

SESSION 6: More Market Failure: Monopoly and Asymmetric Information

1. What does Amazon do to address this problem? [the problem of credibility]

To begin with, the Internet remains something of a “wild west” environment. Many people are still not online – partly because due to trepidation over being bilked – and many who are connected are reluctant to give money to sellers unknown to them. While this may seem strange to you Internet generation members, how long did it take for your parents or grandparents to get comfortable using an ATM? (“When the transaction doesn’t work, whom do I complain to?”)

To address this problem, Amazon makes enormous investments in its reputation through advertising. To be sure, some of this advertising is undertaken to alert consumers to the existence and features of Amazon.com. But much of the advertising is undertaken to promote consumer confidence in Amazon. Amazon’s advertising is an excellent example of a nonsalvageable investment (as in Klein and Leffler). If Amazon deals badly with lots of customers, their reputation will be ruined, and their brand investments will be unrecoverable. To the extent that bad customer service by Amazon can destroy their reputation, the advertising expenditures are like a bond posted by the firm to convey how hard – and honestly – they will work to satisfy customers.

2. How does the nature of the nonmarket environment - and in particular the effective cost of enforcing contracts - affect barriers to entry in this market?

If potential customers are concerned about whether sellers will do what they say – or whether they are operating from the Cayman Islands and lying to them outright – then potential customers’ confidence in online sellers’ claims is important to whether those customers will buy. How can customers be made confident?

One way is for the nonmarket environment to provide strong inducements to honesty. For example, the government can provide not only laws but strong enforcement that credibly promises to catch and punish commercial liars. In that case virtually anyone can be credible with no investment in reputation. At the other extreme, if the nonmarket environment provides no inducements to be honest, then a firm’s credibility depends only on the actions it takes to create its reputation for honesty. These actions, such as Amazon’s advertising, can be expensive and therefore constitute a potential barrier to entry (or at least a factor

limiting the number of successful entrants). Putting all of this together, the cost of successful entry into this market depends directly on the inducements to honesty provided by the nonmarket environment. The larger they are, the smaller the investments required.

3. How does the presence of “information intermediaries,” such as BizRate.com affect barriers to entry? Who is helped, and who is hurt, by such institutions?

Online firms’ reputations can be created by either advertising or historical information firm performance with customers. Traditionally, past performance information is communicated through word of mouth, which can be slow. BizRate.com is in the business of providing potential online customers with information about the reliability of the sellers they are contemplating patronizing. Everyone has access to the entire history of transactions at a large number of firms, not just their friends’ transaction histories. In the presence of such an information intermediary, reputations can form and be communicated quickly and at low cost. And possibly even without expensive advertising campaigns. Hence, information intermediaries can substantially reduce barriers to entry. Of course, this hurts any firms that have already sunk big investments in reputation (incumbents like Amazon) by making it less scary for customers to send money to less known competitors. Customers would tend to win because there are more trustable firms out there.

4. Suppose the government could create regulations that would prevent fraud on the Internet. Who wins and who loses from this?

The government could have strong rules and enforcement. Suppose, for example, that the government could credibly threaten to punish commercial liars. Then all firms – even those with bad histories - would be credible. This would help firms that lack good reputations (that is, it would help both firms with bad reputations and firms with no reputations). It would hurt firms with good existing reputations. Customers would also tend to be helped. I say “tend” because there may be countervailing forces. If credibility ceases to be a source of differentiation, it is possible that businesses move closer to commodity businesses, in which all firms charge the same price and offer no service. Currently, Amazon offers a lot of information to customers at no charge. If customers felt more comfortable buying from Dr. J’s Book Mart.com, they might obtain information at the Amazon site and buy the book elsewhere. Ultimately, Amazon might find it difficult to add or maintain features, unless they can charge for them. This is analogous to the disappearance of service in some retail sectors when discount stores arrived in the 1970s.

Monopoly discussion questions:

1. In what sense does monopoly result in market failure?

When monopoly firms charge a single price, the price exceeds marginal cost. Hence, there are mutually beneficial transactions not consummated in the market. That is, there are potential transactions for which the demand price exceeds the marginal cost of production. These foregone transactions are both socially and privately bad.

A separate problem which is not a “market failure” in the efficiency sense of the term is simply that prices are high. This is a distributional issue, but it’s potentially an important one. Policymakers tend to care when resources are transferred from consumers to producers.

Any firm with market power, if it employs a single price, will cause some deadweight loss. This problem is somewhat offset by the variety benefits associated with the firm’s differentiated product.

When a monopolist can keep other firms out of the market, monopoly can have important dynamic efficiency consequences. The biggest concern is that a firm that controls a market may prevent new, and better, technologies from emerging and taking hold.

2. What strategies can firms employ to correct the inefficiency associated with monopoly?

The simplest solution to the problem is for firms to price discriminate, charging different consumers different prices according to their willingness to pay.