Managerial Economics & Business Strategy

Chapter 14

A Manager's Guide to Government in the Marketplace

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Overview

I. Market Failure

- Market Power
- Externalities
- Public Goods
- Incomplete Information

II. Rent Seeking

III. Government Policy and International Markets

- Quotas
- Tariffs
- Regulations

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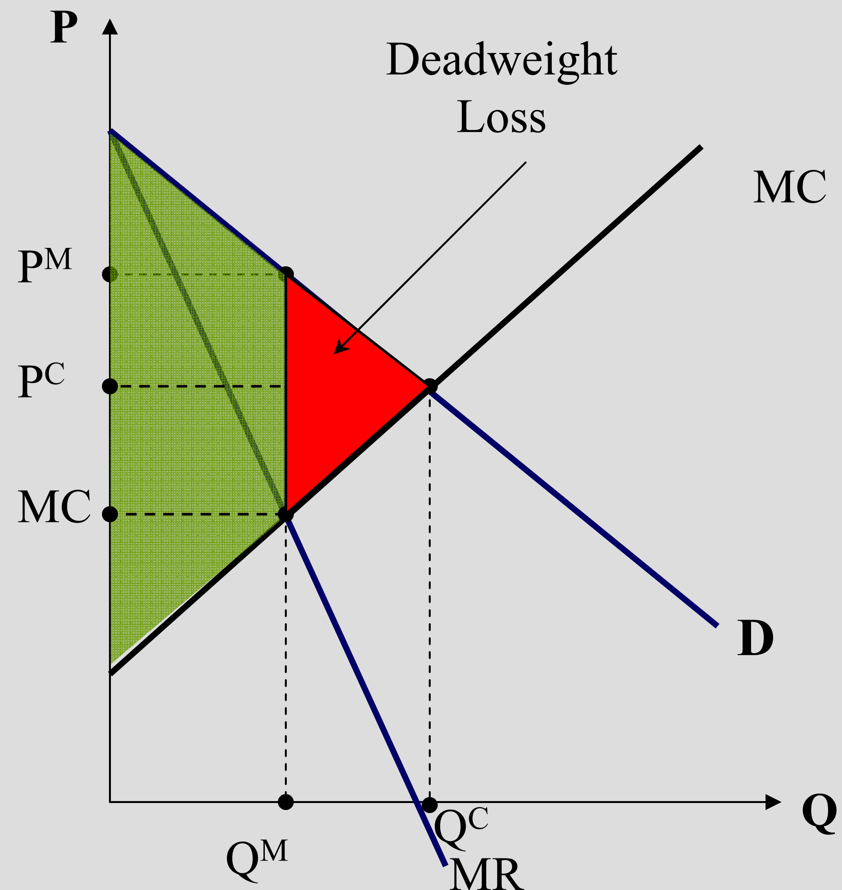
Market Power

- Firms with market power produce socially inefficient output levels.
  - Too little output
  - Price exceeds MC
  - Deadweight loss
    - Dollar value of society's welfare loss



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Antitrust Policies

- Administered by the DOJ and FTC
- Goals:
  - To eliminate deadweight loss of monopoly and promote social welfare.
  - Make it illegal for managers to pursue strategies that foster monopoly power.

Sherman Act (1890)

- Sections 1 and 2 prohibits price-fixing, market sharing and other collusive practices designed to "*monopolize, or attempt to monopolize*" a market.

United States v. Standard Oil of New Jersey (1911)

- Charged with attempting to fix prices of petroleum products. Methods used to enhance market power:
  - Physical threats to shippers and other producers.
  - Setting up artificial companies.
  - Espionage and bribing tactics.
  - Engaging in restraint of trade.
  - Attempting to monopolize the oil industry.
- Result 1: Standard Oil dissolved into 33 subsidiaries.
- Result 2: New Supreme Court Ruling the *rule of reason*.
  - Stipulates that not all trade restraints are illegal, only those that are unreasonable are prohibited.
- Based on the Sherman Act and the rule of reason, how do firms know a priori whether a particular pricing strategy is illegal?

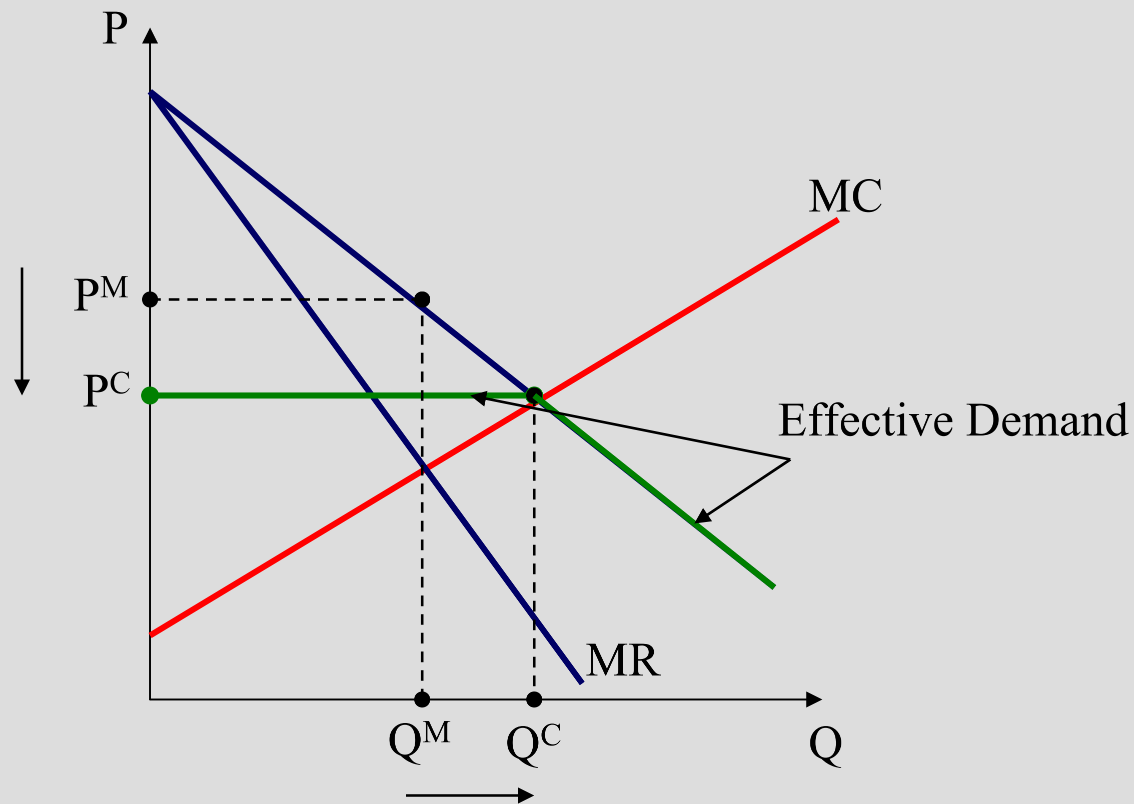
Clayton Act (1914)

- Makes hidden kickbacks (brokerage fees) and hidden rebates illegal.
- Section 3 Prohibits exclusive dealing and tying arrangements where the effect may be to "*substantially lessen competition*."

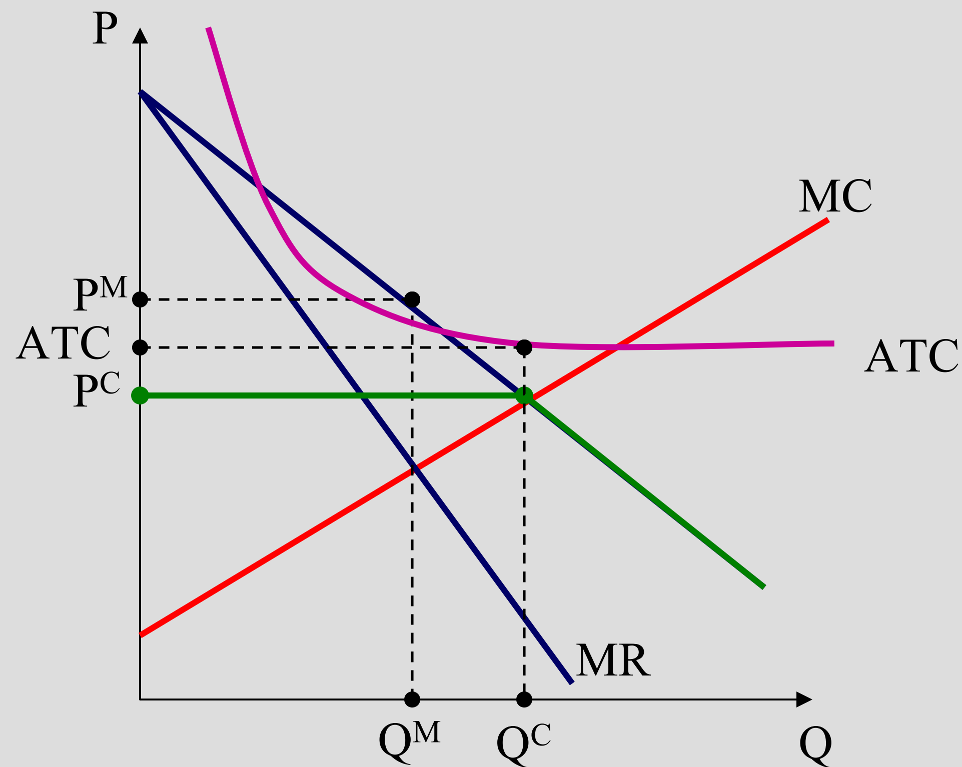
Cellar-Kefauver Act (1950)

- Amends Section 7 of Clayton Act.
- Strengthens merger and acquisition policies.
- Horizontal Merger Guidelines
  - Market Concentration
    - Herfindahl-Hirschman Index: $HHI = 10{,}000 \Sigma w_i^2$
    - Industries in which the HHI exceed 1800 are generally deemed "highly concentrated".
    - The DOJ or FTC may, in this case, attempt to block a merger if it would increase the HHI by more than 100.

Regulating Monopolies: Marginal-Cost Pricing



Problem 1 with Marginal-Cost Pricing: Possibility of ATC > P^C



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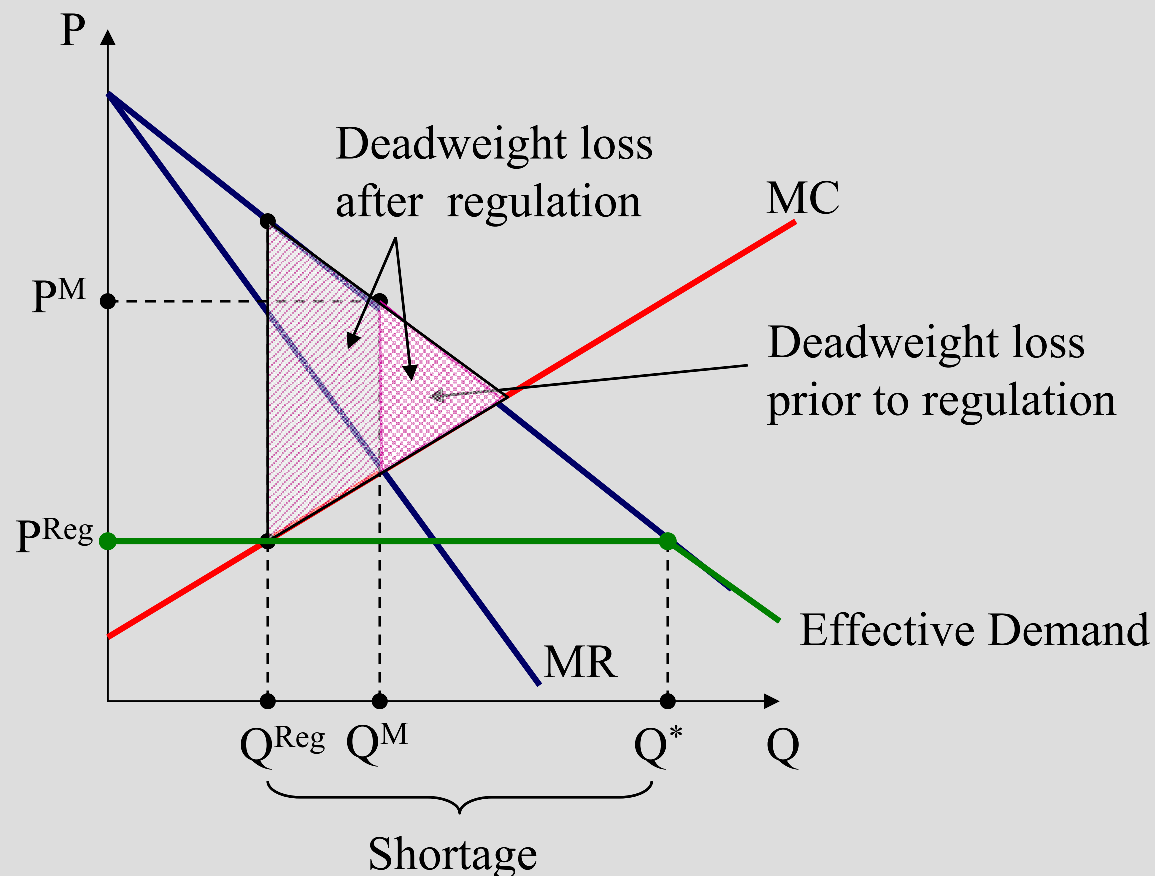
Problem 2 with Marginal-Cost Pricing: Requires Knowledge of MC



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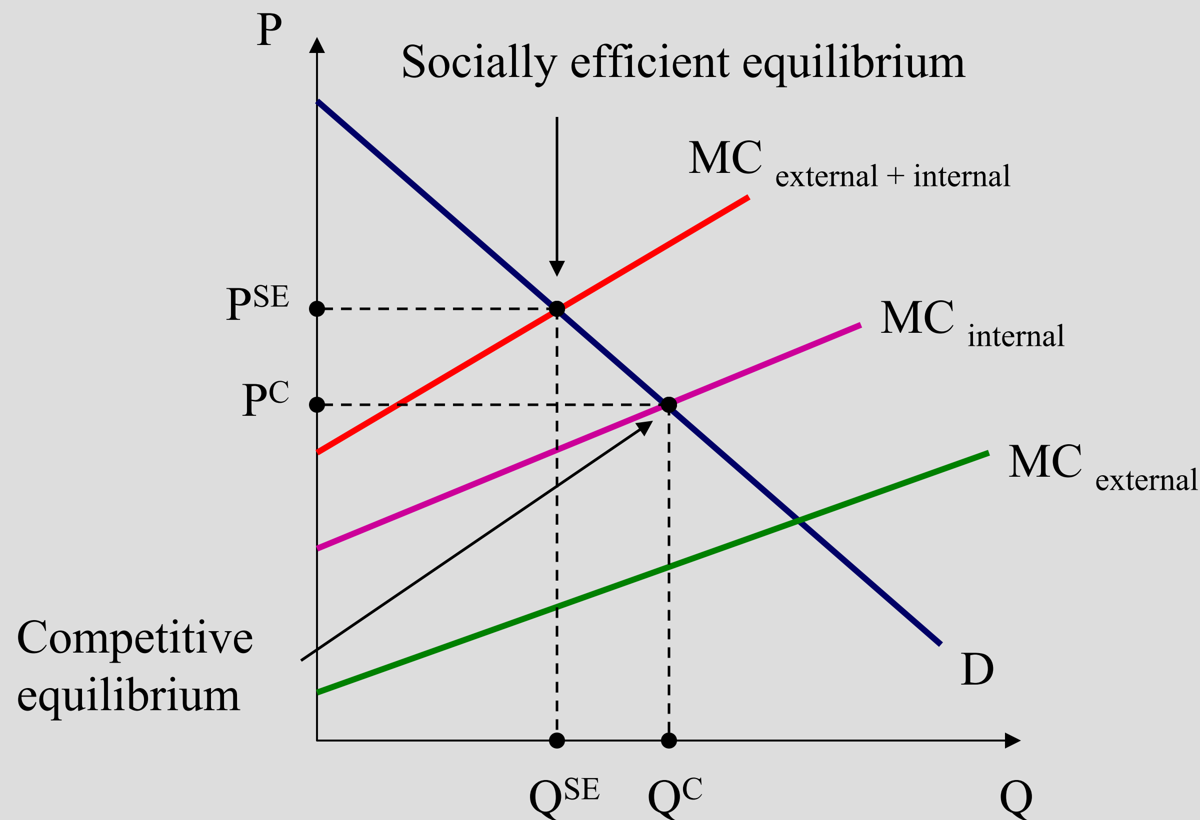
Externalities

- A negative externality is a cost borne by people who neither produce nor consume the good.
- Example: Pollution
  - Caused by the absence of well-defined *property rights*.
- Government regulations may induce the socially efficient level of output by forcing firms to internalize pollution costs
  - The Clean Air Act of 1970

Socially Efficient Equilibrium: Internal and External Costs



Public Goods

- A good that is *nonrival* and *nonexclusionary* in consumption.
  - **Nonrival:** A good which when consumed by one person does not preclude other people from also consuming the good.
    - Example: Radio signals, national defense
  - **Nonexclusionary:** No one is excluded from consuming the good once it is provided.
    - Example: Clean air
- "Free Rider" Problem
  - Individuals have little incentive to buy a public good because of their nonrival & nonexclusionary nature.

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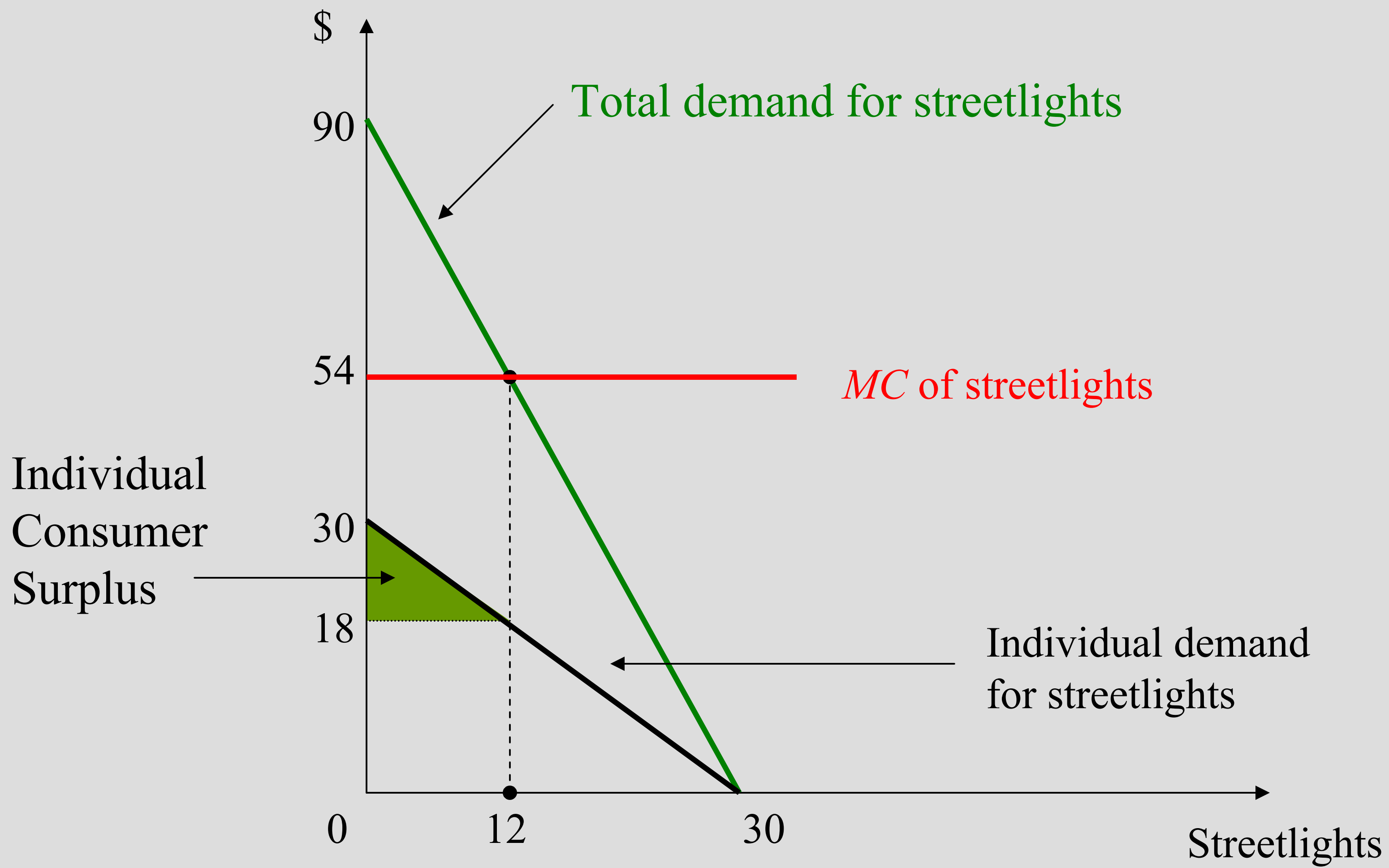
Public Goods



Incomplete Information

- Participants in a market that have incomplete information about prices, quality, technology, or risks may be inefficient.
- The Government serves as a provider of information to combat the inefficiencies caused by incomplete and/or asymmetric information.

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Government Policies Designed to Mitigate Incomplete Information

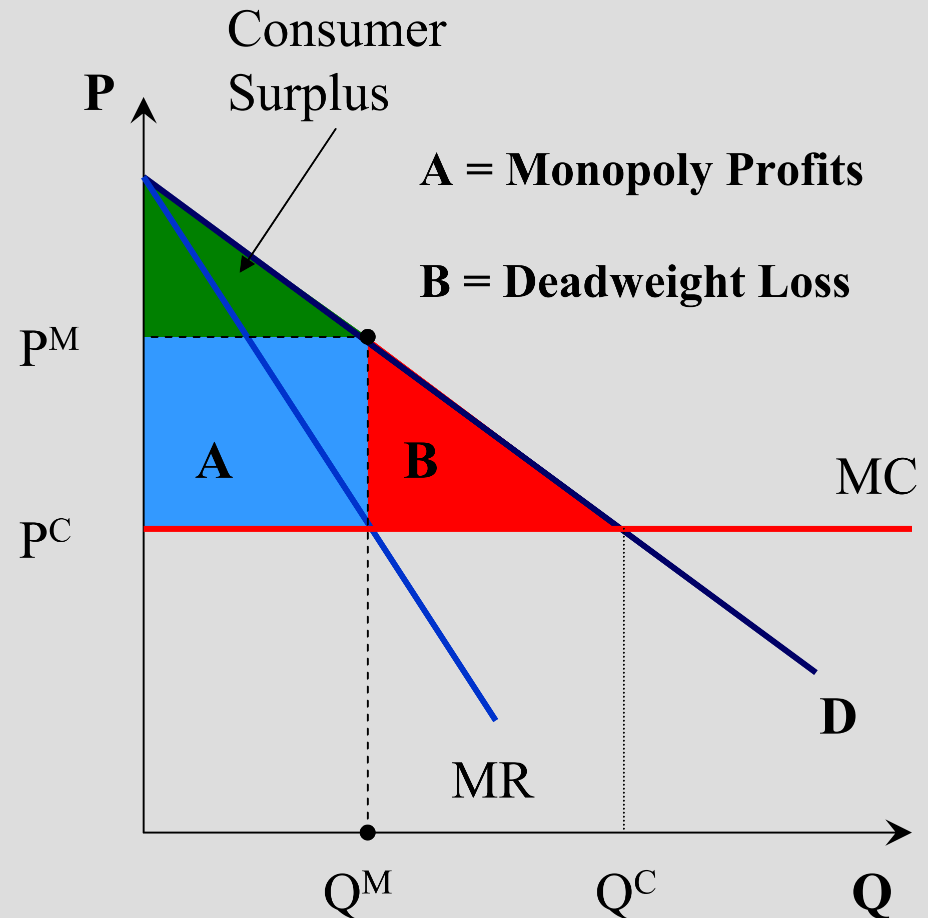
- OSHA
- SEC
- Certification
- Truth in lending
- Truth in advertising
- Contract enforcement

Rent Seeking

- Government policies will generally benefit some parties at the expense of others.
- Lobbyists spend large sums of money in an attempt to affect these policies.
- This process is known as *rent-seeking*.

An Example: Seeking Monopoly Rights

- Firm's monetary incentive to lobby for monopoly rights: A
- Consumers' monetary incentive to lobby against monopoly: A+B.
- Firm's incentive is smaller than consumers' incentives.
- But, consumers' incentives are spread among many different individuals.
- As a result, firms often succeed in their lobbying efforts.



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Quotas and Tariffs

Quota

- Limit on the number of units of a product that a foreign competitor can bring into the country.
  - Reduces competition, thus resulting in higher prices, lower consumer surplus, and higher profits for domestic firms.

Tariffs

- **Lump sum tariff**: a *fixed* fee paid by foreign firms to enter the domestic market.
- **Excise tariff**: a *per unit* fee on each imported product.
  - Causes a shift in the MC curve by the amount of the tariff which in turn decreases the supply of all foreign firms.

Conclusion

- Market power, externalities, public goods, and incomplete information create a potential role for government in the marketplace.
- Government's presence creates rent-seeking incentives, which may undermine its ability to improve matters.

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