Monopoly's new era

By Joseph E. Stiglitz
May 13, 2016 – *Project Syndicate*

For 200 years, there have been two schools of thought about what determines the distribution of income – and how the economy functions. One, emanating from Adam Smith and nineteenth-century liberal economists, focuses on competitive markets. The other, cognizant of how Smith's brand of liberalism leads to rapid concentration of wealth and income, takes as its starting point unfettered markets' tendency toward monopoly. It is important to understand both, because our views about government policies and existing inequalities are shaped by which of the two schools of thought one believes provides a better description of reality.

For the nineteenth-century liberals and their latter-day acolytes, because markets are competitive, individuals' returns are related to their social contributions – their "marginal product," in the language of economists. Capitalists are rewarded for saving rather than consuming – for their *abstinence*, in the words of Nassau Senior, one of my predecessors in the Drummond Professorship of Political Economy at Oxford. Differences in income were then related to their ownership of "assets" – human and financial capital. Scholars of inequality thus focused on the determinants of the distribution of assets, including how they are passed on across generations.

The second school of thought takes as its starting point "power," including the ability to exercise monopoly control or, in labor markets, to assert authority over workers. Scholars in this area have focused on what gives rise to power, how it is maintained and strengthened, and other features that may prevent markets from being competitive. Work on exploitation arising from asymmetries of information is an important example.

In the West in the post-World War II era, the liberal school of thought has dominated. Yet, as inequality has widened and concerns about it have grown, the competitive school, viewing individual returns in terms of marginal product, has become increasingly unable to explain how the economy works. So, today, the second school of thought is ascendant.

After all, the large bonuses paid to banks' CEOs as they led their firms to ruin and the economy to the brink of collapse are hard to reconcile with the belief that individuals' pay has *anything* to do with their social contributions. Of course, historically, the oppression of large groups – slaves, women, and minorities of various types – are obvious instances where inequalities are the result of power relationships, not marginal returns.

In today's economy, many sectors – telecoms, cable TV, digital branches from social media to Internet search, health insurance, pharmaceuticals, agro-business, and many more – cannot be understood through the lens of competition. In these sectors, what competition exists is oligopolistic, not the "pure" competition depicted in textbooks. A few sectors can be defined as "price taking"; firms are so small that they have no effect on market price. Agriculture is the clearest example, but government intervention in the sector is massive, and prices are not set primarily by market forces.

US President Barack Obama's Council of Economic Advisers, led by Jason Furman, has attempted to tally the extent of the increase in market concentration and some of its implications. In most industries, according to the CEA, standard metrics show large – and in some cases, dramatic – increases in market concentration. The top ten banks' share of the deposit market, for example, increased from about 20% to 50% in just 30 years, from 1980 to 2010.

Some of the increase in market power is the result of changes in technology and economic structure: consider network economies and the growth of locally provided service-sector industries. Some is because firms – Microsoft and drug companies are good examples – have learned better how to erect and maintain entry barriers, often assisted by conservative political forces that justify lax anti-trust enforcement and the failure to limit market power on the grounds that markets are "naturally" competitive. And some of it reflects the naked abuse and leveraging of market power through the political process: Large banks, for example, lobbied the US Congress to amend or repeal legislation separating commercial banking from other areas of finance.

The consequences are evident in the data, with inequality rising at every level, not only across individuals, but also across firms. The CEA report noted that the "90th percentile firm sees returns on investments in capital that are more than five times the median. This ratio was closer to two just a quarter of a century ago."

Joseph Schumpeter, one of the great economists of the twentieth century, argued that one shouldn't be worried by monopoly power: monopolies would only be temporary. There would be fierce competition *for* the market and this would replace competition in the market and ensure that prices remained competitive.

My own theoretical work long ago showed the flaws in Schumpeter's analysis, and now empirical results provide strong confirmation. Today's markets are characterized by the persistence of high monopoly profits.

The implications of this are profound. Many of the assumptions about market economies are based on acceptance of the competitive model, with marginal returns commensurate with social contributions. This view has led to hesitancy about official intervention: If markets are fundamentally efficient and fair, there is little that even the best of governments could do to improve matters. But if markets are based on exploitation, the rationale for laissez-faire disappears. Indeed, in that case, the battle against entrenched power is not only a battle for democracy; it is also a battle for efficiency and shared prosperity.

Joseph E. Stiglitz, recipient of the Nobel Memorial Prize in Economic Sciences in 2001, is University Professor at Columbia University.