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THE GAINS AND LOSSES FROM
INDUSTRIAL CONCENTRATION

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Sam Peltzman*

No field in the industrial organization literature has been as well plowed as the relationship between concentration and profitability. Weiss (1974), in his latest review of this literature, discusses over 40 such studies since 1951, and this is not a complete census. The reader has by this late date earned the right to demand strong justification for a new entrant. Mine is simply that, despite its bulk, the literature fails to inform us how to interpret its main findings.

Those findings are well known: with few exceptions, market concentration and industry profitability are positively correlated. Since the correlation is usually weak, the literature has tended to become a search for more complex and/or accurately specified relationships. I eschew that approach to focus on a more basic question: if concentration and profitability are indeed related, what market process produces the relationship? The traditional answer has been that high concentration facilitates collusion and hence super marginal-cost pricing, for which some profitability measure is a proxy. Unfortunately, this answer does not logically follow from the usual evidence, so its acceptance by economists and practitioners of antitrust policy is little more than an act of faith.

Any profitability measure implies a corresponding difference between price and average cost. As a matter of simple arithmetic a causal relationship running from concentration to profitability can operate either through an effect on price (the usual interpretation) or on average cost, or, of course,

both. Acceptance of the pure collusion interpretation of the evidence has so far hinged on the largely untested assumption that concentration has little or no connection with the implied average cost measure. However, indirect tests of the assumption, most notably by Demsetz (1973), imply that it may not be useful, and his finding is one motive to the present work.

In essence, this paper will try to decompose the concentration-profits relationship into separate concentration-price and concentration-cost relationships. By doing this, I hope to shed light on some of the allocative and distributive issues that, I suspect, give the subject its intrinsic interest, but which have not so far been confronted empirically: Does high concentration save or waste resources? Does it lead to higher prices? Who gains and loses from a social policy hostile to high concentration? Since the unique aspect of the paper is its focus on a concentration-cost relationship, most of the analytical effort is spent here. I review the theory underlying such a relationship, and develop and implement a model designed to estimate its importance. Subsequently, I try to estimate how much of the usual profit-concentration relationship is due to cost effects and how much to price effects. The main conclusion is that, while price effects are not absent, the cost effects so dominate them as to cast doubt on the efficacy of any general legal rule hostile to industrial concentration.

I. Market Structure, Costs and Prices

The possibility that market structure and costs are related has of course long been recognized. An unconcentrated industry in which a technological advance produces "natural monopoly" or oligopoly cost conditions will become both more concentrated and more efficient over time. The process by which the old technology is rendered economically obsolete will also entail a fall (or at least no increase) in price. The price decline need not be great enough to eliminate producer rents, either because the associated increase in concentration permits collusion or because the new technology diffuses slowly enough to leave room in the market for a fringe of old-technology firms. Whichever force operates, there is a clear dilemma for antitrust policy: attempts to thwart increased concentration will merely waste resources without benefiting consumers.¹

The concentration-profitability literature has so far given little weight to "natural oligopoly" interpretations of the data. Two reasons for this neglect are important enough to affect the structure of this study:

1. A "natural oligopoly" interpretation is asymmetric. Some technological progress can be scale-reducing. If this sort of change diffuses slowly enough, or cannot be implemented as efficiently by all firms, the large firms will be the marginal firms and small firms will earn rents. Thus we should observe unusually low (or declining) as well as high concentration associated with unusually high rates of return. By and large, such a U-shaped concentration-profits relationship has not been found. One inference could be that rents to size-specific technical change are unimportant empirically. However, it would be just as easy to conclude that large size-related economies are simply more prevalent. Or, to the extent that such economies are specific to a few organizations, the large-size-related economies will

dominate in the usual data: Three clever firms producing 1,000 cars per week at half of General Motors' unit cost will have trivial impact on automobile prices or the measured efficiency of the automobile industry. I shall attempt to disentangle the possibilities empirically rather than intuitively. The model I develop permits any kind of change in market structure to reflect size-related technological change, and leaves the importance of the relationship to be determined empirically.

2. The empirical literature on economies of scale seems to conflict with a "natural oligopoly" interpretation. A common finding of this literature is that of long-run constant costs at the firm level over a wide range of output, wide enough to encompass many existing-firm sizes and a large fraction of industry output. To illustrate, Bain (1954) and Stigler (1958) both find that the minimum-efficient-size steel firm produces something like 2 percent of national output. Smaller firms had less than 20 percent of national capacity in 1951 (Stigler, 1958). While some efficiency might be gained by a decline of this inefficient fringe, any substantial change in market structure would likely involve a reallocation of output among efficient-sized firms.

However, that sort of inference might only mean that the economies-of-scale paradigm is not very useful, rather than that market structure and efficiency are unrelated. Indeed, the imprecision of scale-economy rationalizations of market structure can itself be of help in formulating such a relationship. If there is no unique efficient firm size, but only a wide band encompassing many existing firms, then any of these firms can grow to the upper end of the band before it incurs size diseconomies. This kind of expansion by a firm becomes likely, instead of merely possible, if the firm discovers a lower cost technology which is not immediately available to others. The potential profits from the cost advantage will then

attract capital and permit the firm to grow at least to the upper end of the band, though, to get there, the firm may also have to reduce prices. Thus, the fortunate firm, or firms, become big instead of merely "average" (concentration increases), and resource costs and prices are lowered by this unusual growth.

This argument, which can be found in Demsetz (1973) and McGee (1971), is sketched in Figure 1.

Let P_1L be the long-run supply curve of a competitive industry with demand, D . Let P_1RM be the long-run firm supply curve, so, following the scale-economies literature, firm size is indeterminate in the range OB . We observe an actual (or average) firm output of OA . The industry is in equilibrium with a price of OP_1 , zero rents and a four-firm concentration ratio of, say, $4(OA/OC)$. Now, one representative firm discovers a way to lower marginal costs to $QNRM$. In this perfectly-competitive-industry example, it cuts price trivially, and expands from OA to OB . There are now positive rents for this firm (and for the industry aggregate) equal to the resource cost saving, P_1QNR , and concentration has increased by (AB/OC) . Statistically, the increased concentration will be correlated with the increased rents, but there is a more substantive connection: the increased concentration is the mechanism by which part $(AB \times NR)$ of the resource cost saving is realized.

If enough firms make the same cost-reducing discovery, consumers will share the resource cost saving. For example, if (QS/QN) firms make the discovery, industry supply becomes $QSTL$. Price falls, but there are still positive rents and concentration increases (so long as demand is sufficiently inelastic to keep $CC'/OC < AB/OA$). If the discovery is sufficiently general, of course, the rents will disappear.

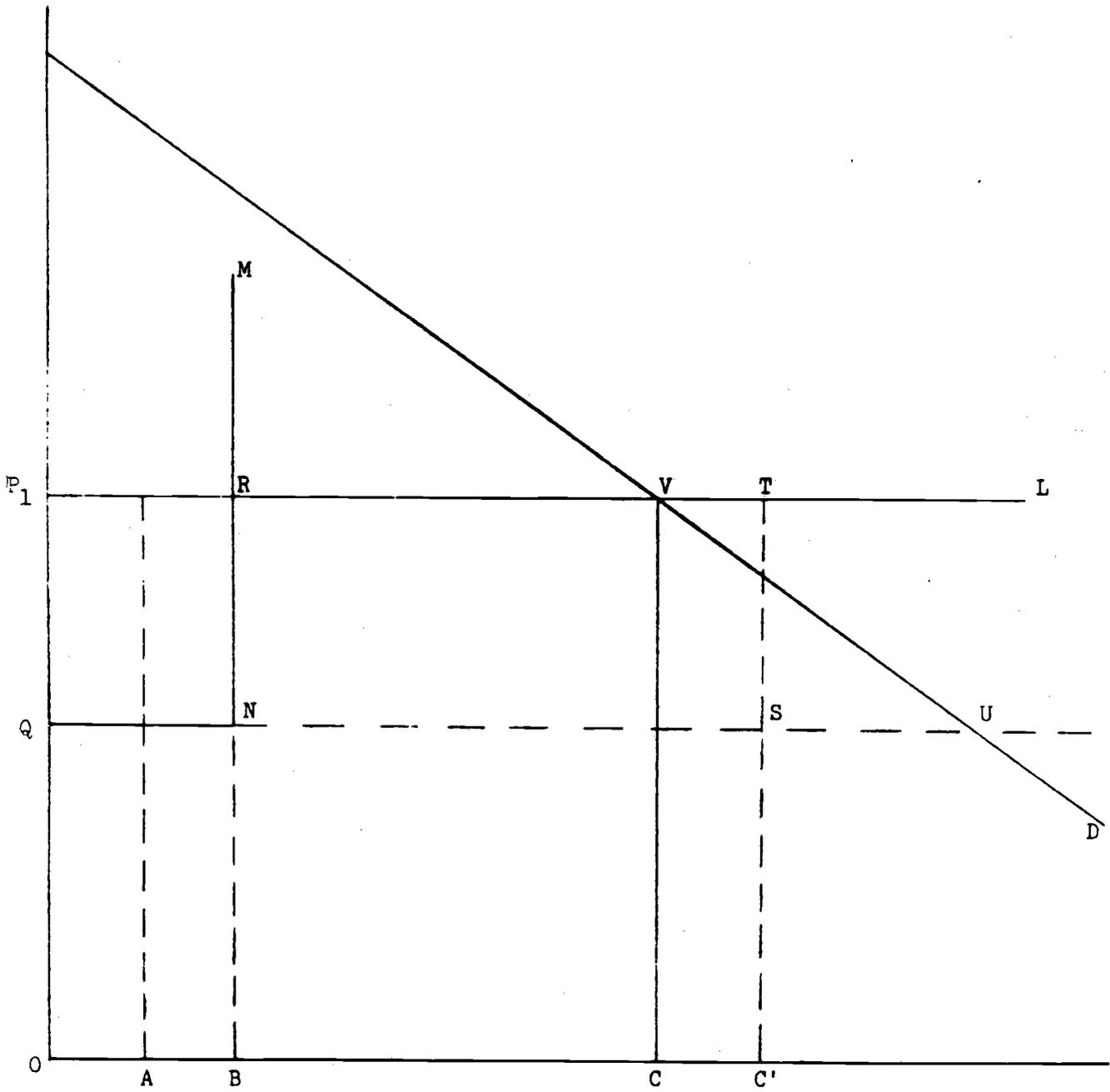


FIGURE 1

However, with an industry supply like QU , the correlation between efficiency and concentration can still hold. As new firms catch on, each grows toward maximal size, and eventually this maximal size becomes the typical firm size. Of course, with a sufficiently elastic demand, this firm growth need not imply increased concentration. But, given the very large maximal sizes usually encountered in the scale economies literature, increased concentration would be the outcome usually expected.

While the constant-returns-to-scale case is important empirically and useful didactically, some of the ambiguities entailed by the more conventional (by text book standards) diminishing returns case merit elaboration. This requires distinguishing between increasing costs at the firm and industry level. If the industry is constant cost, the preceding analysis needs no qualification: in the long-run a uniquely efficient firm will expand as much as others contract, and it will collect as rent all of its differential productivity. The more interesting case analytically is increasing costs for both the firm and industry. This implies rents for some factors, and hence an equilibrium excess of marginal cost over average cost (net of rents) for intra-marginal firms. This means, in turn, that any efficiency induced output expansion has two offsetting effects on a firm's average cost: the efficiency lowers the level of its average cost curve, but the output expansion causes a move up along the curve. Under some supply and demand conditions, the latter effect can dominate, so that average cost increases.² To see just what these conditions are, write the total industry supply (S^T) curve

$$(1) \quad S^T(P) = \bar{S}(P) + S^A(p, \lambda),$$

where

p = price,

\bar{S} = the aggregate of all firms but one (A), and

λ = shift parameter.

Then suppose A becomes more efficient, so its supply curve shifts rightward (i.e., λ increases and $S_{\lambda}^A > 0$, the subscript denoting a partial derivative). Assume for now that the resulting increase in A's output also increases any measure of industry concentration. Let us then see what is required for average cost to decline while profitability increases.

Since costs and rents (R) must exhaust industry receipts, industry unit costs (C) can be written

$$(2) \quad C = p - \frac{R^T}{Q} = p - \left(\frac{\bar{R} + R^A}{Q} \right),$$

where

Q = industry quantity sold.

The effect of A's efficiency (the increase in λ) on C can be shown to be

$$(3) \quad \frac{dC}{d\lambda} = -\frac{R_{\lambda}^A}{Q} + S_{\lambda}^A \cdot \frac{R^T}{Q^2} \left[\frac{1}{1 + \frac{E_S}{E_D}} \right],$$

where

$E_{D,S}$ = absolute value of the industry demand and supply elasticities.³

The first term on the r.h.s. of (3) is the pure "efficiency" effect and, were this a constant cost industry ($R^T = 0$, $E_S = \infty$) that would tell the whole story: industry unit costs and unit rents would change by equal and opposite amounts. The second term, the "output" effect, can offset the first if (a) the supply shift, S_{λ}^A , is large enough, and (b) industry supply is sufficiently inelastic (other firms save few resources by cutting their output) or demand

sufficiently elastic (so output expands enough to make the diminishing returns important).⁴

There is a further ambiguity in the relationship between unit cost and unit rent (i.e. profitability). Since

$$(4) \quad \frac{d(R^T/Q)}{d\lambda} = \frac{dp}{d\lambda} - \frac{dC}{d\lambda},$$

a negative relationship between the two requires that price fall by less than unit cost. Whether or not this holds again depends on supply and demand elasticities, but here it turns out that more elastic demand, on balance,⁵ favors an increase in rents.

All the preceding results--and ambiguities--would hold if A were initially a small firm, except, of course, that concentration could decrease. More generally, where differences in firms' costs underlie changes in their market shares, one ought to expect any change in market structure to promote efficiency. However, with constant returns-to-scale, there is a clear bias toward increased concentration as the main source of lower costs. So long as a firm's superior technology simply lowers the level of its horizontal marginal cost curve, the firm will expand to maximal efficient size.

Demsetz tests for this bias by comparing rates of return of large and small firms by industry. He finds no difference in these rates of return in low-concentration industries, so small firms do not seem to have a cost advantage there. However, in highly concentrated markets, the large firms have the higher rates of return, so Demsetz concludes that they have lower costs, and, by inference, that this cost advantage is the source of their large size.

Even if one accepts that inference, these results can be consistent with either competitive or oligopolistic pricing. For example, an

industry whose supply schedule passes through V in Figure 1, while some firms have marginal costs like QNM could be characterized as competitive, while the cost difference generates both high concentration and producer rents. However, in another industry the aggregate marginal cost of the superior firms could pass through U , while a collusive agreement among them keeps the price at P_1 . In that case, a smaller firm could survive, and the same disparity among rates of return would be observed. Indeed, once one allows for both the traditional connection between concentration and collusion and for differences among firm costs, still less benign solutions become consistent with Demsetz's results. For example, let the long-run supply from less efficient firms be increasing. Then let the process described by Demsetz and McGee generate increased concentration which incidentally decreases the cost of collusion. The large firms may now find it in their interest to set a price above the previous competitive price (P_1), even though they must yield some market share to do this. The marginal firm in this case would be both "small" and earning a "competitive" rate of return, and this result would also be consistent with the Demsetz data.

(See Demsetz, 1974, pp. 178-179.)

My intent here is not to catalog possibilities, but to indicate that there is insufficient evidence for a conclusion that the effects of concentration are either wholly beneficial or costly.

If an eclectic integration of the prevailing theory cannot therefore be ruled out, it becomes a useful framework with which to evaluate the main costs and benefits empirically. In the remainder of the paper I try to do just this. Specifically, I ask the following questions:

1. How important is the relationship between market structure and costs?

2. How much of any resulting change in costs is translated into price changes?

3. How important is the relationship between market structure and collusion, and how much are prices thereby affected?

While answers to these questions would be useful in clarifying an important academic literature, they also have important policy implications. The merits of an anti-concentration policy can hinge on whether the collusion effects of concentration outweigh the cost effects.

The discussion so far can be summarized symbolically as follows. The prevailing view on the effects of market structure on the price of any good would be

$$(5) \quad p = p(X, C, MS)$$

where

p = price of the good

X = set or index of demand shifters

C = index of supply shifters, which can be subsumed under the rubric of "costs"

MS = some measure of market structure, i.e., the number and size distribution of firms, which is a proxy for the cost of collusion.

Putting aside important qualifications about the effects of varying demand elasticities, the measurement and relevance of the various components of C , etc., low cost collusion is assumed to lead systematically to an increase in the ratio of price to either marginal or average cost, so that

$$\frac{\partial p}{\partial MS} > 0 \quad (\text{where higher MS implies lower cost collusion}).$$

The underlying theory permits (5) to be applied across isolated markets for a homogeneous good, or to a particular market over time. For my purposes, it will be useful to treat the variables in (5) as (logarithmic) time derivatives rather than levels. The essential eclecticism is then introduced by a companion function for costs

$$(6) \quad C = C(Y, MS),$$

where

Y = set of exogenous determinants of the cost index, e.g., factor prices.

The MS term in (6) is meant to summarize what is really a two-way (and non-monotonic) relationship: changes in MS (in either direction) both cause costs to decline and are induced by changes in costs. Once a relationship like (6) is admitted, the total effects of MS on p become more complex. Specifically,

$$(7) \quad \frac{dp}{dMS} = \frac{\partial p(\cdot)}{\partial MS} + \frac{\partial p(\cdot)}{\partial C} \frac{dC}{dMS}.$$

If, in the particular case of increased concentration, $\frac{dC}{dMS} < 0$, the prevailing view that the first term on the r.h.s. is positive can be correct even though the total derivative is negative. Moreover, if some of the effect of a cost change shows up in producer rents ($\partial p / \partial C < 1$), the prevailing view can be wrong, but measured profitability will be positively related to MS.

The next section specifies (6). This is subsequently estimated, and the results are used to estimate (5) and (7). These, in turn, provide the answers to the questions I have posed.

II. The Relationship Between Costs and Market Structure

For simplicity, classify the firms in any industry into two groups: Type L firms are or will become the largest in the industry; type M firms are all the others. The industry's cost per unit of output (C) at any point in time is then

$$(8) \quad C = sL + (1 - s)M,$$

where

L, M = the unit cost of a firm in each group, which is assumed to be the same for all firms in the group.

s = Type L's share of industry output (e.g., a four-firm concentration ratio, if the type are defined as the largest four).

Since we will be interested in percentage changes over time in C (\dot{C}), note that

$$(9) \quad \dot{C} = \frac{1}{C} \left[s \dot{L} L + (1 - s) \dot{M} M \right] + \left[\frac{L - M}{C} \right] \frac{ds}{dt}.$$

The last term on the right-hand side of (9) captures the effect of market share changes on efficiency. It says that if, for example, the type L are more efficient ($L < M$) and their market share increases, the resource cost of industry output is thereby reduced. Now, express each type's unit cost change as

$$(10) \quad \dot{L} = r + \ell$$

$$(11) \quad \dot{M} = r + m,$$

where r is the sum of all forces changing costs which are common to the two types such as secular productivity growth and factor price changes, and ℓ, m

summarize forces peculiar to each group. This allows (9) to be expressed as

$$(12) \quad \dot{C} = r + \ell + (1 - s) \frac{M}{C} \delta + \left[\frac{L - M}{C} \right] \frac{ds}{dt},$$

where

$$\delta = m - \ell.$$

This says that the level, as well as the change, of market shares matter. For example, if the type L are becoming relatively more efficient over time ($\ell < 0$, $\delta > 0$), then industry costs will grow more slowly the greater the type L's market share.⁶

Further rearrangement of the terms leads to the following alternative expressions, both of which will be useful subsequently:

$$(13) \quad \dot{C} = r + \ell + \left[\frac{\frac{ds}{dt} + \frac{1}{D} (1 - s) \delta}{s + \frac{1}{D'}} \right], \text{ or}$$

$$(13)' \quad \dot{C} = r + \ell + \left[\frac{-\frac{ds}{dt} + \left(\frac{D' + 1}{D'} \right) (1 - s) \delta}{(1 - s) + \frac{1}{D'}} \right]$$

where

$$D = L/M - 1$$

$$D' = M/L - 1.$$

The meaning of these equations can be grasped by focusing on (13) when $D > 0$. In that case, small firms have a cost advantage. If $ds/dt < 0$, industry

efficiency will improve, because the more efficient firms gain market share (\dot{c} declines). The degree of improvement is greater the larger is the small firm advantage (i.e., the smaller is the $1/D$ term in the denominator-- assume $\delta = 0$ for the moment), and the larger is the share of output due to the more efficient firms (i.e., the smaller is s). Equation (13)' applies symmetrically where the large firms have the cost advantage.

It is now necessary to specify the link between market structure changes (ds/dt) and cost differences (D or D'). I assume the following simple relationships.

$$(14) \quad G_L - G_M = \alpha_1 D' , \quad \text{and}$$

$$(14)' \quad G_M - G_L = \alpha_2 D ,$$

where

$\alpha_1, \alpha_2 > 0$, and are constants

G_i = output growth rate of type i firms.

Each equation is applicable for D' or $D > 0$. These say that the type of firm with a cost advantage grows faster over time in proportion to its cost advantage. Adjustment costs affect the size of the proportionality constants, α_1 and α_2 , and I allow these to differ--mergers may have different costs than divestitures, for example. Notice that the adjustment process is only indirectly affected by differences in the rate of change of firm costs (δ). These will affect D or D' , but, for simplicity, I make no allowance for forecasting: That is, if the δ are expected to be maintained, the future values of D will change, and this could affect the response to the current D . The process described by (14) and (14)' is, however, completely myopic in this regard.

Since

$$(15) \quad \frac{ds}{dt} = s(1-s)[G_L - G_M],$$

the adjustment process can be expressed

$$(16) \quad Z = s(1-s)\alpha_1 D', \quad \text{if } ds/dt > 0$$

$$(16)' \quad Z = s(1-s)\alpha_2 D, \quad \text{if } ds/dt < 0$$

where

$$Z = |ds/dt|.^7$$

The next step is to introduce the adjustment process into (13) and (13)' by solving (16) and (16)' for D and D' and replacing these in the former equations. This yields

$$(17) \quad \dot{c} = r + \lambda + \left\{ \frac{-z^2/(1-s) + [z + \alpha_1 s(1-s)]\delta}{z + \alpha_1 s} \right\}$$

for $ds/dt > 0$

and

$$(17)' \quad \dot{c} = r + \lambda + \left\{ \frac{-z^2/s + \alpha_2 s(1-s)^2\delta}{z + \alpha_2(1-s)} \right\}$$

for $ds/dt < 0$.

Next, I introduce an assumed relationship between δ --the differential between large and small firm cost changes--and market growth.

The motivation for this is the empirical relationship between market structure and growth. For example, Nelson (1963) reports a significant negative correlation between the 1935-54 change in industry concentration ratios and growth

in value added. This is also present in the 1947-67 sample I shall use subsequently.⁸ In a model which purports to link market structure to differential costs, such an empirical regularity must logically be cost related. Therefore assume that rapid market growth reduces the small firm cost change relative to that of large firms, perhaps because it permits the smallest firms to adjust cheaply to minimum efficient size more quickly or creates favorable "learning curve" effects for them.⁹ To incorporate this relationship most simply, let

$$(18) \quad \lambda = ag$$

$$(19) \quad m = bg, \quad \text{so}$$

$$(20) \quad \delta = (b - a)g,$$

where

$a, b = \text{constants}$

$g = \text{growth in demand for output.}$

The sign of a and b need not be specified, but if growth is advantageous for small firms, $(b - a)$ should be negative.¹⁰ If that is true, then (17) and (17)' imply that, given large firm cost changes (λ), growth reduces industry costs. This occurs generally because the growth promotes lower small firm costs. In the specific case of increasing concentration, there is another force at work, captured by the $z\delta$ term in (17). Increased concentration in the face of rapid growth (declining small firm costs) would imply unusually low-cost large firms, and an unusual decline in industry costs as they increase their market share.

To allow for empirical implementation of (17) and (17)' by conventional techniques, I shall use 3-term Taylor expansions about $z = 0$.

These capture most of the important nonlinearities in the model,¹¹ and they can be written as the single equation

$$(21) \quad \dot{C} = r + ags + bg(1-s) + (b-a)g \left[\frac{Z^2 M_1}{\alpha_1^2 K_1} - \frac{Z M_1}{\alpha_1} \right] - \frac{Z^2}{\alpha_1 s(1-s)} + \text{Remainder Term},$$

where, if $ds/dt > 0$ then $i = 1$, and if $ds/dt < 0$ then $i = 2$, and

$$M_1 = -1$$

$$M_2 = +1$$

$$K_1 = s$$

$$K_2 = (1-s)$$

Finally, to obtain an empirical counterpart to r , the cost changes common to all firms, assume for simplicity that each industry's total output (Q) can be described by a Cobb-Douglass production function

$$(22) \quad Q = F(t, \phi) \prod_i I_i^{a_i}, \quad \sum a_i = 1,$$

where

I = input amount

a_i = constants, and

F = input productivity shift function, depending on secular (t) productivity growth and other (ϕ) forces.

Then assume; again for simplicity, that if some firms become more efficient, this efficiency is not specific to any one input. At the industry-aggregate level, this efficiency and its subsequent spread through any change in market structure, can then be included among the other forces (ϕ) in the shift

function in (22). As a further simplification, assume that the competitive profit maximizing conditions for a firm can be used in approximating industry unit cost changes, so

$$(23) \quad \dot{C} = -\dot{F} + \sum_i a_i \dot{p}_i,$$

where

p_i = input prices, and now

a_i = (constant) input cost shares.

Then assume a constant percentage secular growth (γ_i) of industry input productivity, so that \dot{F} can be decomposed

$$(24) \quad \dot{F} = \dot{F}(\phi) + \gamma_i.$$

We can now relate (23) and (24) to (21): r , summarizing the productivity and input price trends common to all firms, is simply $-\gamma_i + \sum a_i \dot{p}_i$, and everything else on the r.h.s. of (21) equals $-\dot{F}(\phi)$.

In the next section, I estimate the scheme in (21), (23) and (24).

III. Empirical Results: Costs and Market Structure

The basic cost relationships just developed are estimated here for a subset of 4-digit SIC manufacturing industries. The subset consists of those industries for which a meaningful change in unit cost (essentially industry expenditures deflated by an output index) can be computed for 1947-67. Since this is the longest period practicable, we face the risk that the basic cost relationships will be obscured by technological change. However, I felt the greater risk was that short-period changes in market structure would hide the more fundamental relationship we seek to measure, a relationship which after all purports to rationalize a nontrivial part of the existing variety of market structure. Even 20 years is not long enough to permit as much change in this variety as we might like.

Many current 4 digit industries had to be dropped because of changes in classification between 1947 and 1967,¹² or because reliable output indexes were unavailable from 1947.¹³ To limit potential measurement error, "industries" with low or changing coverage or specialization ratios were also deleted.¹⁴ Finally, I deleted two industries--drugs and ballpoint pens--which experienced profound technological change in this period. They met all the formal tests for inclusion, but their measured productivity growth was so atypical as to obscure some of the results and raise questions about the comparability of their earlier and later outputs. This left a sample of 165 industries.¹⁵

Cost data available at the 4-digit level include only labor and raw material expenditures by Census establishments. This leaves out expenditures (e.g., advertising) typically incurred by administrative offices rather than plants, and it excludes capital costs. I discuss later a modest adjustment for the former deficiency. I assume that capital costs are proportional to an

industry's gross book value of plant and equipment, for which data are available or can be estimated.¹⁶ The factor of proportionality is derived from Berndt and Christensen's (1973), estimate of annual capital cost shares for all manufacturing. I simply choose the proportionality factor that yields for my sample the Berndt-Christensen cost shares for 1947 and 1967.¹⁷

To calculate the cost-share-weighted input price changes on the r.h.s. of (23), distinguish three inputs: labor, raw materials and capital. The input cost shares are set at their 1947-67 means, and the input price changes are calculated from the following data:

1. Labor--payroll per employee. (Compensation per man hour is not consistently available for 1947.)
2. Raw materials. Purchase price indexes are not available by industry. However, the major change here is a decline in the relative price of agricultural to manufactured materials between 1947 and 1967. Therefore, using 1963 Input-Output (Office of Business Economics, 1967) data on the direct and indirect purchases of agricultural products per dollar of purchases for each SIC industry as weights, I estimate separate raw material price indexes for each industry.¹⁸

3. Capital. Since industry-specific data are unavailable, I assume that the change in the rental price of capital is the same for each industry.

Finding empirical counterparts to the crucial market structure variables on the r.h.s. of (21) poses a major difficulty. The relevant theory applies to firms classified by terminal relative size regardless of initial size. Unfortunately, corresponding published data do not exist. We have only conventional concentration ratios, which do not reveal where today's largest firms came from. Therefore, I must make the strong assumption that the large firms in 1967 are the same as (or at least dominated by) those in 1947. In keeping

with the simple size dichotomy embodied in (21) and to make the results of this study comparable with the bulk of the literature, Z is then defined simply as the absolute 1947-67 change in an industry's 4-firm concentration ratio (and s is the average of the two concentration ratios). The reader should, however, be aware that the model predicts cost effects for turnover of large firms as well as for net changes in their relative size.¹⁹ Finally, g is defined as the log of 1967 divided by 1947 sales net of the log change in the manufactured goods WPI. This variable's accuracy as a demand change proxy depends on an implicit assumption of unit elastic demand for each industry's product.

I want to test Demsetz and McGee's conjecture that the process described by (21) is more important for increases in concentration than decreases. The formal model does not allow for this except through differences in α . Therefore, I simply estimate separately the effects of increases and decreases in concentration, and see whether these effects are indeed different. The basic regression is given in Table 1 for the values of α_i which minimize residual variance (see Note to Table 1).

The results lend some support to the basic model and uncover a few puzzles. For example, the model predicts a coefficient of +1 for the first two factor price variables, and indeed both are insignificantly different from 1. However, the results show neither the expected difference between large and small firm cost changes (the coefficient of G_2 should be less than that of G_1), nor the relationship of the CR_1 coefficients to those of G_2 and G_1 (the former should equal the difference of the latter two). And the coefficients of the CR_2 terms deviate from their theoretical value of -1. In spite of these drawbacks, a market share effect on costs does show through, and as I demonstrate later, it is empirically important. Moreover, this

TABLE 1
REGRESSION ESTIMATE OF EFFECTS OF CHANGES IN CONCENTRATION
ON CHANGES IN UNIT COST, 1947-67
4-digit SIC Industries

Independent Variables		Coefficient	t-ratio
Symbol	Description		
	Input Cost Shares (a_i) × Input Price Changes (\dot{P}_i)		
1. LAB	i = labor	1.211	4.639
2. RMT	i = raw materials	.991	1.480
3. CAP	i = capital (cost share only)	.980	2.053
	Growth in demand:		
4. G1	gs	.079	.901
5. G2	g(1-s)	.116	2.150
	Change in Concentration:		
6. CR1+	$g \left[\frac{s^2 M_1}{\alpha_1^2 K_1} - \frac{s M_1}{\alpha_1} \right]$, for increases in concentration (0 otherwise)	-2.245	-3.245
7. CR2+	$\frac{s^2}{\alpha_1 s(1-s)}$, for increases in concentration (0 otherwise) ($\alpha = .856$ for (6) and (7))	-.006	-.026
8. CR1-	Same as (6), for decreases in concentration	-.645	-1.546
9. CR2-	Same as (7), decreases in concentration ($\alpha = -1.046$ for (8) and (9))	-.484	-1.006
Constant	--	-.328	-1.686
R^2	Coefficient of Determination	.342	
SE	Regression Standard Error × 100	20.760	

Note: The dependent variable is the log difference of 1967 and 1947 unit costs. Unit costs are total industry costs (labor + raw materials + capital) deflated by an output index. Total costs are from the 1947 and 1967 Census of Manufactures (with capital costs estimated--see text). Production Indexes are from the Census of Manufactures, Index of Production volumes. The 1947 value is set at 100, and the 1967 values derived by successive multiplication of cross-weighted 1954, 1958, 1963, and 1967 intercensus output ratios.

The factor cost shares are averages of 1947 and 1967 values. See text for sources of factor price changes. Since the capital cost price change is assumed to be a constant, only the capital factor share is entered on line 3.

Growth in industry sales and concentration ratios are from Census of Manufactures.

The α_1 are estimated by running the regression on the components of CR1 and dividing the coefficient of $g s M_1$ by that of $g s^2 M_1 / K_1$. (Since this uses 2 degrees of freedom, t-ratios are exaggerated by about 1 percent, given the sample size of 165.)

effect is asymmetric in just the way implied by Demsetz and McGee. Decreases in concentration do reduce costs, as predicted, and this does not depend on the aberrant negative α .²⁰ However, the effect is statistically insignificant and only a fraction of that of similar increases in concentration. Essentially, only increases in concentration matter very much. Their effects, moreover, are consistent with all of the nonlinearities emerging from the basic model.²¹ This consistency, though, hides a qualitative discrepancy between the empirical results and the basic thrust of the model. Empirically the main link between market structure and costs comes via the term (CRI+) in which market structure change and growth interact. An increase in concentration in a nongrowing market has trivial cost effects. In the model, this interaction term is supposed to have effects proportional to differences in firm cost growth rates. However, the coefficient of this term in Table 1 is much larger than any plausible difference in cost growth rates, so it seems clear that the model incompletely specifies the interaction of growth and market structure with costs.²² The size of this interaction is a puzzle that demands further work, but here I shall merely draw out its empirical implications.

These are summarized in Tables 2 and 3. These show the estimated reduction in unit costs implied by Table 1 for several combinations of the relevant growth and market share variables. These are chosen so as to range roughly one standard deviation on either side of the sample means. (No "low growth" calculations are shown, because these would uniformly yield trivial cost savings.) Since risk of error increases with distance from sample means, it is best to focus on the upper left-hand-corner entries in both tables. These point to two conclusions: (1) Market share effects can be substantial. With total factor productivity growing at around 2 percent per year in manufacturing, about 1/5 of this growth can be attributed to post-war market structure changes for a typical industry with increased concentration. (2) The effect is much

TABLE 2

REDUCTION IN UNIT COSTS, 1947-57, FOR VARIOUS COMBINATIONS
OF CONCENTRATION, INCREASES IN CONCENTRATION,
AND SALES GROWTH (NATURAL LOGS $\times 100$)

A. Average Sales Growth ($g = .48$)

Increase in Concentration Ratio 1947-67 ($Z+$)	Concentration Ratio (CR)		
	Average (CR = 35.3)	Concentrated (CR = 60)	Unconcentrated (CR = 15)
Average Increase ($Z+ = 8.8$)	8.0	9.2	3.5
Large Increase ($Z+ = 16$)	9.9	13.9	(4.8)
Small Increase ($Z+ = 2$)	2.4	2.4	2.1

B. High Growth ($g = 1$)

$Z+$ \ CR	Average	Concentrated	Unconcentrated
Average Increase	16.6	19.2	7.3
Large Increase	20.4	29.0	(10.2)
Small Increase	4.9	5.0	4.4

Note: () = increase in unit costs.

The entries show the estimated (continuously compounded) percentage decrease in the unit costs of an industry with the specified characteristics compared to an industry with unchanged concentration. The estimates are derived by calculating the $CR1+$ and $CR2+$ (see Table 1) implied by these characteristics, multiplying by the coefficients of these variables and summing. The characteristics are chosen to range roughly a standard deviation either side of the means for the subsample of industries with increasing concentration. The relevant means (standard deviations) for this subsample (89 industries) are:

$$\begin{aligned} Z+ &= 8.8 (7.1) \\ CR &= 35.3 (21.3) \\ g &= .480 (.562) \end{aligned}$$

(Industries with unchanged concentration are included in both subsamples.)

TABLE 3

REDUCTION IN UNIT COSTS, 1947-57. VARIOUS COMBINATIONS
OF CONCENTRATION, DECREASES IN CONCENTRATION
AND SALES GROWTH (NATURAL LOGS $\times 100$)

A. Average Sales Growth ($g = .727$)

Decrease in Concentration, 1947-57 (Z-)	Concentration Ratio (CR)		
	Average CR = 45.8	Concentrated CR = 70	Unconcentrated CR = 20
Average Decrease Z- = 8.1	2.9	3.1	2.1
Large Decrease Z- = 14	4.2	4.8	1.7
Small Decrease Z- = 2	0.9	0.9	0.8

B. High Growth ($g = 1.25$)

Z- \ CR	Average	Concentrated	Unconcentrated
Average Decrease	5.9	6.4	5.0
Large Decrease	9.9	11.3	6.9
Small Decrease	1.5	1.6	1.5

Note: See Note to Table 2. Means (standard deviations) of variables for the 77 industries in the decreasing-concentration subsample are:

Z- = 8.1 (7.1)
CR = 45.8 (23.8)
g = .727 (.535)

longer for increases in concentration than for decreases. A given increase in concentration lowers costs roughly two to three times as much as does an equal decrease.

It is worth examining the sensitivity of these results to the model specification. Note, for example, the implausible negative value of the adjustment coefficient, α , which underlies the estimates for decreases in concentration. Forcing a more, or indeed any, plausible value of α on the estimates turns out to make little difference. I estimated the equation in Table 1 constraining both of the α to take on various values from -30 to +30. Except in the neighborhood of $\alpha_i = 0$ (where the CRI variable essentially reduces to a single term and the explanatory power of the regression deteriorates noticeably), the results are very much the same: the mean cost changes are always within a percentage point of the values in Tables 2 and 3, and the regression standard error is also virtually unchanged.

Another aspect of the model that merits examination is the complexity of the CRI variables. These variables dominate the main empirical result, and they imply a relationship between costs and the level as well as the rate of change in concentration. In Tables 2 and 3, this level effect is almost always such that higher concentration reduces costs, holding constant the change in concentration. This relationship is most pronounced where concentration increases. This result merits skepticism, first because it depends partly on the way CRI is constructed, and second because the underlying model predicts it unambiguously only when concentration $> .5$.²³

As a crude check on the validity of both the theoretical underpinning of the CRI variable and its empirical implications, I estimated a regression in which the 4 market share variables (6-9) in Table 1 were replaced by 4 simpler terms which separated the concentration change from level effects:

a growth interaction term (gZ) and the concentration ratio (s) were entered separately for each subsample. The essential results were:

(1) The explanatory power of this regression is slightly smaller ($R^2 = .33$ v. $.34$) than in Table 1, which lends slight support to the more complex formulation shown there.

(2) Coefficients of gZ and s are both significantly negative ($t = -2.2$ and -2.3) when concentration is increasing and insignificantly negative when it is falling. This corroborates the basic result of Table 1 and the general pattern of results in Tables 2 and 3.

(3) The magnitude of the cost changes implied by this regression around the sample means tends to be larger than in Tables 2 and 3. For example, the changes corresponding to those in the first row of Table 2 would be 10.7, 15.8 and 6.2; for the first row of Table 3, we get 5.5, 8.0 and 2.8. This implies that both the concentration change and level effects in those tables may be conservative, but the patterns here and in the tables are sufficiently similar to support the amalgamation of these effects into the single CRI variable.

So far I have been lumping productivity and input price effects on costs together. To explore any interaction between market structure and input prices, as well as to check on the reasonableness of the preceding results, I estimated market structure effects on two productivity measures. The first is an estimate of F in (23), derived by imposing the Cobb-Douglas restriction that the coefficient of each weighted-factor-price change is unity. This is essentially an estimate of total factor productivity. The second is a conventional labor productivity (change in output per worker) estimate, which is motivated in part by the measurement error in the nonlabor factor prices. When these were regressed on the last six variables in Table 1,

the pattern in that table was repeated: only increased concentration significantly raised productivity. The magnitudes of the productivity improvement are also familiar. At the sample means, these were:

Total factor productivity: 8.6 percent, if concentration increases; 3.1 percent, if concentration falls.

Labor productivity: 11.4 and 3.5 percent respectively.

Finally, I examine the sensitivity of the results to the time period over which they are estimated. The relevant issue here is how long it takes before long-run effects dominate. A shorter time period will, for one thing, make the production function-cost curve relationship in equations (22) and (23) inappropriate. The more substantive risk of specification error arises from the need to distinguish the transitory from the permanent changes in market structure upon which the theoretical link to cost changes rests. Over short periods, concentration changes will be dominated by forces, like differences between the shape of large and small firm short-run marginal costs, which are ignored by our theory. Moreover, firms which are expanding rapidly to take advantage of their lower long-run costs can incur a short-run adjustment cost penalty. All this suggests that if we focus on too short a time period, the market structure-cost relationship will be unreliable and attenuated.²⁵

Theory, though, gives no guidance on what is "too short" concretely. Consequently, Table 4 shows the sample-mean cost changes derived from replications of the regression in Table 1 on data from various subperiods. For ease of comparison, the cost changes are shown per percentage point change in concentration. I also show the t-ratio for the coefficient of the growth interaction variable (CRI), since this turns out to be as concise a summary test of the significance of market structure effects on costs for any subperiod as it is for the whole period.

TABLE 4

COST REDUCTION (LOGS) PER PERCENTAGE POINT CHANGE
IN CONCENTRATION, ESTIMATED AT SAMPLE MEANS,
VARIOUS SUBPERIODS, 1947-67

Period	Industries with Increasing Concentration		Industries with Decreasing Concentration	
	Cost Reduction $\div \bar{Z}+$	t-ratio for Coeff. of CR1+	Cost Reduction $\div \bar{Z}-$	t-ratio for Coeff. of CR1-
1947-67	.91	3.25	.36	1.55
1947-63	.47	2.03	.08	1.28
1954-67	.55	2.29	.26	1.85
1947-58	.60	2.39*	(.12)	1.28
1958-67	.03	.393	.43	1.54

Source: See text and Tables 1, 2, 3. Figures for 1947-67 cost reduction are the upper left-hand-corner entries in Tables 2 and 3 divided by the associated \bar{Z} . All other cost reductions are derived analogously from regressions on subperiod data.

Columns headed "t-ratio . . ." show absolute ratio of the coefficient of the CRI variables to its standard error in the relevant regression.

() = cost increase

* = coefficient of CR2 also had $t > 2$. All other t-ratios for CR2 are less than 2.

The general pattern observed in the full period tends to hold for the subperiods: changes in concentration are associated with cost reductions, and these are more pronounced when concentration increases. However, the subperiod effects tend to be smaller than the full-period effects. This indicates that the underlying process generating the cost reductions indeed takes considerable time--at least two decades--to work itself out and/or that it can be partly obscured by impermanent changes in market structure.²⁶

In broad summary, then, the main result of this section is that long-period changes in market structure are accompanied by increased efficiency. This efficiency gain is most pronounced where concentration is high and rising and where demand is growing. In the next section I discuss the implications of this result for output prices and for the lengthy literature on concentration and profitability.

III. Market Structure, Prices and Profitability

The existing literature on profitability and concentration provides a convenient starting point for our analysis. Its almost universal conclusion is that high concentration and high profitability go hand-in-hand. Since the data used here share a common source with Collins' and Preston's (1968) contribution, their results provide a useful starting point. Their profitability measure is the "price-cost margin" (M) which is essentially:

$$\frac{\text{Revenues} - \text{Costs}}{\text{Revenues}} = \left(\frac{\text{price} - \text{unit cost}}{\text{price}} \right) .$$

They make no explicit adjustment for capital costs, so that their costs are essentially plant payroll + material costs.²⁷ Their sample, like mine, is drawn from the 4-digit SIC universe. Their essential result is the regression reproduced on line 4 of Table 5, in which M is made dependent on the 4-firm concentration ratio and the ratio of gross book value of fixed assets to industry sales. (The latter is meant to adjust for capital costs.) Their results can be compared with those of similar regressions for each census year for the sample used in this study (lines 1-6). The pattern is clear: the coefficient of concentration is almost always significantly positive and on the order of .1. (The generally superior results for the capital intensity variable in my sample, while encouraging, need not concern us here.) The concentration effect seems weaker in the two earliest samples, but confidence in the basic result is greatly strengthened when the equation is estimated in first differences (lines 7-9). Here the already weak level relationship survives the noise introduced by differencing, and its magnitude consistently

TABLE 5
REGRESSIONS OF PRICE-COST MARGIN ON CONCENTRATION AND CAPITAL INTENSITY. 4-DIGIT SIC INDUSTRIES. VARIOUS YEARS

Year of Census	Coefficients (t-ratios) of		R ²	S.E. × 100	N
	CR	GBV			
1. 1967	.112 (3.9)	.097 (4.3)	.21	8.2	165
2. 1963	.118 (4.3)	.103 (4.2)	.23	8.0	165
3. 1958	.099 (3.6)	.069 (2.4)	.14	8.0	165
4. 1958 (Collins and Preston (1968), p. 99)	.122 (2.5)	.011 (1.5)	.13	*	288
5. 1954	.069 (2.6)	.086 (2.5)	.10	7.8	165
6. 1947	.024 (1.0)	.122 (3.9)	.10	7.4	165
<u>Differences</u>					
7. 1967-1947	.103 (2.4)	.018 (.8)	.04	5.9	165
8. 1967-1958	.137 (2.9)	-.031 (1.7)	.07	3.7	165
9. 1958-1947	.120 (2.5)	-.025 (.8)	.04	5.2	165

Note: Source for all data: Census of Manufactures and Annual Survey of Manufactures (various years). Dependent variable (M) = (valued added - payroll costs)/value of shipments for 4-digit SIC industry.

CR = 4-firm concentration ratio.

GBV = gross book value of depreciable assets/value of shipments.

Line 4 is reproduced from a regression which includes an additional variable designed to measure the geographic extent of the market. The coefficient of this variable was insignificant at the .1 level. The simple regression of M on CR yielded a coefficient of .125 (t = 2.6), R² = .12. See Collins and Preston, p. 99.

N = sample size.

* = not reported.

Lines 7, 8, 9: Arithmetic changes in M between years indicated are regressed on changes in CR and GBV.

duplicates that in the Collins and Preston data. This comparability of level and change effects is extremely important, since it permits comparison between the main body of my results (which are necessarily estimated in changes) and that of the literature typified by Collins and Preston's study (which invariably employs levels).

A typical inference drawn from results such as those in Table 5 is that they signify inefficiency in concentrated markets. The problems with this inference may be seen with the aid of the following simplified linear representation of equations (5) and (6). Let the analogue to (5) be

$$(25) \quad P = C + as ,$$

where a = positive coefficient measuring the impact of collusion, which increases with concentration (s), while the analogue to (6) is

$$(26) \quad C = C_0 - bs ,$$

where b is another positive coefficient, and C_0 = constant. Here, all markets are initially atomistic ($s = 0$). Then some firms in some markets discover lower costs and gain market share. If these firms are sufficiently few, (26) will approximate the cross-market deviations of C from C_0 . Now, even if (25) and (26) hold simultaneously (see below), the reduced form typically estimated in the literature will entirely conceal the process in (26). The "margin" in this context can be defined as $P - C$, and (25) implies that

$$(27) \quad "M" = P - C = as .$$

That is, a regression estimate of (27) reveals only the collusion effect, when the reduced form for P is

$$(28) \quad P = C_0 + (a - b)s .$$

The net allocative effect of concentration depends on the relative magnitudes of a and b . Matters become more complicated if P responds differently to the components of C in (26). For example, suppose that low-cost firms fail to capture all the market because they eventually run into scale diseconomies, so that their marginal cost exceeds average cost. Then P will not fall by the whole bs term in (26). Approximate this, by rewriting (28),

$$(29) \quad P = l \cdot C_0 - kbs + as ,$$

where $k < 1$ is a constant. In this world, the reduced form (27) becomes

$$(30) \quad "M" = [a + (1 - k)b]s .$$

Note that both (27) and (30) imply the same sign for the coefficient of s , and that the sign in (30) is positive even if there is no collusion ($a = 0$). Thus, the conventional finding of a positive sign is consistent with an entirely noncollusive process. There are then two main empirical problems that have to be confronted: essentially, (1) what is the relative magnitude of a and b , and (2) is a positive?

The qualitative answer to the first question can be gleaned by looking behind the results in Table 5. Using Collins and Preston's result on line 4 and assuming that something like (28) rather than (30) holds (i.e., that $k = 1$), the definition of the margin implies

$$(31) \quad \frac{dM}{ds} = .122 = (1 - M) \left[\frac{d(nP)}{ds} - \frac{d(nC)}{ds} \right]$$

so that the relevant total derivative is

$$(31)' \quad \frac{d(nP)}{ds} = \frac{.122}{(1 - M)} + \frac{d(nC)}{ds},$$

where the first term on the r.h.s. is the assumed "collusion" component. In these samples, $(1 - \bar{M}) \approx .8$, and the top left-hand entry in Table 4 is an estimate of the second r.h.s. term when there is an increase in concentration. Thus, in this case, an estimate of (31)' yields

$$(31)'' \quad \frac{d(nP)}{ds} \approx .15 - .91 = -.76 .$$

This result--that the cost effect dominates strongly over any collusion effect--will survive the subsequent refinements. So a major inference of the received literature needs to be reversed. In fact, increased concentration signifies a net improvement in efficiency, and this is a substantial multiple of any collusion effects.

To get at these price effects more directly, we want to estimate the structural equation (5). In the present context, this requires estimates of (log) changes in industry price indices. The Census' industry "unit value" indices provide such estimates, but their use entails a major statistical problem. The unit cost variable is industry costs deflated by an output index. But the same output index is often used to deflate industry sales in order to estimate the price index.²⁸ Thus any measurement error in the output index will be shared by both price and unit cost changes, and straightforward OLS estimate of (5) will yield biased and inconsistent coefficients.

To overcome this problem, I use a two-stage procedure in which the predicted values of the unit cost variable from the Table 1 regression are used as regressors explaining price changes, thereby "purging" the cost variable of the measurement error it shares with price changes. The resulting estimate of the price change structural equation is in Table 6. It includes the following independent variables in addition to the change in unit cost.

1. The change in concentration, to capture the partial (i.e., costs-held-constant) effect of market structure on prices.
2. Growth in sales. This is a proxy for growth in demand, and this should increase price if most markets have long-run increasing costs, or adjustment to equilibrium takes over 20 years.
3. A correction (OCST) for costs excluded from the Census. The establishment basis of census reporting means that the Census' cost measure excludes items like advertising and central headquarters overhead. These excluded costs ought to affect price changes when they do not change proportionately with the included costs. However, Internal Revenue Service data from tax returns include total deductions by item for 3-digit industries. The largest item ("cost of sales and operations") corresponds roughly to the costs measured by the Census. Therefore, it is possible to compute a proxy for the ratio of total costs to costs measured by the Census from the IRS data at the 3-digit level. The log change in this ratio (OCST) is then entered for each 4-digit industry falling within any 3-digit class.²⁹ Unless OCST is a perfect proxy, it should have a positive coefficient below that of COST.³⁰

The results are consistent with prior expectations, and all of the coefficients are considerably greater than their asymptotic standard errors.³¹

TABLE 6

EFFECT OF UNIT COST AND CONCENTRATION CHANGES ON PRICE CHANGES,
1947-67. 4-DIGIT SIC INDUSTRIES

Independent Variables		Coefficient	Coefficient - Standard Error
Symbol	Description		
DCR	Change in 4 firm concentration ratio	.212	3.818
COST	Log change in unit cost	.934	21.767
GRO	Log change in total revenues	.050	4.630
OCST	Log change of ratio of "IRS" to "Census Costs"	.323	3.773
Constant	--	1.200	0.911

Note: Dependent variable is log change of 1947-67 industry price index. Census unit value indexes are used where available, otherwise industry value of shipments is deflated by an output index. (The latter procedure introduces error where there is net accumulation or depletion of inventories.) Source: Census of Manufactures, various years.

COST is predicted value from Table 1 regression.
See text.

See text for description of GRO and OCST. Sources: GRO-Census of Manufactures, 1947 and 1967; OCST-Internal Revenue Service, Source Book of Statistics of Income, 1947 and 1967.

Sample size: 165. All variables $\times 100$.

It is especially interesting that a 95 percent confidence interval for the COST coefficient barely overlaps unity. This means that, at least over two decades, sellers appear to retain some small part of any unusual productivity gains (and bear part of atypical cost increases). This coupled with the finding that high and rising concentration is conducive to lower costs may help explain part of the observed correlation between concentration and profitability. But there is more to this story, since the DCR coefficient in Table 6 is also positive. We can get at the net effect of an increase in concentration by using the information in Tables 2 and 6 to evaluate the total derivative in (7). For the "average" case of increasing concentration (DCR = +8.8), the approximate total effect is:

$$\begin{aligned}
 \text{coefficient of DCR} \times +8.8 &= .212 \times 8.8 \\
 - \text{coefficient of COST} \times &- .934 \times 8.0 \\
 \text{cost reduction if} & \\
 \text{DCR} = +8.8 \text{ (see Table 2)} & \\
 &= +1.9\% - 7.5\% \\
 &= -5.6\% ,
 \end{aligned}$$

or $-.54\%$ per percentage point increase in concentration. This last figure is directly comparable to, and not very different from, (31)", which now enables us to understand the process underlying the main result of the concentration-profitability literature. Briefly, more concentration raises profitability, not because prices rise, but because they fall by less than costs. If we ignore doubt about the significance of the cost effect when concentration falls, a similar calculation yields a price reduction of 4.4 percent for the average (DCR = -8.1) case (or .55 percent per point reduction in concentration). The two effects are roughly comparable, because the weak cost effect is reinforced by the pure price effect in the latter case.

These results pose an immediate question about the meaning of the pure price effect. Is it plausible to attribute that effect to collusion? Recall that an alternative interpretation would rely on rents to differential efficiency, and these could be consistent with a competitive process. These alternatives can be distinguished by estimating the effect of DCR separately for the rising and falling concentration subsamples. Since costs decline for both types of change, the "rent" interpretation implies an offsetting DCR effect for both types. In particular, this means that the coefficient of a decrease in concentration should be negative (or, since the cost effect is weak, at least not positive), which offsets some of the tendency of the cost reduction to lower prices.

This "rent" interpretation is not, however, borne out empirically. When the DCR variable in Table 6 is bifurcated, with each new variable equal to the DCR with a common sign and zero otherwise, the coefficients of both are positive and virtually identical to the value in Table 6. This means that when concentration falls, prices decline by more than costs and measured industry profitability falls. This process seems inconsistent with a pure "rent" interpretation, so the asymmetry between the profitability effects of increasing and decreasing concentration renders the "cost of collusion" interpretation more plausible.³²

Noncollusive interpretations cannot, however, be entirely ruled out. For example, when an output expansion by an efficient firm imposes losses on other firms, there is no need for the industry in the aggregate to earn rents from this efficiency. And the likelihood of negative aggregate rents is greater if the efficient, growing firm is small initially than if it is large, simply because the small firm has fewer inputs on which it can earn the efficiency rents that might outweigh everyone else's loss. Unless the small firm gets to be sufficiently

large, concentration will decline. Thus, coexistence of declining rents with declining concentration can be consistent with competition.³³

Even if the results in Table 6 are consistent with some collusion, they may overstate its importance. The theory which permits some rents to efficient firms implies that concentration-induced cost changes have a smaller effect on price than industry-wide changes in, say, wage rates. The positive coefficient of DCR may, in part, be correcting for our failure to allow for such differential effects by lumping all sources of cost change into the one COST variable. To test this, I implemented something like (29) by breaking COST into the component due to the change in concentration and that due to all other forces. The coefficients of these were .75 and .98, respectively, while that of DCR declined to .16. The implied total effect on price of an average increase in concentration becomes -4.5, instead of -5.6 percent. While this procedure does not allow a test of significance, the difference in the cost coefficients is consistent with some rents for innovating firms even in the absence of collusion.

The direct effect of concentration on price seems to have a shorter gestation period than the cost effect. This is evident in Table 7, which gives the coefficient of DCR in subperiod estimates of the regression in Table 6. These are uniformly positive and close to the full period estimate. This means that prices adjust completely to a change in concentration within a decade and that temporary and permanent changes have equally powerful price effects. This pattern may help explain the survival of the erroneous conventional wisdom about concentration. Consider a merger which permanently increases concentration and reduces collusion costs. This permanence may hinge on efficiencies which, however, take a long time for the merged firm to implement. Thus, the immediate and perhaps most easily detectable effect of the merger may well be an increase in price.

Since efficiency effects take hold so gradually, it would be desirable to observe the full price effect of changes in concentration over periods even longer than two decades. The only data currently available for this are crude, but they are suggestive. For a handful of 4-digit industries from 1939 to 1967 output indexes can be pieced together. Since sales data are not uniformly available, deflating value added by output is as close as we can come to a price index. In Table 8, the change in this "unit value added" is shown for 24 industries which experienced a large (10 or more percentage points) change in concentration, from 1939 to 1967, and whose growth in output or value added over the period was at least half that of all manufacturing or of their 2-digit groups. On average, these industries' "price" performance is about 20 percent better than that of either their 2-digit groups or all manufacturing. While it is hardly uniform, this superior performance characterizes virtually all the large deviations. Like the previous results, the degree of superiority is similar regardless of the direction of change in concentration (but, here it is more reliable for decreases). Since the average change in concentration here is about 15 percentage points, the average price effects here are about double those for the 1947-67 sample. Not too much can be made of this result, but it hints at the danger of ignoring the longer run consequences of a change in concentration.

The Role of the Number of Firms in an Industry. The empirical work has so far focused on concentration, since this allows comparability with a large literature. However another structural characteristic, the number of firms, merits examination, for it may affect both costs and prices. Telser (1972) has shown that, holding concentration constant, the price-cost margin increases with the number of firms. While this may disappoint Cournot's descendants, Telser suggests that it is consistent with an alternative, competitive dis-equilibrium explanation:

TABLE 7
PARTIAL PRICE EFFECT OF CHANGE IN
CONCENTRATION, VARIOUS
SUBPERIODS, 1947-67

Period	Coefficient of CR	Coefficient/ Standard Error
1947-67	.212	3.818
1947-63	.233	4.130
1954-67	.251	4.219
1947-58	.159	2.628
1958-67	.286	4.346

TABLE 8

CHANGE IN UNIT VALUE ADDED, 1939-67
INDUSTRIES WITH LARGE CHANGE
IN CONCENTRATION

<u>Increasing Concentration</u>				<u>Decreasing Concentration</u>			
Group: SIC and Industry	(1) Log Change in Unit Value Added (x 100)	(2) (1) - Average Change for Group		Group: SIC and Industry	(3) Log Change in Unit Value Added (x 100)	(4) (3) - Average Change for Group	
<u>Food</u>	111.1	--		<u>Food</u>	111.1		
2043 Cereals	110.2	-0.9		2046 Corn Refining	91.5	-19.6	
2071 Candy	119.2	8.1		2073 Chewing Gum	59.6	-51.5	
2072 Chocolate	128.0	16.9		<u>Printing</u>	89.6		
2082 Beer & Ale	46.4	-64.7		2753 Engraving	64.4	-25.2	
2087 Syrup	21.1	-90.0		<u>Chemicals</u>	26.3		
2098 Macaroni	120.5	9.4		2813 Industrial Gases	-40.6	-66.9	
<u>Chemicals</u>	26.3	--		<u>Petroleum</u>	103.7		
2844 Toiletries	57.3	31.0		2951 Asphalt Paving	38.3	-65.4	
<u>Metal Products</u>	122.5	--		<u>Rubber</u>	103.1		
3496 Collapsible Tubes	88.7	-33.8		3021 Rubber Shoes	125.5	22.4	
<u>Machinery</u>	74.4			<u>Stone, Clay, Glass</u>	105.1		
3555 Printing Mach.	85.6	11.2		3291 Abrasives	102.0	-3.1	
<u>Electrical Eqpt.</u>	72.0			3293 Gaskets	115.2	10.1	
3633 Washers & Dryers	65.9	-6.1		<u>Metal Products</u>	122.5		
<u>Instruments</u>	108.8			3425 Handsaws	132.9	10.4	
3871 Watches	56.5	-52.3		3481 Tacks & Nails	90.0	-32.5	
<u>Miscellaneous</u>	100.2*			<u>Instruments</u>	108.8		
3953 Markers	53.5	-46.7		3843 Dental Eqpt.	88.4	-20.4	
				<u>Miscellaneous</u>	100.2*		
				3953 Pins & Needles	63.0	-37.2	
<u>Column</u>				<u>Column</u>			
Average	100.2*	79.4	-18.2	Average	100.2*	77.5	-23.2
Standard Error		9.9	11.0	Standard Error		13.5	8.5

Note: Columns (1) and (3) are logarithms of a 1967 index of value added per unit of output (1939 = 1.00). Value added per unit is value added deflated by an index of output.

Value added and output indexes are from Census of Manufactures, various years.

"Group" refers to the 2-digit SIC class.

1947 output indexes were unavailable for the following industries: 2844, 3496, 3555, 3953, and all "decreasing concentration" industries, except 2046, 2813, 3021. In these cases, the 2-digit industry output indexes were substituted.

* = total manufacturing.

the high margins are attracting entrants. But our theory of structure-related efficiency raises yet another alternative. In its broadest form that theory posits a relationship between efficiency and inequality, of which concentration is just one indicator. Thus, consider the case where concentration increases even though the number of firms also increases, so smaller firms are losing market share. This means that the discrepancy in size between the largest firm and the "typical" firm grows wider than it would if both were gaining market share. On the other hand, when concentration declines in the face of an exit of firms, this size discrepancy is narrowing more than otherwise. In either case, the unusually rapid growth of one type of firm ought to be related to an unusual cost advantage. To test this, I added two terms to the regression in Table 1: the log change in number of firms if concentration decreased (zero otherwise), and the same variable for industries with decreasing concentration (zero otherwise). On the preceding argument, these should have negative and positive coefficients respectively. They did, though the effects were not overly powerful (both elasticities were around .1, with t-ratios of about 1.6).

To ascertain the competitive effects of a change in the number firms, I then added this variable to the regression in Table 6. On Telser's tentative explanation for his result, more firms would be attracted by rising prices, holding costs constant. However, the coefficient of the log change in number of firms is virtually zero (.003, $t = 0.2$). Thus my data hint that the main role played by the number firms is on the cost side of the profitability equation.

Conclusions

Most practitioners have chosen to interpret the profitability-concentration relationship as evidence for collusion. A minority has

emphasized the concentration-efficiency nexus. The evidence here is consistent with an eclectic view, but one in which efficiency effects predominate. An important implication of this finding is that, for all its bulk, the concentration-profitability literature is incomplete. Since it has largely been motivated by a collusion model, most of its growth has been elaboration of that theme. However, attention to the efficiency effects of concentration may yield the larger research payoff. For example, one major task is to separate the symptomatic from the causal elements in the statistical relationship between concentration and efficiency. A firm may stumble onto a cost-reducing process and then expand its share of the market. The two events yield distinguishable efficiency gains. The former of these is not caused by the increase in concentration, but both will be statistically related to it. More commonly, perhaps, efficiency does not come free, and this creates an immediate complication. Investment in search for efficiency will be induced by low costs of expansion, so in that sense the increase in concentration and the initial discovery are causally related.³⁴

If the literature is incomplete, so is the rationale it provides for legal hostility to concentration. The possibility that an anti-concentration policy can retain most of the efficiency gains associated with concentration and yield a net improvement in resource allocation cannot be ruled out. But if the magnitudes of the effects we have measured here are close to correct, the odds are against that possibility. It is not clear that U.S. antitrust policy restricts concentration very much (Pashigian, 1968; Stigler, 1966). However, if it does this, it is more likely to reduce efficiency, raise prices, and reduce owner wealth.

To get at the magnitude of the risks facing an anti-concentration policy, we can focus on industries which have a four-firm concentration ratio greater than .5. The average concentration ratio in this sector is around .7, and the typical member spent something over 70 cents per dollar of output for payroll and raw materials. Now imagine that through a divestiture action the concentration ratio for such an industry is reduced to .5. Given our empirical results, this could raise unit costs on the order of 20 percent, which in turn would raise price by 10 to 15 percent. Assuming unit elastic demand, the lower figure would impose a cost on consumers of around 9.6¢ per dollar's worth of output, of which 9.1¢ would be a transfer to producers. Resource costs would increase by around 12.7¢ per dollar of output, so producers would lose 3.6¢ per dollar, and the total loss would be just over 13¢. Since this concentrated sector currently accounts for around 1/4 or \$250 billion of manufacturing sales, any extensive deconcentration program would risk imposing losses which are many times greater than the typical estimates (e.g., see Harberger, 1954) of the benefits such a policy might have been thought to produce.

Footnotes

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¹See Williamson (1968) for a discussion of this kind of problem.

²This does not, of course, mean that efficiency, appropriately defined, deteriorates, but only that average cost is an inappropriate efficiency proxy in this case.

³This follows from

$$\frac{dC}{d\lambda} = \frac{-R_{\lambda}^A}{Q} + S_{\lambda}^A \frac{R^T}{Q^2} \left[1 + \frac{S_P^T}{S_{\lambda}^A} \frac{dP}{d\lambda} \right],$$

when we impose a supply-demand equilibrium condition on $dP/d\lambda$. This condition comes down to

$$\frac{dP}{d\lambda} = \frac{-S_{\lambda}^A \cdot P/Q}{E_D + E_S}.$$

⁴For two familiar cases--a constant shift in S^A , and a constant percentage shift-- $dC/d\lambda$ is always < 0 . In the former, $S^A_\lambda = 1$ and $R^A_\lambda = P$, so (3) is

$$\frac{dC}{d\lambda} = \frac{-C}{Q} - \left(\frac{E_S}{E_S + E_D} \right) \frac{R^T}{Q^2} < 0 .$$

In the latter case,

$$\frac{S^A_\lambda}{S^A} = \frac{R^A_\lambda}{R^A} = \frac{1}{\lambda} ,$$

and

$$\frac{dC}{d\lambda} = \frac{-S^A}{\lambda Q} \left[\frac{R^A}{S^A} - \frac{R^T}{S^T} + \frac{R^T}{S^T} \left(\frac{E_S}{E_S + E_D} \right) \right] .$$

if A is initially an "average" firm, so that its unit rents equal R^T/S^T , this too is negative.

⁵It attenuates the price decrease, but also retards the fall in unit cost.

⁶There is another sense in which the level of market share matters, which turns out to be empirically important: the bracketed term gets larger, the larger the share of the most efficient type firm, because C gets smaller. Thus, for a given increase in that type's share, the cost effect is larger the larger its market share.

⁷Note that there is an implicit conjecture here that Z is correlated with $s(1-s)$, because the QD terms affect only relative firm growth rates directly. In fact, in the sample we shall use subsequently, the correlation of the 1947-67 Z with the 1947 $s(1-s)$ is a significant $+0.22$.

⁸The simple correlation is -0.23 .

⁹That is, the small firm in a growing industry could accumulate a given volume of output (and experience) as quickly as a larger firm in a declining industry.

¹⁰There is an ambiguity here in that the empirical regularity we are seeking to incorporate applies to small firms generally, while the m variable applies to firms which end up small whatever their original size. I treat the effect of this ambiguity later, but it is essentially forced by the available data.

¹¹The important nonlinearities arise from the dual role of Z as an indicator and implementor of cost changes. Ignoring the growth interaction implied by (20), this feedback leads to $\dot{C}_{zz} < 0$. The growth interaction complicates this: \dot{C}_{zz} becomes uncertain for $ds > 0$, because higher Z implies loss of the growth benefits on small firm costs. These benefits depend on the level of small firm costs, and this makes $\dot{C}_{zg} \leq 0$ for $ds \geq 0$. For example, if $ds > 0$, $dZ > 0$ implies an increase in the ratio M/L (or D'). Since the beneficial effect of g on \dot{C} is amplified at higher levels of M and diluted by the positive ds , this implies further that $\dot{C}_{zg} < 0$. These results for \dot{C}_{zz} and \dot{C}_{zg} hold both for (17) and (17)' and their Taylor expansion (21).

¹²The main changes in classification occur in 1958. In some cases, the post 1958 SIC combines pre-1958 industries. These were retained in the sample only if pre-1958 concentration ratios could be reliably inferred for the post-1958 industry. In practice, this means that the industries merged have firms so small that none could conceivably be among the four largest prior to 1958, because the total output of the merged industry's largest four is much less than the average output of the merging industry's largest four.

¹³The 1954 Census of Manufactures, volume 5, singles out industries with unreliable output indexes. I deleted such industries where the 1954 index (1947 = 100) was more than 50 percent different from that of its 2-digit class.

¹⁴Low specialization means that the plants in the SIC industry produce substantial amounts for other markets, thus calling into question the relevance of the market definition. Low coverage means that plants elsewhere produce a large part of this industry's output, thus calling into question the meaning of narrowly based market structure measures. I deleted industries where the 1947 or 1967 product of the specialization and coverage ratio was under .6 or where either changed by over .1 between these years.

¹⁵A list of these industries is available on request. They account for about half of U.S. manufacturing sales.

¹⁶Gross book value (GBV) data are available from 1954 (Annual Survey of Manufactures), but the coverage expands over time. Where gaps had to be filled, a log linear form of $GBV_{t-1} = f(GBV_t, X)$ was first estimated, where X is a vector which includes capital expenditures between $t - 1$ and t (so f is an inverse form of the relationship running from GBV_{t-1} to GBV_t),

industry sales (which is used as a size deflator), and Internal Revenue Service data on assets for the 3-digit industry superclass. The missing GBV_{t-1} are then filled in using the regression weights and known values of the independent variables. The entire set of GBV_{1947} had to be estimated in this fashion, since pre-1954 GBV data are unavailable.

¹⁷None of the results reported subsequently are substantially different if capital costs are excluded. The correlation between the capital cost inclusive and exclusive cost changes is +.98.

¹⁸The industry price indexes are:

$$\text{Index}_i = \text{FM} + \text{AG}_i (\text{PA} - \text{FM}),$$

FM = Manufactured products wholesale price index,

PA = Farm products WPI,

AG_i = 1963 direct and indirect purchases of agricultural products per dollar of SIC industry i 's total purchases of materials.

For 1957 = 100: $\text{FM}_{47} = .759$, $\text{PA}_{47} = 1.099$, $\text{FM}_{67} = 1.072$, $\text{PA}_{67} = 1.004$.

¹⁹In addition, if my implicit assumption about the importance of adjustment costs is wrong, effects of intraperiod changes in concentration will not be captured. For example, both a brief rise in concentration and a subsequent fall which offsets it might be cost-induced, and these effects are assumed away here.

²⁰Much the same cost effect was found by assuming any of a wide range of positive values for α for that subsample. See subsequent discussion.

Specifically, at the sample means, we obtain the following signs for partial derivatives from the regression (with the signs derived from (17), for $\delta = (b - a)/\sigma < 0$ in parentheses):

$$\begin{aligned} \dot{C}_z &< 0 & (< 0) \\ \dot{C}_{zz} &> 0 & (?) \\ \dot{C}_g &< 0 & (< 0) \\ \dot{C}_{zg} &< 0 & (< 0) . \end{aligned}$$

²²The importance of the growth interaction is clear when the regression in Table 1 is estimated without some of the other nonlinearities. No explanatory power is gained by adding only the change in concentration, or CR2, to the first 5 variables. However, most of the Table 1 results are reproduced when linear growth interaction terms (gZ_1) are added. See subsequent discussion.

²³There are two types of cost change-concentration level relationships embodied in the model. One is described in footnote 6 above.

The other resides in the market share adjustment process ((16) and (16)'). If we hold Z constant, as is done along the rows of Tables 2 and 3, and the adjustment coefficient is also constant, then the large firm-small firm cost difference (the D' or D in ((16) or (16)')) is implicitly a function of s , and the extent of this difference obviously affects \dot{C} . Specifically, the same Z implies a higher D' the further s is from .5. Thus the relationship between \dot{C} and s is reinforced for $s > .5$, but offset for $s < .5$.

²⁴I added a term--change in the ratio of book value of assets for non-union firms--to the productivity regression, to show that it was not significant. mix.

²⁵One also has to be mindful of the reciprocal nature of this relationship. A firm--and therefore the industry in which it is classified--can become more efficient today, while its cost advantage is only subsequently translated into larger market share.

²⁶One reason for this is that more general long-run equilibrium cost changes occur slowly. The subperiod regressions underlying Table 4 tend to be characterized by insignificant or implausible negative coefficients for the factor-share-weighted input price change terms, which is a symptom of incomplete adaptation to these price changes. Like the market share effects, these input price effects also tend to be more erratic over the two shorter subperiods.

²⁷See Collins & Preston (1968), p. 119 for qualifications.

²⁸And the rest of the time the output index is estimated by deflating industry sales by the price index.

²⁹More precisely, our main cost variable is census costs + estimated capital (interest + depreciation) costs. In computing OCST, therefore, the denominator includes depreciation, interest and $.2 \times$ stockholders equity (roughly the postwar average pre-tax return on equity in manufacturing) as well as "cost of sales" and operations. The numerator is reported total deductions plus the imputed cost of equity.

³⁰Let the true relationship be

$$\dot{P} = a\dot{C}^*$$

where \dot{C}^* = change in total costs. Let C = costs included in COST, so

$$C^* \approx R \cdot C$$

where $R = C^*/C$. However, we know only the proxy for \dot{R} , OCST. If

$$\dot{R} = b + d(\text{OCST}),$$

the estimate of \dot{P} is

$$\dot{P} = ab + ad(\text{OCST}) + a\dot{C}.$$

If there is no measurement error, $b = 0$, $d = 1$, and $ad = a$. But since OCST is not a perfect proxy, $d < 1$ and $E(\hat{ad}) < a$.

So long as $d > 0$, we want to take account of any market share effects on the costs not in C . For example, if the share of central office overhead in total costs grows with concentration, part of the previously calculated cost reduction would be offset. However, regressing OCST on the market share variable in Table 1 yielded insignificant (and numerically trivial) effects of both increased and decreased concentration.

³¹The coefficient of GRO may be partly spurious, since the dependent variable is GRO-change in output. If GRO is deleted, the remaining coefficients are virtually unchanged and their standard errors increase by about 1/5.

³²Stigler (1964) argues that the Herfindahl (H) index is superior to the concentration ratio as a proxy for the cost of collusion. Since the Herfindahl index is unavailable for our sample, this argument cannot be directly tested. However, Nelson (1963) provides H for a sample of 4-digit industries. I regressed the log of H on the log of concentration and its square, and found an essentially constant elasticity of about 1.8. This crude empiricism and Stigler's theory suggest that raising concentration to a power and substituting the change in this variable for DCR in Table 6 will improve the

results, if the "cost of collusion" interpretation is correct. I attempted this transformation for powers ranging from .25 to 2, and the results are encouraging for Stigler's model. The coefficient of this transformed variable rose steadily relative to its asymptotic standard error as the power was increased. At a power = 2, this ratio was 4.97 (compared to 3.82 for power = 1), and the coefficient is $.25 \times 10^{-2}$.

Empirically, this means that the total price effect of a change in concentration is essentially invariant to the level of concentration (s), because the differing price and cost effects cancel. To illustrate, for DCR = +8.8, and the sample average CR (= 36.3), the partial price effect is $.25 \times 10^{-2}(40.7^2 - 31.9^2) = 1.6\%$, and the total price effect is -5.9%. For CR = 60, this calculation is $.25 \times 10^{-2}(64.4^2 - 55.6^2) = 2.6\%$, but note from Table 2 that the cost effect is also larger (9.2% v. 8.0%), and the total effect ($2.6 - .94(9.2) = -6.0$) is the same.

³³I am indebted to Yale Brozen for pointing this out. A simple numerical example may clarify his argument: Consider a five-firm industry where firm A initially has 60 percent of the market and B, . . . , E each have 10 percent. Let "CR" then be 60 percent. Initially $P = C = 1$, and there are zero rents. Now let any one of these firms (a) discover a way to lower C to .8, (b) cut P to .9 and (c) add 20 points to its market share. The efficient, growing firm then gets rent per unit of its output = .1, while all other firms suffer a loss of .1 per unit. If A is the efficient firm, CR will increase to 80, and industry rents per unit will be $+.06 = .80(.1) + .20(-.1)$. If B is the efficient firm and gains sales proportionately from other firms (including A), CR will decline to $46\frac{2}{3}$; B is bigger (30 percent of the market), but still not as big as A. In this case, unit rents are $-.04 = .30(+.1) + .70(-.1)$.

There would be increasing rents together with decreasing concentration if B obtains between 50 and 60 percent of the market and thus replaces A as the dominant firm. The essential logic of the example is that the firm discovering the efficiency can apply it (and earn rents) to all its output, not just the output it adds; and A has the larger output base.

³⁴This is at least one way to interpret the importance of the interaction between growth and concentration in explaining efficiency. The growth can both lower expansion costs and increase the payoff to a cost-saving discovery.

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