AE 503

PUBLIC POLICY

AND MONOPOLY

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Having indicated why monopoly is not Pareto efficient, and what the loss is from monopoly, what is public policy towards the monopoly issue?

**US Anti-Trust Laws**

In the US, public policy towards market power comes under the heading of *anti-trust* laws - most economists see this set of laws as being designed to promote *competition*, and, hence, *economic efficiency*

The major anti-trust statute in the US is the *Sherman Act* passed in 1890 - it represents the political reaction to the widespread growth of large firms (*trusts*) formed in the 1880s.

Essentially, there are two parts to the Sherman Act:

**Section 1:** Prohibits contracts and conspiracies that would constitute a restraint of trade

**Section 2:** This is designed to prohibit monopolization of industries, the relevant wording of the act is:
“Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of trade or commerce among the several states, or with foreign nations, shall be deemed guilty of a felony.”

Important to recognize here that the law forbids the act of monopolizing, and not the monopoly itself. In other words, a monopoly or dominant firm position may come about because:

- a firm is more efficient
- firm has developed new technologies/products that it has been able to patent
- the firm has a natural monopoly

These situations have to be distinguished from those where a firm becomes a monopoly because of predatory actions.
Example: Natural Monopoly

It would seem logical for the government to force a monopoly to set price equal to marginal cost.

In the case of a natural monopoly, this would result in the firm making economic losses.

Suppose that a firm’s minimum point of average cost lies to the right of its demand curve, and intersection of marginal revenue and marginal cost lies under the average cost curve (See next figure).

If the government (regulator) forced the firm to set output at $y^e$, the firm would make losses of area $(p^eabd)$, and it would prefer to go out of business.

Such a situation is common where an industry’s technology exhibits high fixed costs, and small marginal costs - e.g. public utilities such as gas and telephone companies.
NATURAL MONOPOLY
If the natural monopoly is to be regulated, how should the regulator set prices?

If prices are set to marginal cost, a subsidy would have to be paid to cover the losses.

The “second-best” pricing policy would be to set prices at average cost, i.e. firm operates at output of $y^{ac}$, with a price of $p^{ac}$.

At this price, firm just covers its costs, and it provides a service to those willing to pay for it, but the level of output is still below the Pareto efficient level.

The problem for the regulator is to determine the costs of the public utility - in the US, regulatory boards, known as public utility commissions, have the responsibility of setting prices for electricity, gas and telephones so that costs are covered.
As well as the Sherman Act, the *Clayton Act* was enacted in 1914 - this act clarified what is considered to be an anti-competitive act.

The act outlawed activities such as:

- price discrimination
- exclusive territories
- exclusive dealing

However, such practices are only illegal when they:

“substantially lessen competition or tend to create a monopoly”

These acts, and some others, comprise the framework of US anti-trust policy. The language of the acts, however, is very general, and basically interpretation of the laws is left to the courts.