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Buyer power with atomistic upstream entry: Can downstream consolidation increase production and welfare?



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ABSTRACT

This paper investigates the effects of buyer power on entry into an atomistic upstream market and economic welfare. Under reasonable market conditions, we show that industries with a few buyers induce more upstream entry than industries with a larger number of firms. In particular, monopsony can be more conducive to entry and lead to higher social welfare than more fragmented industry structures. This seeming paradox arises because a single buyer better internalizes the positive effects of entry on later-periods' supply conditions than a collection of firms. This result is relevant in a number of market settings, including markets for specialized labor and processing markets for agricultural products.

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A widely held belief among economists and policymakers is that the degree of concentration in an industry is positively related to the extent of market power exercised in that industry and negatively related to the industry's rate of output and social welfare (Farrell and Shapiro, 1990). This belief is a central tenet in guidelines to evaluate

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mergers, including those issued by the U.S. Department of Justice (DOJ) and the Federal Trade Commission (FTC), which state:

The Agencies give weight to the merging parties' market shares in a relevant market, the level of concentration, and the change in concentration caused by the merger [...] Mergers that cause a significant increase in concentration and result in highly concentrated markets are presumed to be likely to enhance market power (U.S. Department of Justice and Federal Trade Commission, 1997).

Although this view is most commonly expressed in terms of output markets and seller power, it is also routinely assumed to hold for input markets and buyer power when the input is supplied atomistically, as with most labor and agricultural product inputs (Blair and Harrison, 1993, pp. 82–83; Noll, 2005). With regard to mergers among competing buyers, the DOJ and FTC Merger Guidelines note that “the Agencies employ essentially the framework [...] for evaluating whether a merger is likely to enhance market power on the selling side of the market.” The same applies to the evaluation of mergers in the European Union (European Commission, 2010).

This presumed inverse relationship between buyer concentration and production of the input by atomistic suppliers and economic welfare emerges readily in static models of oligopsony competition.¹ In this paper, we consider the dynamic nature of upstream entry and show that this conventional wisdom need not be correct. The economic logic of our argument derives from the fact that buyer power is grounded in the immobility of certain factor inputs that are in the short run largely “captive” to a set of available buyers. Modern agriculture, for example, is capital intensive with highly specialized inputs. Farms' geographic locations are fixed and most are specialized to producing one or a few products. These products are typically bulky and perishable and, hence, difficult and costly to transport (Rogers and Sexton, 1994; Vukina and Leegomonchai, 2006; Crespi et al., 2012). Thus, processing and packing facilities located in geographic proximity to farms, and likely spatially distributed in their own right, will have buyer power over farms located in their vicinity. The same idea applied to labor markets is that workers, such as nurses or physicians, who have specialized skills and are immobile in the short run, may face a limited number of employers demanding those skills within a relevant geographic market.

Buyers in these settings can exploit short-run inelasticities in the supply of these inputs and increase profits by reducing input employment and driving input price below the value of marginal product. Such behavior, however, is likely to have adverse consequences on supply of that input in the long run because input prices that are suppressed relative to the competitive level will incite extant suppliers of the input to exit the market and/or

¹ Examples using a homogeneous product framework and quantity competition include Bergman and Brännlund (1995), Azzam and Schroeter (1995), Xia and Sexton (2004), and Zhang and Brorsen (2010). Examples using price competition and product differentiation include Alvarez et al. (2000), Zhang and Sexton (2000), and Mérel et al. (2009) in the context of agricultural procurement markets and Thisse and Zenou (2000), Bhaskar et al. (2002), and Staiger et al. (2010) in studies of monopsony power in labor markets.

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