BS2243 – Lecture 11
Regulation and deregulation

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Antitrust laws – key points

- The interpretation of (US) antitrust laws varies over time.
- Antitrust laws should promote efficiency.
- Monopoly is not prohibited, but certain activities that can lead to a firm's acquiring or exercising monopoly powers are banned.
- Price fixing is generally prohibited.
- Certain agreements among competitors, vertical relations between firms, and various other strategic acts may increase or decrease welfare; hence, they should be evaluated on a case-by-case basis.
- A few antitrust laws, such that the prohibition on price discrimination that allegedly reduces competition among companies, almost always lower welfare.
- Prohibiting certain activities and not others can lead to inefficient organisation of firms.

What does the UK law say?

- Competition law prohibits almost any attempt to fix prices - for example, **you cannot**:
  - **agree prices** with your competitors, e.g. you can't agree to work from a shared minimum price list
  - **share markets** or limit production to raise prices, e.g. if two contracts are put out to tender you can't agree that you'll bid for one and let your competitor bid for the other
  - impose minimum prices on different **distributors** such as shops
  - agree with your competitors what **purchase** price you will offer your suppliers
  - cut prices below cost in order to force a smaller or weaker competitor out of the market

- The law doesn't just cover formal agreements. It also includes other activities with a **price-fixing effect**. For example, you shouldn't discuss your pricing plans with your competitors. If you then all 'happen' to raise your prices, you are fixing prices

- The law is enforced by the OFT, which can impose a **fine** of up to 10 per cent of your turnover. It can also apply for company directors to be disqualified

Source: http://www.businesslink.gov.uk

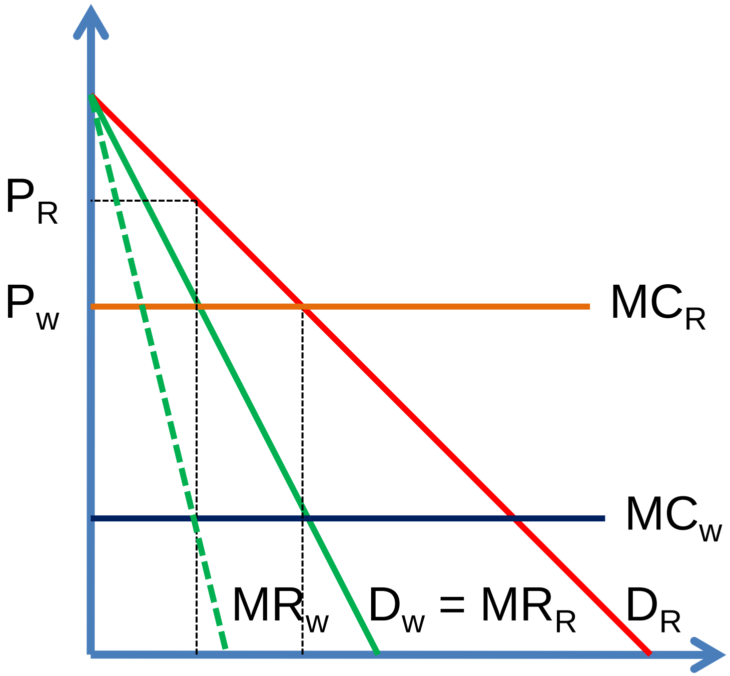
The US legal environment

- Common law
  - Price fixing among firms not illegal but unenforceable in court
  - Agreements not to compete that accompanied sale of businesses also unenforceable if deemed "unreasonable"
  - Practices like predatory pricing not illegal unless accompanied by fraud

- Sherman Act (1890)
  - Explicitly forbids cartels
  - Monopoly not a crime so long as it does not commit "bad acts"

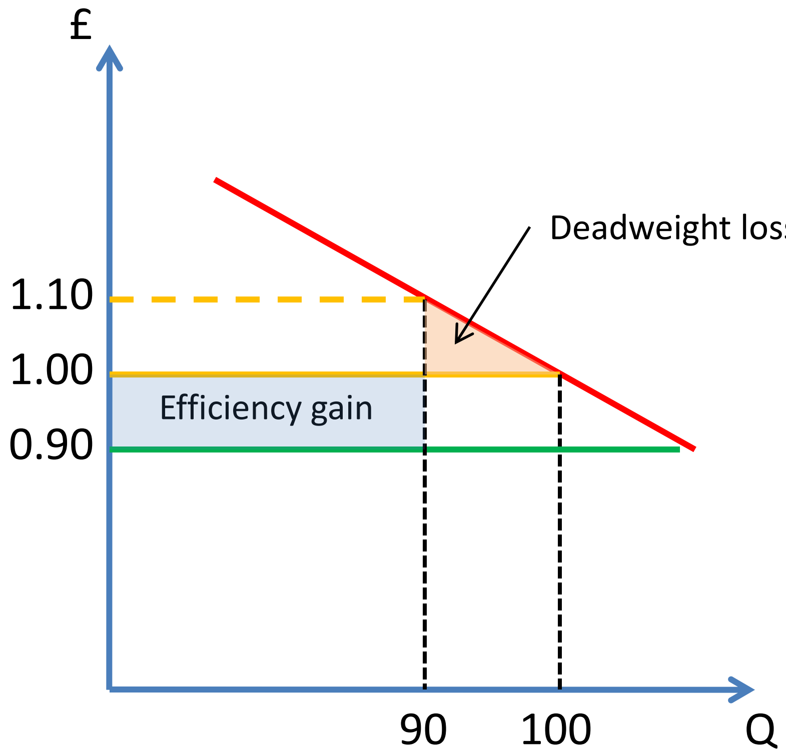
- Clayton Act (1914)
  - Prevents price discrimination that reduces competition
  - Prohibits tie-ins and exclusive dealing when they reduce competition
  - Prohibits mergers that reduce competition
  - Addresses interlocking directorates among competing firms
  - Allows the "injured" party three times actual damages plus attorneys' fees

Are antitrust laws efficiency enhancing? - I



- Demand curve for product (and hence for retailer) = D_R
- Wholesaler knows that retailer uses the MR curve to decide on output, and hence $D_w = MR_R$
- Wholesaler charges price P_w, which then is the MC for the retailer
- Price for the consumer is P_R
- In the case of vertical integration, price would have been P_w

Are antitrust laws efficiency enhancing? - II



- Merger outcomes:
  - Price raised from £1 to £1.10
  - MC (= AC) declines from £1 to £0.90
- Implications:
  - Deadweight loss = 0.5 x 0.10 x 10 = 0.50
  - Efficiency gain = 0.10 x 90 = 0.90
- In general, efficiency gain is more likely to dominate if the output level sold in the market is large
- Regulations generally take a dim view of price rises following mergers even if there are compensating efficiency gains
  - Conflicting views of US and European regulators about GE-Honeywell merger

Challenge I – estimating market power

- Market power
  - Definition: $(P - MC)/P = 1/\varepsilon$, where ε is the elasticity of demand
- Problem
  - How can we estimate ε of the firm created by mergers between two firms?
- Rule of thumb
  - Compute HHI before and after merger
  - (a) If initial HHI less than 1000, merger is deemed unproblematic

    (b) If initial HHI is 1000-1800 and HHI increases by 100, merger is deemed problematic

    (c) If HHI is greater than 1800 and HHI increases by 50, merger is deemed problematic

Challenge II – estimating extent of market

- Are Coke and Fanta in the same market? Is tea?

- Estimating the extent of the market requires the identification of all demand and supply substitutes
  - Product B is a *demand substitute* of Product A if a rise in the price of A increases the demand for B
  - Product C is a *supply substitute* of Product A if a rise in price of A makes a firm switch from production of C to production of A

- Rule of thumb
  - Decide whether two products are in the same market either by interviewing producers or by checking correlation between their prices
  - More often than not, the (own) price elasticity – and not the cross-price elasticity – is taken into account to decide whether or not a firm has market power

Are all agreements among competitors bad?

- Price fixing and output agreements
  - Price fixing and output fixing are fundamentally in violation of antitrust laws
  - The court does not need to undertake additional inquiry about the “reasonableness” of these actions to deem them to be illegal
  - However, courts do take into consideration the question as to whether price fixing in specific cases might promote competition in some way

- Information exchange among competitors
  - An important consideration is whether the group of firms exchanging information is small enough to effectively form a cartel

- Oligopoly behaviour
  - Similarity of behaviour (e.g., with respect to pricing) is deemed unacceptable

- Mergers
  - Mergers among competitors (and even among potential competitors) generally not allowed
  - However, courts do entertain the *failing firm* defence of such mergers

Status of other strategic behaviour

- Case of *Alcoa*
  - Exclusive supply contracts with power companies
  - Price-fixing with foreign firms to reduce import competition in the USA
  - Selling aluminium at higher prices to producers of aluminium sheets
  - Expanding capacity

- Contrast: Case of *Kodak*
  - Did not pre-disclose its 110 film format to rival company
  - $\Rightarrow$ Pre-disclosure is not required under anti-trust laws, and the resultant monopoly is not necessarily unacceptable

- Predatory pricing
  - Is a product priced below its production cost?

- Refusal to do business with a rival
  - Is the product/service being denied essential for the survival of the rival?

- Vertical integration and vertical restraints (e.g., MRP, exclusive territories)
  - Might also involve cross-ownership of shares (e.g., Du Pont taking 23% stake in GM)

- Tie-in sales

The case of the US banking industry

- National Bank Act (1864)
  - Banks have to be chartered (licensing)
- McFadden Act (1927)
  - Required national banks to restrict branching to the state in which they were located
- Glass-Steagall Act (1933)
  - Separated commercial banking from investment banking (economies of scope)
- Regulation *Q*
  - Prohibited banks from paying interest on demand deposits (and imposed interest rate ceilings for savings accounts)
- Foreign Bank Supervision Enforcement Act (1991)
  - Federal Reserve must approve the entry of all foreign banks
  - Bars branches of foreign banks from accepting deposits of less than $100,000 from US residents and citizens
  - Fed must be notified if a foreign bank owns 5% of a US bank; and Fed must approve foreign parent bank as a holding company if it owns 25% of a US bank