MODULE 77 / 41: PUBLIC POLICY TO PROMOTE COMPETITION

The purpose of this module is to learn the basic goals of U.S. antitrust policy and to see how natural monopolies can be regulated to achieve more efficiency and lower prices.

Student learning objectives:

- The three major antitrust laws and how they are designed to promote competition.
- How government regulation is used to prevent inefficiency in the case of natural monopoly.
- The pros and cons of using marginal cost pricing and average cost pricing to regulate prices in natural monopolies.

Key Economic Concepts For This Module:

- The Sherman Antitrust Act of 1890 was a reaction to growing power in many key American industries of the late 19th century.
- Because the Sherman Act created many ambiguities, Congress passed the Clayton Antitrust Act of 1914 to more clearly define specific actions that could be too anticompetitive and unlawful.
- The Federal Trade Commission Act of 1914 created the FTC as a government agency to protect the public from anticompetitive business practices including "unfair and deceptive" practices.

Common Student Difficulties:

- Teachers might discover that students have already seen some of this material in other courses. And because this material will not play a huge role on the AP Micro exam, the instructor should give the students a quick overview so that they will recognize the important pieces of legislation should they appear on a multiple-choice question.

In-Class Presentation of Module and Sample Lecture

Suggested time: Because there is some overlap with previous modules and because this may have been covered in other courses, this module should be covered in no more than a one-hour class session.

- **I.** Promoting Competition
- **II.** Antitrust Policy
  - **A.** The Sherman Antitrust Act of 1890
  - **B.** The Clayton Antitrust Act of 1914
  - **C.** The Federal Trade Commission Act of 1914
  - **D.** Dealing with Natural Monopoly

I. Promoting Competition

We have seen that competitive markets, in the absence of externalities, tend to produce efficient outcomes. Markets with monopoly power tend to be less efficient, with higher prices, and fewer units of output. It should make sense that there are laws in place to promote competition and limit monopolies.

II. Antitrust Policy

In the late 1800s, large monopoly firms (US Steel, Standard Oil, e.g.) were created when industrialists merged or acquired many competing firms. To combat the negative consequences of growing monopoly power, Congress wrote laws to break up, or prevent, monopolies from dominating the economic landscape.

The Department of Justice's Antitrust Division describes the goals of antitrust laws as:

- protecting competition,
- ensuring lower prices, and
- promoting the development of new and better products.
- It emphasizes that firms in competitive markets attract consumers by cutting prices and increasing the quality of products or services.
- Competition and profit opportunities also stimulate businesses to find new and more efficient production methods.

A. The Sherman Antitrust Act of 1890

The Sherman Antitrust Act of 1890 has two important provisions, each of which outlaws a particular type of activity.

1. It is illegal to create a contract, combination, or conspiracy that unreasonably restrains interstate trade.
2. It outlaws the monopolization of any part of interstate commerce.

The Act had a couple of peculiarities. For example, it wasn't illegal to be a monopoly, but it was illegal to monopolize, or to act like a monopoly. It was also a little vague because it didn't provide details regarding specific actions or activities that would be prohibited.

B. The Clayton Antitrust Act of 1914

The Clayton Act was intended to clarify the Sherman Act and specifically prohibited four firm behaviors.

1. Price Discrimination. It is illegal to charge different prices to different people for the same product. There are some obvious exceptions like discounted movie theatre tickets for children.
2. Anticompetitive practices of exclusive dealing and tying arrangements.
   - An exclusive deal is one where a seller won't sell to you if you are buying products from another seller. For example, a wholesale food company might be selling steaks to a restaurant. If the food

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company tried to prohibit the restaurant from buying meat from a competing food wholesaler, they might be in violation of the Clayton Act.

- A tying arrangement is when a seller will sell you product X only if you also purchase product Y. For example if McDonald's told you that you could buy a cheeseburger only if you also bought fries, this would be a tying arrangement that might get McDonald's in trouble for anticompetitive behavior.

3. Anticompetitive mergers. If Coca-Cola and Pepsi Cola were going to merge into one ginormous soda company, this would probably be judged as illegal under the Clayton Act. The government would look at what such a merger would do to the concentration ratio, HHI, and pricing power within the post-merger industry.
4. Interlocking Directorates. Two companies cannot share members of the board of directors.

C. The Federal Trade Commission Act of 1914

- Prohibits unfair methods of competition in interstate commerce and created the Federal Trade Commission (FTC) to enforce the Act.
- The FTC Act outlaws unfair competition, including "unfair or deceptive acts." The FTC Act also outlaws some of the same practices included in the Sherman and Clayton Acts.
- In addition, it specifically outlaws price fixing (including the setting of minimum resale prices), output restrictions, and actions that prevent the entry of new firms.
- The FTC's goal is to promote lower prices, higher output, and free entry—all characteristics of competitive markets.

Note: to give students an idea of the breadth of the scope of the FTC, you might direct them to the website ftc.gov.

D. Dealing with Natural Monopoly

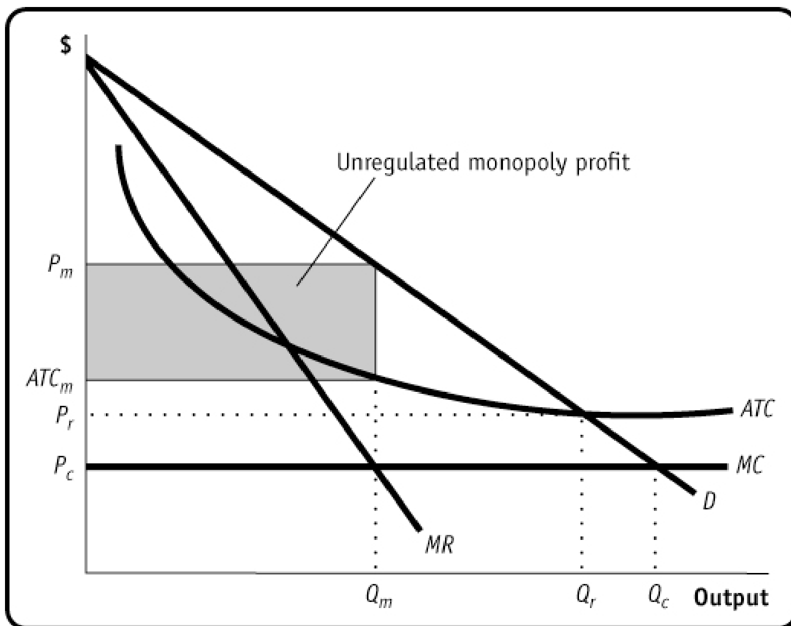
A natural monopoly occurs when economies of scale make it efficient to have only one firm in a market.

We saw in Module 62 that a natural monopoly can either be taken over by the government, or it can be regulated. Price regulation can be designed as either marginal-cost or average-cost pricing.

<u>Marginal-cost pricing</u>: the firm must operate at the point where $P=MC$. This is the outcome consistent with perfect competition and zero deadweight loss, but this might create economic losses for the firm. The government would need to subsidize these losses at taxpayer expense.

<u>Average-cost pricing</u>: the firm must operate at the point where $P=ATC$. This outcome insures that the firm will earn normal economic profit, but will not be at the most efficient level of output. In other words, some deadweight loss will exist.

The graph below is replicated from Module 62 and shows all three possibilities: unregulated monopoly (P_m, Q_m); Marginal-Cost pricing (P_c, Q_c); Average-Cost pricing (P_r, Q_r).



In-Class Activities and Demonstrations

Here is a link to a three-minute animated “A Brief History of the Birth of the Federal Trade Commission” that can be used to light-heartedly introduce the material for the students.
http://www.youtube.com/watch?v=NssfPApe5iQ

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