Executive Summary: The Free Market Fallacy

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Most Americans are concerned about how inequitable our economic system is: 70% believe that it is not fair, and that our economy favors the wealthy and powerful[1]. Rising inequality, stagnant median wages, unaffordable health care, and the explosive rise in top-bracket incomes all contribute to this sense that the economy is rigged.

In my just-published article *The Free Market Fallacy*[2], I describe how basic economics explains a good deal of this stark divergence in fortunes. Exploring competition this way debunks the widespread notion that "free, unregulated markets are good for society" by reminding us that that ideology applies only to markets that are structurally highly competitive, a market type that has become increasingly rare. I show that for markets without this structural feature, pro-competition regulations can correct social phenomena such as working poverty while simultaneously encouraging economic growth.

Three Levels of "Optimal Scale" for Three Types of Industries

Most of our markets fall somewhere between the extremes represented by the "free markets" (all markets are highly competitive) and "socialist" (all markets tend towards monopoly) views. Using, instead, the lens of "optimal scale" can improve on our conventional wisdom with three guiding principles:

1. Society gains the most when commodity markets are kept highly competitive;
2. When firms in industries with economies of scale are allowed to reach "minimum efficient scale" (MES) in order to achieve the lowest cost per unit, but not significantly more than MES;
3. When high innovation industries are provided intellectual property protection to incent innovation, but are prevented from extending the life of their patents beyond their expiration.

In other words, society's "return to scale" – benefits to society from allowing an industry to grow more concentrated – **peaks,** at a level of scale we'll call "optimal scale" (or S_{SO}), and decreases for levels of scale beyond that. But without protections against market power, the profits of a large corporation can keep increasing by growing *beyond* S_{SO}, because market power (aka monopoly or monopsony power) keeps increasing until a firm controls the entire market. And the problem with market power – i.e. the reason for anti-trust laws – is that the use of it to increase prices or suppress wages *always* decreases total benefit to society, as I discuss in more detail in *The Free Market Fallacy*.

So, a pro-competition approach to regulation focuses on two things: first, keeping industry scale close to S_{SO} (via antitrust protections and the like), and second, providing protections for consumers, workers and small businesses against the market power that accrues – even at S_{SO} – in industries with significant economies of scale or high degrees of innovation.

However, the deregulatory fervor that started in the 1980's has resulted in much weaker protections against market power: anti-trust enforcement is down dramatically since the 1970's; the federal minimum wage is just two-thirds of its inflation-adjusted value in 1970; private-sector unionization rates have fallen by more than half; and so on. Firms have taken advantage of this to grow well beyond societally-optimum scale (S_{SO}), and they do so using three major tools for decreasing market competitiveness.

As a result, a lot of our U.S. markets are now very concentrated: four airlines serve 80% of all passengers[3]; banking is concentrated into just four large banks, insurance is dominated by five major companies; and globally, 10 companies control almost every food and beverage brand in the world[4]. Three quarters of our markets became more concentrated over the past decade. And at least five major sectors of our economy —manufacturing, retail, utilities, finance, and wholesale trade, accounting for over two-thirds of total U.S. corporate profits— are all considered "highly concentrated" by DOJ guidelines[5].

How Reducing Competition Increases Profits at the Expense of Society

The second half of *The Free Market Fallacy* illustrates, through six industry examples, how exceeding those levels of optimal scale – through mergers and acquisitions, by erecting barriers to entry, or from the use of misinformation – harms society overall, increasing profits at the expense of workers or consumers, and reducing output at the same time. We see how almost a third of health care expenses come from abuse of market power by hospitals and pharmaceutical companies; how the root of sub-poverty wages is the wage-suppressing power of high-market share employers, not workers' lack of skills; how generic drug manufacturers may be colluding, dividing up markets to jack up prices several-fold; how the fossil fuel industry has maintained demand in the face of climate change through a multi-decade misinformation campaign about the harms from emissions; and more.

These consumer and worker harms show up on the firm's side as *supranormal* profits, profits from market power, as opposed to profits from exploiting economies of scale, or from product and process innovation. In the six examples, these supranormal profits range from 25% - 50% of total profits, showcasing a key reason corporate profits per GDP in the 2010's have been 50% higher than they were in the late 1990's. This is the divergence in fortunes mentioned earlier: exceeding optimal scale, combined with weakened protections against market power, benefits big businesses and their executives, while the other stakeholders – consumers, workers and small business suppliers – lose in the process. And this divergence in fortunes has motivated the biggest misinformation campaign of them all, documented in Oreskes' and Conway's excellent *Merchants of Doubt*, Nancy MacLean's *Democracy in Chains*, and by other scholars. As Sharon Beder puts it: "[t]he rise of corporate propaganda since the 1970s has been particularly aimed at selling the idea of free, unregulated business enterprise and an accompanying policy agenda….".[6]

Most importantly, correcting these social harms through pro-competition policies is economically sound. In the case of low wage workers in fast food and retail, for example, raising the minimum wage up to the competitive-market rate *increases* employment, both in theory[7] and in practice[8]. Removing collusive market division agreements (e.g., generic pharmaceuticals) reduces prices, and increases output, as will ending “patent evergreening” in branded pharmaceuticals.

In short, a pro-competition regulatory agenda can be pro-growth while also addressing important social issues like working poverty, unaffordable health care and climate change. This will keep consumer prices in check, ensure that workers are paid close to the value of their work to their employer, and enable suppliers – especially small businesses – to sell for fair prices. At the same time, it will increase output and growth, while ensuring that profits – which can still be quite high -- come not from market power, but from more efficiently organizing production, and from creating new and better products and services. This is an economy that can work for everyone.

[1] Igielnik, R. (2020). *70% of Americans say economic system unfairly favors the powerful* [Online]. Pew Research Center. Available at: https://www.pewresearch.org/fact-tank/2020/01/09/70-of-americans-say-u-s-economic-system-unfairly-favors-the-powerful/ (Accessed: 13 May 2020).

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[5] Autor, D., Dorn, D., Katz, L., Patterson, C. and Reenen, J.V. (2017). 'Concentrating on the Fall of the Labor Share.' *American Economic Review: Papers and Proceedings*, 107 (5), p180–85.

[6] Beder, S. (2005). 'Corporate propaganda and global capitalism -Selling free enterprise?', in Lacy, MJ and Wilkin, P. (eds.) *Global Politics in the Information Age*. Manchester, UK: Manchester University Press, p116-130.

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[8] Card, D. and Krueger, A. (1994) 'Minimum Wages and Employment: A Case Study of the Fast Food Industry in new Jersey and Pennsylvania', *The American Economic Review,* 84(4), p772-793.