the EC found that Microsoft was in violation of Europe’s competition law because the company made it difficult for software developers to create programs interoperable with Windows. The EC required Microsoft to make available its “protocol technology” and, after legal delays, compliance misfires, and the EC’s imposition of fines totaling \$2.5 billion, the company released 30,000 pages of software code.

The EC then held that Microsoft had violated the continent’s competition law by tying its Media Player to Windows. Microsoft caved to the EC, offering in 2005 to provide two ver-

sions of Windows XP at the same price, one with and one without Media Player.

In 2008, the EC followed the U.S. Justice Department’s lead, deciding that “Microsoft’s tying of Internet Explorer to the Windows operating system harms competition between web browsers, undermines product innovation and ultimately reduces consumer choice.” Bruised by its past futile legal maneuvering with the EC, Microsoft again offered a remedy in mid-2009 to the new antitrust complaint: the company would introduce an opening “ballot screen” in its forthcoming Windows 7 that would allow European buyers to easily download one or all of several competing browsers and to deactivate Internet Explorer. Stay tuned to see if the EC will be satisfied with Microsoft’s proposal.

Back on this side of the Atlantic, the Antitrust Division of the Obama Justice Department gave notice in early 2009 that it intends to investigate AT&T’s contract with Apple that makes AT&T the sole network on which Apple’s extraordinarily popular iPhone can be used. Moreover, the Federal Communications Commission in mid-2009 indicated that it intends to investigate Apple’s refusal to include Google Voice, an application that permits users to make Internet phone calls, on its iTunes site for downloads to iPhones. Apparently, the FCC fears that Apple’s rejection of Google Voice bolsters AT&T’s presumable monopoly delivery of phone calls through the tens of millions of iPhones in subscribers’ hands.

Antitrust enforcers on both sides of the Atlantic appear dedicated to taking on a monopoly wherever it raises its wicked head in markets. Never mind that antitrust enforcement everywhere has a dubious record on actually promoting competition. During the last century, antitrust enforcement has consistently suppressed competition by frequently restraining the market moves of large firms at the behest of their smaller competitors, a point supported in voluminous scholarly literature on antitrust enforcement. Three decades ago, Robert Bork spoke bluntly for many antitrust economic and legal scholars when he wrote, “[M]odern antitrust has so decayed that the policy is no longer intellectually respectable. Some of it is not respectable as law; more of it is

**Richard B. McKenzie** is the Walter B. Gerken Professor of Enterprise and Society in the Merage School of Business at the University of California, Irvine. He is the co-author (with Dwight Lee) of *In Defense of Monopoly: How Market Power Fosters Competition* (University of Michigan Press, 2008).

not respectable as economics; ...a great deal of antitrust is not even respectable as politics.”

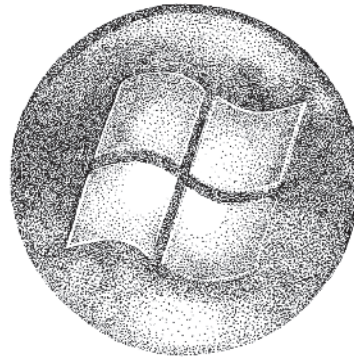
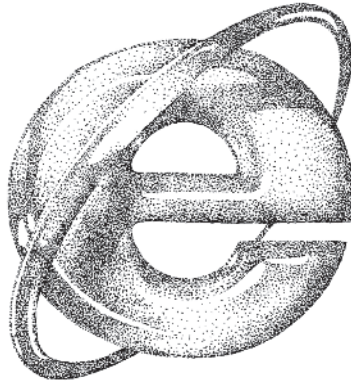
Over the past three decades, the record of antitrust enforcers has improved little to none. A targeted firm’s competitors continue to prompt enforcers both here and abroad to take action. During the 1990s, Microsoft competitors — Netscape, IBM, Sun Microsystems, WordPerfect, Oracle, and others — pressed the Justice Department to sue Microsoft for tying Internet Explorer to Windows even though only one of them, Netscape, had a browser. RealNetworks pushed the EC to force Microsoft to untie Media Player from Windows. The makers of the Opera and Firefox browsers pressed the EC’s demands on Microsoft to integrate competitors’ browsers into Windows. And in 2008, when Google and Yahoo sought to team up to display Yahoo’s ads on Google search results, Microsoft supported the Justice Department’s threat to investigate the joint venture for antitrust violations, which caused Google and Yahoo to part ways.

### TEXTBOOK MONOPOLY

Many economists and antitrust lawyers have concluded that the problem with antitrust enforcement largely has been a matter of wrongful application of monopoly theory. A better diagnosis is that a deeply flawed conventional monopoly theory has misguided, and continues to misguide, enforcement.

All budding antitrust lawyers and economists learn the conventional monopoly theory, which is almost always depicted with a graph like Figure 1. From such a graph and underlying theory, four theoretical conclusions, all of which paint monopoly as nothing less than a source of “market failure,” are drawn:

- Monopolies everywhere lead to curbs on production to achieve higher-than-competitive prices. That allows a monopoly to collect “rents” — supracompetitive profits — and impose an “inefficiency” or “deadweight loss” on markets. In Figure 1, the monopoly restricts production, reducing it from the competitive output level where price equals marginal cost, to the point where marginal revenue equals marginal cost. That enables the firm to raise its price to the monopoly price, which is above the competitive price (and the marginal cost of production). Efficiency in the allocation of resources is always fully maximized when price equals marginal cost, or so students are required to repeat in rote fashion.
- The monopoly benefits from barriers to competitors’ entering the market and thus gains pricing power (caused by market dominance, if not just bigness), a practice that is (conventionally) antithetical



to competition and welfare gain. The barriers enable the monopoly to maintain its supply constraint, monopoly profits, and the deadweight loss of consumer welfare.

■ The monopoly achieves rents that are unearned and forcibly

taken from consumers’ “surplus value” (the whole of the area under the demand curve and above the marginal cost curve in Figure 1).

- “Perfect competition” — a market in which all resources are perfectly fluid and in which monopoly rents are nowhere achievable — should be viewed as the goal to which antitrust enforcement presses real-world markets. Then, consumers would get their entire consumer surplus (including the striped rectangle and triangle in the graph), which is to say that consumer welfare is maximized.

The conclusion is that antitrust enforcers enhance consumer welfare when they prevent or destroy barriers to market entry and increase the number of competitors — and thereby undermine the market power of monopolies.

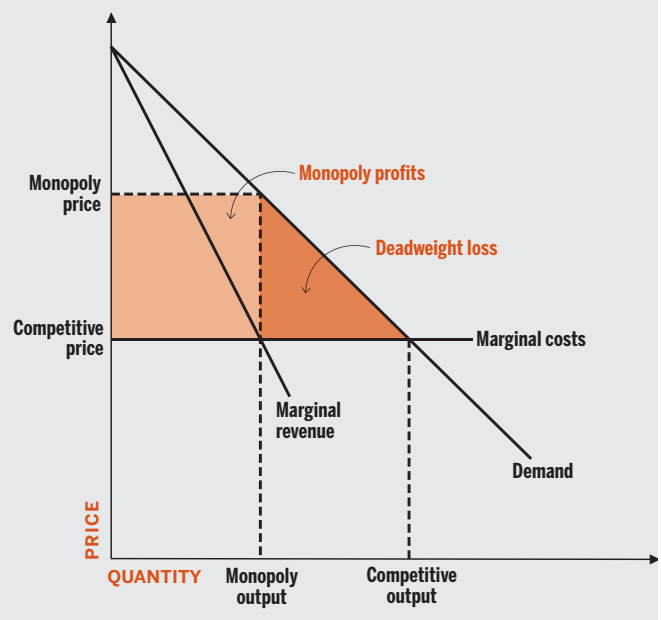
### THE REAL WORLD

That is all nice in theory, but it is grossly misleading for several reasons.

From the theory on which antitrust law is founded, one has

Figure 1

### Monopoly Market Model



to wonder why competitors to a dominant monopoly firm would press for antitrust complaints against a monopolist when the monopolist acts like one — that is, when it curbs production to hike its price. Would that not mean the monopoly would be giving its competitors a chance to gain market share even with higher prices? Would competitors really want their market to be made even more competitive through antitrust enforcement, as Microsoft’s competitors indicated they wanted when they proposed the breakup of Microsoft into two “Baby Bills”? Clearly, William Baumol and Janusz Ordover damned much antitrust enforcement when they observed, “Paradoxically, then and only then, when the joint venture [or other market action] is beneficial [to consumers], can those rivals be relied upon to denounce the undertaking as ‘anticompetitive.’”

Notice also how the theoretical model rigs the debate. Both in Figure 1 and in abstract discussions of monopoly, the monopolized product and the monopoly itself are subjected to analysis only after the firm and product have come to dominate the market. Nothing is said about how the monopoly arose. Could it not have arisen by besting its competition with a superior product at a lower (or even higher) price?

**IGNORING THE GOOD** Setting that issue aside, in the market model portrayed in the graph, any output level below the idealized competitive output level that the monopoly causes is considered to be detrimental to consumers. Consumers have less to buy and must pay an inflated price for what they are able to buy because of the monopolist’s constricted market supply. Thus, the argument goes, consumers lose the potential welfare gain that goes up in the smoke of the monopoly profits and in the market inefficiency. Because the good itself and all that went into bringing it to market are not considered by the analysis, the analysis simply assumes that the monopoly has no just claim to any consumer surplus.

However, products bought and sold in real-world markets do not appear by assumption or fall like manna from heaven. Monopolies do not achieve their dominance for no good reason (unless established by government fiat). Products and their markets have to be created and developed with significant initial investments. Once those points are recognized, a monopoly that is alone responsible for achieving its market dominance will not want to restrict output. On the contrary,

- The monopoly expands total output along with the array of available products.
- The monopolist does not charge higher prices; it lowers them.
- Consumer welfare is not lowered; it is elevated (at the very least equal to the triangular area in Figure 1 that is above the monopoly price and below the demand curve).
- The monopolist does not produce inefficiently; the identified inefficiency area in the graph would not likely exist in many monopolized markets were it not for the prospect of monopoly profits.
- Without the monopoly product, many products of

monopoly would not exist in the first place.

- Rents are not an unjustified cash grab, they are likely the impetus for creating the product in the first place.
- When the product is created by the monopoly, the assertion that the monopoly has no just claim on the consumer surplus surely loses at least some of its force.

Of course, a monopoly would not restrict its output and elevate its price if it faced perfectly competitive market conditions. But if a potential monopolist anticipated anything close to perfectly competitive market conditions, it would not create the good in the first place because there would be no incentive to do so. In a market with complete resource fluidity, a firm would be foolish (and negligent to its stakeholders) to incur the product and market development costs of a new product because such costs are not recoverable in totally fluid markets. All prospects for recovery of development costs would be wiped out as numerous producers replicate the newly created product at zero development costs, forcing down the price of the good to the marginal cost of production. It follows that where there are no barriers to entry, product and market development costs cannot be recovered and “monopolized” products and their markets will not be developed, leaving consumers less well off.

The idealized competitive price, which equals marginal cost, becomes all the more absurd as a viable price when the marginal cost of production approaches zero, which is the case for many digital goods. A competitive price of zero is hardly a price that is sustainable, given product and market development costs in addition to production costs — unless, of course, the product is a “give-away” that enables producers to charge monopoly prices on some other product tied to the give-away.

Indeed, in the real world where entrepreneurs create goods, the idealized competitive price (which equals marginal cost) is hardly a better signal of what products should be produced because it captures little (actually none in Figure 1) of the value of the product to consumers. Instead, a monopoly price can more efficiently direct entrepreneurial energies because such a price captures more of the value of the product than the competitive price, a point that Paul Romer has made with force. (Remarkably, economists typically start their classes by heralding the mutual benefits from trade going to trading partners, only to later idealize the perfectly competitive market in which producers receive no net gain from production while consumers who had nothing to do with the product and market development get all the gains.)

Paradoxically, the potential for market power over price through the generation of new products can lead to greater competition in markets than when there is a complete absence of market power, which is the case under so-called perfect competition. Perfect competition is far less “perfect” in terms of generating consumer value over the long run than markets with more constricted resource fluidity.

Think about it: how much entrepreneurial and intrapreneurial effort is being applied right now to the development of products and markets where there is no chance of making



(directly or indirectly) at least enough monopoly rents to cover product and market development costs? Indeed, the exact opposite occurs. Firms are constantly searching for potential products that come with natural entry barriers or harbor the prospect of being protected by artificially created and continually fortified entry barriers with, if nothing else, ongoing product improvement. As opposed to being destructive of consumer welfare, entry barriers in some form and at some level are essential for product and market creation — and for the advancement of consumer welfare beyond what can be achieved when products are given.

Antitrust enforcers decry “monopoly prices” because they cause monopoly rents. But how many consumers and firms would want to deal with firms that make zero monopoly profits and stand always on the brink of being supplanted by competitors at the slightest of errant moves? Firms in such markets cannot make credible commitments to do what they say they will do.

The standard models of monopoly and perfect competition that all antitrust enforcers learn set aside a reality of markets: the vast majority of new products (and even new firms) fail. Under such market conditions, the potential for monopoly prices and profits on the relatively few successful products are absolutely essential, just so that the development costs of all products — the successful and unsuccessful — can be covered with some margin left over. Otherwise, firms would not systematically take on the risk associated with the development of an array of products.

### **BACK TO MICROSOFT**

When the U.S. Justice Department took Microsoft to court in 1998, it chided Microsoft for having developed its market dominance on the back of “network effects” and consumer “switching costs.” Network effects mean that the value of the product to consumers increases as more consumers adopt the product. Switching costs mean that consumers cannot easily move to an alternative product. The Justice Department never realized that its network-effect/switching-cost arguments together mean that consumers have a strong interest in the maintenance of the network — and of the network-good producer, Microsoft, taking strong action to prevent the dissolution of the network through the entry of alternative producers.

Finally, for sake of argument, let us assume that a firm — call it Microsoft, Apple, or Google — is the worst of monopolies as conventionally conceived. It constricts output in order to hike its price and profit to the limit, resulting in the maximum inefficiency in its market. Is such a firm a drag on the economy, on balance and over the long term? Conventional monopoly theory offers a resounding “yes.” But not so fast. There could be an untold number of firms out there busting their organizational butts to create an array of heretofore unknown products at their own expense because they want to be like the monopoly that is making monopoly profits.

Paradoxically, monopolized markets can be more creative, competitive, and welfare enhancing than the most perfect of perfectly competitive markets. Indeed, perfectly competitive markets would be totally stagnant markets, if they could

exist, which is unlikely because no one would have an incentive to create and develop the products and their markets in the first place. Moreover, antitrust enforcers who seek to impose their version of a “competitive” market based on wrongheaded lessons learned from standard monopoly theory very likely can impose more damage — inefficiency — on the world’s economy than their targeted “monopolies” ever could do.

Joseph Schumpeter is renowned for coining the term “creative destruction,” a term most people either misinterpret or do not understand. Schumpeter had in mind a subtle point that needs to be emblazoned in the corner of the computer screens of all antitrust enforcers everywhere:

A system — any system, economic or other — that at every given point in time fully utilizes its possibilities to the best advantage may yet in the long run be inferior to a system that does so at *no* given point in time, because the latter’s failure to do so may be a condition for the level or speed of long-run performance.

The prospect (and the necessary reality) of monopoly power and profits at some level is a necessary and crucial market force driving so much creativity and competitiveness and, thus, long-term maximization of resource efficiency and consumer welfare. Particular products might be protected by barriers to entry from replicators of the product, but new ideas incorporated in new and improved products cannot be denied. Or as Schumpeter observed, “The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers’ goods, the new methods of production or transportation, and the new markets, the new forms of industrial organization that capitalist enterprises create.” It does not come from simple price competition, as so many conventional microeconomics courses wrongly stress.

Unlike the price competition idealized in conventional monopoly discussions, competition from new ideas incorporated into new and improved products strikes “not at the margins of the profits and the output of the existing firms but at [the firms’] foundations and their very lives.” Without including an analysis of this type of non-price competition, Schumpeter argues, any discussion of markets, even though technically correct, is as empty as a performance of “Hamlet without the Danish prince,” — a point that Schumpeter would surely stress to modern-day antitrust enforcers on both sides of the Atlantic. **R**

### *Readings*

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- “Use of Antitrust to Subvert Competition,” by William J. Baumol and Janusz Ordover. *Journal of Law and Economics*, Vol. 28 (May 1985).