

The Economics of Market Dominance

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Preface

This volume is the outcome of a conference on the economics of market dominance held at Nuffield College, Oxford in September 1985. We are grateful to the college for providing a congenial environment for our discussions.

The expenses of the conference were covered by a grant from the National Economic Research Associates. We wish to record our appreciation of their generous assistance, without which it would have been extremely difficult to call the conference.

Versions of the five contributed papers in the volume were presented at the conference. We are particularly grateful to those speakers who came from overseas, making time in very busy personal schedules to do so. We extend our thanks too to the 25 participants – academics and practitioners from government and the legal world – who provided a lively discussion of issues arising from the papers. The authors then responded to requests for revisions with good grace and alacrity.

The first paper in the volume was written by us, after the conference, in order to set the scene for the contributed papers, and to present our own reflections on the major issues raised at the conference and in the papers. We are grateful to Tom Sharpe for detailed comments on an earlier draft. Neither he, nor any of the conference participants, bears any responsibility for the contents.

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1

The Economics of Market Dominance

JOHN VICKERS AND DONALD HAY

The Problem of Market Dominance

The theme of this book is market dominance – the power of a single firm or group of firms over the supply of goods or services in a market or set of markets. As a phenomenon it is neither new nor surprising. Monopolistic market structures and their consequences have for long been part of established economic analysis, and governments have designed monopoly policies to deal with them in practice. However, real-world monopolies do not always fit the textbook categories, and their persistence in the face of monopoly policies raises questions about those policies. The matter has been brought to a head in recent years by cases initiated by antitrust authorities against allegedly monopolistic firms in technologically progressive industries. These cases have served to highlight the inadequacies of traditional monopoly analysis; they have also engaged the talents of many specialists in industrial economics. From these cases has emerged a much better understanding of dominant firms. The objective of this book is to explain the new analysis to a wider audience, and in particular to suggest implications for the principles and practice of policy towards dominant firms.

This introductory chapter is intended to provide a guide to these new developments, as a framework for understanding the original papers which make up the rest of this book. The second section of this chapter sketches the new analysis, in both its positive and its normative aspects, under the headings of the exercise, the acquisition, and the maintenance of dominance. The third section suggests a set of principles which should be applied in constructing an effective policy. These are then deployed in the fourth section, which contains a brief description and evaluation of competition policy in the UK, the EEC, and the US. The comparison

serves to indicate the important differences in policy in the three jurisdictions. It also suggests that the UK and Europe have a lot to learn from the US. That section also explores two aspects of policy that give rise for concern in all three jurisdictions. The first is the vexed question of the definition of markets – the calculation and the relevance of market shares. The second is the appropriate legal and administrative structure for competition policy.

The final section of the chapter introduces the contributed papers. These papers form part of a continuing debate about the economics of market dominance. Many develop in detail points which could only be touched upon in this introductory chapter. More importantly, they serve to demonstrate that this is an area where our knowledge is developing fast, and where dogmatic conclusions should preferably be avoided. They may therefore act as a useful corrective to some of our more categorical statements in this introductory essay.

Economic Analysis of Competition and Monopoly

The prime purpose of competition policy is, in our view, to promote and maintain a process of effective competition so as to achieve a more efficient allocation of resources. Competition policy is often motivated also by other considerations – for example those of political liberty – but in the following we shall focus on the economic criterion of resource allocation. Competition policy cannot properly be viewed in isolation. It should be considered as part of government microeconomic policies generally, including industrial policies, trade policy, regulation, and privatization. This general perspective is needed in order to assess possible conflicts between the instruments of microeconomic policy (see the discussion of innovation below) and to consider which instruments are most appropriate to which targets of policy.

In examining competition policy in these terms we must insist on a broad interpretation of ‘resource allocation’. All too often it is seen through the lens of familiar textbook models that are static, and which typically treat the firm as a black box. Recently, however, there have been major advances in our understanding of the *dynamics* of competition, and its role in a world characterized by *imperfect and asymmetric information*. The theory of competition by innovation, which examines the allocation of resources to R & D, is an important example of the dynamic perspective, and we discuss it further below. Other examples of the dynamic approach include analysis of strategic competition (see

Schmalensee's paper in this volume). On imperfect information there now exists a vast literature exploring, for example, *signalling* (in models of product quality, advertising, entry deterrence, etc.), *reputation* (in models of predatory pricing, collusion, etc.), and *incentive systems* (e.g. on the role of competition as an incentive system). Philips's paper in this volume analyses imperfect information and collusion.

Here is not the place to undertake a survey of these developments. The point is simply that there now exist methods to analyse essential features of competition – of which we have emphasized dynamics and imperfect information – that traditional textbook analyses were not designed to address. These topics have long been recognized as important (consider Schumpeter on innovation) but were not previously so amenable to precise analysis. In the rest of this section we employ these perspectives on competition to examine a range of issues concerned with the economics of market dominance. We consider in turn the *exercise* of dominance, its *acquisition*, and its *maintenance*. These three elements obviously overlap, but it is useful as a starting point to consider them separately. Table 1.1 is a summary chart of the following discussion. It is not intended to be exhaustive. Some aspects of behaviour appear under both the exercise and the maintenance of dominance, for example pricing. This indicates the shortcomings of separating analysis of the two, although that separation is helpful in other respects.

The Exercise of Dominance

Under this heading comes the conduct of firms designed to exploit a position of market dominance, including nonlinear and discriminatory pricing, non-price conditions of sale, advertising, and innovation. These are not the only instruments that may be used in the exercise of dominance, but they are sufficient to illustrate the major points. It hardly needs saying that the same instruments may be used also to acquire or maintain positions of dominance (see below), but it is useful analytically to consider each case separately, even though most real-world situations are hybrid cases.

Traditional analysis focuses on the pricing and output decisions of a dominant firm in a market for a homogeneous good, and shows how a profit-maximizing firm with market power restricts output in order to raise price above marginal cost. Resource allocation becomes distorted from the competitive norm, whose welfare properties are well known. This welfare loss is usually measured by the sum of producers' and consumers' surplus (see Willig, 1976). Using this method, a wide variety of

Table 1.1 Summary chart on dominance

The exercise of dominance

Price level	Too high
Price discrimination (and related practices)	Likely to be used if possible. Ambiguous welfare effect
Conditions of sale (including vertical restraints)	May be used for pro- or anticompetitive purposes; hence problems of inference
Innovation	Too slow (but competition also has difficulties). Need for suitable industrial policies
Advertising	Too high (but competition also has difficulties)
Brand introduction	Possibly too many
Internal efficiency	Too low; insufficient incentive

The acquisition of dominance

Government grant	Generalization impossible. For example, patents are usually desirable; regulatory capture is bad
Skill, foresight, and industry	Desirable; to be encouraged
Collusion: explicit } tacit }	In general bad, but R & D sometimes an exception.
Merger: horizontal	Ambiguous effect on welfare: efficiency gains may offset danger to competition
vertical } conglomerate }	Neutral for welfare unless part of campaign of predatory conduct
Predatory behaviour	To be condemned, but problems of inference

Maintaining dominance

Pricing	Low – to discourage entry. Good, unless predatory
Innovation	High, which is usually desirable
Advertising	Probably too high
Brand introduction	Undesirable proliferation

estimates of the social cost of monopoly has been provided, ranging from Harberger's (1954) 0.1 per cent of US GDP to Cowling and Mueller's (1978) estimates in the region of 10 per cent of gross corporate product¹. One reason why it is important to try to assess the cost of monopoly is that it gives some indication of the possible gains from competition policy. However, social cost should be measured relative to some practically feasible alternative, rather than some theoretical ideal. In this regard, it must be borne in mind that market structure and conduct are in general jointly caused by the fundamental parameters of technology and demand.

The analysis of pricing in markets with differentiated products is less straightforward than the standard homogeneous good case. Demand for the product(s) of a firm then depends to some extent on the prices charged by producers of 'neighbouring' products as well as its own price(s). The question of which product varieties are produced becomes relevant. For example, does the market produce too few or too many varieties? Are they the 'right' ones? What difference does dominance make? Unfortunately, but not surprisingly, there is no simple answer to these questions.

For example, if there are economies of scale there is a trade-off between diversity of choice, which requires more product varieties, and lower unit costs, which require fewer varieties. In general there is no reason to expect market outcomes with product differentiation to be optimal, whatever the market structure, although the direction of inefficiency is typically ambiguous (see Dixit and Stiglitz, 1977; Spence, 1976; Schmalensee, 1978; Salop, 1979).

Although the simplest economic models assume that firms charge uniform prices for their products, it commonly happens that price is made contingent upon, for example, quantity purchased, or the time or place of purchase. In addition, conditions of sale ('vertical restraints') are often imposed upon the buyer, especially in transactions between manufacturers and retailers. These questions of discriminatory pricing and conditions of sale have often been the subject of antitrust scrutiny. As regards the economic analysis of these practices, there are two distinct questions. First, there is the issue of whether the practices are detrimental to competition, or to social welfare generally. Secondly, there is the issue

¹ Littlechild (1981) criticized Cowling and Mueller's calculations, and they (1981) replied to him. Kay (1983) analyses the social cost of monopoly in a general (rather than partial) equilibrium framework. The social cost of oligopoly and the value of competition is investigated by Masson and Shaanan (1984).

of whether the practices are indicative of a lack of effective competition.

A thorough overview of the literature on price discrimination, including nonlinear pricing, is provided by Philips (1983). Contrary to what is often believed, optimal resource allocation generally requires discriminatory pricing. However, it is another question whether it is desirable for a dominant firm to be able to practise price discriminations. For example, Schmalensee (1981a) shows that simple price discrimination is undesirable unless it leads to higher output, because discrimination allocates output across consumers inefficiently, which is undesirable unless offset by higher total output. The latter condition may be met in so far as price discrimination serves to open up new markets. (For analyses of nonlinear pricing see Oi (1971), Schmalensee (1981b), and Maskin and Riley (1984).) A form of nonlinear pricing occurs where price is related to a consumer's *past* purchases from the supplier. This 'loyalty rebate' form of quantity discount gives rise to switching costs, because the discount is lost by a consumer who changes supplier. Airline discounts for frequent fliers are an example. Klemperer (1984) shows how switching costs may facilitate collusion and entry deterrence. (See also von Weizsäcker (1984).)

A form of nonlinear pricing by multiproduct firms is commodity bundling – the practice of selling several goods as a package. Bundling allegations have of course been central to major antitrust cases, such as those involving IBM. One rationale for bundling is to economize on the costs of production and exchange, but there also exists another explanation which is related to price discrimination. Adams and Yellen (1976) show how bundling can serve to sort consumers into groups with different demand characteristics and thereby enhance profits.

In addition to welfare questions concerning price discrimination, there is the positive question of whether competition eliminates the practice. In that event the existence of discrimination would be indicative of market power. Questions of this sort must be addressed if dominance is to be inferred from allegedly abusive conduct. Neven and Philips (1985) show that price discrimination can occur in oligopoly, and they apply their results to the European car market, in which substantial international price differences have existed. In their model discrimination vanishes as competition grows. Oren et al. (1983) examine competitive nonlinear pricing. They show that price approaches marginal cost as the number of firms grows. However, Katz (1984a) has a model with informed and uninformed consumers in which price discrimination does occur at (monopolistically) competitive equilibrium.

We now turn to other conditions of sale. Manufacturers sometimes place vertical restraints on their retailers, including exclusive dealing conditions and territorial allocation. A type of vertical restraint which is illegal in many jurisdictions is resale price maintenance (RPM). Hay (1985a) distinguishes between vertical restraints which affect competition with other brands (*interbrand* competition), and those which affect competition between retailers of the brand in question (*intra*brand competition). The latter type of restraint has been the subject of much recent controversy. Restraints imposed by a manufacturer upon competition between retailers of his product should not be treated on a par with horizontal agreement between the retailers. The difference is that it is the manufacturer who places the restraint, and *prima facie* he has no incentive to see his retailers collude. (On the other hand he may be acting at the behest of the retailers, or with a view to facilitating collusion with other manufacturers, both of which would be undesirable.) Telser (1960) considered vertical restraints upon *intra*brand competition as a way round the free-rider problem between retailers that exists when they provide desirable pre-sales services for which it is impossible to charge. (Each would prefer to benefit from the services provided by other retailers rather than provide his own.) On this view, such vertical restraints enhance efficiency and competition between brands. Recent elaborations of this idea have been made by Mathewson and Winter (1984) and Marvel and McCafferty (1984).

Here there is an obvious difficulty of distinguishing between the pro- and anticompetitive explanations of the phenomenon in particular cases. Antitrust policy has often been hostile to vertical restraints, despite their possible benefits. However, in the United States a somewhat more permissive attitude towards *intra*brand vertical restraints has recently been adopted (for example in the Vertical Restraint Guidelines issued by the Department of Justice; see Hay's paper in this volume). Vertical restraints involving price continue to be *per se* unlawful, but a rule of reason approach is followed for non-price restraints. Economic analysis supports this step in respect of non-price vertical restraints on *intra*brand competition, and would justify a similar approach for vertical restraints involving price.

Having considered pricing and conditions of sale, we now turn to other aspects of company behaviour. A welfare analysis of *advertising* is given by Dixit and Norman (1978). They focus on advertising which changes tastes (as opposed to the role of advertising as a signal of quality in a world of imperfect information: see Nelson, 1970; Milgrom and

Roberts, 1984). A difficulty here is that the welfare yardstick – consumer tastes – is itself altered by the conduct being assessed. Dixit and Norman nevertheless find that the market equilibrium level of advertising is socially excessive even when judged by post-advertising tastes. The result holds for a variety of market structures; indeed it holds more strongly in monopolistic competition or oligopoly than in monopoly. Non-price competition in the form of advertising can be especially wasteful.

The relationship between *innovation* and market structure is one of even greater complexity. Intuitively one might expect that a monopolist would introduce new products and processes too slowly. As Hicks said, perhaps the greatest monopoly profit is the quiet life. And indeed, it can be shown that a profit-maximizing monopolist's incentive to introduce a new technology is smaller than its value to society. The comparison between alternative market structures again yields ambiguous results (and may be inappropriate if market structure is endogenous: see Dasgupta and Stiglitz, 1980). A central difficulty is the appropriability problem. An incentive to make the next innovation requires that the innovator be protected from immediate imitation by rivals, but an innovation is most efficiently exploited when it is freely available, in which case the innovator receives no reward unless there are subsidies to R & D. Von Weizsäcker's (1980) schema of different levels of competition makes the point clearly: proper incentives for competition by innovation require restrictions on competition in product markets, in combination with other policy measures.

Whereas the appropriability problem leads to the expectation that each firm does *too little* R & D, there may also exist excessive duplication of R & D effort if each firm is attempting to do essentially the same thing. In the aggregate it is therefore possible that *more* R & D expenditure occurs than is socially optimal (see Dasgupta and Stiglitz, 1980 for an illustration). The effect on welfare of increased competition, in the sense of more firms competing, is ambiguous. The competition will be beneficial in the product market, where the price-cost wedge will narrow but the allocation of resources to R & D may conceivably worsen, either because incentives to do R & D are dulled when there are problems of appropriability, or because of increased duplication of research efforts. And we have yet to consider innovation in the presence of entry threats (see below).

Innovation is perhaps the clearest example in which competition policy must be considered as part of microeconomic policies more generally. On the one hand, competition policy in innovative industries cannot ignore

its consequences for the allocation of resources to R & D. And on the other hand it must be seen as one policy among several, including patent and copyright laws, R & D subsidies, R & D licensing policies, and other instruments of industrial policy. A number of recent antitrust cases, which we shall refer to below, concern just these questions. (On R & D joint ventures, licensing arrangements, and mergers in high-technology industries, see Katz (1989), Shapiro (1985), and Ordover and Willig (1985).)

Until now we have assumed implicitly that a firm is a profit-maximizing black box, but dominance is ultimately exercised by decision-takers within firms, namely managers, whose interests may not lie with maximum profits. The internal efficiency of a firm depends on the degree of competition it faces in so far as competition affects managerial incentives and opportunities (recall Hicks's remark about the quiet life). One way in which competition sharpens incentives, and hence internal efficiency, is by permitting the *relative* performance of agents to be compared. When such comparisons can be made, rewards naturally become linked – implicitly if not explicitly – to relative performance. This idea is related to Leibenstein's well-known (1966) paper on X-efficiency, where it was argued that the welfare loss to society due to X-inefficiency within firms outweighed that due to inefficient resource allocation in the markets, and also that competition spurs X-efficiency. The role of competition as an incentive mechanism is an important part of any welfare analysis of competition and monopoly.

To summarize this section on the exercise of monopoly, we have seen that the non-price decisions of managers in a dominant firm are just as likely to be out of line with the public interest as their pricing decisions. Relative to the 'first best' there is, for example, a tendency to excessive advertising, insufficient innovation, and internal inefficiency. However, comparison with the first best is not entirely appropriate if firms are to be left to take their decisions independently. In that event the proper comparison is between alternative market outcomes, rather than between some market outcome and the 'social optimum'.

The Acquisition of Dominance

If the exercise of dominance tends to be to the detriment of consumers, there is a *prima facie* case for policy to prevent the achievement of dominant positions. However, market power can be acquired in a variety of ways, of which we shall focus on five:

The grant of market power by public authority
Skill, foresight, and industry
Collusion
Merger
Predatory behaviour

The grant of market power by public authority Firms in the utility industries (power, water, and telecommunications) and elsewhere have often enjoyed monopoly franchises granted by government. In the United States, private firms have operated in those industries subject to a framework of regulation. In other countries, for example the UK, the utilities have generally been in public ownership and operated according to economic, financial, and other criteria of a loosely specified nature. Many of these industries (or parts of them) are or have been natural monopolies, i.e. efficiency requires single-firm production.

Numerous criticisms have been levelled against US-style regulation. Regulatory systems, even when operated by benign and omniscient agencies, can give rise to major inefficiencies in resource allocation, as the literature on Averch-Johnson effects, rate-base padding and gold-plating makes clear (see Kahn, 1971; Baumol and Klevorick, 1970).

If regulators are human, however, matters may be even worse. The so-called 'economic' theory of regulation – or 'capture' theory – describes how regulatory agencies may end up more or less in the pockets of those whom they purport to regulate (see Stigler, 1971; Posner, 1974; and Brock's 1981 account of the US telecommunications industry). In response to these perceived failings, there has been a substantial dismantling of regulation in a number of American industries. In the last decade or so deregulation has occurred in airlines, trucking, financial services, and telecommunications, to name a few. The massive reorganization of the telecommunications industry followed the ending of the case against AT & T in January 1982. The company was divested of its various local operating companies (horizontal separation) but retained its long-distance, manufacturing, and research divisions (vertical integration). Public authority has thereby rescinded much of its earlier grant of market power, and regulation has been partly replaced by monitoring by antitrust authorities.

In the UK several major nationalized industries – many of them with substantial market power – are being transferred to private ownership. The main examples include telecommunications, gas, water, airports, and possibly electricity. Regulatory bodies are being established, and competition is being introduced on a limited scale. Criticisms have

been made that the liberalizing measures introduced by governments stop a long way short of what could and should have been achieved (see Vickers and Yarrow, 1985). The privatization of utility companies in the UK is happening in a way that effectively involves government grant of market power. We comment further on this below.

Skill, foresight, and industry The fact that a firm might owe its position of market power to competitive superiority over its rivals – to ‘skill, foresight, and industry’ as it was put in the Alcoa case (see later) – poses a dilemma for antitrust policy. Even if it could be shown unequivocally that dominance was bad, a universal condemnation of dominance would stifle competition *for* positions of market power, which could be detrimental in overall terms. Patents provide the clearest example. The results accruing from market power due to the ownership of a patent are of course the very reason why firms compete by innovation for the patent. To diminish that market power is to diminish the incentive to innovate. The same applies to firms that owe their positions of market strength to superior organizational efficiency, marketing strategies, and so on. To attack their competitive success would be to subvert the process itself.

There are two principal difficulties. The first is to strike a balance between the welfare gain of dynamic competition and the welfare loss of the resulting market power. This balance depends on such things as the length of patent life, and also upon the stance adopted by antitrust authorities towards firms that appear to owe their success partly to superior skill, foresight, and industry. The second difficulty is that of inferring the cause of a firm’s market position. Does IBM owe its position to succeeding in fair competition with others, or to anticompetitive practices? We discuss further this problem of inference, and the inevitable errors to which it leads, in a later section on the economics of policy.

Collusion Collusion may be thought of as multifirm dominance. Such dominance is gained by the explicit or tacit co-ordination of firms’ strategies. With few exceptions, explicit horizontal agreements between firms are banned. Research joint ventures are a type of horizontal agreement that is sometimes permitted – partly to avoid excessive duplication of R & D efforts and also perhaps for international strategic reasons. Cartels do of course have their defenders, often from the industries in question, who appeal to such things as rationalization, risk reduction,

and forward planning. Aside from the area of R & D, where special considerations apply, defences of this sort are generally unimpressive and not such as to disturb the case for the *per se* condemnation of explicit horizontal agreements that exists under most jurisdictions.

Tacit collusion poses particular problems. There is no reason to suppose that the pursuit of self-interest by firms will necessarily undermine tacit collusion. Indeed, it has been shown rigorously, and under a variety of assumptions about information conditions, that collusive outcomes are supportable as Nash (and perfect) equilibria in repeated games (see Friedman, 1971; Abreu, 1984; Kreps et al., 1982; Green and Porter, 1984). That is to say, collusive outcomes can perfectly well occur as a result of the independent pursuit of each firm's self-interest. Collusion is maintained by the (credible) threat of retaliation in the event of defection. The range of threat strategies available – and hence the range of supportable collusive outcomes – depends on the information conditions and incentive structures of each firm. Although it is difficult for public policy to strike directly at tacit collusion (after all, each firm is behaving independently) it can affect the information and incentive conditions that are more or less conducive to collusion. For example, information agreements have long been a target of antitrust scrutiny, because there is more incentive for one firm to 'cheat' if it is more difficult for others to detect that cheating.

Similarly, there is also a role for public policy to attack 'facilitating practices' which create incentive structures conducive to collusion. Salop (1985) shows how pricing systems involving 'most favoured nation' clauses or 'meeting competition clauses' may facilitate collusion.

While we favour policy against facilitating practices, it is only a partial answer to the problem of multifirm dominance. Existing antitrust policies contain weaknesses in this regard, although it is no easy matter to see what practicable policies and remedies could be designed to combat tacit collusion (see Philips's paper in this volume).

Merger Much of the increase in industrial concentration to have occurred in recent decades is due to horizontal merger (see Hannah and Kay, 1977, for evidence on the UK). Although concentration and market power are by no means the same, merger is unquestionably one of the main possible routes to a dominant position. Superficially, merger might appear to be the ultimate form of explicit collusion, and it may be asked why the prohibition of the latter does not extend to the former. There are