

Monopoly and the Generic Auto Parts Controversy - An Economic Perspective

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I. Background and Overview

Generic auto body parts, sometimes referred to as crash parts or cosmetic parts, are sheet metal components such as hoods, fenders and doors, which account for the majority of damage to cars in auto accidents. Hundreds of thousands of accidents involving damage to these parts occur each year. The repair and replacement of these parts is an important source of revenue for auto body repair shops and the parts manufacturers themselves.

Prior to 1970, auto body repair shops had to buy replacement parts like fenders, door panels and grills only from auto manufacturers. Original equipment manufacturers (OEM)s had virtually no competition in this market. Car-makers had a lucrative monopoly, which they have fought to preserve. When independent manufacturers in several countries, including the United States, began making sheet metal replacements, the OEMs found themselves facing some tough competition. Because most of the independently made parts are lower priced, they have helped to bring down the prices of OEM parts. Many states now require the option of generic parts, sometimes called aftermarket parts.

Despite the obvious cost advantages associated with the use of generic parts, in a lawsuit against State Farm Mutual Auto Insurance Co. involving the insurer's use of generic parts, an Illinois jury last October found the company liable for \$456 million in damages and an additional \$730 million in punitive damages, bringing the total awards in the case to \$1.19 billion. Although State Farm is appealing, it has discontinued using generic parts. Other insurers have suspended their use as well.

II. Monopoly: The Impact on the Crash Parts Market

The verdict in favor of the plaintiffs in the State Farm case is allowing automakers to regain the monopoly they exploited in the past when there was no competition in the market for crash parts business. That a local state court would actually act to eliminate competition in an otherwise competitive market, impose its own views on all US consumers, and grant monopoly power to a small number of corporations is not only unprecedented—it is also anathema to the concept of free and fair competition that is at the core of the United States economy.

Prices for most goods and services in a modern society are determined in competitive markets through the interaction of supply from sellers and demand from buyers. This presupposes that there be choices available. The State Farm case essentially eliminates competition among sellers in the market for crash parts, effectively granting a monopoly to the manufacturers of original equipment parts. The law of supply and demand does not work to the public's benefit when there is only one supplier.

What is the Impact of Monopoly?

Most consumers have an instinctive revulsion toward monopoly. Their visceral response to the concept of

monopoly shows an intuitive understanding of economic theory.Â They know as well as economists that monopoly is bad news for them. That monopoly prices are higher than competitive prices makes consumers angry, but higher prices are just one of monopolyâ€™s many undesirable effects.Â Fortunately, economists have studied monopoly for centuries.Â Its impacts on producers, consumers and the overall economy are well understood.Â These undesirable consequences of monopoly are the subject of the discussion that follows.

1. Monopoly Leads to Higher Prices

Higher prices are the most widely recognized consequence of monopoly.Â This recognition led the famous 18th century English economist Adam Smith to declare: â€œThe price of monopoly is upon every occasion the highest which can be got.â€•

The impact of competition in the parts business is considerable.Â For example, according to *Consumer Reports*, the cost in 1982 of a nose cover for a 1983 Chevrolet Camaro made by GM was \$325.Â In 1988, after generic parts began to appear, the same part cost \$225â€”a decline of 31 percent.(1)Â Â Likewise, the cost in 1992 for a Toyota-manufactured fender for a new 1992 Toyota Camry was \$253.Â Non-OEM manufacturers began to produce this same part in 1993 for just \$202.Â By 1996, the price for the Toyota-manufactured part had declined by 43 percent to \$143.88.Â The competition also affected the price of the generic part, which fell 70 percent to just \$60.(2)Â Â Similar examples abound.

Testimony in the State Farm case revealed direct savings of about \$40 per generic part used.Â This means that the simple choice of a generic part over an OEM part produced an immediate savings of \$40.Â Additional savings accrue from the restraining effect that generic parts have on prices in the crash parts market.Â In other words, the price of OEM parts would be still higher if it were not for the existence of competition from generic equivalents.Â Â These savings amount to \$17 per OEM part and \$36 per generic part.

The elimination of competition from the crash parts business could easily lead to price increases of 50 to 100 percent or more.Â The higher cost for parts will also lead directly to more cars being declared constructive total losses.Â This is because higher repair costs create a disincentive to effect repairs. Insurers will simply pay policyholders the actual cash value of the vehicle and, in turn, will have to charge higher premiums to cover the costs of the increased number of total losses.Â Car owners without collision or comprehensive coverage will suffer from the higher prices as well.Â Many will be unable to afford to repair their vehicle.Â Ultimately, more cars will wind-up in the junk yard and they will be junked at a faster rate than would be the case with a competitive crash parts market.Â Of course more junked autos means more new cars will be purchased to replace them.Â Hence, automobile manufacturers benefit even if cars are never repaired.

2. Monopolists Restrict Output

Monopolists get away with charging so much more for their product because they restrict output.Â In other words, by deliberately undersupplying the market with their product monopolists create artificial shortages forcing consumers to bid up the price for the limited quantities available.Â If the manufacturers of OEM parts are successful at eliminating competition from the crash parts business, not only will prices rise but many cars will take longer to be repaired, go entirely unrepaired or, as discussed previously, be unnecessarily declared constructive total losses.

3. Monopoly Results in Lower Quality Products

In competitive markets firms compete not only on the basis of price, but also on the basis of quality and service. Under a monopoly situation, product quality would likely suffer.Â In the case of OEM parts, there would be little incentive for manufacturers to maintain anything other than minimal quality standards.

4. Monopoly Wastes Valuable Resources

The combination of higher prices and lower output found in monopolistic markets causes an inefficient allocation of resources. In other words, monopolies waste money. In the case of OEM parts, consumers will be forced to pay more for parts and repairs than under competitive circumstances. This reduces the amount of income that consumers would otherwise have at their disposal to spend on other goods and services.

Because monopoly adversely impacts all consumers, economists often refer to the “social cost” or “deadweight loss” associated with monopoly. These two terms refer to the fact that the misallocation of resources by monopolists invariably leads to a reduction in the standard of living for society as a whole. Evidence presented during the State Farm case provides a vivid illustration of this point.

Testimony during the State Farm case revealed that between 1987 and 1997 the existence of competition in the crash parts market saved State Farm policyholders alone nearly \$1 billion. Because State Farm insured one out of every five cars over this period, the savings to policyholders across the entire industry likely totaled between \$4 billion and \$5 billion. These are considerable sums of money that in the absence of a competitive crash parts market would have wound up in the pockets of OEM parts manufacturers like GM, Ford, Chrysler, Honda and Toyota.

5. Other Consequences of Monopoly

Monopolists generate other types of losses in addition to those discussed above. Specifically, monopolists also waste considerable resources attempting to preserve their monopoly position in the form of lobbying, litigation, political largess and advertising.

III. Can a Case be Made for Monopoly in the Market for Crash Parts?

Despite the documented harmful effects of monopolies, they have existed throughout history. Can a compelling case be made for the institution of monopoly in the market for crash parts? The answer is unequivocally no. While there are cases when a monopoly could be deemed to be in the public interest, as the discussion of “natural” monopoly later in this section illustrates, a monopoly in the market for crash parts results in an unambiguous economic loss to society.

Historically, monopolies arose for several reasons: ownership or control of a natural resource (such as the OPEC oil cartel’s control over most of the world’s petroleum supply) or unique managerial talent, a patent or other exclusive right to produce a commodity or use a particular production process (such as might be held by a pharmaceutical company), and government franchise (such as the U.S. Postal Service was until private companies showed that competition could improve even the post office). Economists use the term “pure monopoly” when discussing monopolies of this sort. A pure monopoly is an industry in which there is only one supplier of a product for which there are no close substitutes, and in which it is very hard or impossible for another firm to exist.

In the case of crash parts, close substitutes have been available in the form of generic parts. It is in fact quite easy for other firms to exist since the fabrication of crash parts is a relatively low-tech business. Moreover, manufacturers of OEM parts control no scarce resource or input nor do they hold patents that prevent the manufacture of parts by others. To gain monopoly power, the manufacturers of OEM parts hope to use courts, state legislatures and insurance departments to erect legal barriers that would restrict or eliminate the use of generic substitutes.

Clearly, the crash parts market does not fit the definition of pure monopoly. Pure monopolies are seldom encountered in today’s modern economy and antitrust laws are on the books to protect consumers against attempts by corporations to monopolize markets.

Monopoly can also arise in situations where the advantages of large-scale production make it possible for a single firm to produce the entire output of the market at lower average cost than a number of firms each

producing a smaller quantity.Â Economist refer this situation as â€œnatural monopoly.â€•

Utilities are often considered to be natural monopolies.Â Because of the tremendous initial investment in plant, equipment and infrastructure, a compelling case can be made that a utilityâ€™s production is economical only at a very large scale.Â Natural monopolies, where they exist, are heavily regulated to protect consumers against the harmful impacts mentioned previously.Â Natural monopoly can also exist when a firmâ€™s technological superiority far exceeds that of its potential competitors.Â IBM and Microsoft temporarily held monopolies under this definition before competitors began to catch up.

The very existence of a low-cost generic parts market today proves that the crash parts market is not a natural monopoly.Â Generic parts manufactures can operate profitably even at a scales of production far below those found at OEM plants.Â The low-tech nature of crash parts manufacturing eliminates technological superiority as a basis for monopoly as well.

In short, the crash parts market does not fit any definition of monopoly and there is no compelling economic or legal rationale for permitting one to exist, let alone creating one.

IV. Conclusion

Monopolies are a rarity in todayâ€™s modern economy and for good reason.Â They bring financial harm to consumers and to society as a whole.Â Antitrust laws, technological innovation, deregulation and globalization have swept most monopolies into the dustbin of history. The crash parts industry does not fit any definition of natural monopoly nor do the manufacturers of OEM parts deserve protected monopoly status under the law.

The State Farm court decision threatens to bring monopoly pricing for automobile crash parts to every driver in America.Â If allowed to stand, the verdict will legitimize and validate a transfer of billions of dollars from drivers to automobile manufacturers that has already begun. Keeping competition free and fair in the crash parts market is not just an option, it is the solution.

(1) â€œThe War Over Bent Fenders,â€• <i>Consumer Reports</i>, April 1989, p. 201.

(2) Bratton, John, C. and Avila, Stephen M., â€œAfter-Market Parts: An Analysis of State Regulations,â€• Journal of Insurance Regulation, 1999.

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