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.

A business trust 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. A business 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.

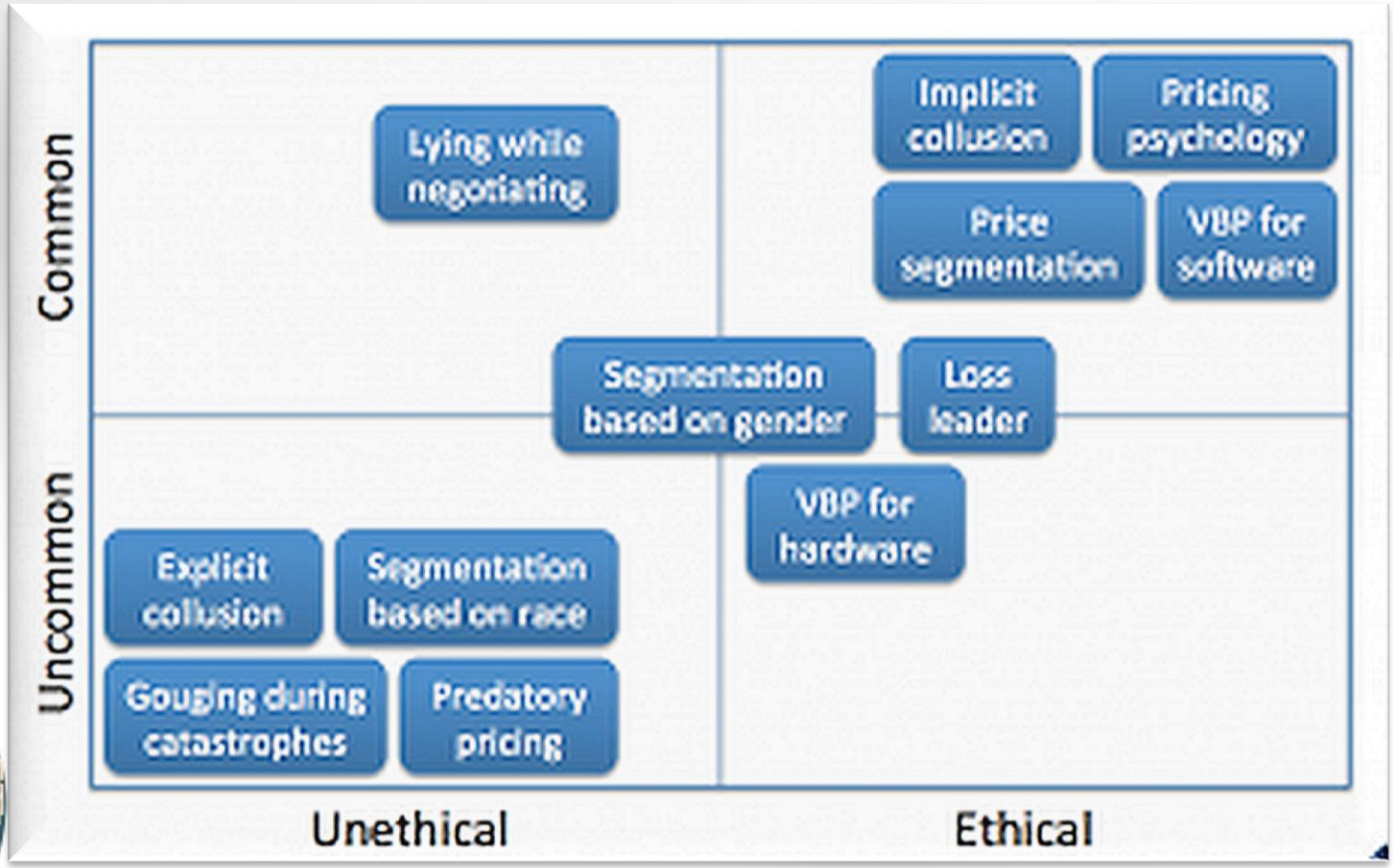
The term corporate trust is often used for a large business with significant market power. Originally, the corporate trust was a legal device used to consolidate power in large American corporate enterprises.

The concept of the corporate trust was originally used to help John D. Rockefeller consolidate his control over the many acquisitions of Standard Oil, which was already the largest corporation in the world.

The Standard Oil Trust was formed pursuant to a "trust agreement" in which the individual shareholders of many separate corporations agreed to convey their shares to the trust. It ended up entirely owning 14 corporations and exercising majority control over 26 others.

Nine individuals acted as Standard Oil Trust's board of trustees. Of course, one of those trustees was Rockefeller himself, who held 41% of the trust; the next most powerful trustee only held about 12%. This kind of arrangement became popular and soon had many imitators.

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.

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

When was the age of the robber barons?

The late 1800s and the first decade of the 20th century is sometimes referred to as the age of the robber barons. The term itself dates back centuries, and was originally applied to noblemen in the Middle Ages who functioned as feudal warlords and were literally “robber barons.”

In the 1870s the term began to be used to describe business tycoons, and the usage persisted throughout the rest of the 19th century.

The term was applied to businessmen who engaged in unethical and monopolistic practices, wielded widespread political influence and amassed enormous wealth.

Political cartoon depicting robber barons, including Jay Gould and Russell Sage, sitting atop workers.

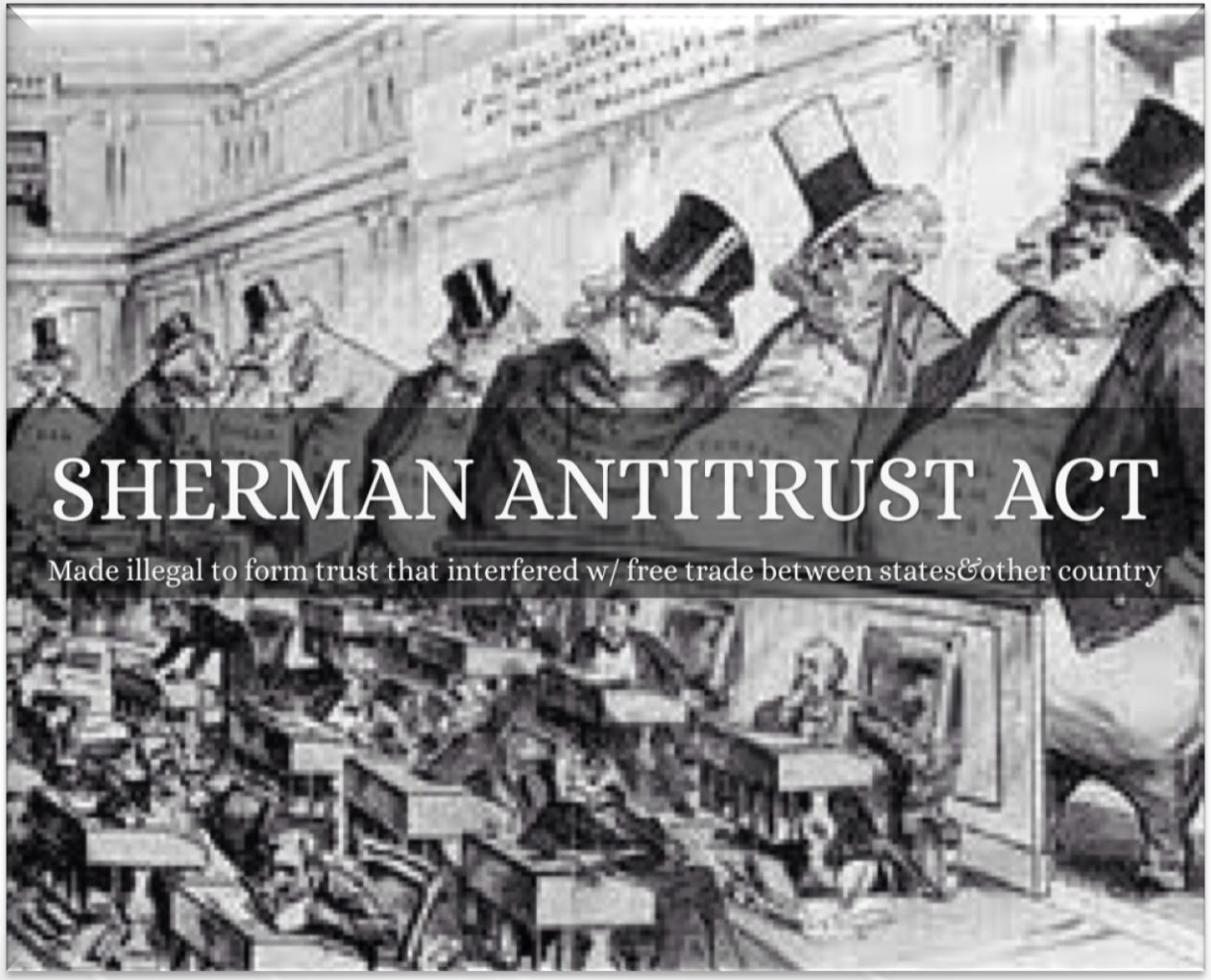
What was done to limit the power of trusts?

Trusts quickly faced widespread accusations of abusing their market power to engage in anticompetitive business practices. This caused the term "trust" to become strongly associated with such practices among the American public.

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

Meanwhile, 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?

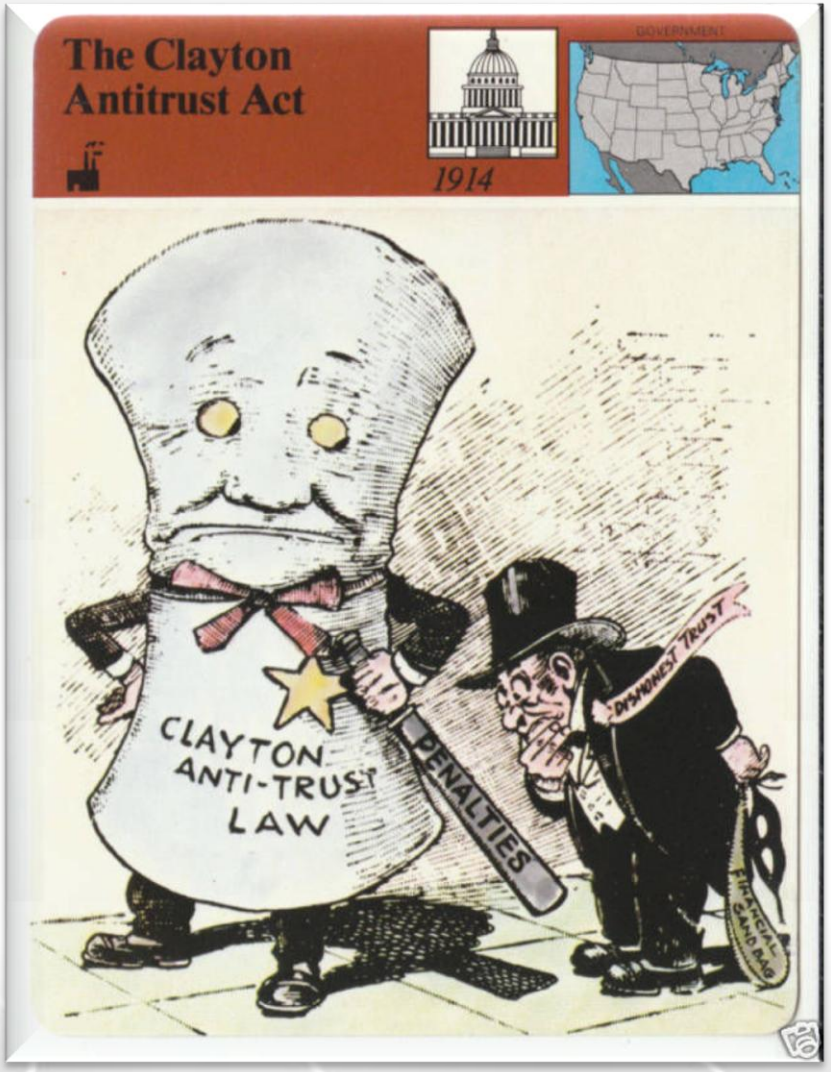


The Sherman Antitrust Act is the federal antitrust law enacted in 1890 that prohibits monopolization and conspiracies to restrain trade.

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

It has since been used more broadly to oppose a combination of entities that could potentially harm competition, such as cartels.

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

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

Was 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.

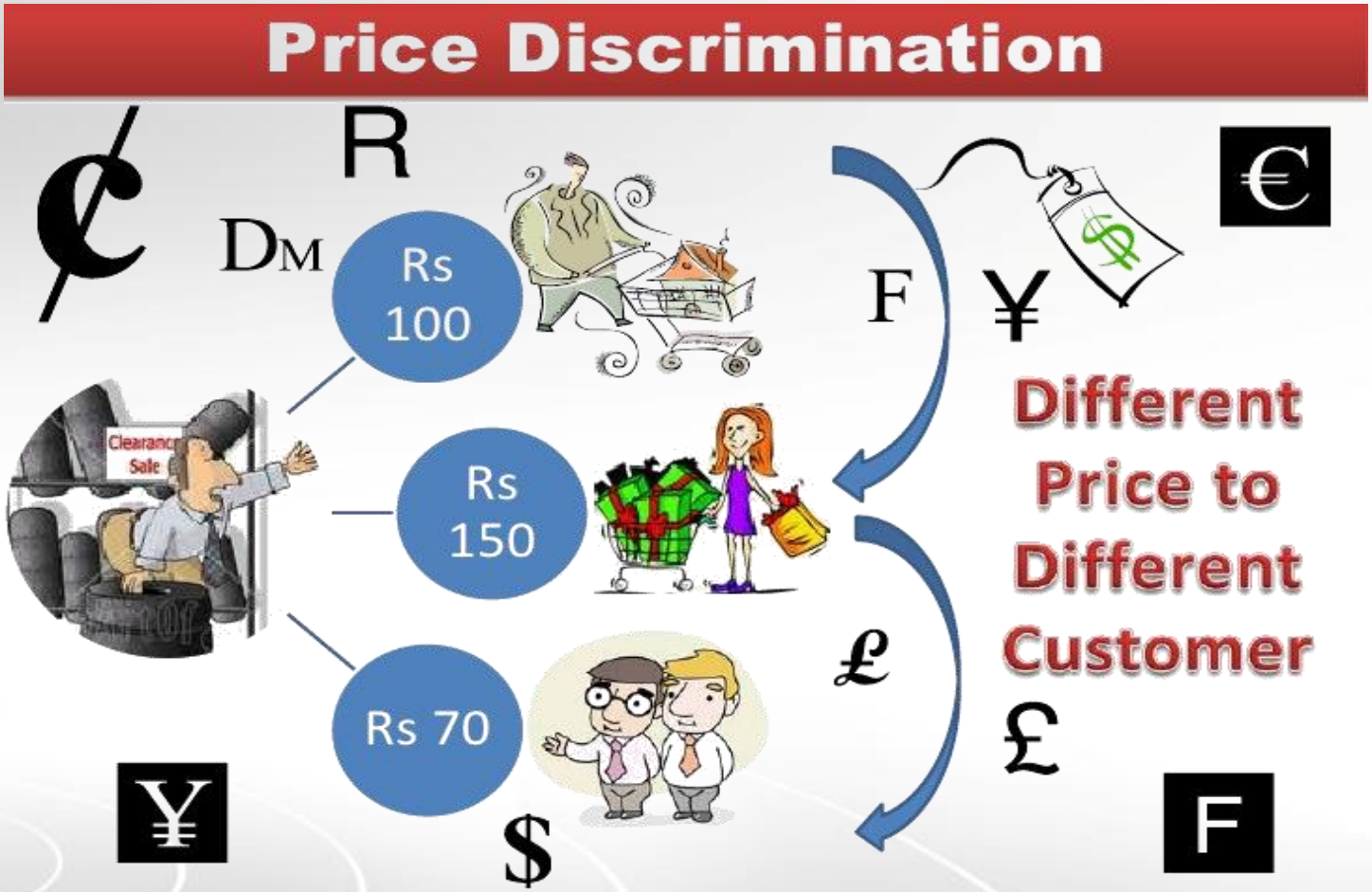
What is the Federal Trade Commission Act?

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 ROLE OF GOVERNMENT

REGULATION OF MERGERS

Celler-Kefauver Act (1950)
Extended the government's authority to ban vertical and conglomerate mergers.

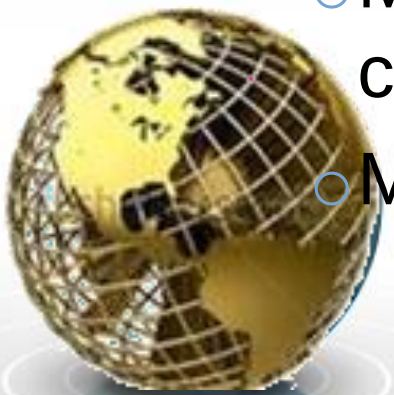
Herfindahl-Hirschman Index (HHI) A mathematical calculation that uses market share figures to determine whether or not a proposed merger will be challenged by the government.

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 – MS could not acquire a competitor
- Microsoft 2001 – predatory pricing



What was the outcome of the Standard Oil case?

The outcome of the Standard Oil case was the *rule of reason* – the antitrust doctrine that the existence of a monopoly alone is not illegal unless the monopoly engages in illegal business practices.

What was the outcome of the Alcoa case?

The outcome of the Alcoa case was the *per se rule* – the antitrust doctrine that the existence of a monopoly alone is illegal, regardless of whether or not the monopoly engages in illegal business practices.

What was the result of the IBM case (1982)?

The result of the IBM case was a return to the *rule of reason* – that the existence of a monopoly alone is not illegal unless it engages in illegal business practices.

What was the result of the AT&T case (1982)?

The result of the AT&T case was that technology made the government-regulated natural monopoly obsolete, and so AT&T was guilty of anticompetitive pricing.

What was the result of the MIT case (1992)?

As a result of the MIT case, eight Ivy League schools agreed to stop colluding to fix prices, and MIT was found guilty of price fixing.

What was the result of the Microsoft case (1995)?

Microsoft was not allowed to purchase Intuit Inc., a competitor in the personal finance software industry.

What was the Microsoft case of 2001?

The 2001 Microsoft case charged Microsoft with predatory pricing by tying its monopoly in Windows to its Internet Explorer browser.

How can firms avoid charges of price fixing?

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

When did many of these mergers begin taking place?

Many US business mergers occurred in the 1980s.

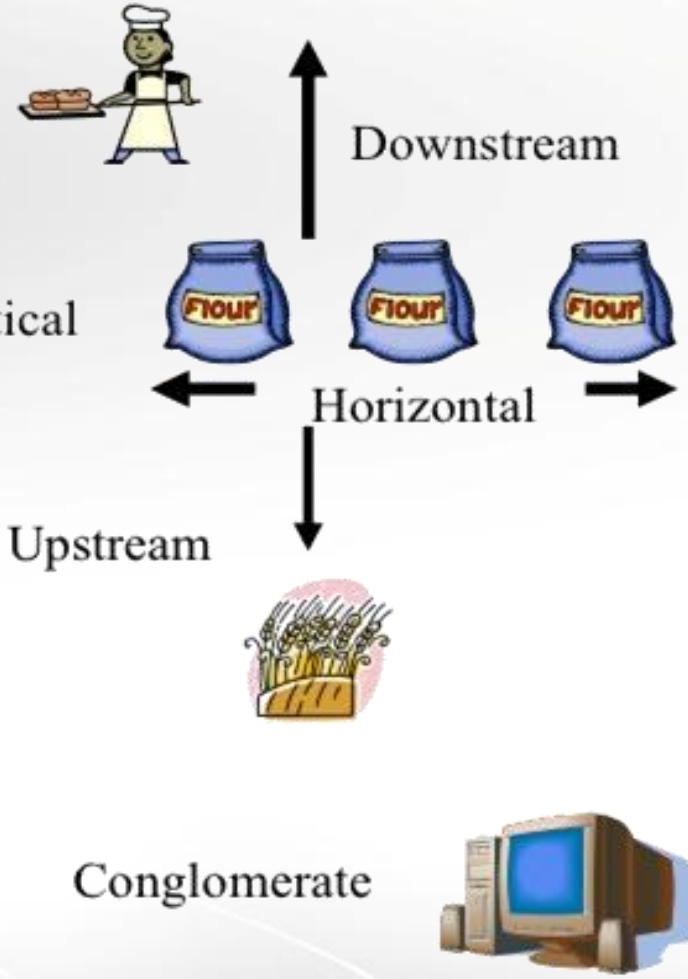
The federal government had relaxed antitrust restrictions on mergers. State courts and legislatures were not yet serious about blocking acquisitions. Many major firms had been pursuing unsound business strategies that reduced their market values but offered potential profits for those who could run them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

By the late 1980s, conditions affecting mergers had changed, resulting in the end of the 1980s takeover binge.

What are the different types of mergers?

Mergers

- Horizontal
- Vertical
  - Upstream
  - Downstream
- Conglomerate



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 later 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.

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.

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

In what ways does the market fail?

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.

An example of a natural monopoly is tap water. Because there are very high capital costs involved in setting up a network of pipes and sewage systems, it makes sense to have just one producer.

[Note: Some reputable economists theorize that there is no such thing as a natural monopoly, that it is an economic fiction.]

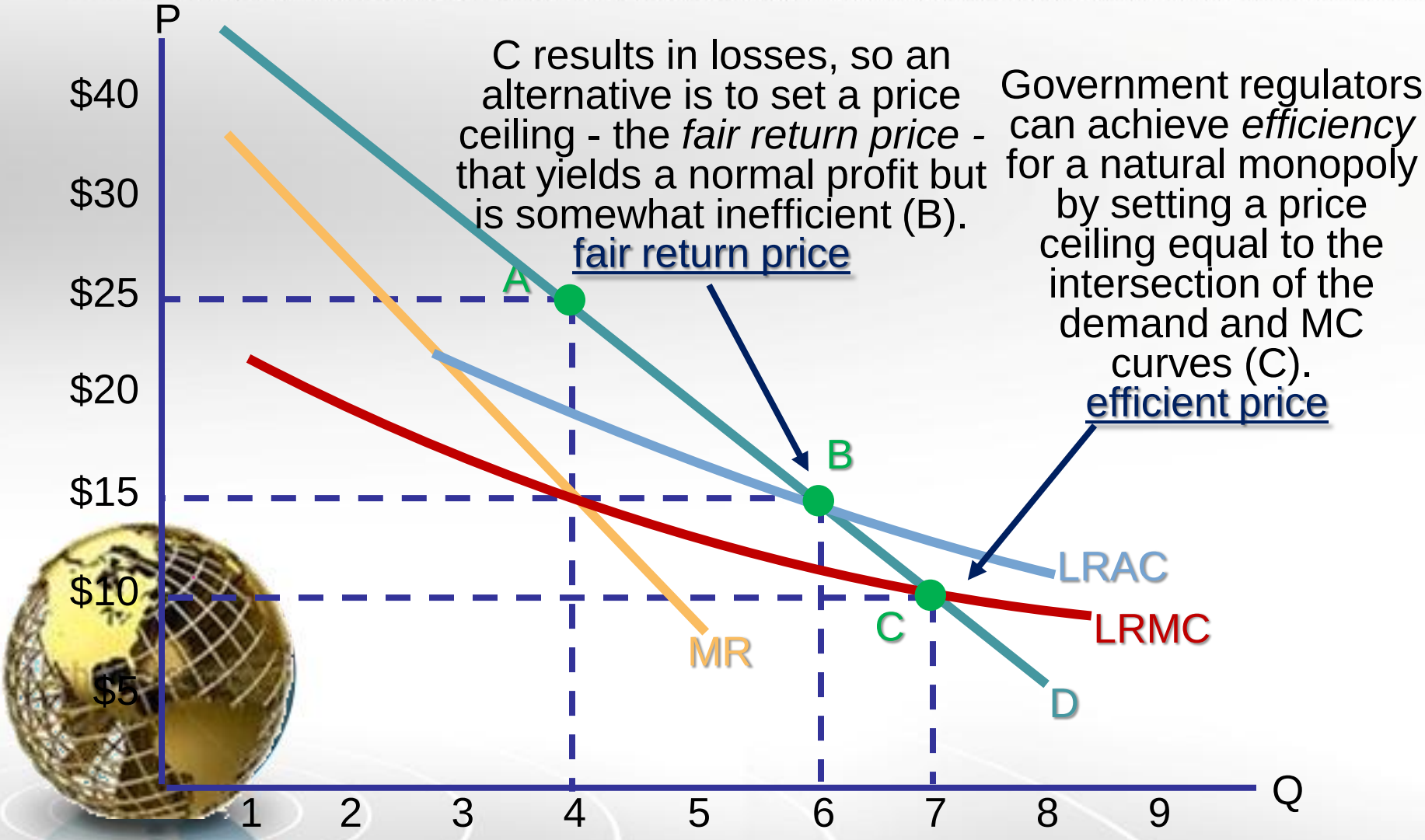
What is marginal cost pricing?

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.

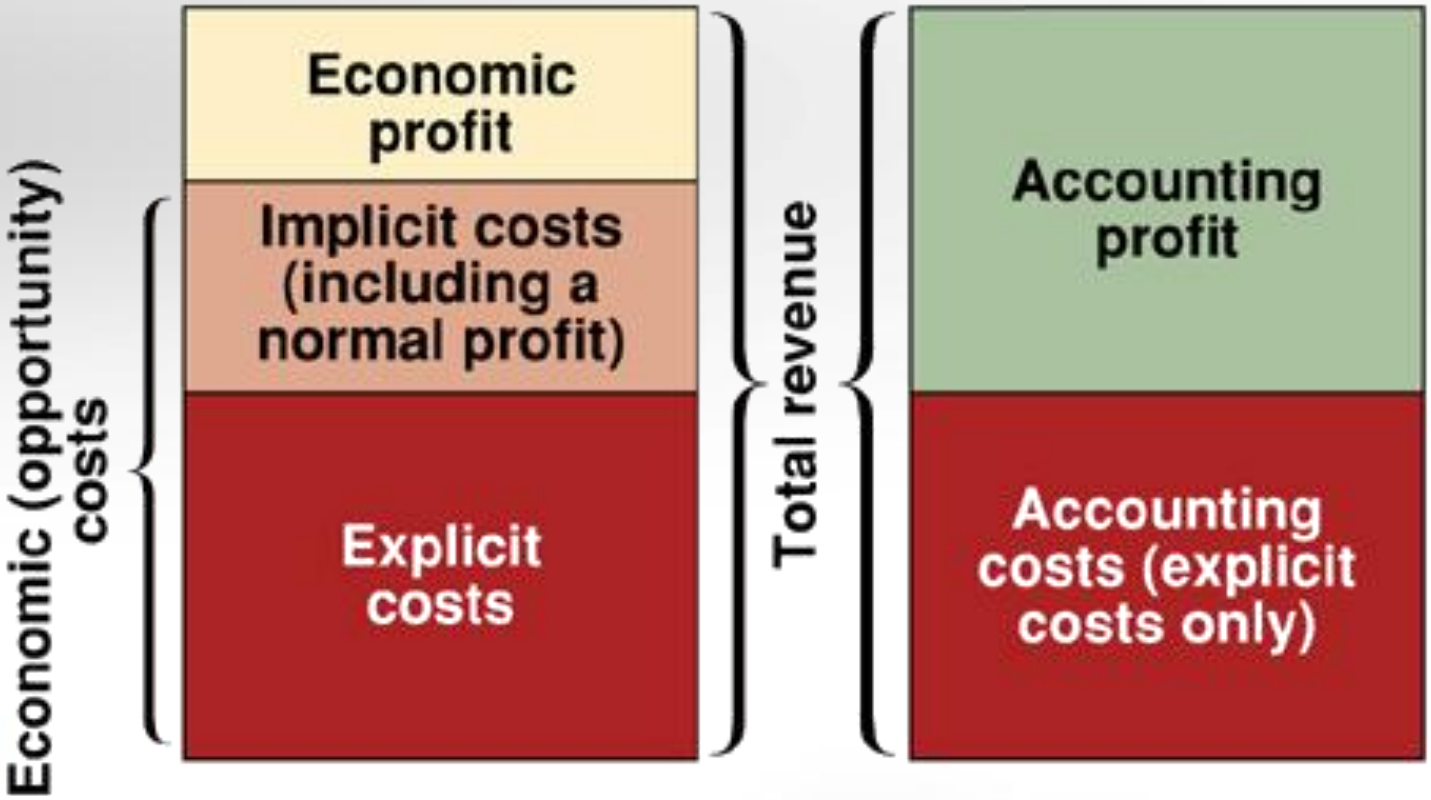
Marginal Cost Pricing

- 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

Chart: Regulated Monopoly



What is a normal profit?



Normal profit occurs at the point at which the resources available to the firm are being efficiently used and couldn't be put to better use elsewhere, so that the difference between *total revenue* and *total cost* (explicit and implicit costs) equals zero.

Normal profit is different than accounting profit because opportunity cost is taken into consideration.

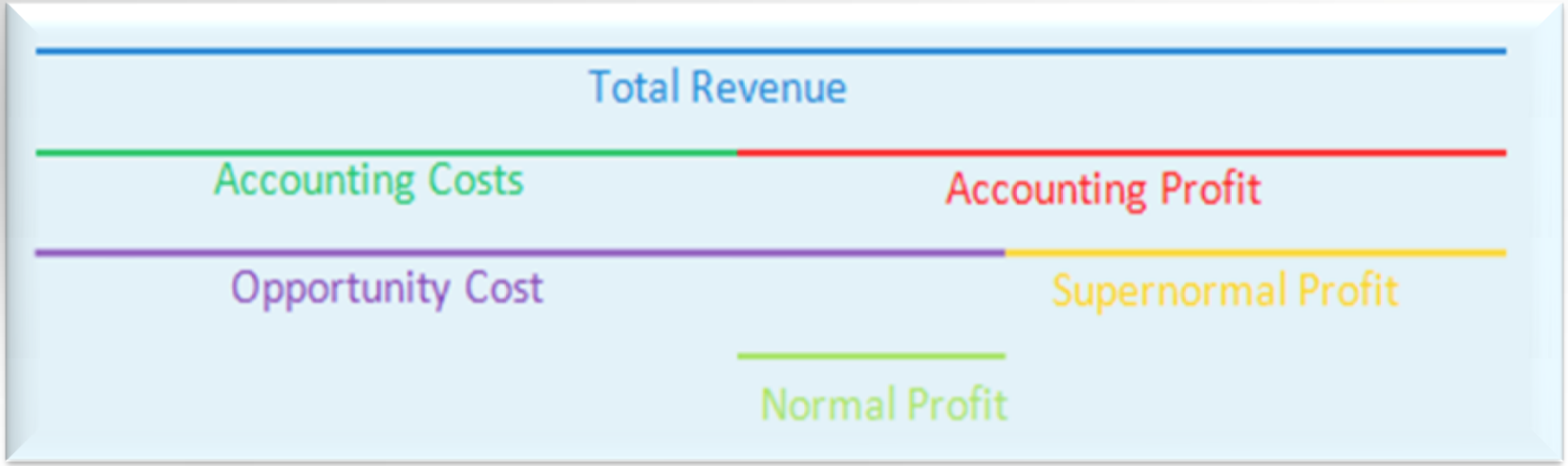
Normal profit is the minimum level of profit needed for a company to remain competitive in the market.

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

A business can earn an accounting profit and still incur an economic loss.

After adding up all expenses and subtracting them from the sales revenue, the firm might show an accounting profit. But if the business owners could have earned more profit pursuing an alternative venture, then the business could show an economic loss. In such a situation, the business owners should consider closing the business and engaging in more profitable ventures.

Do production costs include normal profit?



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

Normal profit is a concept that takes a different view of an income statement. 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. In other words, the 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.

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

Revenue - Explicit Expenses - Implicit Expenses = Normal Profit.

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

What kind of profit is made at the fair return price? (Review slide #63.)

The fair return price yields a normal profit but is somewhat inefficient.

$$\text{Normal Profit} = \text{Revenue} - \underbrace{(\text{Accounting Costs} + \text{Economic Costs})}_{\text{Opportunity costs}}$$

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.

A negative externality is the cost that affects a party who did not choose to incur that cost. For example, manufacturing activities that cause air pollution impose health and clean-up costs on everyone.

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 business expenditures.

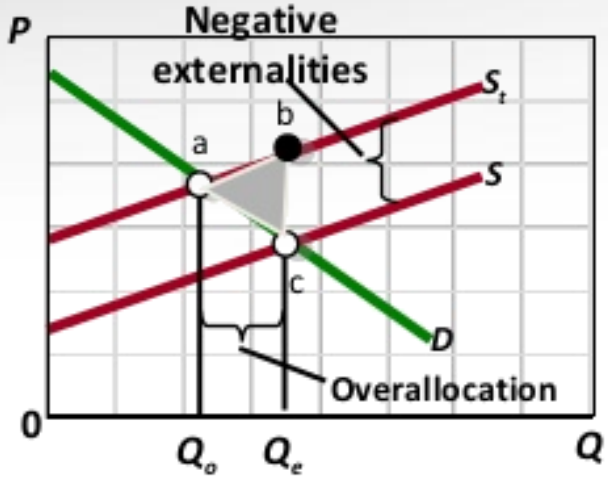
What happens when the negative externality of pollution is present?

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

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

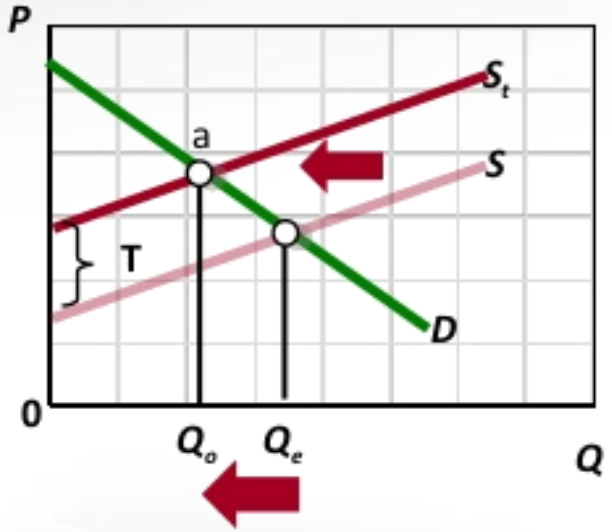
Government regulation of the industry can minimize the pollution.

Government Intervention



(a)

Negative externalities



(b)

Correct externality with tax

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,

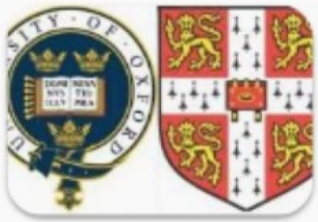
What happens with imperfect information?

Examples of Information Failure

In nearly every market we find instances / risks of information gaps

Risks from using tanning salons

Addiction to painkillers & other drugs



Gaining entry to elite degree courses

Complexity of pension schemes

Uncertain quality of second hand products

Knowledge of the nutritional content of foods

Cowboy builders or other "rip-off merchants"

Tourist Bazaars or buying and selling antiques

tutor2u

An important element of a competitive market is perfect information. By perfect information we mean anything that may impact a buyer’s or seller's decision making process is known and understood.

Poor or insufficient information can lead to poor choices.

Missing/incorrect information may lead to market failure because the party with better information has a competitive advantage.

Chart: Impact of Imperfect Information

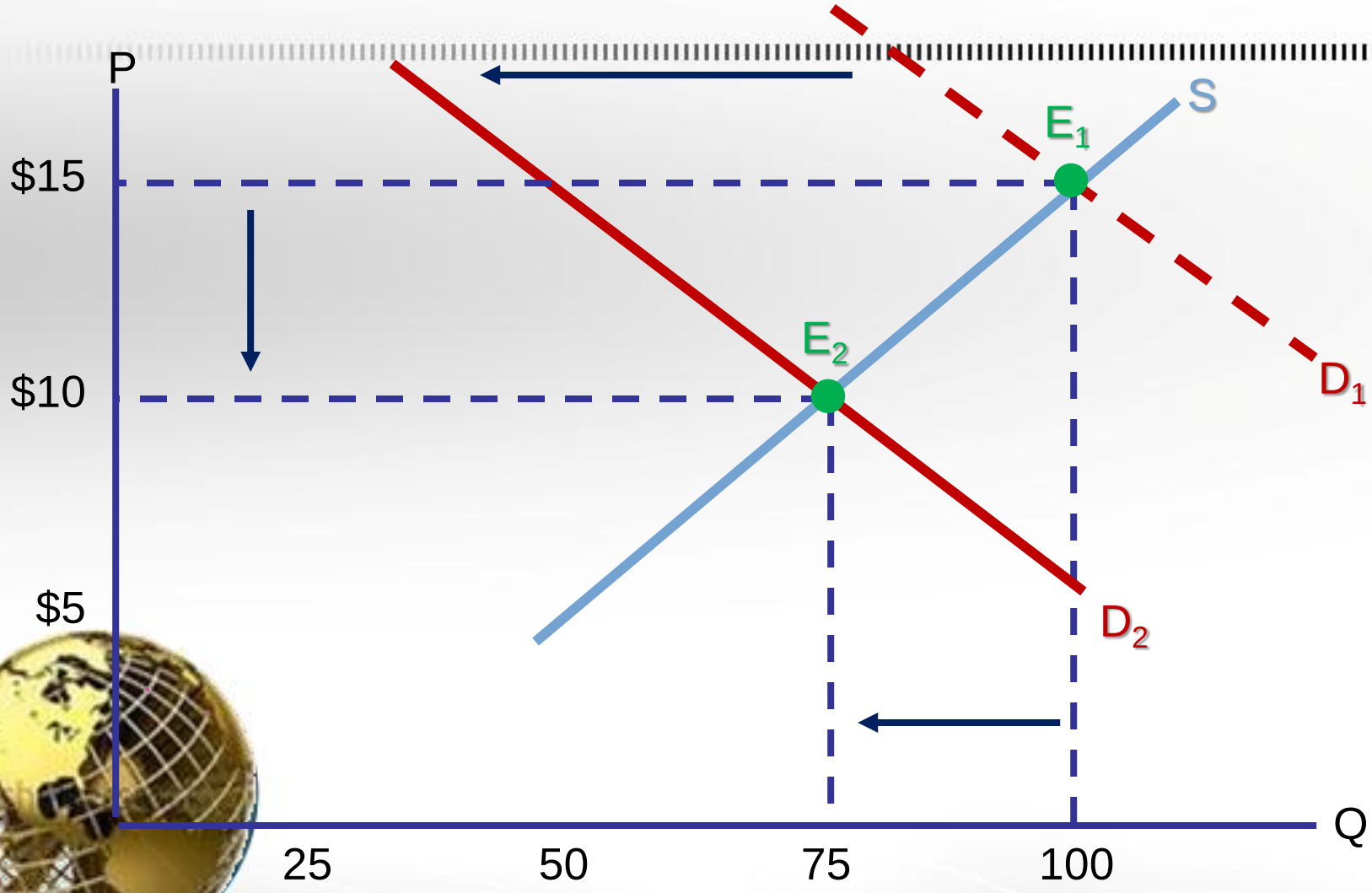
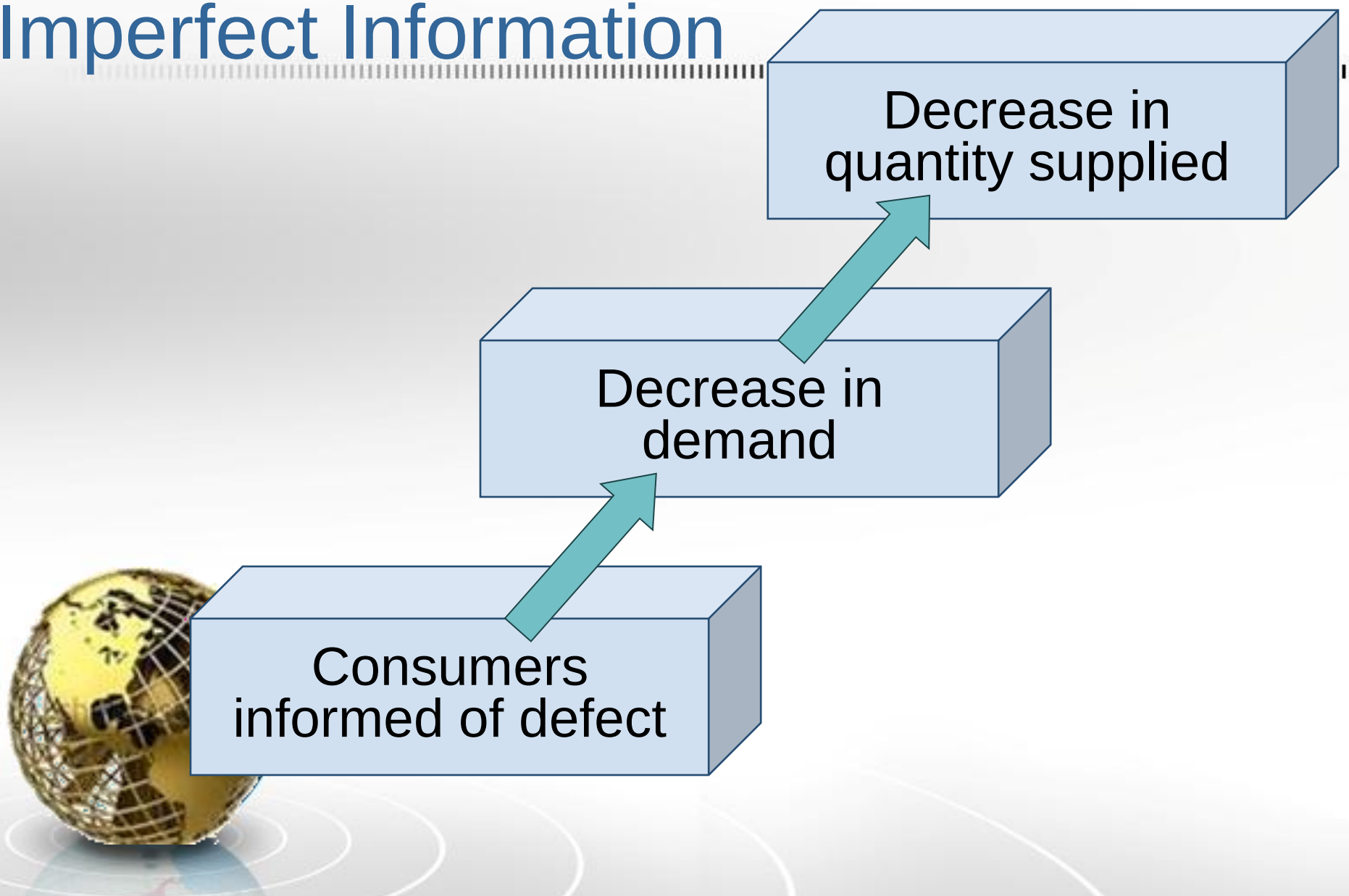


Diagram: Impact of Imperfect Information



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