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Is market concentration a result of natural competition, or does it stem from anti-competitive behaviour?

The discussion surrounding market concentration, which pertains to how market share is distributed among firms, is an important debate within economics, as it can have crucial effects on the three economic agents. It can dictate consumer choices, provide barriers to entry for new producers, and provide direction for government policy.

But where does it stem from? Market concentration has been argued by Neoclassical economists to stem naturally from the rational tactics of producers in a market (Marshall, 1890; Chamberlin, 1951), but ultimately, market concentration can stem from both natural competition and anti-competitive behaviour.

How does Neoclassical economic theory explain the formation of market concentration?

Neoclassical economic theory argues that markets should ideally aim to have low Herfindahl-Hirschman Index (HHI) values (indicating low market concentration) and fit within the perfect competition category of market structure (Walras, 1874). This indicates that the resources within this market are being distributed as efficiently as they can be whilst also maintaining prominent, fair levels of competition. However, it is also acknowledged by Neoclassical economists that the formation of market concentration is a dynamic process where highly concentrated markets can exist in certain situations (Penrose, 1959).

Alfred Marshall (1890) suggested that market concentration can naturally arise through economies of scale within the production process. This depicts a specific example of how market concentration is influenced by the forces of natural competition. Marshall (1890) acknowledged that when economies of scale are implemented, companies can often produce their goods and services more efficiently, which leads to a lower cost per unit, potentially leading to higher profits, ceteris paribus. When this occurs, these firms then obtain higher percentages of market share within an industry, therefore contributing to a higher market concentration within a specific market, hence being an example of how natural competition can lead to higher market concentration.

Another Neoclassical argument takes its roots in the differentiation of products within a market, an example of non-price competition that can result in a higher degree of market concentration (Chamberlin, 1951). Firms may make their products slightly different to existing products in the market to gain a marginal increase in market share.

What is the role of the government in the formation of market concentration within Neoclassical economics?

Firstly, according to Neoclassical economic theory, free markets are the most efficient way of allocating resources, with government intervention being minimalised (Friedman, 1962). Hence, the belief is that government intervention is harmful to markets. Competition within markets should be driven by the market forces of supply and demand because this makes allocating resources more efficient. Although, this theory is likely to lead to anti-competitive behaviour within a market in the long run due to limited government regulation (Galbraith, 2007). This has led some Neoclassical economists to suggest that some government intervention may be necessary. Their argument goes on to state that, in certain situations, the government is needed to stop excess market concentration from forming, an example of market failure (Marshall, 1890).

What are the arguments for market concentration being a result of natural competition?

A convincing argument regarding market concentration being a result of natural competition could be the presence of natural barriers to entry. Natural barriers to entry usually occur within markets that are monopolistic or oligopolistic, where the costs and challenges faced by new firms to enter a market may be too substantial (Schumpeter, 1942). Schumpeter (1942) focused on the 'Creative Destruction' theory, where new technologies constantly disrupt and replace established firms within industries. This means firms can acquire market share by implementing new and improved technology. However, this comes at a cost. High capital costs may be needed to acquire this market share, creating a barrier to entry and increasing market concentration.

The concept of Cost Disadvantages Independent of Size (CDIS) (Porter, 1980), which refers to the need for high costs that make it difficult for newcomers to compete effectively, can explain the natural barriers to entry of high capital costs within a market. An example of excessive start-up costs may be for the production factors needed to enter that specific market. Consider aspiring firms desiring market share within the airline industry, where they may experience imminent barriers such as extortionate capital expenses for resources such as aircraft and fuel whilst also having large labour requirements, which include hiring highly skilled professionals like pilots and engineers. This, therefore, poses a considerable challenge for those seeking to enter specific sectors, like the airline sector and can consequently create highly concentrated markets. New firms seeking to enter these markets could require capital from investors or hold vast amounts of capital before entering a market. For these reasons, both scenarios are deemed highly improbable for new ventures.

Similarly, another compelling argument may include the theory of network effects. Farrell and Saloner (1985) introduced the concept of network effects, also known as demand-side economies of scale, referring to how the value of a product increases as the total consumption of the product increases. It is also important to examine the dynamics of which network effects are significant, especially highlighting the importance of compatibility and interoperability (Wegner, 1996), which are important within online industries. Network effects can create markets with very high concentration due to one firm being the dominant choice in the market, i.e., the market has 'Winner-Takes-All Dynamics' (Frank and Cook, 2010). In certain markets, differences in quality or popularity may lead to significantly different outcomes. Other economists such as (Rosen, 1981) also support this idea, arguing that a marginal difference in popularity may lead to a high percentage of market share; this is the network effect. However, the network effect may not be deemed as a force of competition, but instead as a natural phenomenon that can influence the competitive landscape of an industry by contributing to market concentration. Therefore, the market concentration stemmed from natural forces within the market, thus contributing to the argument for natural competition forming market concentration.

One more natural mechanism could be an access-related barrier, where new firms may struggle to find essential resources needed in a particular industry's production process, usually due to regulatory barriers (Ansari, 2023). This may include access to suppliers with limited resources or exclusive contracts providing natural resources essential to a sector's production process. These regulations will provide an unstoppable barrier to entry for aspiring firms, especially if the regulations are passed on limited resources, e.g. land mined by mining companies. Moreover, regulatory policies may create high market concentration as they do not promote competition due to the monopolistic nature of regulations (Stigler, 1971). One could argue that barriers to access, such as regulatory barriers, using the example of exclusive contracts, might be a strategic manoeuvre firms employ to diminish competition. This perspective suggests that such practices could be interpreted as instances of anti-competitive behaviour. However, this is not anti-competitive behaviour because exclusive contracts may be essential for a firm's survival. This means that the diminishing competition within that firm's industry, cultivated from a barrier to access, may be an external benefit for a producer that was not deliberately intended, thus making it a type of natural competition.

What are the arguments for market concentration being a result of anti-competitive behaviour?

Market concentration may also develop through anti-competitive practices, one such example being cartels. Cartels are a cluster of firms that collude to behave like a monopoly; by limiting supply and fixing prices, they essentially dominate the market as one. Forming a cartel is one of the most harmful anti-competitive practices, as it limits consumer surplus and restricts new firms from entering the market (Hayek, 1944). These practices distort price signals, which leads to an inefficiency in the distribution of resources. Cartel behaviour increases market concentration because of the process by which the involved firms collude and act as an oligopoly, halting market share from being distributed across firms outside the cartel and creating a significant HHI value in a specific market. These markets also include monopolistic features such as inefficient distribution of resources and higher prices which can also emphasise how cartels can affect consumers negatively.

"People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices." (Smith, 1776, p. 111).

Smith perfectly summarises the nature of cartels and emphasises the tendency producers have to collude. Cartels are illegal in the UK, meaning although cartel behaviour is not desired, market concentration can be formed from anti-competitive behaviour in this manner illegally.

High market concentration may also stem from anti-competitive behaviours that do not focus on the direct adjustment of price to force out competition but instead focus on the direct approach of reducing the number of firms in the market. An example is acquisitions, when a more dominant business gains control over a smaller entity. Although acquisitions are common in modern industries, acquisitions of potential competitors by a more dominant firm can raise anti-competitive concerns. Simply put, the acquisition of one firm by another leads to a reduction in the total number of firms within a market. This, in turn, increases the market share of the more dominant firms, contributing to an overall increase in the market's concentration (Kwoka, 2014). This is a situation where anti-competitive behaviour has been practised. If a firm reduces the number of firms in competition by reducing overall competition in their industry, their acquisition can be deemed anti-competitive. However, it is important to note that if two firms merge or one firm acquires another for survival reasons, it is not deemed anti-competitive behaviour.

Furthermore, brand recognition could be another argument linked to market concentration stemming from anti-competitive behaviour. Within oligopolistic markets, certain firms hold dominance before new firms enter these markets, meaning that firms are more likely to have existing consumer preferences, which may have started due to the vast levels of brand recognition that a firm may have acquired, giving them a competitive advantage. This makes it a more challenging dilemma for new firms to gain market share. For instance, consumers who buy electrical gadgets from established firms such as Apple are unlikely to consider switching allegiance when a new phone manufacturer emerges within the marketplace, which can be owed to fixed brand loyalty and trust directed towards Apple.

This means that an industry with prominent levels of brand loyalty/consumer preference, such as the electrical device industry, is likely to stay highly concentrated because of barriers to entry that have been artificially enforced.

Conclusion

While the debate between natural competition and anti-competitive behaviour as drivers of market concentration persists, the complexity lies in their interdependence. Clearly, both reasons for the formation of market concentration are valid, and they can be justified with real-world examples; however, the extent to which one of these reasons is applicable depends on the dynamics of the market. As stated before, it is theorised that the formation of market concentration is a dynamic process, where highly concentrated markets that form are ideally under natural conditions. However, anti-competitive behaviours can form high market concentrations, linking to Keynesian theory of how government intervention is necessary to correct economic failures (Keynes, 1936). Therefore, a nuanced understanding reveals that market concentration emerges from a complex interplay between natural competitive forces and deliberate anti-competitive actions.

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