Chapter 10

The Economics of Antitrust Law

This chapter examines the economic justification for antitrust laws, or that body of statutes and judicial rulings whose objective is to prevent anticompetitive business practices. The analysis also identifies various explanations, besides monopoly, that might explain certain business practices that have traditionally been seen as anticompetitive.

Key Points

- The economic rationale for antitrust laws is to promote competitive markets by making efforts to exercise monopoly power—whether by a single firm or a group of firms—illegal.

- Monopoly causes an inefficient allocation of resources by restricting output below what would be achieved by a competitive market. As a result, there is a deadweight loss in welfare. In addition, monopoly redistributes gains from consumers to producers by transferring some consumer surplus to profit.

- A cartel is a group of firms that colludes to behave like a monopolist by restricting output and raising price. Economic theory shows, however, that cartel agreements are difficult to sustain because there is always an incentive for individual firms to cheat on the agreement by lowering their price in order to capture a larger share of the profits. This problem is an example of the prisoner's dilemma.

- Most markets are oligopolistic, meaning that a "few" firms compete with one another.

- The extent to which equilibrium outcomes in oligopolistic markets depart from the competitive ideal depends on which model one employs to describe firm behavior.

- The Sherman Act, passed in 1890, was the first anti-monopoly law enacted by Congress. It prohibited the formation of monopolies and cartels.

- The Clayton Act, passed in 1914, made illegal several other anti-competitive business practices. There remains, however, considerable discretion on the part of courts and the justice department in the enforcement of anti-trust laws.

- Courts have generally interpreted antitrust laws based on a balancing of the anti-competitive and pro-competitive effects of a targeted practice. This standard is referred to as a "rule of reason" test. This is in contrast to a "per se rule," which forbids a prohibited practice, regardless of any possible pro-competitive effects it might have.

- The optimal fine for an antitrust violation—that is, the fine that deters the violation—equals the sum of the deadweight loss and the monopoly transfer from the prohibited practice, divided by the probability of detection, plus the plaintiff's cost of bringing suit. This may or

may not coincide with the prescribed fine of treble damages plus litigation costs under the Clayton Act.

- The "new" antitrust law and economics recognizes the possible efficiency-enhancing aspects of many seemingly monopolistic practices. Specifically, it points out how certain business practices, which on their face appear to create market power, may actually serve to correct an existing market failure.

- As an illustration, long term contracts and vertical mergers can facilitate productive, long term business relationships by economizing on various transaction costs that often plague such relationships. A common example is when a firm wants to ensure a steady supply of an essential input.

- Horizontal mergers, or mergers between competitors, reduce competition by increasing the concentration of a market, but they can also promote efficiency by allowing the consolidated firm to exploit scale economies. A balancing of the costs and benefits of such a merger is therefore the appropriate criterion for judging its acceptability.

- Network effects arise when the value to a consumer of a particular product depends on how many other consumers also buy the same product or complementary products. When network effects are present, one brand will often come to dominate the market, potentially leading to monopoly power. Again, the courts need to balance the efficiency benefits of such dominance against the possible costs.

- Imperfect information on the part of consumers about product quality poses a significant threat to the efficient operation of markets. Producers of high quality products are at a particular disadvantage unless they can credibly distinguish their products from low-quality imitators.

- Several alleged anti-competitive practices can be interpreted as devices for conveying information about product quality, including tie-in sales, pricing above marginal cost, and resale price maintenance.

- Occupational licensing, whether by the government or a professional group, also serves to ensure minimum service quality in many professions, but it does so by limiting entry into the profession.

- Natural monopoly is defined as an industry where average production costs are minimized when a single firm serves the entire industry demand. Formally, average costs of production are falling throughout the relevant range of production.

- From an antitrust perspective, one response to natural monopoly is to allow a single firm to serve the industry so as to exploit the scale economies but to regulate its price so as to prevent monopoly pricing. However, if price is set equal to marginal cost in order to achieve the efficient output level, a subsidy will be needed to cover the firm's losses, given that marginal cost is below average costs when average costs are falling.

- Alternatively, the firm could simply set price equal to average costs. In this case, no subsidy is needed, but the firm operates at an inefficient level of output.

- An alternative to price regulation of a natural monopoly is for the government to take control of the firm and run it as a public enterprise. One example of this is the U.S. Postal Service.