

CHAPTER

19

Antitrust Policy and Regulation

IN THE SPIRIT of the TV show *Do You Want to Be a Millionaire?* try to answer these questions:

- Which one of the following companies did a Federal District Court find guilty of violating U.S. antitrust laws? (a) Napster, (b) Microsoft, (c) J. C. Nickels, (d) Colgate-Palmolive. Final answer?
- Business firms subject to *industrial regulation* are often called (a) unnatural monopolies, (b) monopolistic competitors, (c) monopsonists, (d) public utilities. Final answer?
- The requirement that businesses make reasonable accommodations for disabled workers and customers is an example of (a) antitrust policy, (b) industrial policy, (c) social regulation, (d) economies of scale. Final answer?

The answers, in order, are (b), (d), and (c). ■ The five chapters that constitute Part 5 examine selected microeconomic issues and policies. In this chapter we look at three sets of government policies toward business: antitrust policy, industrial regulation, and social regulation. **Antitrust policy** consists of the laws and government actions designed to prevent monopoly and promote competition. **Industrial regulation** consists of government regulation of firms' prices (or "rates") within selected industries. **Social regulation** is government regulation of the conditions under which goods are produced, the physical characteristics of goods, and the impact of the production and consumption of goods on society. ■ Then, in the four chapters that follow, we discuss issues and policies relating to agriculture, income inequality, labor markets (unions, discrimination, and immigration), and health care.

■ The Antitrust Laws

The underlying purpose of antitrust policy (anti-monopoly policy) is to prevent monopolization, promote competition, and achieve allocative efficiency. Although all economists would agree that these are

meritorious goals, there is sharp conflict of opinion about the effectiveness of U.S. antitrust policy. As we will see, antitrust policy over the years has been neither clear-cut nor consistent.

Historical Background

Just after the U.S. Civil War (1861–1865), local markets widened into national markets because of improved transportation facilities, mechanized production methods, and sophisticated corporate structures. In the 1870s and 1880s “trusts” (monopolies) emerged in several industries, including the petroleum, meatpacking, railroad, sugar, lead, coal, whiskey, and tobacco industries.

Firms often used questionable tactics to monopolize these industries and then charged monopoly prices to customers and extracted price concessions from resource suppliers. Farmers and owners of small businesses were particularly vulnerable to the power of large corporate monopolies and were among the first to oppose them. Consumers, labor unions, and economists were not far behind in their opposition.

The main economic case against monopoly is familiar to you from Chapter 11. Monopolists tend to produce less output and charge higher prices than would be the case if their industries were competitive. With pure competition, production occurs where $P = MC$. This equality represents an efficient allocation of resources because P measures the marginal benefit to society of an extra unit of output while marginal cost MC reflects the cost of an extra unit. When $P = MC$, society cannot gain by producing 1 more or 1 less unit of the product. In contrast, a monopolist maximizes profit by equating marginal revenue (not price) with marginal cost. At this $MR = MC$ point, price exceeds marginal cost, meaning that society would obtain more benefit than it would incur cost by producing extra units. There is an underallocation of resources to the monopolized product, and so the economic well-being of society is less than it would be with greater competition.

Government concluded in the late 1800s and early 1900s that market forces in monopolized industries did not provide sufficient control to protect consumers, achieve fair competition, and achieve allocative efficiency. So it instituted two alternative means of control as substitutes for, or supplements to, market forces:

- **Regulatory agencies** In the few markets where the nature of the product or technology creates a *natural monopoly*, the government established public regulatory agencies to control economic behavior.

- **Antitrust laws** In most other markets, social control took the form of antitrust (antimonopoly) legislation designed to inhibit or prevent the growth of monopoly.

Four particular pieces of Federal legislation, as refined and extended by various amendments, constitute the basic law relating to monopoly structure and conduct.

Sherman Act of 1890

The public resentment of trusts that emerged in the 1870s and 1880s culminated in the **Sherman Act** of 1890. This cornerstone of antitrust legislation is surprisingly brief and, at first glance, directly to the point. The core of the act resides in two provisions:

- **Section 1** Every contract, combination in the form of a trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states, or with foreign nations is hereby declared to be illegal.
- **Section 2** Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any person or persons, to monopolize any part of the trade or commerce among the several states, or with foreign nations, shall be deemed guilty of a felony (as later amended from “misdemeanor”).

The Sherman Act thus outlawed *restraints of trade* (for example, collusive price fixing and dividing up markets) as well as *monopolization*. Today, the U.S. Department of Justice, the Federal Trade Commission, injured private parties, or state attorney generals can file antitrust suits against alleged violators of the act. The courts can issue injunctions to prohibit anticompetitive practices or, if necessary, break up monopolists into competing firms. Courts can also fine and imprison violators. Further, parties injured by illegal combinations and conspiracies can sue the perpetrators for *treble damages*—awards of three times the amount of the monetary injury done to them.

The Sherman Act seemed to provide a sound foundation for positive government action against business monopolies. However, early court interpretations limited the scope of the act and created ambiguities of law. It became clear that a more explicit statement of the government’s antitrust sentiments was needed. The business community itself sought a clearer statement of what was legal and what was illegal.

Clayton Act of 1914

The **Clayton Act** of 1914 contained the desired elaboration of the Sherman Act. Four sections of the act, in particular, were designed to strengthen and make explicit the intent of the Sherman Act:

- Section 2 outlaws *price discrimination* when such discrimination is not justified on the basis of cost differences and when it reduces competition.
- Section 3 forbids **tying contracts**, whereby a producer would sell a desired product only on condition that the buyer acquires other products from the same producer.
- Section 7 prohibits the acquisition of stocks of competing corporations when the outcome would be less competition.
- Section 8 prohibits the formation of **interlocking directorates**—situations where a director of one firm is also a board member of a competing firm—in large corporations where the effect would be reduced competition.

The Clayton Act simply sharpened and clarified the general provisions of the Sherman Act. It also sought to outlaw the techniques that firms might use to develop monopoly power and, in that sense, was a preventive measure. Section 2 of the Sherman Act, by contrast, was aimed more at breaking up existing monopolies.

Federal Trade Commission Act of 1914

The **Federal Trade Commission Act** created the five-member Federal Trade Commission (FTC), which has joint Federal responsibility with the U.S. Justice Department for enforcing the antitrust laws. The act gave the FTC the power to investigate unfair competitive practices on its own initiative or at the request of injured firms. It can hold public hearings on such complaints and, if necessary, issue **cease-and-desist orders** in cases where it discovers “unfair methods of competition in commerce.”

The **Wheeler-Lea Act** of 1938 gave the FTC the additional responsibility of policing “deceptive acts or practices in commerce.” In so doing, the FTC tries to protect the public against false or misleading advertising and the misrepresentation of products. So the Federal Trade Commission Act, as modified by the Wheeler-Lea Act, (1) established the FTC as an independent antitrust agency and (2) made unfair and deceptive sales practices illegal.

Celler-Kefauver Act of 1950

The **Celler-Kefauver Act** amended the Clayton Act, Section 7, which prohibits a firm from merging with a competing firm (and thereby lessening competition) by acquiring its stock. Firms could evade Section 7, however, by instead acquiring the physical assets (plant and equipment) of competing firms. The Celler-Kefauver Act closed that loophole by prohibiting one firm from obtaining the physical assets of another firm when the effect would be reduced competition. Section 7 of the Clayton Act now prohibits anticompetitive mergers no matter how they are undertaken. (**Key Question 2**)

Antitrust Policy: Issues and Impacts

The effectiveness of any law depends on how the courts interpret it and on the vigor of government enforcement. The courts have been inconsistent in interpreting the antitrust laws. At times, they have applied them vigorously, adhering closely to their spirit and objectives. At other times, their interpretations have rendered certain laws nearly powerless. The Federal government itself has varied considerably in its willingness to apply the antitrust laws. Administrations holding a *laissez-faire* philosophy about monopoly have sometimes ignored them or have reduced the budgets of the enforcement agencies.

Issues of Interpretation

Differences in judicial interpretations have led to vastly different applications of the antitrust laws. Two questions, in particular, have arisen: (1) Should the focus of antitrust policy be on monopoly behavior or on monopoly structure? (2) How broadly should markets be defined in antitrust cases?

Monopoly Behavior versus Monopoly Structure A comparison of two landmark Supreme Court decisions reveals two distinct interpretations of Section 2 of the Sherman Act as it relates to monopoly behavior and structure.

In the 1920 **U.S. Steel case** the courts applied the **rule of reason**, saying that not every monopoly is illegal. Only monopolies that “unreasonably” restrain trade—so-called “bad trusts”—are subject to antitrust action. The Supreme Court held in this case that size alone was not an offense. Although

U.S. Steel clearly possessed monopoly power, it was innocent of “monopolizing,” because it had not resorted to illegal acts against competitors in obtaining that power nor had it unreasonably used its monopoly power.

In the **Alcoa case** of 1945 the courts touched off a 20-year turnabout. The Supreme Court sent the case to the U.S. court of appeals in New York because four of the Supreme Court justices had been involved with litigation of the case before their appointments. Led by Judge Hand the court of appeals held that, even though a firm’s behavior might be legal, the mere possession of monopoly power (Alcoa held 90 percent of the aluminum ingot market) violated the antitrust laws. So Alcoa was found guilty of violating the Sherman Act.

These two cases point to a controversy in antitrust policy. Should a firm be judged by its behavior (as in the U.S. Steel case) or by its structure, or market share (as in the Alcoa case)?

“Structuralists” say that a firm with a very high market share will behave like a monopolist. Since the economic performance of such firms will be undesirable, they are legitimate targets for antitrust action. Changes in the structure of the industry, say, by splitting the monopolist into several smaller firms, will improve behavior and performance.

“Behavioralists” assert that the relationship between structure, behavior, and performance is tenuous and unclear. They feel a monopolized or highly concentrated industry may be technologically progressive and have a good record of providing products of increasing quality at reasonable prices. If a firm has served society well and has engaged in no anticompetitive practices, it should not be accused of antitrust violation just because it has an extraordinarily large market share. That share may be the product of superior technology, superior products, and economies of scale. “Why use antitrust laws to penalize efficient, technologically progressive, well-managed firms?” they ask.

Over the past 20 years, the courts have returned to the rule of reason, and most contemporary economists and antitrust enforcers reject strict structuralism. For instance, in 1982 the government dropped its 13-year-long monopolization case against IBM on the grounds that IBM had not unreasonably restrained trade. More recently, the government has made no attempt to break up Intel’s monopoly in the sale of microcircuits for personal computers. And in prosecuting the Microsoft case (the subject of this chapter’s Last Word), the Federal

government made it clear that the behavior used by Microsoft to maintain and extend its monopoly, not the presence of its large market share, violated the Sherman Act. That is, the government in effect declared Microsoft “a bad monopoly.”

The Relevant Market Courts often decide whether or not market power exists by considering the share of the market held by the dominant firm. If the market is defined broadly to include a wide range of somewhat similar products, the firm’s market share will appear small. If the market is defined narrowly to exclude such products, the market share will seem large. The Supreme Court’s task is to determine how broadly to define relevant markets, and it has not always been consistent.

In the Alcoa case, the Court used a narrow definition of the relevant market: the aluminum ingot market. But in the **DuPont cellophane case** of 1956 the Court defined the market very broadly. The government contended that DuPont, along with a licensee, controlled 100 percent of the cellophane market. But the Court accepted DuPont’s contention that the relevant market included all “flexible packaging materials”—waxed paper, aluminum foil, and so forth, in addition to cellophane. Despite DuPont’s monopoly in the “cellophane market,” it controlled only 20 percent of the market for “flexible wrapping materials.” The Court ruled that this did not constitute a monopoly.

Issues of Enforcement: Tradeoffs among Goals

Promoting competition is only one of society’s goals, and strict enforcement of the antitrust laws may sometimes conflict with some other goal. Below are three examples.

Balance of Trade Large U.S. trade deficits have led the government to seek ways to increase exports. Antitrust actions that undo a merger between two chemical suppliers, break up a dominant aircraft manufacturer, or dissolve a microchip or software monopolist might weaken the targeted firm, thereby reducing its competitiveness and sales abroad. Consequently, U.S. exports might decline and thus increase the nation’s trade deficit. Should government strictly enforce antitrust laws, even when significant amounts of U.S. exports are at stake? Or should the antitrust goal of efficiency be superseded by the goal of balancing exports and imports?

Defense Cutbacks Cutbacks in defense spending over the past decade have reduced government purchases of military equipment, placing some major defense suppliers in financial jeopardy. Should the government allow defense firms to merge in order to bolster sagging profits and thus reduce the number of worker layoffs that would result if one or both firms went out of business? Or should the government block such mergers as violations of Section 7 of the Clayton Act and simply let the market sort matters out, perhaps through bankruptcies? In 1994 the Defense Department and antitrust regulators reached an informal agreement, easing the way for consolidation of the defense industry via mergers. Several large mergers quickly followed.

Emerging New Technologies Occasionally, new technologies combine to create new products and services. A current example is the meshing of computers and communications technologies relating to the Internet. This interactive network has improved the communications capabilities of households, businesses, and governments across the globe. It also enables people to access unprecedented amounts of information and directly buy and sell goods and services. The emergence of this new technology has set off a spate of “megamergers” among entertainment companies, telecommunication companies, computer manufacturers, and software producers.

Should the government strictly enforce the Clayton Act to block some of those mergers, specifically ones that produce dominant firms and threaten to reduce competition? Or should the government temporarily suspend antitrust rules to encourage the restructuring of industries and speed the expansion of this new technology? Hastening the advance of Internet-related technologies might also increase U.S. exports of “electronic services” and decrease the large U.S. trade deficit.

Each of these enforcement tradeoffs, by itself, triggers controversy. Some argue that the gains from an antitrust policy must be weighed against the effects of the policy on conflicting objectives. Others contend that selective enforcement of antitrust laws dangerously interferes with the market process. Obviously, different policymakers and different administrations may view such considerations and tradeoffs differently.

Effectiveness of Antitrust Laws

Have the antitrust laws been effective? Although this question is difficult to answer, we can at least observe how the laws have been applied to existing market structures, mergers, price fixing, and tying contracts.

Existing Market Structures On the basis of the rule of reason, the government generally has been lenient in applying antitrust laws to market structures that have already developed or to firms that have expanded their market shares “naturally.” Generally, a firm will be sued only if it has more than 60 percent of the relevant market and there is evidence suggesting that it used abusive conduct to achieve, maintain, or extend its market dominance.

Since 1980 there have been two noteworthy actions aimed at altering existing market structures. The first was the 1982 out-of-court settlement between the government and AT&T. That firm was charged with violating the Sherman Act by engaging in anticompetitive actions designed to maintain its domestic telephone monopoly. As part of the settlement, AT&T agreed to divest itself of its 22 regional telephone-operating companies.

The second significant action was the Federal district court ruling in 2000 that Microsoft violated the Sherman Act through a series of unlawful actions designed to maintain and extend its monopoly of computer operating software. The court’s remedy was to split Microsoft into two competing firms and to prohibit either of the two firms from engaging in certain anticompetitive behaviors. Microsoft has appealed the court decision to a higher court.

Mergers The treatment of mergers, or combinations of existing firms, varies with the type of merger and its effect on competition.

Merger Types There are three basic types of merger, as represented in Figure 19.1. This figure shows two stages of production (the input stage and the output, or final-product, stage) for two distinct final-goods industries (autos and blue jeans). Each rectangle (A, B, C, . . . X, Y, Z) represents a particular firm.

A **horizontal merger** is a merger between two competitors that sell similar products in the same geographic market. In Figure 19.1 this type of merger is shown as a combination of glass producers T and U.

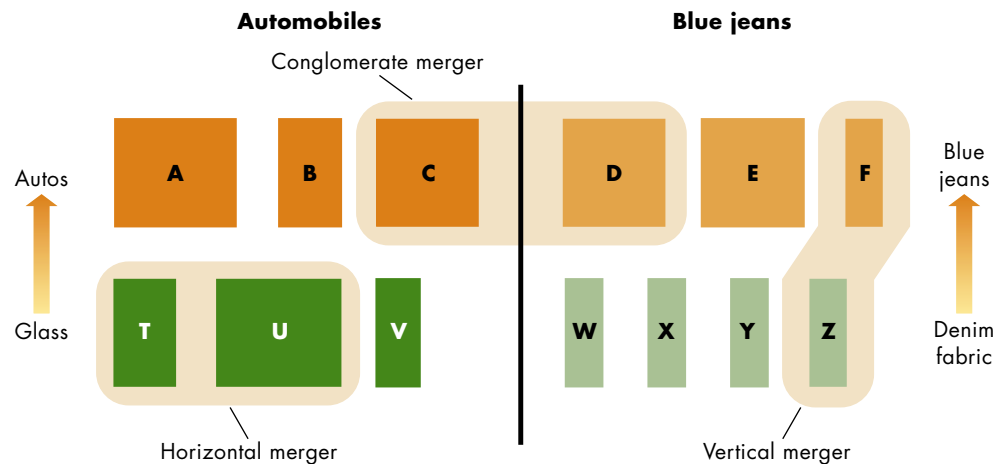


Figure 19.1

Types of mergers. Horizontal mergers (T + U) bring together firms selling the same product in the same geographic market; vertical mergers (F + Z) connect firms having a buyer-seller relationship; and conglomerate mergers (C + D) join firms in different industries or firms operating in different geographic areas.

Actual examples of such mergers include Chase Manhattan's merger with Chemical Bank, Boeing's merger with McDonnell Douglas, and Exxon's merger with Mobil.

A **vertical merger** is a merger between firms at different stages of the production process. In Figure 19.1, the merger between firm Z, a producer of denim fabric, and firm F, a producer of blue jeans, is a vertical merger. Vertical mergers are mergers between firms that have buyer-seller relationships. Actual examples of such mergers are PepsiCo's mergers with Pizza Hut, Taco Bell, and Kentucky Fried Chicken. PepsiCo supplies soft drinks to each of these fast-food outlets. (In 1997, PepsiCo spun off these entities into a separate company called Tricon Global Restaurants.)

A **conglomerate merger** is officially defined as any merger that is not horizontal or vertical; in general, it is the combination of firms in different industries or firms operating in different geographic areas. Conglomerate mergers can extend the line of products sold, extend the territory in which products are sold, or combine totally unrelated companies. In Figure 19.1, the merger between firm C, an auto manufacturer, and firm D, a blue jeans producer, is a conglomerate merger. Real-world examples of conglomerate mergers include the merger between Walt Disney Company (movies) and the American Broadcasting Company (radio

and television) and the merger between America Online (Internet service provider) and Time Warner (communications).

Merger Guidelines: The Herfindahl Index The Federal government has established very loose merger guidelines based on the Herfindahl index. Recall from Chapter 12 that this measure of concentration is the sum of the squared percentage market shares of the firms within an industry. An industry of only four firms, each with a 25 percent market share, has a Herfindahl index of 2500 ($= 25^2 + 25^2 + 25^2 + 25^2$). In pure competition, where each firm's market share is minuscule, the index approaches 0 ($= 0^2 + 0^2 + \dots + 0^2$). In pure monopoly, the index for that single firm is 10,000 ($= 100^2$).

The U.S. government uses Section 7 of the Clayton Act to block horizontal mergers that will substantially lessen competition. It is likely to challenge a horizontal merger if the postmerger Herfindahl index would be high (above 1800) and if the merger has substantially increased the index (added 200 or more points). However, other factors, such as economies of scale, the degree of foreign competition, and the ease of entry of new firms, are also considered. Furthermore, horizontal mergers are usually allowed if one of the merging firms is suffering major and continuing losses. (This is one reason Boeing was allowed to acquire McDonnell

Douglas in 1996: MD was losing money in producing its commercial airplanes.)

In recent years, the Federal government has blocked several proposed horizontal mergers. For example, it blocked the mergers between Staples and Office Depot, two major office-supply retailers, and between WorldCom and Sprint, two competing telecommunications firms.

Most *vertical mergers* escape antitrust prosecution because they do not substantially lessen competition in either of the two markets. (In Figure 19.1 neither the Herfindahl index in the industry producing denim fabric nor the index in the blue jeans industry changes when firms Z and F merge vertically.) However, a vertical merger between large firms in highly concentrated industries may be challenged. For example, in 1999 the threat of FTC action spurred Barnes & Noble to abandon its merger with Ingram Book group, the nation's largest book wholesaler. The merger would have enabled Barnes & Noble to set the wholesale price of books charged to its direct retail competitors such as Borders and Amazon.com.

Conglomerate mergers are generally permitted. If an auto manufacturer acquires a blue jeans producer, no antitrust action is likely, since neither firm has increased its own market share as a result. That means the Herfindahl index remains unchanged in each industry. (**Key Question 5**)

Price Fixing Price fixing is treated strictly. Evidence of price fixing, even by small firms, will bring antitrust action, as will other collusive activities such as scheming to rig bids on government contracts or dividing up sales in a market. In antitrust law, these activities are known as **per se violations**; they are “in and of themselves” illegal, and therefore are *not* subject to the rule of reason. To gain a conviction, the government or other party making the charge need show only that there was a conspiracy to fix prices, rig bids, or divide up markets, not that the conspiracy succeeded or caused serious damage to other parties. **19.1**

Price-fixing investigations and court actions are common. Recent examples include:

- Archer Daniels Midland (ADM) and other agribusinesses admitted fixing the prices of an additive to livestock feed, a sweetener made from corn, and citric acid.
- ConAgra and Hormel agreed to pay more than \$21 million to settle their roles in a nationwide price-fixing case involving catfish.

- Reebok agreed to pay nearly \$10 million in damages to settle a lawsuit in which it was accused of fixing the minimum price retailers could charge for its footwear.
- The Justice Department fined UCAR International \$110 million for scheming with competitors to fix prices and divide the world market for graphite electrodes that are used in steel mills.
- Seven international makers of common vitamins agreed to pay \$1.2 billion to corporate buyers of bulk vitamins to settle a lawsuit that alleged the producers engaged in a 9-year conspiracy to artificially inflate the price of vitamins.

Tying Contracts The Federal government has strictly enforced the prohibition of tying contracts, seeing them as a violation of either the Clayton Act or Section 1 of the Sherman Act. For example, it has stopped movie distributors from forcing theaters to “buy” the projection rights to a full package of films as a condition of showing a blockbuster movie. More recently, the government argued successfully that Microsoft illegally tied Internet Explorer (IE) to Windows and entered into contracts with personal computer makers that required them to feature IE, rather than Netscape Navigator, on the personal computer desktop.

What then can we conclude about the overall effectiveness of antitrust laws? Antitrust policy has not been very effective in restricting the rise of or in breaking up monopolies or oligopolies resulting from legally undertaken internal expansions of firms. But most economists do not deem that to be a flaw. The antitrust laws have been used more effectively against predatory or abusive monopoly, but that effectiveness has been diminished by the slow legal process and consequently long time between the filing of charges and the implementation of remedies. In contrast, antitrust policy *has* been effective in blocking blatantly anticompetitive mergers and in identifying and prosecuting price fixing and tying contracts.

Most economists conclude that, overall, U.S. antitrust policy has been moderately effective in achieving its goal of promoting competition and efficiency. Some, however, think that enforcement of antitrust laws has been too weak. Others believe that U.S. antitrust policy is anachronistic in an era of rapidly changing technology that continuously undermines existing monopoly power.

QUICK REVIEW 19.1

- The Sherman Act of 1890 outlaws restraints of trade and monopolization; the Clayton Act of 1914 as amended by the Celler-Kefauver Act of 1950 outlaws price discrimination, tying contracts, anticompetitive mergers, and interlocking directorates.
- The Federal Trade Commission Act of 1914 as bolstered by the Wheeler-Lea Act of 1938 created the Federal Trade Commission (FTC) and gave it authority to investigate unfair methods of competition and deceptive acts or practices in commerce.
- “Structuralists” say highly concentrated industries will behave like monopolists; “behaviorists” hold that the relationship between industry structure and firm behavior is uncertain.
- Enforcement of antitrust laws may be moderated when other government goals might be affected.
- Currently, government treats existing monopoly relatively leniently, as long as it is not abusive; blocks most horizontal mergers between dominant, profitable firms in highly concentrated industries; and vigorously prosecutes price fixing and tying contracts engaged in by firms of all sizes.

Industrial Regulation

Antitrust policy assumes that society will benefit if monopoly is prevented from evolving or if it is dissolved where it already exists. We now return to a special situation in which there is an economic reason for an industry to be organized monopolistically.

Natural Monopoly

A **natural monopoly** exists when economies of scale are so extensive that a single firm can supply the entire market at a lower unit cost than could a number of competing firms. Clear-cut circumstances of natural monopoly are relatively rare, but such conditions exist for many *public utilities*, such as local electricity, water, natural gas, and telephone providers. As we discussed in Chapter 11, large-scale operations in some cases are necessary to obtain low unit costs and a low product price. Where there is natural monopoly, competition is uneconomical. If the market were divided among many producers, economies of scale would not be achieved and unit costs and prices would be higher than necessary.

There are two possible alternatives for promoting better economic outcomes where natural monopoly exists. One is public ownership, and the other is public regulation.

Public ownership or some approximation of it has been established in a few instances. Examples: the Postal Service, the Tennessee Valley Authority, and Amtrak at the national level and mass transit, water supply systems, and garbage collection at the local level.

But *public regulation*, or what economists call *industrial regulation*, has been the preferred option in the United States. In this type of regulation, government commissions regulate the prices (usually called “rates”) charged by natural monopolists. Table 19.1 lists the two major Federal regulatory commissions and their jurisdictions. It also notes that all 50 states have commissions that regulate the intrastate activities and “utility rates” of remaining natural monopolies.

The economic objective of industrial regulation is embodied in the **public interest theory of regulation**. According to that theory, industrial regulation is necessary to keep a natural monopoly from charging monopoly prices and thus harming consumers and society. The goal of such regulation is to garner for society at least part of the cost reductions associated with natural monopoly while avoiding the restrictions of output and high prices associated with unregulated monopoly. If competition is inappropriate or impractical, society should allow or even encourage a monopoly but regulate its prices. Regulation should then be structured so that ratepayers benefit from the economies of scale—the lower per-unit costs—that natural monopolists are able to achieve.

Table 19.1
The Main Regulatory Commissions Providing Industrial Regulation

| Commission (Year Established) | Jurisdiction |
|--|--|
| Federal Energy Regulatory Commission (1930)* | Electricity, gas, gas pipelines, oil pipelines, water-power sites |
| Federal Communications Commission (1934) | Telephones, television, cable television, radio, telegraph, CB radios, ham operators, etc. |
| State public utility commissions (50 states) | Electricity, gas, telephones |

*Originally called the Federal Power Commission; renamed in 1977.

In practice, regulators seek to establish rates that will cover production costs and yield a “fair” return to the enterprise. The goal is to set price equal to average total cost so that the regulated firm receives a normal profit, as described in the “Regulated Monopoly” section of Chapter 11. In particular, you should carefully review Figure 11.9.

Problems with Industrial Regulation

There is considerable disagreement on the effectiveness of industrial regulation. Let’s examine two criticisms.

Costs and Inefficiency An unregulated firm has a strong incentive to reduce its costs at each level of output because that will increase its profit. The regulatory commission, however, confines the regulated firm to a normal profit or a “fair return” on the value of its assets. If a regulated firm lowers its operating costs, the rising profit eventually will lead the regulatory commission to require that the firm lower its rates in order to return its profits to normal. The regulated firm therefore has little or no incentive to reduce its operating costs.

Worse yet, higher costs do not result in lower profit. Because the regulatory commission must allow the public utility a fair return, the regulated monopolist can simply pass through higher production costs to consumers by charging higher rates. A regulated firm may reason that it might as well have high salaries for its workers, opulent working conditions for management, and the like, since the “return” is the same in percentage terms whether costs are minimized or not. So, although a natural monopoly reduces cost through economies of scale, industrial regulation fosters considerable X-inefficiency (Figure 11.7). Due to the absence of competition, the potential cost savings from natural monopoly may never actually materialize.

Perpetuating Monopoly A second general problem with industrial regulation is that it sometimes perpetuates monopoly long after the conditions of natural monopoly have evaporated.

Technological change often creates the potential for competition in at least some or all portions of the regulated industry. Examples: Trucks began competing with railroads; transmission of voice and

data by microwave and satellites began competing with transmission over telephone wires; satellite television began competing with cable television; and cell phones began competing with regular phones. But spurred by the firms they regulate, and believing the regulated firms are natural monopolies, commissions often protect the regulated firms from new competition by either blocking entry or extending regulation to competitors. The rationale usually is that the competitors simply want to “skim the cream” from selected highly profitable portions of the regulated industry but do not want to offer the universal service required of the regulated firm. By losing the highly profitable portion of the business, the regulated firms would have to increase rates for services that do not pay their own way in order to continue to receive a fair rate of return on their assets.

But where regulators block entry or extend regulation to competitive firms, industrial regulation may perpetuate a monopoly that is no longer a natural monopoly and would otherwise erode. Ordinary monopoly, protected by government, may then supplant natural monopoly. If so, then the regulated prices may be higher than they would be with competition. The beneficiaries of outdated regulation are the regulated firms, their employees, and perhaps consumers of some services. The losers are all other consumers and the potential competitors that are barred from entering the industry.

Example: Regulation of the railroads by the Interstate Commerce Commission (ICC) was justified in the late 1800s and early 1900s. But by the 1930s, with the emergence of a network of highways, the trucking industry had seriously undermined the monopoly power of the railroads. That is, for the transport of many goods over many routes, railroad service was no longer a natural monopoly. At that time it would have been desirable to dismantle the ICC and let railroads and truckers, along with barges and airlines, compete with one another. Instead, in the 1930s the ICC extended regulation of rates to interstate truckers. The ICC remained in place until its elimination in 1996.

Second example: Until very recently, unregulated long-distance telephone companies such as AT&T and WorldCom have been prohibited from offering local telephone services in competition with regulated local and regional telephone com-

panies. But the very fact that these and other firms wish to try to compete with regulated monopolies calls into question whether those local providers are in fact natural monopolies or, rather, are government-protected monopolies. (**Key Question 10**)

Legal Cartel Theory

The regulation of potentially competitive industries has produced the **legal cartel theory of regulation**. In place of having socially minded officials forcing regulation on natural monopolies to protect consumers, holders of this view see practical politicians “supplying” regulation to local, regional, and national firms that fear the impact of competition on their profits or even on their long-term survival. These firms desire regulation because it yields a legal monopoly that can guarantee a profit. Specifically, the regulatory commission performs such functions as blocking entry (for example, in local telephone service). Or, where there are several firms, the commission divides up the market much like an illegal cartel (for example, prior to airline deregulation, the Civil Aeronautics Board assigned routes to specific airlines). The commission may also restrict potential competition by enlarging the “cartel” (for example, the ICC’s addition of trucking to its regulatory domain).

While private cartels are illegal and unstable and often break down, the special attraction of a government-sponsored cartel under the guise of regulation is that it endures. The legal cartel theory of regulation suggests that regulation results from the rent-seeking activities of private firms and the desire of politicians to be responsive (Chapter 18).

Proponents of the legal cartel theory of regulation note that the Interstate Commerce Commission was welcomed by the railroads and that the trucking and airline industries both supported the extension of ICC regulation to their industries, arguing that unregulated competition was severe and destructive.

Occupational licensing is a labor market application of the legal cartel theory. Certain occupational groups—barbers, dentists, hairstylists, interior designers, dietitians, lawyers—demand stringent licensing on the grounds that it protects the public from charlatans and quacks. But skeptics say the real reason may be to limit entry into the oc-

cupational group so that practitioners can receive monopoly incomes. It is not surprising to these skeptics that a recent study found that, other things equal, dental fees were about 15 percent higher and dentists’ income 10 percent higher in states with the most restrictive licensing laws compared to states with the least restrictive laws. The quality of dentistry apparently was not affected.¹

Deregulation

Beginning in the 1970s, the legal cartel theory, evidence of inefficiency in regulated industries, and the contention that the government was regulating potentially competitive industries all contributed to a wave of deregulation. Since then, Congress and some state legislatures have passed legislation that has deregulated in varying degrees the airline, trucking, banking, railroad, natural gas, electricity, and television broadcasting industries. Deregulation has also occurred in the telecommunications industry, where antitrust authorities dismantled the regulated monopoly known as the Bell System (AT&T). Deregulation in the 1970s and 1980s was one of the most extensive experiments in economic policy to take place during the last 50 years.

Controversy

Deregulation was controversial, and the nature of the controversy was predictable. Proponents of deregulation, basing their arguments on erosion of natural monopoly and the legal cartel theory, contended that deregulation would lower prices, increase output, and eliminate bureaucratic inefficiencies.

Some critics of deregulation, embracing the view of continued natural monopoly and the public interest theory, argued that deregulation would result in destructive price wars and eventual re-monopolization of some of the deregulated industries by a single firm. They predicted higher prices, diminished output, and deteriorating service. Still other critics were concerned that deregulation would lead to industry instability and that vital services (for example, transportation) would be withdrawn from smaller communities. Still others stressed that as

¹Morris Kleiner and Robert Kudrle, “Does Regulation Affect Economic Outcomes? The Case of Dentistry,” *Journal of Law and Economics*, October 2000, pp. 547–582.

increased competition reduced the revenues of each firm, firms would lower their safety standards to reduce costs and remain profitable.

Outcomes of Deregulation

While there are still some critics of deregulation, most economists believe that deregulation has clearly benefited consumers and the economy. According to studies, deregulation of formerly regulated industries is now contributing more than \$50 billion annually to society's well-being through lower prices, lower costs, and increased output.² Most of those gains are accruing in three industries: airlines, railroads, and trucking. Airfares (adjusted for inflation) have declined by about one-third, and airline safety has continued to improve. Trucking and railroad freight rates (again, adjusted for inflation) have dropped by about one-half. Significant efficiency gains have occurred in long-distance telecommunications, and there have been slight efficiency gains in cable television, stock brokerage services, and the natural gas industry. Moreover, deregulation has unleashed a wave of technological advances that have resulted in such new and improved products and services as fax machines, cellular phones, fiber-optic cable, microwave systems in communications, and the Internet.

The success of past deregulation has led to further calls for deregulation. The latest industry to begin the deregulation process is electricity. Deregulation is now occurring at the wholesale level, where firms are free to build generating facilities and sell electricity at market prices. The Federal government's goal is for all consumers to have a choice among competing power suppliers by 2010. Several states have now deregulated electricity rates and opened competition to alternative suppliers. Some have experienced lower electricity costs and rate reductions. But deregulation of wholesale electricity rates (but not retail rates) in California contributed to an energy crisis in the winter of 2001 and large financial losses for California electric utilities. It is too soon in the process to declare deregulation of electricity either a success or a failure.

²Clifford Winston, "Economic Deregulation: Days of Reckoning for Microeconomists," *Journal of Economic Literature*, September 1993, p. 1284; and Robert Crandall and Jerry Ellig, "Economic Deregulation and Consumer Choice," Center for Market Processes, Fairfax, Virginia.

QUICK REVIEW 19.2

- Natural monopoly occurs where economies of scale are so extensive that only a single firm can produce the product at minimum average total cost.
- The public interest theory of regulation says that government must regulate natural monopolies to prevent abuses arising from monopoly power. Regulated firms, however, have less incentive than competitive firms to reduce costs. That is, regulated firms tend to be X-inefficient.
- The legal cartel theory of regulation suggests that some firms seek government regulation to reduce price competition and ensure stable profits.
- Deregulation initiated by government in the past three decades has yielded large annual efficiency gains for society.

Social Regulation

The industrial regulation discussed in the preceding section has focused on the regulation of prices (or rates) in natural monopolies. But in the early 1960s a new type of regulation began to emerge. This *social regulation* is concerned with the conditions under which goods and services are produced, the impact of production on society, and the physical qualities of the goods themselves.

The Federal government carries out most of the social regulation, although states also play a role. In Table 19.2 we list the main Federal regulatory commissions engaged in social regulation.

Distinguishing Features

Social regulation differs from industrial regulation in several ways.

First, social regulation applies to far more firms than does industrial regulation. Social regulation is often applied "across the board" to all industries and directly affects more producers than does industrial regulation. For instance, while the industrial regulation of the Federal Energy Regulatory Commission (FERC) applies to a relatively small number of firms, Occupational Safety and Health Administration (OSHA) rules and regulations apply to firms in all industries.

Second, social regulation intrudes into the day-to-day production process to a greater extent than

Table 19.2
The Main Federal Regulatory Commissions
Providing Social Regulation

| Commission (Year Established) | Jurisdiction |
|--|---|
| Food and Drug Administration (1906) | Safety and effectiveness of food, drugs, and cosmetics |
| Equal Employment Opportunity Commission (1964) | Hiring, promotion, and discharge of workers |
| Occupational Safety and Health Administration (1971) | Industrial health and safety |
| Environmental Protection Agency (1972) | Air, water, and noise pollution |
| Consumer Product Safety Commission (1972) | Safety of consumer products |

industrial regulation. While industrial regulation focuses on rates, costs, and profits, social regulation often dictates the design of products, the conditions of employment, and the nature of the production process. As examples, the Consumer Product Safety Commission (CPSC) regulates the design of potentially unsafe products, and the Environmental Protection Agency (EPA) regulates the amount of pollution allowed during production.

Finally, social regulation has expanded rapidly during the same period in which industrial regulation has waned. Between 1970 and 1980, the U.S. government created 20 new social regulatory agencies. More recently, Congress has established new social regulations to be enforced by existing regulatory agencies. For example, the Equal Employment Opportunity Commission, which is responsible for enforcing laws against workplace discrimination on the basis of race, gender, age, or religion, has been given the added duty of enforcing the Americans with Disabilities Act of 1990. Under this social regulation, firms must provide reasonable accommodations for qualified workers and job applicants with disabilities. Also, sellers must provide reasonable access for customers with disabilities.

The names of the regulatory agencies in Table 19.2 suggest the reasons for their creation and growth: As much of our society had achieved a fairly affluent standard of living by the 1960s, attention shifted to improvement in the nonmaterial quality of

life. That focus called for safer products, less pollution, improved working conditions, and greater equality of economic opportunity.

The Optimal Level of Social Regulation

While economists agree on the need for social regulation, they disagree on whether or not the current level of such regulation is optimal. Recall that an activity should be expanded as long as its marginal benefit (MB) exceeds its marginal cost (MC). If the MB of social regulation exceeds its MC, then there is too little social regulation. But if MC exceeds MB, there is too much (review Figure 17.6). Unfortunately, the marginal costs and benefits of social regulation are not always easy to measure and therefore may be illusive. So ideology about the proper size and role of government often drives the debate over social regulation as much as, or perhaps more than, economic cost-benefit analysis.

In Support of Social Regulation Defenders of social regulation say that it has achieved notable successes and, overall, has greatly enhanced society's well-being. They point out that the problems that social regulation confronts are serious and substantial. According to the National Safety Council, about 5000 workers die annually in job-related accidents and 3.8 million workers suffer injuries that force them to miss a day or more of work. Air pollution continues to cloud major U.S. cities, imposing large costs in terms of reduced property values and increased health care expense. Numerous children and adults die each year because of poorly designed or manufactured products (for example, car tires) or tainted food (for example, *E. coli* in beef). Discrimination against some ethnic and racial minorities, persons with disabilities, and older workers reduces their earnings and imposes heavy costs on society.

Proponents of social regulation acknowledge that social regulation is costly. But they correctly point out that a high "price" for something does not necessarily mean that it should not be purchased. They say that the appropriate economic test should be not whether the costs of social regulation are high or low but, rather, whether the benefits of social regulation exceed the costs. After decades of neglect, they further assert, society cannot expect to cleanse the environment, enhance the safety of the

workplace, and promote economic opportunity for all without incurring substantial costs. So statements about the huge costs of social regulation are irrelevant, say defenders, since the benefits are even greater. The public often underestimates those benefits, since they are more difficult to measure than costs and often become apparent only after some time has passed (for example, the benefits of reducing global warming).

Proponents of social regulation point to its many specific benefits. Here are just a few examples: It is estimated that highway fatalities would be 40 percent greater annually in the absence of auto safety features mandated through regulation. Compliance with child safety-seat and seat belt laws has significantly reduced the auto fatality rate for small children. The national air quality standards set by law have been reached in nearly all parts of the nation for sulfur dioxide, nitrogen dioxide, and lead. Moreover, recent studies clearly link cleaner air, other things equal, with increases in the values of homes. Affirmative action regulations have increased the labor demand for racial and ethnic minorities and females. The use of childproof lids has resulted in a 90 percent decline in child deaths caused by accidental swallowing of poisonous substances.

Some defenders of social regulation say there are many remaining areas in which greater regulation would generate net benefits to society. For instance, some call for greater regulation of the meat, poultry, and seafood industries to improve food safety. Others favor greater regulation of health care organizations and insurance companies to ensure “patients’ rights” for consumers of health care services. Still others say that more regulation is needed to ensure that violent movies, CDs, and video games are not marketed to children.

Advocates of social regulation say that the benefits of such regulation are well worth the considerable costs. The costs are simply the price we must pay to create a hospitable, sustainable, and just society. **(Key Question 12)**

Criticisms of Social Regulation Critics of social regulation contend that, in many instances, it has been expanded to the point where the marginal costs exceed the marginal benefits. In this view, society would achieve net benefits by cutting back on mettlesome social regulation. Critics say that many social regulation laws are poorly written, making regulatory objectives and standards difficult to understand. As a result, regulators pursue goals well

beyond the original intent of the legislation. Businesses complain that regulators often press for additional increments of improvement, unmindful of costs.

Also, decisions must often be made and rules formed on the basis of inadequate information. Examples: Consumer Product Safety Commission (CPSC) officials may make decisions about certain cancer-causing ingredients in products on the basis of limited laboratory experiments with animals. Or government agencies may establish costly pollution standards to attack the global-warming problem without knowing for certain whether pollution is the main cause of the problem. These efforts, say critics, lead to excessive regulation of business.

Moreover, critics argue that social regulations produce many unintended and costly side effects. For instance, the Federal gas mileage standard for automobiles has been blamed for an estimated 2000 to 3900 traffic deaths a year because auto manufacturers have reduced the weight of vehicles to meet the higher miles-per-gallon standards. Other things equal, drivers of lighter cars have a higher fatality rate than drivers of heavier vehicles.

Finally, opponents of social regulation say that the regulatory agencies may attract overzealous workers who are hostile toward the market system and “believe” too fervently in regulation. For example, the EPA staff allegedly sees all pollution as bad and all polluters as “bad guys.” They have been accused of avoiding the challenge of trying to identify the optimal amount of pollution based on a careful analysis of marginal costs and marginal benefits.

Two Reminders

The debate over the proper amount of social regulation will surely continue. We leave both proponents and opponents of social regulation with pertinent economic “reminders.”

There Is No Free Lunch On the one hand, fervent supporters of social regulation need to remember that “there is no free lunch.” Social regulation can produce higher prices, stifle innovation, and reduce competition.

Social regulation raises product prices in two ways. It does so directly because compliance costs normally get passed on to consumers, and it does so indirectly by reducing labor productivity. Resources invested in making workplaces accessible to disabled workers, for example, are not available for invest-

ment in new machinery designed to increase output per worker. Where the wage rate is fixed, a drop in labor productivity increases the marginal and average total costs of production. In effect, the supply curve for the product shifts leftward, causing the price of the product to rise.

Social regulation may have a negative impact on the rate of innovation. Technological advance may be stifled by, say, the fear that a new plant will not meet EPA guidelines or that a new medicine will require years of testing before being approved by the Food and Drug Administration (FDA).

Social regulation may weaken competition, since it usually places a relatively greater burden on small firms than on large ones. The costs of complying with social regulation are, in effect, fixed costs. Because smaller firms produce less output over which to distribute those costs, their compliance costs per unit of output put them at a competitive disadvantage with their larger rivals. Social regulation is more likely to force smaller firms out of business, thus contributing to the increased concentration of industry.

Less Government Is Not Always Better than More On the other hand, fervent opponents of social regulation need to remember that less government is not always better than more government. While the market system is a powerful engine of producing goods and services and generating income, it has its flaws. Through social regulation gov-

ernment can clearly increase economic efficiency and thus society's well-being. Ironically, by "taking the rough edges off of capitalism," social regulation may be a strong pro-capitalist force. Properly conceived and executed, social regulation helps maintain political support for the market system. Such support could quickly wane should there be a steady drumbeat of reports of unsafe workplaces, unsafe products, discriminatory hiring, choking pollution, ill-served medical patients, and the like. Social regulation helps the market system deliver not only goods and services but also a "good society."

QUICK REVIEW 19.3

- Social regulation is concerned with the conditions under which goods and services are produced, the effects of production on society, and the physical characteristics of the goods themselves.
- Defenders of social regulation point to the benefits arising from policies that keep dangerous products from the marketplace, reduce workplace injuries and deaths, contribute to clean air and water, and reduce employment discrimination.
- Critics of social regulation say uneconomical policy goals, inadequate information, unintended side effects, and overzealous personnel create excessive regulation, for which regulatory costs exceed regulatory benefits.

L A S T W O R D

*The Microsoft Antitrust Case***In 2000 a U.S. District Court Found Microsoft Guilty of Violating the Sherman Act. What Were the Charges and Specific Findings? What Remedy Did the Court Propose?**

The Charges In May 1998 the U.S. Justice Department, 19 individual states, and the District of Columbia (hereafter, "the government") filed antitrust charges against Microsoft under the Sherman Antitrust Act. The government charged that Microsoft had violated Section 2 of the act by taking a series of unlawful actions designed to maintain its "Windows" monopoly. It also charged that some of those specific actions violated Section 1 of the Sherman Act.

Microsoft denied the charges, arguing that it had achieved its success through product innovation and lawful business practices. Microsoft argued that it should not be penalized for its superior foresight, business acumen, and technological prowess. It also pointed out that its monopoly was highly transitory because of rapid technological advance.

The Findings In June 2000 the district court ruled that the relevant market was that of software used to operate Intel-compatible personal computers (PCs). Microsoft's 95 percent share of that market clearly gave it monopoly power. The court pointed out, however, that being a monopoly is not illegal. The violation of the Sherman Act occurred because Microsoft used anticompetitive means to maintain and broaden its monopoly power.

According to the court, Microsoft feared that the success of Netscape's Navigator, which allowed people to browse the Internet, might allow Netscape to expand its software to include a competitive PC operating system—software that would threaten the Windows monopoly. It also feared that Sun's Internet applications of its Java programming language might eventually threaten Microsoft's Windows monopoly.

To counter these and similar threats, Microsoft illegally tied Internet Explorer (Microsoft's Internet browser) to Windows and provided Internet Explorer at no charge. It also signed contracts with PC makers that required them to feature Internet Explorer on the PC desktop and penalized companies that promoted software prod-

ucts that competed with Microsoft products. Moreover, it gave friendly companies coding that linked Windows to software applications and withheld it from companies featuring Netscape. Finally, under license from Sun, Microsoft developed Windows-related Java software that made Sun's own software incompatible with Windows.

The court concluded:

Microsoft mounted a deliberate assault upon entrepreneurial efforts, that, left to rise or fall on their own merits could well have enabled the introduction of competition into the market for Intel-compatible PC operating systems. . . . More broadly, Microsoft's anticompetitive actions trammelled the competitive process through which the computer software industry generally stimulates innovation and conduces to the optimum benefit of consumers.*



The Remedy The district court ordered that Microsoft be split into two companies, one selling the Windows operating system and the other selling Microsoft applications (such as Word, Hotmail, MSN, PowerPoint, and Internet Explorer). Also, both companies are expressly prohibited from entering into joint ventures with one another, licensing or selling products to one another at more favorable terms than those given to other firms, or engaging in any of the activities that Microsoft had used to thwart competition and maintain its monopoly. Both companies

are free, however, to develop new products that compete with each other, and both can derive those products from the intellectual property embodied in the common products existing at the time of the divestiture. The rights to Internet Explorer, however, reside with the applications company.

The Appeal Stunned by the verdict and the perceived harshness of the remedy, in late 2000 Microsoft appealed the district court decision to a U.S. court of appeals. Microsoft claimed that the government had not proved its case and that District Court Judge Thomas Jackson evidenced bias against Microsoft throughout the case. A decision from the appeals court was still pending at the time of publication of this book. We urge you to update the status of the Microsoft case via an Internet search.

* *United States v. Microsoft* (Conclusions of Law), April 2000, p. 9.

Source: *United States v. Microsoft* (Conclusions of Law, April 2000; Final Order, June 2000) and Reuters News Service.

SUMMARY

1. The cornerstones of antitrust policy are the Sherman Act of 1890 and the Clayton Act of 1914. The Sherman Act specifies that “every contract, combination . . . or conspiracy in the restraint of interstate trade . . . is . . . illegal” and that any person who monopolizes or attempts to monopolize interstate trade is guilty of a felony.
2. The Clayton Act was designed to bolster and make more explicit the provisions of the Sherman Act. It declares that price discrimination, tying contracts, intercorporate stock acquisitions, and interlocking directorates are illegal when their effect is to reduce competition.
3. The Federal Trade Commission Act of 1914 created the Federal Trade Commission to investigate antitrust violations and to prevent the use of “unfair methods of competition.” Empowered to issue cease-and-desist orders, the commission also serves as a watchdog agency over false and deceptive representation of products.
4. The Celler-Kefauver Act of 1950 prohibits one firm from acquiring the assets of another firm when the result will curtail competition.
5. Issues in applying antitrust laws include (a) determining whether an industry should be judged by its structure or by its behavior; (b) defining the scope and size of the dominant firm’s market; and (c) balancing the gains from antitrust against other desirable goals, such as balancing exports and imports, consolidating the defense industry, and encouraging new technologies.
6. Antitrust officials are more likely to challenge price fixing, tying contracts, and horizontal mergers than they are to break up existing market structures. Nevertheless, antitrust suits by the Federal government led to the breakup of the AT&T monopoly and the proposed breakup of Microsoft.
7. The objective of industrial regulation is to protect the public from the market power of natural monopolies by regulating prices and quality of service.
8. Critics of industrial regulation contend that it can lead to inefficiency and rising costs and that in many instances it constitutes a legal cartel for the regulated firms. Legislation passed in the late 1970s and the 1980s has brought about varying degrees of deregulation in the airline, trucking, banking, railroad, and television broadcasting industries. Studies indicate that deregulation is producing sizable annual gains to society through lower prices, lower costs, and increased output. The latest U.S. industry to begin the deregulation process is electricity.
9. Social regulation is concerned with product safety, working conditions, and the effects of production on society. Whereas industrial regulation is on the wane, social regulation continues to expand. The optimal amount of social regulation occurs where $MB = MC$.
10. Those who support social regulation point to its numerous specific successes and assert that it has greatly enhanced society’s well-being. Critics of social regulation contend that businesses are excessively regulated to the point where marginal costs exceed marginal benefits. They also say that social regulation often produces unintended and costly side effects.

TERMS AND CONCEPTS

| | | | |
|-----------------------|---------------------------|------------------------|--------------------------------------|
| antitrust policy | interlocking directorates | U.S. Steel case | conglomerate merger |
| industrial regulation | Federal Trade | rule of reason | per se violations |
| social regulation | Commission Act | Alcoa case | natural monopoly |
| Sherman Act | cease-and-desist order | DuPont cellophane case | public interest theory of regulation |
| Clayton Act | Wheeler-Lea Act | horizontal merger | legal cartel theory of regulation |
| tying contracts | Celler-Kefauver Act | vertical merger | |

STUDY QUESTIONS

1. Both antitrust policy and industrial regulation deal with monopoly. What distinguishes the two approaches? How does government decide to use one form of remedy rather than the other?
2. **Key Question** Describe the major provisions of the Sherman and Clayton acts. What government entities are responsible for enforcing those laws? Are firms permitted to initiate antitrust suits on their own against other firms?
3. Identify the basic issue involved in the U.S. Steel, Alcoa, and DuPont cellophane cases. What issues in antitrust enforcement are implicit in these cases?

4. Explain how strict enforcement of the antitrust laws might conflict with (a) promoting exports to achieve a balance of trade, (b) easing the burdens of cutbacks in the defense industry, and (c) encouraging new technologies. Do you see any dangers in using selective antitrust enforcement as part of a broader policy to increase exports?
5. **Key Question** How would you expect antitrust authorities to react to:
 - a. A proposed merger of Ford and General Motors.
 - b. Evidence of secret meetings by contractors to rig bids for highway construction projects.
 - c. A proposed merger of a large shoe manufacturer and a chain of retail shoe stores.
 - d. A proposed merger of a small life-insurance company and a regional candy manufacturer.
6. Suppose a proposed merger of firms would simultaneously lessen competition and reduce unit costs through economies of scale. Do you think such a merger should be allowed?
7. In the 1980s, PepsiCo Inc., which then had 28 percent of the soft-drink market, proposed to acquire the Seven-Up Company. Shortly thereafter the Coca-Cola Company, with 39 percent of the market, indicated it wanted to acquire the Dr. Pepper Company. Seven-Up and Dr. Pepper each controlled about 7 percent of the market. In your judgment, was the government's decision to block these mergers appropriate?
8. "The antitrust laws tend to penalize efficiently managed firms." Do you agree? Why or why not?
9. "The social desirability of any particular firm should be judged not on the basis of its market share but on the basis of its conduct and performance." Make a counterargument, referring to the monopoly model in your statement.
10. **Key Question** What types of industry, if any, should be subjected to industrial regulation? What specific problems does industrial regulation entail?
11. In view of the problems involved in regulating natural monopolies, compare socially optimal (marginal-cost) pricing and fair-return pricing by referring again to Figure 11.9. Assuming that a government subsidy might be used to cover any loss resulting from marginal-cost pricing, which pricing policy would you favor? Why? What problems might such a subsidy entail?
12. **Key Question** How does social regulation differ from industrial regulation? What types of benefits and costs are associated with social regulation?
13. Use economic analysis to explain why the optimal amount of product safety may be less than the amount that would totally eliminate risks of accidents and deaths. Use automobiles as an example.
14. **(Last Word)** Under what law and on what basis did the Federal government find Microsoft guilty of violating the antitrust laws? What was the government's proposed remedy? In mid-2000 Microsoft appealed the district court decision to a higher court. Update the Microsoft story, using an Internet search engine. What is the current status of that appeal? Is it still pending? Did Microsoft win its appeal? Or was the district court's decision upheld?
15. **Web-Based Question: Enforcement of antitrust laws—who is responsible?** The U.S. antitrust laws are available at www.law.cornell.edu/uscode/15/ch1.html. Both the Federal Trade Commission's Bureau of Competition (www.ftc.gov/ftc/antitrust.htm) and the Antitrust Division of the Department of Justice (www.usdoj.gov/atr/index.html) enforce these laws. How do those agencies prevent duplication of effort? What are their current antitrust activities? Are any of those activities of major significance?
16. **Web-Based Question: The Consumer Product Safety Commission—what is it and what does it do?** What are the major functions of the Consumer Product Safety Commission (www.cpsc.gov)? What products are the subjects of the latest CPSC press release? Identify two product categories of interest to you from Recalls by Product. List three specific product recalls for each of your two product categories. What products are covered by other government agencies and not by the CPSC? List a relatively recent major product recall relating to the National Highway Traffic Safety Administration.