

The design of competitive markets

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Outline

1. Markets free from what?
2. How to intervene?
3. How to prevent capture?

Markets free from what?

- Very often in the political and economic debate we encounter the expression “free market”
- “One of the most powerful defenses of **the free market** ever written.”
- What does it mean exactly?
- Webster Dictionary:
 1. “An economy operating by free competition”
 2. “An economic market or system in which prices are based on competition among private businesses and not controlled by a government”

- How we define competition?
- Webster dictionary has two meanings
 - 1) “ the effort of two or more parties acting independently to secure the business of a third party by offering the most favorable terms”
 - 2) “a contest between rivals”
- As economists we have a third meaning
 - 3) “price taking behavior”
- There is an active confusion among the three definitions
- Regardless of the definition one uses, can competition take place without rules?

One of the oldest competitions



- In the race, there are no rules
 - You can hit other jockeys
 - Try to bribe them
 - Drug their horses
- Yet, there are very precise rules before the race
- A lottery determines which horse will run for each contrada.
- Who sets those rules?
- Is anarchy the ideal setting to foster competition?

Anarcho-capitalists/Libertarians

- Anarchocapitalists says yes
- In the absence of any state, society tends to contractually self-regulate
- This self-regulation is superior to public regulation and extend to law enforcement too
- Law enforcement would be operated by privately funded competitors rather than centrally through compulsory taxation
- The difference between free-market capitalism and "state capitalism" is the difference between "peaceful, voluntary exchange" and a collusive partnership between business and government that uses coercion to subvert the free market (Rothbard, 1973).

A Test of the Libertarian Dream

The screenshot displays the Silk Road anonymous market interface. At the top, the site logo features a green camel and the text "Silk Road anonymous market". Navigation links include "messages 1", "orders 0", and "account \$0.00". A search bar is present, and the user "the Dread Pirate Roberts" is logged in. A sidebar on the left lists categories such as Food, Beverages, Apparel, Art, Books, Collectibles, Computer equipment, Custom Orders, Digital goods, Drug paraphernalia, Drugs, Electronics, Erotica, Forgeries, Hardware, Herbs & Supplements, Home & Garden, Jewelry, Lab Supplies, Lotteries & games, Medical, Money, Packaging, Services, Weight loss, Writing, and Yubikeys.

The main content area shows a list of items for sale, sorted by "ascending" price. The items are:

- Cocaine Energy Drink - Banned**: Price \$0.74, seller: namedlined(190), ships from: United States of America. Includes a red "Cocaine" sticker image.
- Kefir grains - water kefir**: Price \$0.83, seller: etolan(37), ships from: United States of America. Includes an image of white kefir grains.
- 3Jane Stealth Listing Feedback**: Price \$0.00, seller: 3Jane(100), ships from: Canada. Includes a "no image" placeholder.
- Kefir grains - milk kefir**: Price \$0.90, seller: etolan(37), ships from: United States of America. Includes an image of white kefir grains.

At the bottom, a partially visible listing for "Bad Wine Bad Times Down Offay Bottle 75cl" is shown.

Another Test: Crypto Governance

- Cryptos are sold as completely private regulation
- The decentralized autonomous organization (DAO) is form of investor-directed venture capital fund
- The DAO is stateless, and not tied to any particular nation state.
- The DAO was crowdfunded via a token sale in May 2016.
- In June 2016, users exploited a vulnerability in the code to siphon off 1/3 of the DAO's funds to a subsidiary account
- On 20 July 2016, the Ethereum community decided to hard-fork the Ethereum blockchain to restore virtually all funds to the original contract.

2. Neoliberals

- Neoliberals believe that the state is needed for
 1. Enforcement of property rights
 2. National Defense
- Implicit or explicit assumption is that
 - if property rights are well protected then
 - in the absence of any state intervention
 - free entry will eventually generate competitive conditions in all markets.
- Several questions:

1. How Property Rights Are Defined?

- A scientist works for Acme and discovers a new drug
- Does the patent to the drug belong to Acme or to the scientist?
- In 1837 Charles River Bridge Company was granted the right to build a bridge over the Charles river
 - did it have an implied monopoly right on traffic over the Charles River?
- A phone company assigns you a phone number who owns that phone number?
- Even in the minimalist state, the definition of property is very important to shape the competitive process

2. Is There Too Much of a Good Thing?

- If we push the protection of property rights to the limit, we strangle any new opportunity.
- Imagine a world in which the inventor of the alphabet (or his descendants) had right to a royalty every time we use one letter, and the inventor of each word (or her descendants) had right to a royalty every time we use that word
- Even communication would be impaired, let alone commerce.

3. Eventually

- Railways had a monopoly. Eventually, (70 years later) truck appeared and provided a substitute
- The telegraph was a monopoly. Eventually, (40 years later) telephones came along.
- Telephone was a monopoly. Eventually, (110 years later) the internet came along.
- Visa/Mastercard was a duopoly. Eventually, (50 years later) digital wallets came along

3. Ordoliberalism

- It is not sufficient to protect the individual from the power of the government, because governments are not the only threats to individual freedom.
- Powerful economic institutions (i.e. cartels) could also destroy or limit freedom, especially economic freedom.
- “The legislator must intervene to level daily the trenches behind which groups of producers barricade themselves so as to acquire privileges that are harmful to other producers and to consumers.” (Einaudi, 1942).

“To level daily the trenches”

1. The Government has a proactive role in promoting competition
 - Not only in breaking monopolies, but in reducing the artificial barriers to entry
2. “The trenches behind which groups of producers barricade themselves”
 - Even without the help of the government, producers can erect inefficient barriers to entry (“that are harmful to other producers and to consumers”).
 - These are cases in which competition is not taking place “by offering the most favorable terms”, but as rivalry, as a *Palio* where delaying the rival is more important than speeding

Competition vs. Contrapetition

- The word competition comes from Latin *competere*:
 - *com* "with, together" + *petere* "to strive, seek"
- ⇒ *to strive in common, strive after something in company with or together"*
 - ⇒ What Italians call "*concorrenza*"
- Only later since in races where striving after something in company, the word competition is associated with a contest between rivals
 - => What Italians call "*competizione*"
 - But etymologically the more appropriate term would be **contrapetition** (seek against somebody else)
- Trenches are **contrapetition**

Examples of Contrapetition

- Aghion and Bolton (1987): long term contracts are signed for the only reason to ex-tract some of the surplus an entrant would get if he entered the seller's market.
- Hewlett Packard lobby for a very strict e-waste regulation because it hurts rival more than it hurt HP (Richter, 2019)
- Incumbent banks refuse a collateral registry because negatively impact competitors more
- Cellular service companies make it hard for a customer to switch provider

Free Markets vs Competitive Markets

- There is no guarantee that “laissez faire” would lead to competitive and not contrapetitive markets
- Even natural selection does not lead to the survival of the fittest



Summary So Far

- If we want free competition (and not contrapetition) we need rules that actively promote competition
- What kind of rules?

2

How To Intervene?

1. Define Property Rights to Promote Competition

- Why it is *you* and not the phone company who owns your phone number?
- This has nothing to do with “fairness”, it has only to do with competition
 - If the company owns your phone number, you are locked in -> reduced competition to attract customers
 - If you own it, companies can more easily compete to attract you
- What is the effect?

Phone Number Portability

- Faccio and I study the effect of number portability (and other rules) in 148 countries
- We find that number portability leads to
 - Lower prices
 - Lower profit margins
 - If anything better quality
 - No less investments
 - No lower wages

- The idea is not limited to phones.
- What about your bank accounts?
- How difficult it is to transfer bank accounts?
- What about your social networks?
- Who owns our connections that are known as our "social graph"?
- Personal ownership of the social graph will dramatically lower barriers to enter and compete in the world of digital platforms

2. Force Interoperability

- If I can call an AT&T customer with my T-Mobile phone, it is not because AT&T is nice, but because it is forced to do so by regulation.
- Power Ventures case
- By forcing interoperability, we allow multi-homing that reduces the winner-take-all feature of the market

3. Functional Separation in Market Subjected to Tipping

- The last mile in a telephone network is a natural monopoly
- Any operator who controls that has an advantage vis-à-vis the competition
- A structural separation of the last mile from the rest allows all the other operators to compete on a level playing field
- The last mile should be run as a regulated monopoly
- The rest can be in free competition
- The same idea can be applied in many other businesses

I. Social Media

- Social media play two roles
 - i. They connect people
 - ii. They “help manage” the social interaction by editing what we see
- Huge networks externalities in the connection component.
- No networks externalities in the editorial component
- Force a separation between the two businesses
 - The first one run as a regulated monopoly
 - the second as can operate under free competition

II. Searches

- The same idea is true for computer searches
- Google provides us with two services:
 1. The search itself
 2. The interface with the user and how that search is displayed
- The first activity has huge economies of scale (the more you search, the better the search output)
- The second does not.
- Force a separation between the two businesses
 - The first one run as a regulated monopoly
 - the second as can operate under free competition

III. Private Pension funds

- Both Sweden and Chile have private pension funds
- A pension fund needs a network to reach every citizen
- Both Sweden and Chile separate the “last mile” from asset management
- Sweden keeps the last mile in public hands
- Chile leaves it in the hands of the incumbent pension funds
- The cost charged to contributors and the profitability of the funds is very different in the two countries.

Too radical?

Stigler (1952):

- “The obvious and economical solution is to break up the giant companies.
- This, I would emphasize, is the minimum program, and it is essentially a conservative program”
- Dissolution of big business is a one-for-all measure in each industry (if the recent anti-merger amendment to the Clayton Act is adequately enforced), and no continuing interference in the private operation of business is required or desired.”

3

Preventing Capture

Tension

- If we need the power of the state to “level daily the trenches”, how do ensure this power is not use to make “a collusive partnership between business and government”?
 - “the executive of the modern state is nothing but a committee for managing the common affairs of the whole bourgeoisie” (Marx, 1848).
- How can we ensure that the power is used to promote competition, not to protect existing businesses?

- In a “free market” system everything should be for sale except the rules themselves
- The rules should be set by an independent arbiter
- How to assure independence?
- Learn from Bitcoin:
 - The best way to protect against the risk of collusion is to make collusion as expensive as possible
 - The best way to make collusion as expensive as possible is to make necessary for collusion to bribe as many people as possible
 - Thus, by decentralizing the power to design (or at least approve) the rule as much as possible

=> Democratization of intervention

Example

1. Keep rules simple (Glass Steagall better than Volker rule)
 - Simple rules are
 - i. easier to sell to a larger public
 - ii. easier to monitor for violation
 - iii. easier to trigger class actions

2. Facilitate Switzerland-style referenda
 - Possibly with limits on campaign financing

Conclusions

- All too often we use the term “free market” as synonymous both of competitive markets and unregulated markets.
- This is wrong.
- Competitive markets arise only in presence of rules
- In some cases, very interventionist rules
- How can these rules be implemented?
- Some form of direct democracy seems the preferable solution

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