

# Testimony to the Joint Economic Committee Regarding the Concentration of Corporate Power

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Free markets have been a bedrock of the American economy for more than a century. Free and competitive markets have many virtues: they lead to lower prices for consumers; they encourage businesses to hire, invest and innovate; they increase the variety and quality of goods and services; and competitive labor market improve compensation and working conditions.

Recent years, however, have witnessed troubling signs that US markets have become less competitive: most industries have become more concentrated and dominant firms have become more entrenched; prices in several key sectors are significantly higher in the U.S. than in other rich countries; corporate profits have increased while the labor share of national income has decreased; investment has been weak while payouts to shareholders have increased. Several factors probably contribute to each of these facts, but taken together they suggest a significant decline in competition.

In this short essay I will review the evidence, explain why free markets are fragile, and assess the impact of declining competition on the living standards of American families.

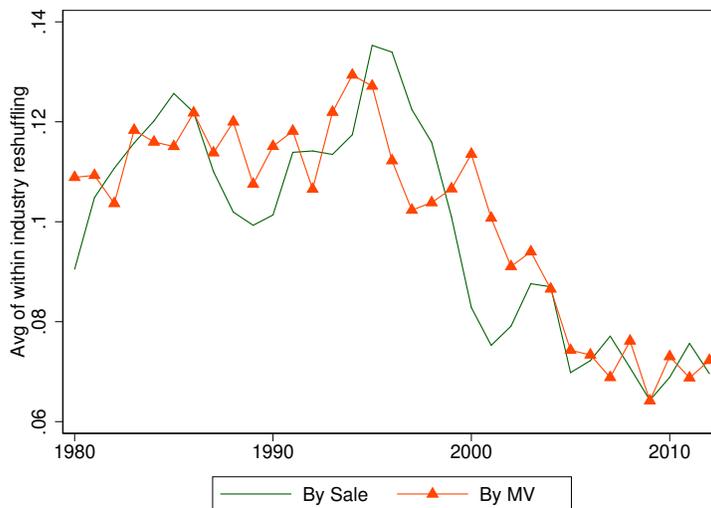
## 1 Evidence

Some studies offer a broad view of the US economy. Others focus on the markets for specific products or services in specific locations. These two types of studies are complementary. With broad studies it can be difficult to isolate confounding factors and establish precise causal mechanisms. Specific studies are not always timely and can miss important trends that cut across several markets.

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Figure 1: Declining Turnover of Dominant Firms



The figure shows one minus the rank correlation of (sales, market value) over the following 5 years. Sources: Covarrubias et al. (2019), Philippon (2019).

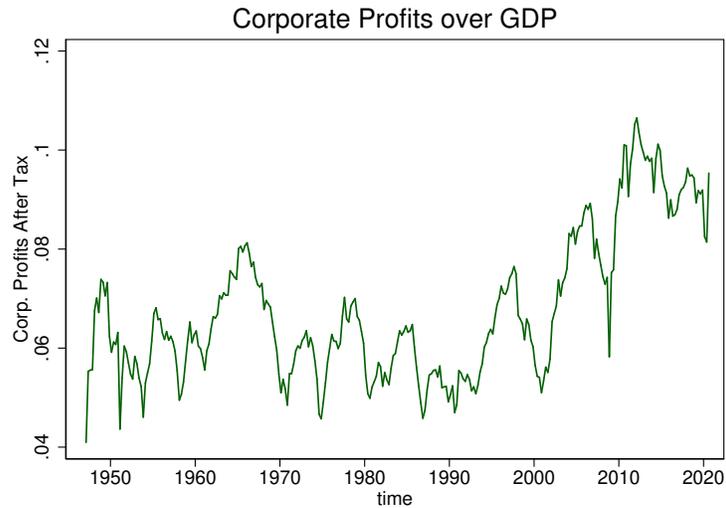
## 1.1 Concentration and Entrenchment

Trends in industry concentration are by far the most discussed in mainstream media, so I will be brief. Many studies have shown that concentration has increased in more than three quarters of US industries since the 1990s (Grullon et al., 2019; Autor et al., 2020). Concentration is a useful but imperfect indicator because it is the outcome of a dynamic process. As a result, concentration can be benign or harmful depending on the underlying driving force. Concentration is beneficial when it is driven by lower trade costs, e.g. lower shipping costs or lower search costs. When these costs are low the best producers expand at the expense of inefficient ones, which improves consumers’ welfare and increases concentration simultaneously. This reallocation can happen within a country (geographical expansion, Rossi-Hansberg et al.) or across countries (international trade, Covarrubias et al. (2019)). An important point is that this type of concentration is beneficial precisely because new competitors enter into existing markets. Some industries – in manufacturing, in retail and wholesale trade – fit this pattern, but many – in telecom, air transportation or healthcare – do not.

Instead of looking at the concentration of market shares at a point in time, Figure 1 considers the reshuffling of markets shares. In competitive industries entrants should challenge dominant firms and thus we would expect market shares to change over time. To test this idea we rank all large firms – by market value or by revenue – in a particular year, and we rank them again five years later. The change in rankings over a five-year window is a measure of reshuffling. Figure 1 shows that reshuffling has decreased over the past twenty years.<sup>1</sup> We can make similar point by looking at top 100 (or 500) companies. In 2000 only 45 of the largest 100 American companies

<sup>1</sup>Formally the figure shows one minus the rank correlation in year  $t$  and  $t + 5$ . If the correlation between the two rankings is one, it means that the relative position of firms has not changed at all over five years. If it is zero, it means that there has been a complete reshuffling within the industry. We can therefore define reshuffling as one minus the rank correlation.

Figure 2: Corporate Profits



Sources: NIPA and Financial Accounts of the United States.

had been in the top 100 every year between 1991 and 2000. In 2019 that figure was 71 out of 100. I find this statistic useful because it provides a dynamic view of the economy. It suggests that dominant firms have become more entrenched over the past 20 years.

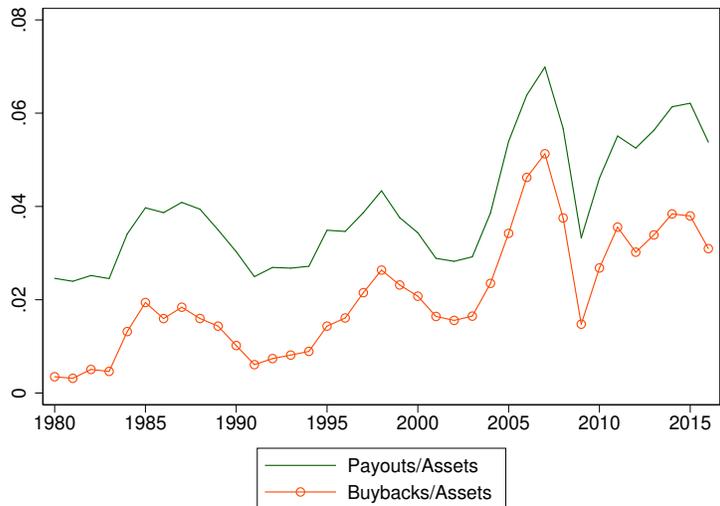
## 1.2 Corporate Profits

Figure 2 shows the evolution of after-tax non-financial corporate profits in the US since 1946. After-tax profit used to fluctuate around 6% of GDP for most of the post-war period. After 2000, however, they increased substantially to around 9% of GDP. Several factors could explain this evolution. Technological change, for instance, could have increased the role of capital in production. This explanation would imply a boom in investment, however, and Gutiérrez and Philippon (2017) show that investment - both tangible and intangible - has been lower than expected over the past 20 years.

High corporate profits did not, in fact, lead to high investment, but, as Figure 3 shows, to high payouts to shareholders. Figure 3 also shows that the increase in payouts is entirely explained by the increase in share buybacks. Dividends have been roughly constant as a share of assets.

These trends reflect in part the rise of intangible assets past 40 years (Crouzet and Eberly, 2019). Intangible expenses explain a large part of the rise in markups documented by (De Loecker et al., 2020). Intangible assets can blur the line between efficient and inefficient concentration: they make some firms more productive but also create barriers to entry.

Figure 3: Payouts to Shareholders



Total Payouts (Dividends+Buybacks) in Green; Buybacks in Red Circles. All series are scaled by total assets. Sources: Compustat and Gutiérrez and Philippon (2018).

### 1.3 Labor Markets

Industry consolidation can affect workers as well as consumers. Monopoly and monopsony power have broadly similar implications for the distribution of national income. Dominant employers can mark down wages and have weak incentives to improve working conditions. They can also impose noncompete agreements on their employees. Azar et al. (2017) show that employers in many local labor markets enjoy monopsony power. The academic discussion centers around the size of the effect. Schubert et al. (2021) argue that the aggregate impact is relatively small since most U.S. workers are not in highly concentrated labor markets, but they find that a subset of workers experience meaningful negative wage effects from employer monopsony power. Stansbury and Summers (2020), on the other hand, emphasize the decline in unionization and argue that a decrease in labor power (the opposite of monopsony) can account for recent trends in the US economy.

### 1.4 Specific Studies

We must complement the broad trends discussed above with detailed studies of specific industries. For instance, Gaynor and Town (2012) study Hospital consolidation and show that they generally results in higher prices, and Gaynor (2021) provides a recent review of competition in the US healthcare system. Micro studies make it possible to carefully study prices, how they relate to costs, and how they vary across locations (Cooper et al., 2019, 2021). Faccio and Zingales (2017) estimate that US consumers would gain \$65b a year if US mobile service prices were in line with German ones, and Philippon (2021) shows that American consumers pay more for broadband and wireless services than consumers in other industrialized nations.

Several studies point out that the weakening of antitrust enforcement is at least partly responsible for the decline in competition (Kwoka, 2015). Ashenfelter et al. (2014) survey 49 studies that estimates the price effects of consummated horizontal mergers in 21 industries over 30 years. Of the 49 studies surveyed, 36 find evidence of merger-induced price increases.

## 1.5 Take Away

Several economic forces are always simultaneously as play in a large and diversified economy such as that of the US. The conclusion of our rapid review of the literature is not that every industry has experienced a rise in market power. Some industries are subject to increasing foreign competition. The bulk of the evidence suggests, however, that many industries have become less competitive and that excessive market power has become a serious issue.

## 2 Consequences for Consumers and Workers

The economic consequences of monopoly power are complex so I find it useful to decompose them into redistribution effects (inequality and transfers of wealth) and production effects (investment, productivity growth).

### 2.1 Direct Impact on Consumers

Let us start with the redistribution effects. Combining data on prices, wages, concentration and investment, Philippon (2019) concludes that prices in the US are somewhere between 7% and 8% too high. The typical household spends about \$53,000 each year. Increased monopoly rents over the past 20 years thus represent an additional cash outlay of about about \$3,700 per year. This is a significant expense. According to the 2019 Report on the Economic Well-Being of U.S. Households from the Federal Reserve, “relatively small, unexpected expenses, such as a car repair or a modest medical bill, can be a hardship for many families.” In their survey, only about 60% of adults report that they would be able to cover a hypothetical expense of \$400 with cash (or its equivalent).

If we aggregate these extra payments across all households, we find that American families pay around \$600 billion each year in excessive monopoly rents. These transfers of wealth increase inequality because capital income is more highly concentrated than labor income. The median household does not earn much capital income compared to households in the top deciles or percentiles of the income distribution.

### 2.2 Impact on Growth

Let us now turn to production effects. The estimates we have just discussed reflect direct wealth transfers from households to corporations, and from workers to shareholders, but they do not take into account changes in quantities of goods and services produced. Market power not only redistributes income, but it also affects GDP. To understand the full consequences of monopoly power we must therefore take into account its impact on investment, employment,

and production. Economists use models to answer this type of question.<sup>2</sup> I will use a simple model to perform the following thought experiment: suppose we could roll back the barriers to entry, undo the bad mergers, and somehow return to the level of competition we had in the late 1990s. How much better off would we be?

We start from an economy where GDP is 100 units and labor earns 65 of these units, so the labor share is exactly 65%, which is its historical value until 2000. Firms include a 5% markup in their (gross) output prices and their net profits exactly cover their fixed costs. This corresponds to a standard economy with free entry. We then engineer an increase in gross markups from 5% to 10%.<sup>3</sup> The demand for capital, labor and intermediate inputs decreases. In this economy with lower competition, GDP drops to 95 units and labor income drops to 58 units. The new labor share is therefore  $58/95 = 0.61$ , which is in line with the decline observed in the US. The stock of productive private capital decreases by 10%, consistent with Gutiérrez and Philippon (2017).

Let us put these numbers into perspective. US GDP is about \$20 trillion. If we could make the economy as competitive as it was 20 years ago, this would increase by 5% to \$21 trillion. The compensation of employees is about \$11 trillion. In a competitive economy it would be  $65/58 \times 11 = \$12.3$  trillion. These calculations suggest that the lack of competition has deprived American workers of about \$1.3 trillion of labor income each year. For the median households, this represents a decrease in living standards of more than \$5,000 per year. These calculations give us a sense of the magnitude of the benefits that enhanced competition would bring.

### 3 Free Markets as a Public Good

In the conclusion of my recent book, *The Great Reversal* (Philippon, 2019), I write that free markets are surprisingly good, and surprisingly fragile. I would like to conclude this essay by explaining why. The list of industries where dominant firms threaten free and competitive markets is long and diverse. It includes widely different types of goods, services, and technologies, which appears puzzling at first, and suggests that some fundamental economic principle must be at play.

Free markets are fragile because of a collective action problem (Olson, 1965). Since – by definition – market power is concentrated, the dominant players can coordinate to maintain and reinforce it. The beneficiaries of free markets, on the other hand, are at best loosely connected and face a nearly insurmountable collective action problem. One internet service provider and one landlord can effectively restrict the options of many tenants.

Free markets, then, are a kind of public good, like clean air or clean water. We all benefit from them, but our individual incentives to protect them are rather weak. This is why we need public institutions to protect free

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<sup>2</sup>A model is a set of equations that represent the decisions of economic agents and the clearing of all markets. For instance, households supply labor and make consumption/saving decisions. Firms hire capital, labor and intermediate inputs, and compete with each other to supply the goods and services that households and other businesses want to buy. They understand that demand is elastic: they lose customers if they set their prices too high. All of these decisions can be written as mathematical objects. We can also incorporate the decisions of the government (taxes, spending, regulations) and the central bank (interest rates).

<sup>3</sup>There is an important technical point here. Because intermediate inputs are also marked up, value added markups increase by more than gross output markups. How much more depends on the details of the production process (e.g., linear vs. roundabout) but with an intermediate revenue share around 0.4, this increase of 5 percentage points in gross output markups corresponds to an increase of 7 to 9 p.p. in value added markups.

markets, so that consumers, workers and small firms can trust the prices they see and focus on making the right decisions without excessive fear of being abused by market power.

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