C50: Lecture 2

Antitrust and Oligopoly theory: Price-fixing and Section 1 of the Sherman Act
Market Failure: Contrived monopoly power. Remedy: Antitrust

Sherman Antitrust Act (1890)
- Section 1: “conspiracies in restraint of trade”
- Section 2: monopolization

Federal Trade Commission Act (1914)
- Section 5: “unfair competition”

Clayton Antitrust Act (1914)
- Section 2: price discrimination
- Section 3: exclusionary practices
- Section 7: mergers that “substantially lessen competition”

Amended by:
- Robinson Patman Act (1936): quantity discounts
- Celler-Kefauver Act (1950): mergers by asset acquisition
Industrial Organization theory: an economic framework for Antitrust

Structure, Conduct, Performance Paradigm
- Market structure influences
- Market conduct, which determines
- Market performance

Antitrust policy influences
- Structure
  - Monopolization (SA 2)
  - Mergers (CA 7)
- Conduct
  - Price-fixing (SA 1)
  - “Unfair” competition (FA)
The Economics of Oligopolistic Interaction

Basic paradigm: “game theory”
– The analysis of small group behavior in rivalrous and cooperative situations

Solution concept: Nash equilibrium
– Each player does as well as he can, taking others actions as given

Fundamental properties of oligopolistic equilibrium
– Incentive to make collusive agreements
  • SA 1 makes collusive agreements illegal, \textit{per se}
– Incentive to cheat on collusive agreements
  • Antitrust seeks to make it harder to prevent cheating on collusive agreements
Sherman Act, Section 1: Horizontal price-fixing conspiracies

“[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States or with foreign nations, is declared to be illegal.”

Intervention to affect market conduct

The economic issues:

- **Collusion pays**: “People of the same trade seldom meet together, even for merriment and diversion, but the conversations ends in a conspiracy against the public, or in some contrivance to raise prices.” - Adam Smith
- But, so does “cheating” on a collusive agreement

Legal standards of proof:

- Per se
- Rule of reason
Early development of the *per se* standard

**U.S. v. Trans-Missouri Freight Association (1897)**
- Facts:
  - Monthly meetings to approve rate changes
  - Penalties levied on violators
- Decision
  - Court rejected “reasonable rate” defense
  - Strict *per se* standard applied

**U.S. v. Joint-Traffic Association (1898)**
- Facts: Similar
- Decision:
  - Modified *per se* standard
  - Restraints necessary to promote business are legal

Obvious source of confusion
Addyston Pipe (1899) and Taft’s rule of reason analysis

Facts:
- Geographical market division
- Bid rigging

Decision:
- Rule of reason applies to reasonable contracts, not reasonable prices
- Distinction between ancillary and primary restraints of trade

Basic Logic
- Ancillary (lawful) restraints protect one party from the other
- Primary (unlawful) restraints protect both parties from themselves
Further development of the *per se* standard

*U.S. v. Trenton Potteries Company* (1927)

- Facts: Jury instructions to disregard reasonableness of prices that had been fixed
- Decision:
  - “The reasonable price fixed today may through economic and business changes become the unreasonable price of tomorrow.”
  - Price-fixing as a business practice is deemed an inherently *unreasonable* restraint of trade.

*U.S. v. Socony-Vacuum Oil Co.* (1940)

- Facts: Oil companies did not fix prices directly, but agreed to buy up excess supplies of independents
- Decision: “Any combination which tampers with price structures is engaged in an unlawful activity.”
Oligopoly and Tacit Collusion

Economic issues:
– How can supra competitive profits be sustained in the absence of explicit collusion
– What practices facilitate oligopolistic coordination?

Legal issues:
– When can the existence of a “conspiracy in restraint of trade” be inferred from circumstantial evidence?
– What facilitating practices can be attacked as “unfair competition” under the FTC Act?
Practical problems of cartels and price-fixing conspiracies

Agreeing on price
- Cost differences among firms lead to different desired collusive prices

Dividing markets
- Quotas must be established and enforced because $P > MC$ creates incentives for all firms to expand output

“Policing” collusive agreements
- Detecting cheaters
  - Widespread dissemination of price information
  - Simplified price structures (e.g., basing point)
- Making collusion “self-enforcing”
  - Most Favored Customer clauses
  - Low price “guarantees”
Circumstantial evidence of conspiracy
(Conscious Parallelism)

*Interstate Circuit, Inc. v. United States*

- **Facts:** Exhibitor “suggested” to 8 distributors that they disadvantage its competitors
- **Decision:** “It is elementary that unlawful conspiracy may be formed . . . Without simultaneous action or agreement. Acceptance by competitors of a plan which is restraint of interstate commerce is sufficient to establish an unlawful conspiracy under the Sherman Act.”

*American Tobacco*

- **Facts:** Parallel actions in:
  - Raising cigarette prices
  - Responding to entry
  - Manipulating tobacco prices
- **Decision:** “Acts done to give effect to the conspiracy may be innocent. Yet if they effectuate the conspiracy which the statute forbids, they come within its prohibition. Nor formal agreement is necessary to constitute an unlawful conspiracy.”
Theater Enterprises and limits to conscious parallelism

Facts:
- All major producers and distributors refused to release first-run movies to a suburban theater.

Decision:
- “Circumstantial evidence of consciously parallel behavior may have made heavy inroads into the traditional judicial attitude toward conspiracy; but ‘conscious parallelism’ has not yet read conspiracy out of the Sherman Act entirely.”

Economic analysis:
- Refusal makes individual economic sense for each distributor, regardless of the action of the others
  - I.e., firms exhibited Nash equilibrium behavior
  - No incentive to “cheat”
The Ethyl Case (E.I. Du Pont DeNemours & Co. v. FTC)

Facts:
- No overt collusion,
- But industry alleged to achieve noncompetitive results through
  - Uniform delivered pricing
  - Pre-announcing price changes
  - Use of Most Favored Customer clauses

Decision:
- “Before business conduct in an oligopolistic industry may be labeled ‘unfair’ . . . At least some indicia of oppressiveness must exist such as (1) evidence of anticompetitive intent or purpose on the part of the producer charged, or (2) the absence of an independent legitimate business reason for its conduct.”
Delivered Pricing

*Cement Institute v. FTC*
- Facts: Used basing-point system to
  - Discourage price competition
  - Punish cheaters

*Triangle Conduit & Cable v. FTC*
- Facts: Charged with the
  "\ldots Concurrent use of a formulat method of making delivered price quotations with the knowledge that each did likewise, with the result that price competition between and among them was unreasonable restrained."

Decisions: Guilty of “unfair” competition

Economic issue: Is delivered pricing a “facilitating practice” without any redeeming virtues?