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Should Antitrust Laws Tame Big Business?

Antitrust authorities in Washington and the states have been busy in recent years scrutinizing mega-mergers in the banking, communications and defense industries, among others. As the number of competitors in certain markets dwindles, the potential combination of former rivals raises concerns about market concentration and the consequent implications for consumers and other firms.

But mergers aren't the only business activities that have drawn regulators' attention. Antitrust authorities are also examining allegations of exclusionary actions—like predatory pricing, exclusive dealing and tying arrangements—in a host of industries and firms. Because the application of antitrust law relies heavily on economic principles and analysis of potential outcomes, let's take a look at what economists have to say about the structure and operation of American business.

Potentially Punishable Practices: A Glossary of Antitrust Terms

Exclusive Dealing	A firm prohibits its distributors from selling competitors' products.
Exclusive Territories	A firm assigns a geographic area to a distributor and prohibits other distributors from operating in that territory.
Predatory Pricing	A firm prices a product below the marginal cost of producing it to drive rivals out of business.
Price Discrimination	A firm charges different customers different prices for the same product.
Refusals to Deal	A firm prohibits a rival from purchasing/using scarce resources (called essential facilities) that are needed to stay in business.
Resale Price Maintenance	A manufacturer sets a minimum retail price for its product.
Tie-In Sales	A firm conditions the purchase of one product upon the purchase of another.

Antitrust Basics

Antitrust economics is part of a branch of economics known as industrial organization, which attempts to explain the structure and competitive behavior of firms and industries. The structure of an industry generally refers to the number of firms that provide products or services to a given market, the barriers to entry for new firms, and the degree of product differentiation.

The structure of an industry selling a similar product or service can be described in one of three ways:

- perfectly competitive—no barriers to entry, many sellers with no pricing power;
- oligopolistic—barriers to entry, a few sellers with some pricing power; or
- a pure monopoly—barriers to entry, one seller with complete pricing power.1

More recently, economists have also defined a structure called the dominant firm with a competitive fringe, which consists of a single firm with a large market share and some price-setting power that competes with smaller, price-taking firms.2 Examples of dominant firms are IBM in the market for mainframe computers and Kodak in the photographic film market.

Since it is the exercise of monopoly or market power that is problematic, economists and policy-makers are more concerned about the way firms in an industry behave than the structure of the industry per se. Indeed, in some circumstances, a monopoly structure yields the most efficient, socially desirable outcome. Natural monopolies are one example. They occur in markets in which additional output can be produced at a lower per-unit cost, such as the public utility industries. Monopolies are even encouraged in other types of markets. For example, a pharmaceutical company that is issued a patent for a new drug is essentially given a limited-life monopoly over the product to help the firm recoup the upfront research and development costs that are associated with introducing a socially desirable innovation.

According to the nation's antitrust laws, a monopoly is not—strictly speaking—illegal. Rather, the laws are used primarily by federal authorities—the Department of Justice and the Federal Trade Commission (FTC)—both to rein in firms that exercise excessive market power and to limit the way in which firms compete with one another. Antitrust officials are guided by three major federal statutes: 1) the Sherman Act of 1890, which prohibits the restraint of trade; 2) the Clayton Act of 1914, which further describes the type of conduct and practices that will get a firm into trouble; and 3) the Federal Trade Commission Act of 1914, which created the FTC, whose Bureau of Competition enforces the FTC act and other antitrust laws. For the most part, these statutes allow the courts to make determinations of what is considered unfair or excessive.

Leave Them Alone?

Most antitrust officials—and the economists who advise them—believe that the antitrust laws have two main purposes: to ensure that markets operate efficiently and that consumers are not harmed by a firm's actions toward them or the firm's competitors. It has not always been this way, however. At the turn of the century, for example, when Standard Oil, U.S. Steel and other huge monopoly trusts prevailed, bigness was equated with badness. During this era, policy-makers were more concerned about protecting small company competitors than they were about encouraging economic efficiency.

Such thinking dominated antitrust policy until the mid-1970s and 1980s, when antitrust officials in Washington adopted a laissez-faire approach to antitrust policy. They argued that a firm's size did not matter and that the benchmark for bringing an antitrust case should be the exertion of market power that demon-strably hurts consumers. Moreover, they held that justifiable antitrust cases would be rare since market forces would deter firms from engaging in inefficient behavior.

This market-based approach to solving antitrust problems is predicated in part on contestable markets theory. A contestable market is one in which firms can costlessly enter or exit it in response to high profits and

challenge the dominant firm or firms for market share. If a market is determined to be contestable, then most economists believe that the threat of competition is enough to deter a dominant firm from engaging in anticompetitive practices.

It's Still A Fine Line

Antitrust policy and analysis have evolved yet again in the 1990s. Economists have increasingly agreed, for example, that easy and costless market entry and exit—a necessary condition for a contestable market—rarely exists in the real world because of the presence of sunk costs. Sunk costs are the fixed costs—like the funds that are expended on real estate and legal services—that cannot be recovered if a business fails. The greater the sunk costs, the less incentive there is for new firms to enter a market and compete against a dominant incumbent. Without competition, the incumbent may then be tempted to exercise its market power by restricting output and raising prices.

Technological improvements have aided antitrust officials in determining whether a particular business practice or merger is likely to be anticompetitive. For example, by using scanner data from the retail outlets of several competitors in a given geographic market, economists can calculate how prices are likely to be affected by the addition or subtraction of one of those competitors in a different geographic market.

Despite all the advances made in antitrust economics, it's still as much of an art as it is a science. There remains a very fine line between good, hard-nosed competition and illegal, anticompetitive practices. Economists have much to contribute to the analysis, and the better they are able to incorporate new tools and real world imperfections into theoretical models, the easier that line will be to see.

This article was adapted from "Does Big Business Need Taming? The Role of Economics in Antitrust Law," which was written by economist Michelle Clark Neely and appeared in the July 1998 issue of The Regional Economist*, a St. Louis Fed publication.*

Endnotes

1. Monopoly, price or market power all refer to the ability of a firm to profitably set the price of its good or service above the marginal cost of producing it. [back to text]
2. Firms with monopoly power are referred to as price setters, while firms operating in a competitive industry are referred to as price takers-they take the market price as given. [back to text]

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Q & A

How big a problem is personal bankruptcy?

Personal bankruptcies across the United States hit a record 1.35 million in 1997, with many analysts expecting another record in 1998. In fact, there has been close to a 370 percent increase in personal bankrupt-cies since 1980.

What laws govern consumer bankruptcy?

Bankruptcy laws vary from state to state, since states are permitted to set their own levels and types of asset exemptions. There are two main types of consumer bankruptcy protection: Chapter 7 and Chapter 13. About two-thirds of current filers choose Chapter 7 in which the debtor is required to give up nonexempt property (assets) to a trustee, who sells it and pays creditors with the proceeds. Exempt property includes assets that the law has deemed necessary to support the debtor and his dependents. Equity in a house, which is called a homestead exemption, is one example. Unsecured debt, like credit card debt, is wiped off the books, or discharged. Chapter 13 filers, on the other hand, are allowed to retain more assets than Chapter 7 filers, but must agree to pay creditors their outstanding debt—in full or in part—over a period of three to five years. In both types of debt, certain types of debt are not eligible for discharge, including alimony, recent income taxes, child support and government-backed student loans.

What is causing such increases in bankruptcies?

Economic factors like high debt-to-income ratios explain much of the increase in bankruptcy filing. Since 1980, lenders have reached out to borrowers who would not have met previous income and creditworthiness standards. While this "democratization of credit" has certainly benefited many households, it has also made it easier for them to live beyond their means. When polled, Americans filing for personal bankruptcy routinely list credit card bills as the pivotal factor in their decision. In addition, personal bankruptcies are strongly influenced by factors like divorce, medical bills and gambling, as well as state laws regarding wage garnishment and asset exemptions.

Is the government concerned about the level of personal bankruptcies?

The level of personal bankruptcies has captured the attention of both the media and policy-makers. In 1994, the National Bankruptcy Review Commission was formed to study the increase in consumer bankruptcies and to recommend changes in the current federal bankruptcy code. Both the House and Senate have recently passed bankruptcy reform bills that may increase the proportion of debtors filing for Chapter 13 bankruptcy.

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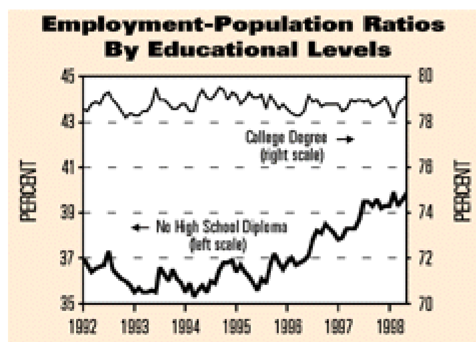
Economic Snapshot

3rd Quarter 1998

	Q4-97	Q1-98	Q2-98	Q3-98
Growth Rate—Real Gross Domestic Product	3.0%	5.5%	1.8%	3.9%*
Inflation Rate—Consumer Price Index	2.1%	0.5%	2.0%	1.8%
Civilian Unemployment Rate	4.7%	4.7%	4.4%	4.5%

**Preliminary*



SOURCE: National Economic Trends*, Federal Reserve Bank of St. Louis, February 1998.*

Do employment rates vary among people with differing education levels?

We've often heard that education helps you get a job; here are some statistics that back this up. As seen in the chart above, during the first four months of 1998 an average of only 39.6 percent of those who did not finish high school were at work, but 78.7 percent if college-educated adults held jobs. The figures for those with a high school diploma and those with some college lie in between, at 62 .9 percent and 72.3 percent, respectively.