ECONOMICS 201: WEEK 6 ANTITRUST AND REGULATION

ANTITRUST

REGULATION

BIG BUSINESS: GOOD OR BAD?

PUBLIC POLICY TOWARD MONOPOLIES

Government responds to the problem of monopoly in one of four ways.

- Making monopolized industries more competitive.
- Regulating the behavior of monopolies.
- Turning some private monopolies into public enterprises.
- Doing nothing at all.

HISTORY OF U.S. ANTITRUST LAWS

A trust or cartel is a combination of firms in which the firms have not actually merged, but act as a single entity.

HISTORY OF U.S. ANTITRUST LAWS

In the 1870s and 1880s, trusts were formed in railroads, steel, tobacco, and oil, and other industries.

HISTORY OF U.S. ANTITRUST LAWS

A trust sets common prices and governs the output of individual member firms.

A trust can, and often does act like a monopolist.

STANDARD OIL

John D. Rockefeller's Standard Oil Company was the first and largest trust.

When the oil trust was formed, Standard Oil used its monopoly power to close refineries and limit the production of oil.

STANDARD OIL

Rebate – Rockefeller negotiated a “refund” from the railroads on part of the rate for shipping kerosene.

“Drawback” – Rockefeller also negotiated “refund” on other firms’ payments for shipping kerosene.

Rockefeller also demanded that railroads not reduce rates to any other supplier.

STANDARD OIL

Rockefeller was able to accumulate capital from these special deals.

Used to buy out other refiners.

Also used capital to slash prices to threaten any refinery that refused to sell.

STANDARD OIL

The price of oil rose from a competitive level to a monopolistic level.

Affected both consumers and Standard Oil's competitors.

As competitors were driven out of business, Standard Oil raised prices.

STANDARD OIL

By 1911 Standard Oil controlled 90% of the sales of refined products in US

Earned an average 25% rate of profit.

STANDARD OIL

Standard Oil of New Jersey

Standard Oil of NY (Mobil)

Standard Oil of CA (Chevron)

Standard Oil of Ohio (Sohio and American arm of BP

Standard Oil of Indiana (Amoco)

Continental Oil (Conoco)

THE SHERMAN ANTITRUST ACT

Public outrage at the formation and activities of trusts such as Standard Oil led to the passage of

- the Sherman Act,
- the Clayton Act, and
- the Federal Trade Commission Act.

THE SHERMAN ANTITRUST ACT

Its two main provisions are:

- "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce . . . shall be guilty of a misdemeanor . . ."

EARLY DEBATES OVER ANTITRUST POLICY:

Two views of the best approach to antitrust policy:

- judgment by performance and
- judgment by structure.

ANTITRUST POLICY: JUDGMENT BY PERFORMANCE OR STRUCTURE?

Judgment by performance **–**

- Should we judge the competitiveness of markets by the performance (behavior) of firms in the market?
- Economists reflecting the **performance** viewpoint argue that market competition alone would ultimately limit monopolies.

ANTITRUST POLICY: JUDGMENT BY PERFORMANCE OR STRUCTURE?

Judgment by structure –

- Should we judge the competitiveness of markets by the *structure* of the industry?
- Economists reflecting the **structure** viewpoint argued that trusts should be broken up by government because competition will not work when there is only a few firms with a great deal of market power.

THE STANDARD OIL CASE

In 1911, the U.S. Supreme Court determined that Standard Oil was a structural monopoly that controlled over 90 percent of its markets.

In spite of this, they were not judged to have violated the Sherman Act because of their structure but because of their “unfair business practices.” i.e. because of their performance.

THE STANDARD OIL CASE

This judgment on performance, not structure, is often called the *abuse theory* since a firm is legally considered a monopoly *only if it commits monopolistic abuses.*

CLAYTON ACT AND FEDERAL TRADE COMMISSION ACT

- ***Price discrimination***, -- selling identical goods to different customers at different prices.
- ***Tie-in contracts*** in which the buyer must agree to deal exclusively with one seller and not to buy goods from competing sellers.
- ***Interlocking directorships*** in which memberships of boards of directors of two or more firms are almost identical.
- ***Buying stock in a competitor's company*** when the purpose of buying that stock is to reduce competition.

CLAYTON ACT AND FEDERAL TRADE COMMISSION ACT

The Federal Trade Commission Act made it illegal for firms to use “unfair methods of competition.”

It also made it illegal to engage in “unfair or deceptive acts or practices,” whether or not those actions had any effect on competition.

PREDATORY PRICING

Predatory pricing occurs when a large firm begins to cut the price of its product(s) with the intent of driving its competitor(s) out of the market.

TYING

Tying refers to a situation where a firm offers two (or more) of its products together at a single price, rather than separately.

- i.e. the consumer must buy both goods whether or not he/she wants both of them.

MEASURING MARKET POWER: CONCENTRATION

Concentration of an industry

- Measures the share of the total sales or assets of the industry in the hands of its largest firms

Highly concentrated industry

- Few firms with large shares

Unconcentrated industry

- Many small firms

MEASURING MARKET POWER: CONCENTRATION

Concentration ratio (CR)

- Percentage of an industry's output produced by its four largest firms
- Measures the degree to which the industry is dominated by large firms

Herfindahl-Hirschman Index (HHI)

- Measure: market power
- Add together the squares of market shares of all firms in the industry
- Government uses in merger analysis

MEASURING MARKET POWER: CONCENTRATION

HHI values:

- ranges from 0 for perfect competition to 10,000 for monopoly
- If HHI < 1,000: unconcentrated market
- If HHI > 1,800: Highly concentrated market

HHI preferable to CR

- Counts all firms in the industry
- Weights larger firms more (squaring market share)

WHAT IS REGULATION?

Regulation of industry

- Process established by law
- Restricts or controls some specified decisions made by the affected firms
- Designed to protect the public from exploitation by firms with monopoly power
- Carried out by a special government agency
  - Administering and interpreting the law
  - Enforcing the regulatory laws

SOME OBJECTIVES OF REGULATION

Control of market power resulting from

- Economies of scale
- Economies of scope
  - Savings obtained through simultaneous production of many different products
  - A firm that produces many commodities can supply each good more cheaply than a firm that produces fewer commodities

SOME OBJECTIVES OF REGULATION

Where monopoly production is cheapest

- Free competition is not sustainable: natural monopoly
- Society may not want to have competition

Universal service

- Available to everyone at reasonable prices

Cross-subsidization

- Selling one firm's product at a loss, balanced by higher profits on another firm's products

KEY ISSUES THAT FACE REGULATORS

Setting prices

- To protect consumers' interests
- To allow regulated firms to cover their costs

Goals may be at odds

- Prices that serve public interest may cause financial problems for firms
- Preventing excessive profits may reduce incentive for innovation & efficiency

BIG BUSINESS

GOOD OR BAD FOR SOCIETY?

BIG BUSINESS

Background:

- The American economy is dominated by very large corporations.
- The trend is toward ever larger companies and has been for most of the 20th century.

How do firms get to be so large?

BIG BUSINESS

Mergers and combinations

- Most common route to “bigness”

TYPES OF MERGERS

Horizontal mergers

- When 2 firms in the same industry combine.
- Former competitors.
- Example: ABC Pizza Company buys XYZ Pizza Company

TYPES OF MERGERS

Vertical Mergers

- When 2 firms in the same chain of production combine.
- A firm buys the supplier
- Example: ABC Pizza Company buys Acme Tomato Sauce Company

TYPES OF MERGERS

Conglomerate merger

- When 2 apparently unrelated firms combine.
- Many of the largest corporations in the US are “conglomerates.”

PROBLEMS IN THE MARKETPLACE:

Jane buy shoes from ABC shoe store.

- What happens if the shoes turn out to be defective?
- What happens if the shoes were made in an illegal sweat-shop?
- What if ABC shoe store engages in fraud?
- What if the shoes were made in a factory that disposed of toxic by-products in a way that harmed the environment?

PROBLEMS IN THE MARKETPLACE:

- **Who protects the consumer?**
- **Who protects the worker?**
- **Who protects the investor?**
- **Who protects the public?**

PRIVATE MARKET SOLUTIONS

Will the market take care of these problems on its own?

- Answer depends on economic power.
- The ideal situation in any market transaction is one in which everyone has equal power.
- There is a “level playing field.”

PRIVATE MARKET SOLUTIONS

Level playing field for consumer.

- Jane is free to buy the shoes or not.
- Jane can buy shoes from a different store.
- Consumers can choose not to deal with unscrupulous firms.
- ABC shoe will lose money if it sells defective products or violates social norms of ethical behavior.
- These firms will go out of business.
- Problems are resolved.

PROBLEMS IN THE MARKETPLACE:

What happens if there is unequal power?

- Firms may be able to sell defective products.
- Firms may be able to produce in a manner that harms workers or the public.
- Firms may be able to charge higher prices.
- Firms may be able to engage in unethical behavior.
- Problems are not resolved.

SOURCES OF ECONOMIC POWER

Monopoly power

- Only 1 seller
- Jane may be able to buy shoes from another store, BUT she can only buy Cable TV, local telephone service, electricity from 1 firm.

Oligopoly power

- A few sellers
- Jane may be able to buy lots of different breakfast cereal, but they are really only a few companies.
- Choices are very similar, prices are very similar.
- Possibility that firms are “cooperating” rather than “competing.”

SOURCES OF ECONOMIC POWER

Coercion

- Are all market transactions voluntary?
- How “free” is the free market?
- How much “choice” is there?
- Examples:
- Jane needs a job. She looks in the paper and finds only 1 job available.
- Jane needs medical care. She goes to the hospital emergency room, and later receives a bill for $2000.
- Jane needs to buy water service for her house. Her first month’s water bill is $100. She thinks that’s too high.