Achieving Economic Efficiency in Spite of Market Failures: The Case of the Luxury Goods Industry

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According to standard economic theory, unfettered free markets lead to an efficient allocation of resources. Importantly, this result is generally taken to hold only insofar as market failures are absent. One of these failures, market power, is defined as the ability to elevate prices above competitive levels for a significant period of time. Generally speaking, the exercise of market power harms consumer welfare.

This logic appears quite general and is commonly accepted by policy makers. Indeed, precisely for this reason most competition authorities aim to limit firms' ability to gain or exercise market power. However, can it be the case that markets are efficient, even in the presence of substantial market power? Economic theory answers the question affirmatively. In fact, this is likely to happen in those industries where yet another market failure is also present at the same time: externalities.

Market externalities arise when actions of one party affect others. For instance, in certain industries the welfare of one consumer depends not only on the quantity of goods that the consumer buys, but also on the goods that are bought by other consumers. A typical example of, so called, network externalities is telephony services. The benefits of using a telephone network depend on the number of callers that a particular consumer can reach, i.e. the size of the network. In other words, the more people have telephones, the more valuable is the network. In this case, externalities are positive: by subscribing to the network, a consumer obtains not only personal benefit, but also creates benefits for other consumers.

However, externalities can also be negative. The luxury industry is a case in point. Consumers of luxury goods are often driven by the desire to distinguish themselves and stand out from their peers.[fn]Clearly this may not be the only motive. Another possibility could be that consumers want to show off their wealth by buying exclusive and expensive goods.[/fn] To the extent that this effect is significant, by buying a luxury item (of a specific brand) a consumer would exert negative externalities on existing owners and potential buyers of this item (or brand). Thus the expected benefits would decline with the volume of sales because the luxury good becomes more common, i.e. less unique. Put simply, the satisfaction of owning a prestigious model of a *BMW* would be much less if everyone else also owned the same model.

Individually, the presence of various market failures may distort efficient market outcomes. But when several of them are present at the same time, they may counterbalance each other. Recent economic research shows that the combination of substantial market power (i.e. prices being raised well above competitive levels) and negative network externalities may be efficient.[fn]See S. Petrova and V. Pruzhansky (2011) "The Economics of Luxury Goods: Utility Based on Exclusivity", *Social Science Research Network* paper, dx.doi.org/10.2139/ssrn.1930361, and V. Pruzhansky (2012) "Luxury Goods, Vertical Restraints and Internet Sales", *European Journal of Law and Economics,* DOI: 10.1007/s10657-012-9335-2, www.springerlink.com/content/y42463t128j91n88/.[/fn] Moreover, the conclusion holds under quite general conditions.[fn]For instance, it may not depend on how exactly social welfare is defined. The latter could be associated with consumer surplus only – this is how competition authorities often see it. Or, it can be a sum of both consumer and producer surpluses – the approach usually favoured by economists.[/fn] In order to understand the driving force behind this curious result, let us consider the effects of market power and negative externalities in more detail.

On the one hand, the exercise of market power leads to higher prices. Because the demand function for luxury goods is downward slopping (this is generally true, even in the presence of externalities), higher prices result in lower volumes of sales, relative to a situation when the industry were fully competitive. Clearly, if prices were reduced, more consumers would buy the good.[fn]Theoretically, in the absence of fixed costs the highest volume of sales would be achieved when prices equalled marginal costs of production.[/fn] This would clearly benefit the utility of new or, so called, marginal consumers.

On the other hand, price reductions would decrease the utility of those who already consume the product, i.e. infra-marginal consumers. Of course, infra-marginal consumers also benefit from price reductions and would continue to buy the good. However, their overall level of utility would be lower. All in all, those consumers would be worse off when more marginal consumers make purchases.

The interplay between these two forces shows that the desire to limit the exercise of market power and bring prices closer to marginal costs may not always be in the interest of all consumers. Price reductions could benefit one group of buyers, but simultaneously could hurt the other group. Assuming that competition authorities equally care about all consumers, the benefits of price reductions for marginal customers will have to be weighed against the losses that infra-marginal customers will suffer as a result. In particular, it cannot be excluded that the overall consumer welfare is maximized precisely at those prices and volumes of sales that would be selected by a monopoly producer exercising market power!

In sum, the relationship between network externalities and substantial market power has interesting policy implications. The traditional objective of competition authorities to strive for lower consumer prices may no longer be optimal when dealing with the luxury goods industry. This finding casts doubts on the ability of various pricing pressure indices, such as UPP and others, to accurately predict the impact of a merger on consumers. For instance, even if the merger is shown to produce significant unilateral effects, consumer welfare will not necessarily be harmed. This, of course, does not imply a merger in the luxury goods industry will never create any problems. One would also need to consider whether the merger adversely affects advertising, innovation and many other important dimensions that there are especially valuable for consumers in this industry.

Obviously, a precise assessment of all these effects in practice is not easy. Importantly, however, estimating the extent to which various market failures are present and possibly counterbalance each other in a given situation cannot be done on an ad hoc basis. This only underlines the need for a thorough economic analysis in such cases.