9.6.06

# Lesson 5:
# What is a monopoly?

🕒 45 minutes

**PREPARING TO TEACH**

- ☑ Post lesson outcomes.
- ☑ Show Documentary Chapter #4.
- ☑ Discuss chapter using questions on Handout #1.
- ☑ Is there an antitrust violation? Handout #2.
- ☑ Full class discussion using the questions following the strategy.

## LESSON OVERVIEW

In general, antitrust laws govern competition in our free market economy. Their main focus is on maintaining fair competition. In this lesson students will look at monopoly power. When a firm has monopoly power it can raise prices, exclude competition, and stifle innovation. However, monopolies are not always illegal. This lesson explores key questions that arise when companies cross the line from being a legal monopoly to illegal monopolizing.

## OUTCOMES

As a result of this lesson students will be able to:

*Identify and define monopoly and unfair competition practices;
*Describe the facts in the Microsoft case and identify the parts of the case where the actions of the company collide with antitrust law;
*Explain why the actions of the corporation violated the Sherman Act;
*Describe how consumers were impacted by this case;
*Identify two important concepts related to monopolies to keep in mind as a consumer.

CALIFORNIA STATE STANDARDS

| **Antitrust Lessons** | U.S. History/8th grade | U.S History and Geography- Twentieth Century/11th Grade | Principles of Economics/12th Grade |
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| Lesson 4 | | | 12.3 Students analyze the influence of the federal government on the American economy. (Specific reference to "attempting to make markets more competitive)<br><br>12.2 Students analyze the elements of America's market economy in a global setting (No specific reference to antitrust, but focuses on a market economy) |

Handouts

Handout #1: Discussion Questions for Documentary Chapter #4 (need class set)

Handout #2: Is there an antitrust violation?

Handout #3: Optional Exercises for Further Exploration

Description of Documentary Chapter #4

In this documentary chapter the students will take a look at the United States v. Microsoft, a case involving the allegation that Microsoft violated the Sherman Act. The government argued that Microsoft had monopoly power and used it to illegally maintain its monopoly of the operating system for personal computers by creating barriers to market entry, exclusionary contracts and other anticompetitive activity. At the time Microsoft had 95% of the market and there were significant barriers to entry into that market. Specifically, Microsoft began manufacturing its windows operating system so that its own browser would be part of the product, in effect offering it to the public at a cost of zero. At the same time, Microsoft used its monopoly position in the operating system to force manufacturers of personal computers to agree not to install the competing browser from Netscape. According to the courts, Microsoft saw that Netscape could eventually become the platform for a competing operating system and decided to block Netscape to keep this from happening.

Microsoft defended its actions by arguing that what they were doing was innovation and that their behavior was not exclusionary but was justifiable competitive conduct. This is a complicated case and the documentary only focuses on some of the strategies that Microsoft used to maintain its monopoly and drive out competition.

The federal courts upheld the allegation of illegally maintaining a monopoly, Microsoft filed an appeal but then the government settled the case with Microsoft on terms that remain controversial to this day. The documentary shows the opposing views and strong opinions of those connected to the case.

You may want to ask students if they have ever played the "Monopoly" game. What makes a monopoly in that game? It is when one has all the similar properties of one color. The player (owner) can then charge higher rent to people who land on that property. This is not the legal definition of monopoly though exclusive ownership can lead to monopoly.

## Community Resource People

You might want to invite a lawyer specializing in antitrust law or someone from your county prosecutor or state Attorney General's Office as a resource person for this lesson. Send a copy of the lesson when confirming the date and location of the class.

WEB RESOURCES

www.americanantitrustinstitute.org

Teaching Tips

**1.** Before students enter the classroom, set up the DVD to show the chapter. When the students arrive, explain to them that they will be watching a chapter from *Fair Fight in the Marketplace,* an antitrust documentary, showcasing some of the important issues and cases in the history of antitrust in the United States. The fourth chapter focuses on monopolization.

2. Ask students to quickly review the following concepts--
What is a monopoly?

A monopoly is a company that has such a large share of the market that it is able to set its own prices at the profit-maximizing level, instead of having to take the price that would be set by competitive supply and demand. A monopoly may be legal if it was the result of being the best and smartest competitor. Another example is that in some markets, economies of scale are so large that there is only room for one efficient company. On the other hand, suppose a company became a monopoly by burning down its rivals' plants. If a company gains monopoly power, maintains monopoly power, or extends its monopoly power by improper means, it goes over the line into illegality.

What are examples of monopolistic behavior?

A monopolist is not allowed to engage in what is called exclusionary conduct. Three examples are driving out competitors by predatory pricing, or by exclusive dealing contracts, or by tying arrangements. Here is an example of a tying arrangement-
A monopolist in the market for product A wants to expand its market share for product B, which competes in a competitive market. So A says, if you want to buy my product A (which you need to get from me, since I am a monopolist), you have to buy my product B, as a condition of my willingness to sell you product A. A variation of this might be, I will sell you the bundle of product A and product B for a low price, but if you want to buy each one separately, the price will be much higher. The result is that competitors in

product B's market will lose many, perhaps all, of their customers because of A's monopoly -- even if they are more efficient in the B market.

What kinds of contracts would give an unfair advantage in the market to a monopolist?

Contracts that are imposed by a monopolist can give unfair advantage in the marketplace. The ability to obtain exclusive dealing contracts (e.g., I will deal with you only if you agree not to deal with anyone else) and tying contracts (I will sell you A –a product I monopolize and you need—only if you agree to buy my product B, which you don't want) often reflects monopoly power.

What are unfair means?

All businesses are set up to make a profit. This is perfectly legal and in fact it is the engine that drives our capitalist system. However, profit-making conduct is not legal if it restrains trade. For example, suppose a sneaker manufacturer makes a deal with a shoe lace manufacturer that the lace manufacturer will not supply any other shoe manufactuter. There is no problem if there are lots of sneaker manufactuers and lots of lace companies. But what happens if the shoe lace manufacturer is the only shoe lace manufacturer? If this happens, it might be more difficult or even impossible for another company to sell shoes. Competition would be constrained. What is not unfair when there is plenty of competition might be unfair if it forecloses a substantial amount of competition. Since exclusive dealing is evaluated under the Rule of Reason, a court would balance the disadvantage to competition against any positive business justifications to determine whether it is illegal.

What does a monopoly do?

By not having to worry about competitors, it can set its prices at the level that exceeds the competitive level. This means that less is produced than would be produced in a competitive market and many consumers are not able to purchase goods or services that they would be willing to purchase at a competitive price. The failure to produce at the competitive level is economically inefficient for the whole society and because consumers pay more than what the competitive price would have been, the redistribution of money from consumers to monopolists may also be considered unfair. But monopolies are not necessarily illegal. How they behave within a particular factual setting may make them illegal.

How is a monopoly set up?

A monopoly may be granted by the government, e.g. by issuance of a patent or a copyright. A patent legally protects inventions in order to motivate people to spend their time and energy making inventions. A copyright protects the owner (e.g. an author) against other people taking their written words without permission. Thus, a successful inventor is given protection against competition, since no one else may copy the invention without the inventor's approval. Alternatively, a monopoly may be formed when one firm buys out all the competing companies, or the company might grow into a monopoly by being the best at what it does. If it already enjoys a large market share, it may temporarily cut its prices to drive others out of business, or follow other strategies aimed at the exclusion of others rather than working at being the best it can be.

What is a competitive market?

In a competitive market, a firm will be forced to set its prices only a little above its costs -- enough so that there will be profits for those who invest in the firm, and these profits will not be excessive. Also, in a competitive market, a firm will have to be on its toes to find ways to do a better job. Thus, a competitive market encourages improvement and innovation along with a constant awareness of the need to serve the consumer well.

3. Ask students to think about the following questions while watching the documentary chapter—

Did Microsoft stifle competition? If so how did it do it?

How strong should the government's role be in cases like Microsoft?

Did Microsoft know that what they were doing was anticompetitive?

4. Show chapter #4. (_____minutes)

5. Debrief the chapter using the following questions-

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| **What happened in this case? What did Microsoft do? |

The government alleged that Microsoft had monopoly power and used it to illegally maintain its monopoly in the operating system for personal computers by creating barriers to market entry, exclusionary contracts and other anticompetitive activity.

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|---|
| **What was Microsoft worried about? |

Microsoft was worried about losing its lucrative operating system monopoly, because it feared that Netscape's browser could eventually become an alternative operating system.

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| **Did Microsoft stifle competition? If so, how did they do it? |

After a lengthy trial a federal district court and an appeals court both found that Microsoft tried to prevent competition from eroding their operating system monopoly by eliminating competition (Netscape) from the browser market. They tied their browser to the Microsoft Windows operating system and in effect offered it at a price of zero, while Netscape had to sell its browser at a profit in order to survive.

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|---|
| **Did Microsoft know that what they were doing was anticompetitive? |

Microsoft was of course trying to exclude their competitors---that was not in doubt. The only question was whether the y did this by legal means. Microsoft said it was being innovative by weaving their browser into the

Windows operating system. The judge found that weaving the browser into the operating system diminished competition. He also found that the two products could be separated.

**What happened to consumers as a result of Microsoft's actions?

Critics of Microsoft argue that prices for the operating system did not go down as rapidly as prices for other aspects of the computer industry. Most important, innovation was chilled because companies that might have played in the market understood that Microsoft might do to them exactly what it succeeded in doing to Netscape. The absence of a competing operating system meant that applications had to be written to Microsoft's own specifications and that many new ideas simply wouldn't have a chance to be tried in the marketplace.

**What was the decision in the case?

Microsoft was blocking competition. Their actions were illegally maintaining a monopoly in violation of Section 2 of the Sherman Act.

**How strong should the government's role be in cases like the Microsoft?

People may disagree about the extent to which a government should intervene in the marketplace. Some people felt that Microsoft was only engaged in aggressive but normal competition and the government should not have done anything. Others, including the federal government and many of the states, felt that Microsoft was undermining an important market and that it was necessary to stop it in its tracks before it became any more powerful or used its monopoly to leverage its way into additional markets. The argument about Microsoft and more generally about monopolies is going on around the world today.

## 6. Is there an antitrust violation? Strategy

Divide the class into small groups (3-5) students. Each group is a legal team trying to make a decision about whether or not to bring an antitrust case.

Use Handout #1 with students for this strategy.
Below find Handout #1 with answers for the teacher.

The Sherman Act does not outlaw monopolies. It outlaws monopolizing—an important though not always clear distinction. By not having to worry about competitors, a monopoly can set its prices at the level that exceeds the competitive level. This means that less is produced than would be in a competitive market and many consumers are not able to purchase goods or services that they would want to purchase at a competitive level. A seller does not have to have 100% of the market to be a monopolist; but less than 60% would probably not be monopolistic. There is no magic market share number that establishes one as a monopolist. It is how monopolies behave that may make them illegal.

When does the action of a corporation cross the line into monopolizing the marketplace?

Court decisions have evolved the following two-part test for illegal monopolistic behavior:
1. The corporation must possess "monopoly power," a large enough share of a product's market and enough protection from new entries that it has the power to control prices or exclude competition.
2. The corporation must willfully create or maintain that "monopoly power" using tactics not related to the development of a superior product or good business skills but instead attributable to their anticompetitive behavior.

In the situation below discuss the questions and decide whether or not to bring an antitrust suit-

**The Cypress Express**

In Maxima County the local newspaper, the Cypress Express, dominated the dissemination of news and information. Last year a new radio station was built and began broadcasting music, weather, and news. The Cypress Express was concerned about their market and decided to tell all its advertisers that if they advertised on the new radio station they could no longer advertise in the newspaper. Many of the advertisers were concerned about losing their ability to advertise in the newspaper and did not buy radio advertising.

Questions to consider-
What are the relevant markets?
Answer—Newspapers, radio, and advertising in the community.
Does the corporation have a large share of the market?
Answer- Yes, it has a monopoly in the local newspaper market.
Can the corporation control prices?
Answer-Yes, as a monopolist it can set the price for its own advertisements without worrying about other local newspapers. But if advertisers value radio or TV or billboard advertising equally, these other options would be competitive and would help restrain the newspaper's prices.
Can the newspaper exclude competition?
Answer-
No—The new radio station would be a competitor, but if it cannot sell advertisements, it probably cannot succeed. If advertisers feel they will be disadvantaged unless they advertise in the newspaper and the newspaper refuses to sell advertising to anyone who also advertises on the radio, then the newspaper can exclude competition.

Can a new company enter the market?
Answer- No—not this one, if the newspaper's refusal to deal is upheld.
Does the newspaper corporation have good business skills and/or better product which would justify maintaining its monopoly in this way?
Answer-We can't tell, since they are not competing on the merits.
Do consumers have any choices?
Answer-Because advertisers do not have much of a chance to advertise with the radio station, consumers will be deprived of the information about goods and services that they might have obtained over the radio. Ultimately they may be deprived of having an independent radio station to listen to.

# Is there an antitrust violation in the Cypress Express Case? Why or Why not?

Answer-Yes.
In the actual case, Lorain Journal Co. v. United States, 342 U.S. 143 (1951), the Court decided that a business in a position of economic dominance cannot use its power to interfere with new businesses trying to get into the market. The Court said that this violated Section 2 of the Sherman Act.

Wrap –up Question for Discussion

A famous former Federal judge, Robert Bork, said that this case is just like the Microsoft case. Do you agree? Why or Why not?

Answer –Yes --It is similar ---Just as the newspaper said that if advertisers want to advertise with the newspaper they cannot advertise by radio, so Microsoft said that if the computer makers want to use the Microsoft operating system, they cannot use Netscape's browser.

Handout #1: Discussion Questions for Documentary Chapter #4

1. What happened in this case?  What did Microsoft do?

2. What was Microsoft worried about?

3. Did Microsoft stifle competition?  If so, how did they do it?

4. Did Microsoft know that what they were doing was anticompetitive?

5. What happened to consumers as a result of Microsoft's actions?

6. What was the decision in the case?

7. How strong should the government's role be in cases like the Microsoft?

## Handout #2-- Is this an antitrust violation?

The Sherman Act does not outlaw monopolies. It outlaws monopolizing—an important though not always clear distinction. By not having to worry about competitors, a monopoly can set its prices at the level that exceeds the competitive level. This means that less is produced than would be in a competitive market and many consumers are not able to purchase goods or services that they would want to purchase at a competitive level. A seller does not have to have 100% of the market to be a monopolist; but less than 60% would probably not be monopolistic. It is how monopolies behave that may make them illegal.

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Questions to consider-

What were the relevant markets?

Does the corporation have a large share of the market?

Can the corporation control prices?

Can the newspaper exclude competition?

Can a new company enter the market?

Does the newspaper corporation have good business skills and/or better product which would justify maintaining its monopoly in this way?

Do consumers have any choices?

## Is there an antitrust violation? Why or Why not?

Wrap –up Question for Discussion

A famous former Federal judge, Robert Bork, said that this case is just like the Microsoft case. Do you agree? Why or Why not?