Test Yourself: Antitrust and Regulation

A significant piece of the wealth that the NFL owners garner is a result of the enormous TV revenues they get - and those revenues are supported by a legislatively granted exemption from the antitrust laws that has been made applicable to sports leagues, primarily the NFL.

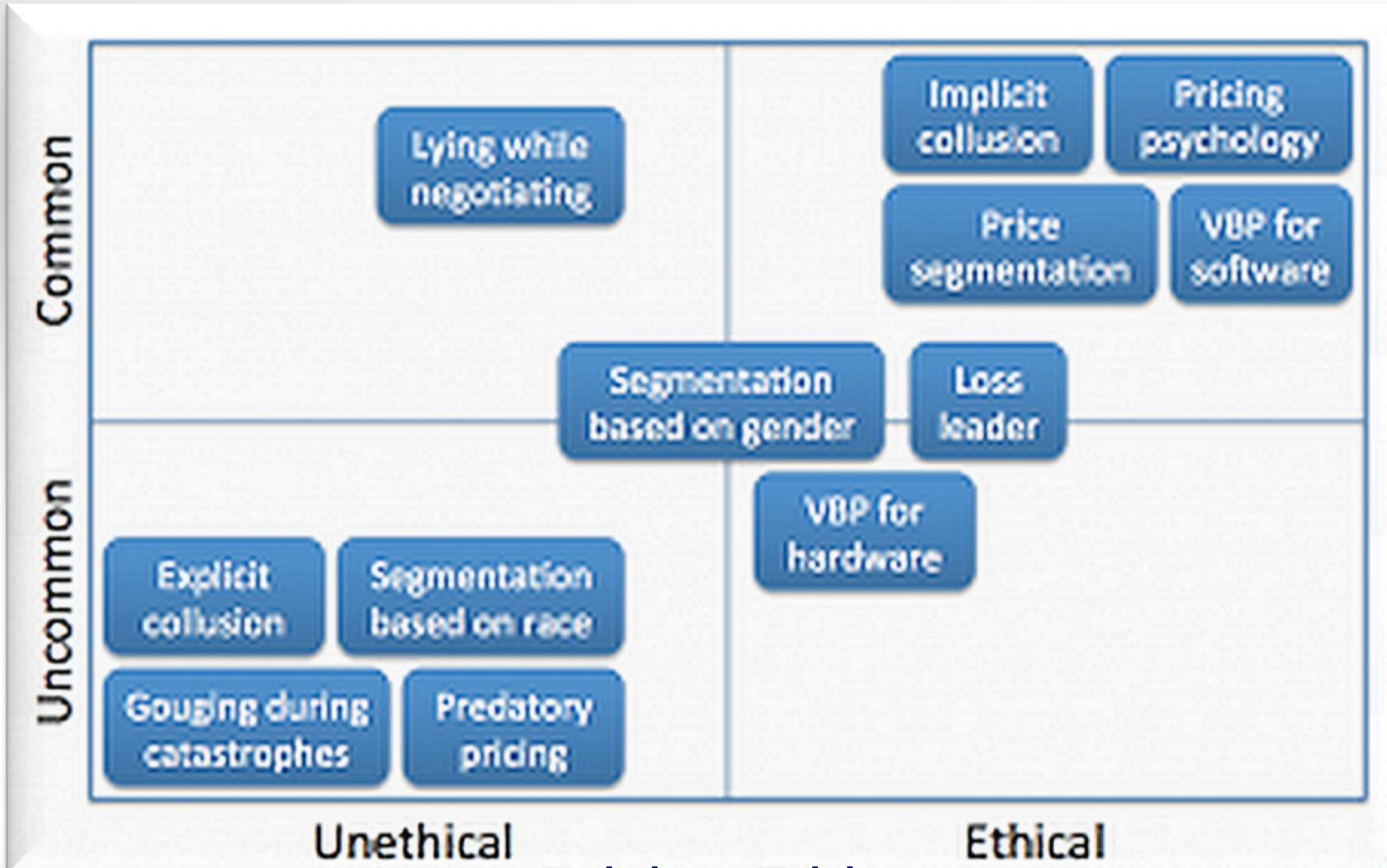
Eliot Spitzer

What is a trust?

John D. Rockefeller

A trust is a group of firms that place their assets in the custody of a board of trustees. It is a legal organization set up for the control and management of assets and property. The trustees take responsibility for the management of the assets in the trust for the benefit of one or more beneficiaries. The trust essentially becomes the owner of the assets within it, providing a way to keep business assets safe from creditors and lawsuits, and certain types of taxation.

What is predatory pricing?



Pricing Ethics

Predatory pricing (or undercutting) is a pricing strategy where a product or service is set at a very low price, intending to drive competitors out of the market or create barriers to entry for potential new competitors. One or more firms temporarily reduce prices to eliminate competition and then, once the competition is eliminated, raise prices.

Is predatory pricing legal?

Predatory pricing is illegal under anti-trust laws because it makes markets more vulnerable to a monopoly.

What was done to limit the power of trusts?

Congress passed laws aimed at preventing firms from engaging in anticompetitive activities.

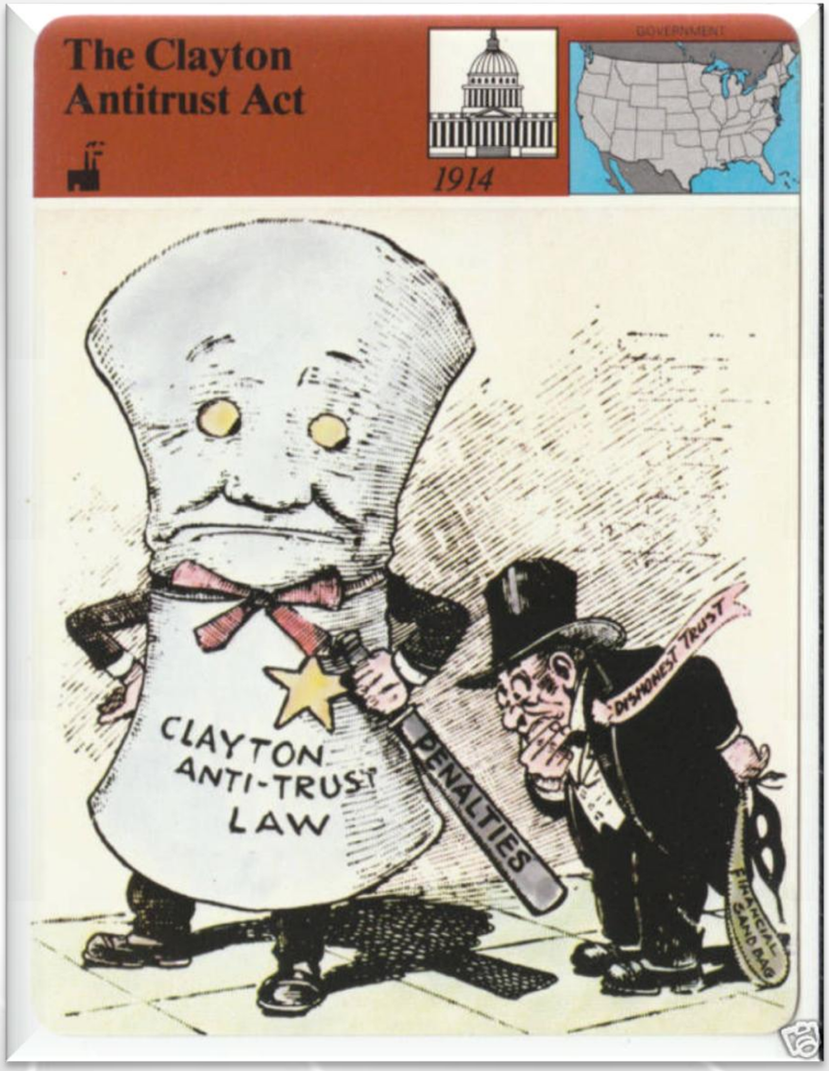
Trust agreements received a hostile reception in state courts during the 1880s and were quickly phased out in the 1890s in favor of other devices for maintaining corporate control.

What is the Sherman Antitrust Act?

The Sherman Antitrust Act is the federal antitrust law enacted in 1890 that prohibits monopolization and conspiracies to restrain trade.

It prohibits certain business activities that federal government regulators deem to be anti-competitive, and requires the federal government to investigate and pursue trusts.

What is the Clayton Act?



The Clayton Act is a 1914 amendment passed by Congress that strengthens the Sherman Act by making it illegal for firms to engage in certain anticompetitive business practices.

The Sherman Act had outlawed practices considered harmful to consumers (monopolies, cartels, trusts). The Clayton Act specified particular prohibited *conduct*, a three-level enforcement scheme, exemptions and remedial measures.

What four principles of economic trade and business does the Clayton Act cover?

The Clayton Act discusses four principles of economic trade and business:

- price discrimination
- exclusive dealings
- mergers and acquisitions
- corporate directors

What business practices were declared illegal under the Clayton Act?

Under the Clayton Act, the following business practices were declared illegal.

- price discrimination
- exclusive dealing
- tying contracts
- stock acquisition of competing companies
- interlocking directorates

Is the Clayton Act an improvement over the Sherman Act?

Although more specific than the Sherman Act, the Clayton Act is also vague and open to interpretation on many points. However, later amendments helped clarify the act and, like the Sherman Act, much of the substance of the Clayton Act has been developed and animated by the US courts, particularly the Supreme Court.

What is the Federal Trade Commission Act?

The Federal Trade Commission Act is the 1914 federal act that established the Federal Trade Commission (FTC) to investigate unfair competition.

What is the Robinson-Patman Act?

The Robinson-Patman Act is a 1936 amendment to the Clayton Act that strengthens the Clayton Act vis-à-vis price discrimination.

What is the basic purpose of the Robinson-Patman Act?

The basic purpose of the Robinson-Patman Act is to prevent large sellers from offering different prices to different buyers where the effect is to harm even a single small firm.

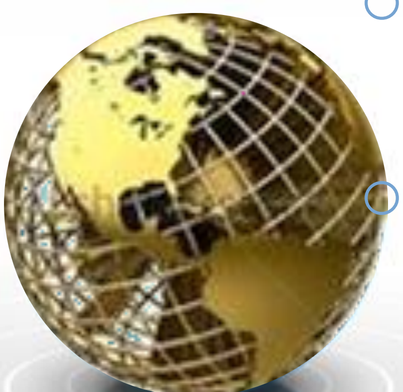
What is the Celler-Kefauver Act?

The Celler-Kefauver Act is a1950 amendment to the Clayton Act that prohibits a firm from merging with a competitor by purchasing its physical assets if the effect is to substantially lessen competition.

What are some key antitrust cases?

The following are some key antitrust cases.

- *Standard Oil* 1911 – the rule of reason
- *Alcoa* 1945 – the per se rule
- *IBM* 1982 – return to the rule of reason
- *AT&T* 1982 – technology made obsolete its natural monopoly making it guilty of anticompetitive pricing
- *MIT* 1992 – price fixing
- *Microsoft* 1995 – Microsoft could not acquire a competitor
- *Microsoft* 2001 – predatory pricing



How can firms avoid charges of price fixing?

Firms can avoid charges of price fixing by merging into one company.

When did many mergers begin taking place?

Many US business mergers occurred in the 1980s when the federal government relaxed antitrust restrictions on mergers. State courts and legislatures were not serious about blocking acquisitions. Many major firms had been pursuing unsound business strategies that reduced their market values but offered potential profits for those who could run them more competently. And new innovations in debt financing made money cheaper.

What are the different types of mergers?

There are three types of mergers.

- Horizontal – a merger of firms that compete in the same market
- Vertical – the merger of a firm with its suppliers
- Conglomerate – a merger between firms in unregulated markets ... They are generally allowed because they do not significantly decrease competition.

How do antitrust laws in other countries compare with those in the US?

Antitrust laws in other countries are *weak* in comparison to US antitrust laws.

What are the trends in US government regulation of business?

From the latter part of the 1800s to the 1970s there was an increase in regulation.

Beginning in the 1970s, government and public opinion began to move away from regulation.

What is the basic argument in favor of government regulation?

The argument in favor of government regulation is based on *market failure*.

Government action is necessary in order to reduce or eliminate market failures.

What is a market failure?

A market failure is a situation where markets fail to allocate resources efficiently. The quantity of a product demanded by buyers does not equate to the quantity supplied by sellers.

What are some causes of market failure?

Economists identify the following specific causes of market failure.

- productive or allocative inefficiency
- monopoly power
- missing, incomplete or unstable markets
- de-merit goods
- negative externalities
- property rights
- information failure
- inequality

What is a natural monopoly?

A natural monopoly is an industry in which long-run average cost is minimized when only one firm serves the market, the most efficient number of firms in the industry is one.

A natural monopoly will typically have *very high fixed costs*, meaning that it would be impractical to have more than one firm producing the good.

What is marginal cost pricing?

Marginal cost pricing is the practice of setting the price of a product to equal the extra cost of producing an extra unit of output. By this policy, a producer charges, for each unit sold, only the addition to total cost resulting from materials and direct labor. Businesses often set prices close to marginal cost during periods of poor sales.

Marginal Cost Pricing

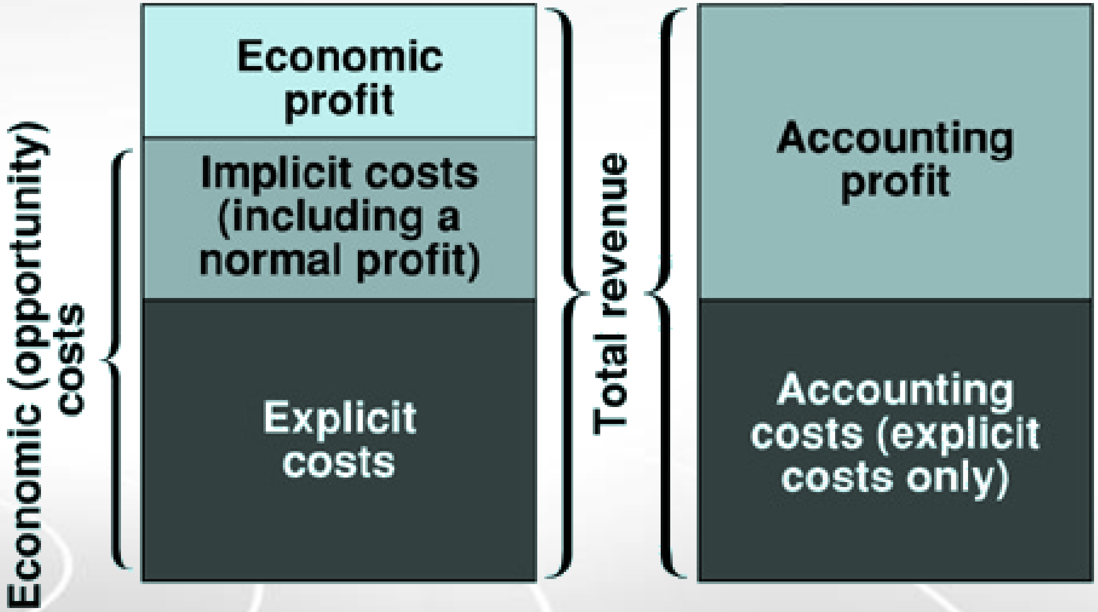
- Marginal cost – the cost of producing ONE extra or ONE fewer item of production
- MC pricing – allows flexibility
- Particularly relevant in transport where fixed costs may be relatively high
- Allows variable pricing structure – e.g. on a flight from London to New York – providing the cost of the extra passenger is covered, the price could be varied a good deal to attract customers and fill the aircraft

What is a normal profit?

A normal profit is the amount necessary to compensate the business owners for their services and to keep the business functioning.

Revenue - Explicit Expenses - Implicit Expenses = Normal Profit

If the amount earned is greater than a normal profit, it is an economic profit; if less, then it is an economic loss.



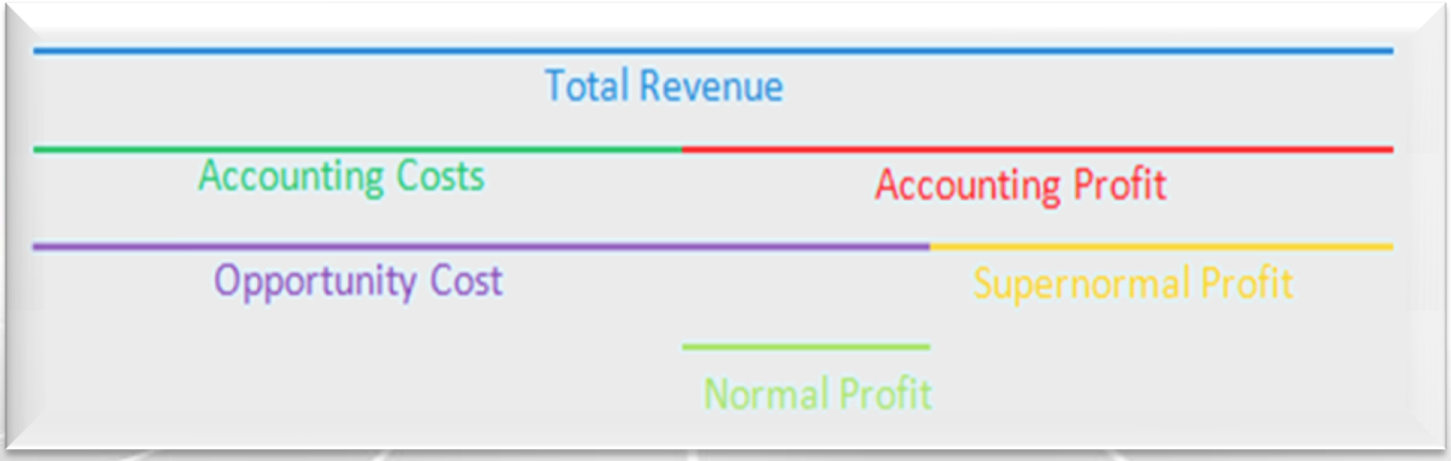
Does zero economic profit mean that a company is not earning any money?

Zero economic profit does *not* mean that a company is not earning any money. It is simply a measure of how well resources are being used relative to all possible options.

Do production costs include normal profit?

Yes, production costs include normal profit because normal profit is considered a necessary expense of a business.

When calculating the cost of production, an economist *assumes that all resources are paid*, including the business owner. Natural resources, labor, capital and entrepreneurship are compensated. Normal profit includes the implicit costs associated with lost opportunities -- the dollar value of the next best alternative for the business owner to employ his/her time and resources.



What is a negative externality?

A negative externality occurs when an individual or firm making a decision does not have to pay the full cost of the decision. It is the cost that affects a party who did not choose to incur that cost (third party).

If external costs exist, how might that affect the producer's production choices?

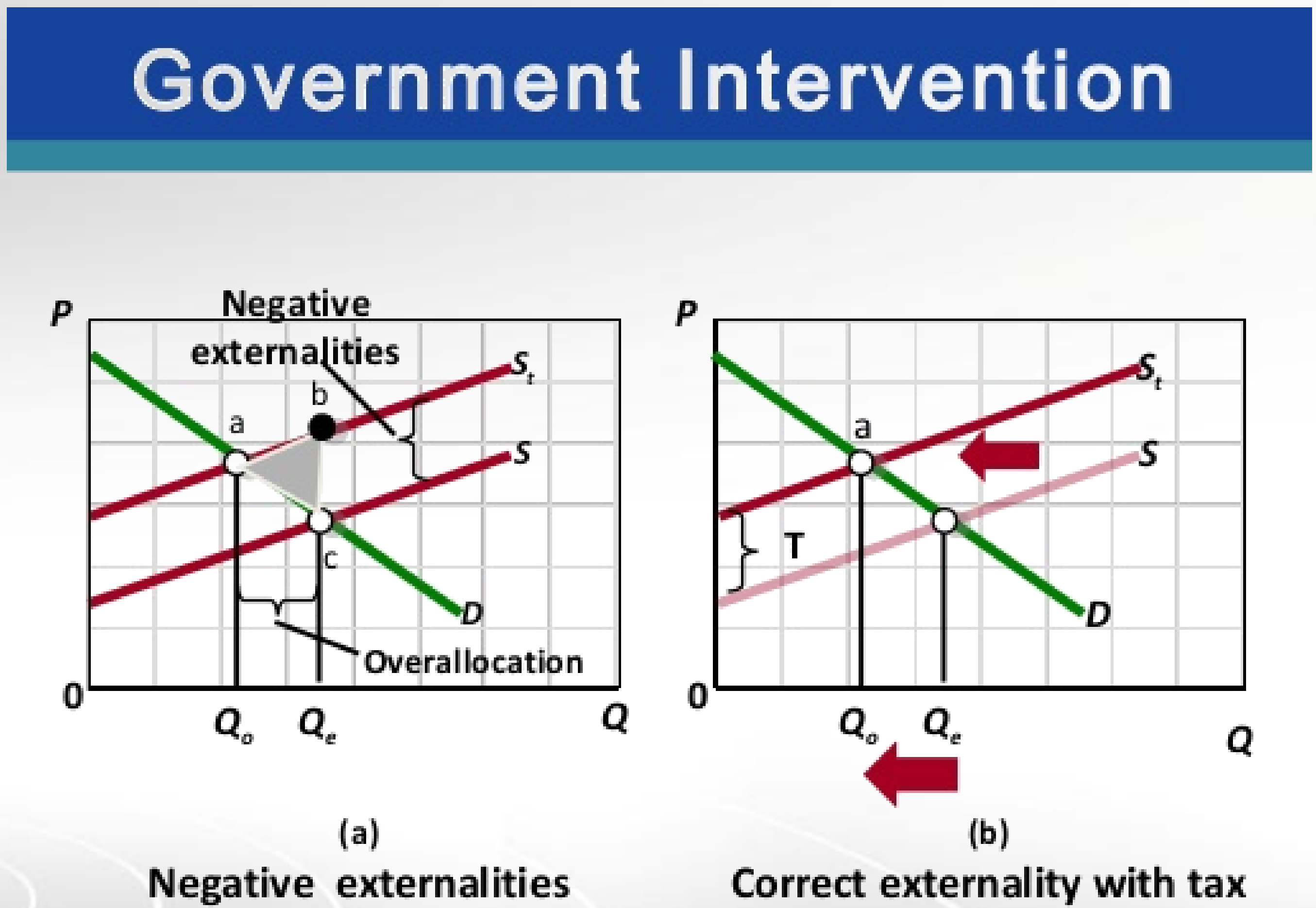
If external costs exist, such as pollution, the producer may choose to produce more of the product than would be produced if the producer were required to pay all associated environmental costs as part of his/her business expenditures.

What happens when the negative externality of pollution is present?

A negative externality such as pollution causes polluting firms to *overproduce*, while causing firms that pay the cost of cleaning up the pollution to *underproduce*.

What can be done when a negative externality such as pollution is present?

Government regulation of the industry can minimize the pollution.



What are some types of market failure and the possible resulting government interventions?

Market Failure and Intervention

Failure	Definition	Examples	Possible Interventions
Public Goods	Goods which are non-rival and non-excludable (a)	Defence, Police, Medical Care Public health	Public provision; competitive tendering
Externalities	Actions of individuals or firms affect others but the cost or benefit of this is not reflected in the value of the transactions	Pollution, road congestion, intellectual property	Taxes, subsidies, legislation, creation of property rights – e.g. tradable permits
Imperfect information and Asymmetric information	Transactions where the parties (e.g. buyer and seller) have different sets of information; or where individuals often do not have good information about risk	Dentistry, legal services, second hand cars, insurance, personal behaviours that may be detrimental to health	Regulation of quality, information provision; accreditation
Increasing returns	Average cost decreases as output increases	Natural monopolies	Structural separation, public ownership, regulation of private monopoly
Market power	One or a few buyers or sellers have sufficient market power to influence prices	Monopolies; single buyers, cartels	removing market barriers; mergers regulation, competitive tendering,

What do we mean by perfect information?

An important element of a competitive market is **perfect information**, meaning anything that may impact a buyer’s or seller's decision-making process is known and understood.

How did you do?! If you didn't do as well as you'd like, review the margin notes and presentations and test yourself again.

CONTINUED IN TEST YOURSELF: EXTERNALITIES