

ECON 5103 Unit 7, Video 2

Nature of an Industry: Market Power

Lerner index :

$$L = (P - MC) / P$$

Example: It costs Bill's Dry Cleaner \$1 to dry clean each additional shirt that customers bring in. Meanwhile, Bill charges these customers \$1.20 to dry clean each shirt.

$$L = (1.20 - 1) / 1.20 = 0.1667$$

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Example: It cost Microsoft \$5 to produce and sell each additional unit of Microsoft Office. Microsoft charges \$200 to each customer who wants to buy a copy of Microsoft Office.

$$L = (P - MC) / P$$

$$L = (200 - 5) / 200 = 0.975$$

L ranges between 0 and 1. When it's close to ZERO (say, .25 or lower) then firms have very little market power in their industry. When it's closer to 1 (say, .5 or higher) then firms have a lot of market power in their industry.

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TABLE 7-5 Lerner Indexes and Markup Factors for Selected U.S. Industries

Industry	Lerner Index	Markup Factor
Food	0.26	1.35
Tobacco	0.76	4.17
Textiles	0.21	1.27
Apparel	0.24	1.32
Paper	0.58	2.38
Printing and publishing	0.31	1.45
Chemicals	0.67	3.03
Petroleum	0.59	2.44
Rubber	0.43	1.75
Leather	0.43	1.75

Source: Michael R. Baye and Jae-Woo Lee, "Ranking Industries by Performance: A Synthesis," Texas A&M University, Working Paper No. 90-20, March 1990; Matthew D. Shapiro, "Measuring Market Power in U.S. Industry," National Bureau of Economic Research, Working Paper No. 2212, 1987.

Economists separate markets into 4 categories:

- perfect competition**
- monopolistic competition**
- oligopoly**
- monopoly**

Let us briefly examine the qualities of each category of market

Perfect competition:

1. There are many, many small sellers (technically, there must be an infinite number of sellers)
2. Each seller produces an identical product.
3. It is very easy for new sellers to enter this market, and it is easy for existing sellers to leave the market.
4. Advertising by a single firm is generally considered useless.

Example: Agricultural markets (corn, rice, apples, etc.)

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Monopolistic competition:

1. There are many, many small sellers.
2. Each seller produces a slightly different product.
3. It is very easy for new sellers to enter this market, and it is easy for existing sellers to leave the market.
4. Advertising by a single firm is generally considered important.

Examples: Dry cleaners; Chinese food restaurants

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Oligopoly:

1. A few large sellers produce most of the output of a product.
2. In some oligopolies, each seller produces a slightly different product (e.g. airlines). In other oligopolies, each seller produces a virtually identical product (e.g. copper).
3. It is very hard for new sellers to enter this market, can be hard for existing sellers to leave the market.
4. Advertising by a single firm is sometimes considered important (e.g. airlines) and other times it is unimportant (e.g. copper).

Production in modern economies is dominated by oligopolies.

The 500 largest firms in the U.S. sold \$10.1 trillion of products in 2008. (Total output of all 25 million U.S. firms was around \$25 trillion.)

Monopoly

1. One large firm produces 100% of the output of a product. (Examples: patented drugs, regulated monopoly)
2. Very hard, either legally or economically, to enter the industry and compete.
3. Advertising can be important for a monopoly (to raise product awareness).