Klick
Law and Economics of the Firm
Final Exam
Summer 2019

You have 24 hours to complete this exam, but the latest you may turn it in is 5pm on June 17, 2019. You may use your casebook, notes, and commercial outlines in the completion of this exam, but you may not confer with anyone else about it during the exam period (i.e. June 7 at 9:00 am through 5:00 pm on June 17). Each question (1 and 2) is equally weighted subject to your choice in question 3. Good luck.

1. After pressure from a number of legislators, Amazon has agreed to drop the "most favored nation" clauses it had with a number of its third-party sellers (as it had earlier done in Europe). These clauses required the sellers to commit to not selling their products for a lower price in any other on-line marketplace (e.g., E-Bay, Alibaba, or their own websites). While these clauses were common in Amazon's arrangements with third party sellers, Amazon did not have similar arrangements with bigger name first party selling partners (e.g., Nike). Provide arguments that getting rid of these clauses will be good for consumers as well as arguments that the clauses can be helpful to consumers; also provide a sketch of ways one might be able to test these arguments.

The anti-competitive/consumer side of the argument centers around this practice potentially limiting price competition in a handful of ways. First, there is the straightforward intuition that the Amazon price sets a price floor for the seller and this preempts the seller from responding to downward pricing pressures in any other forum. By this logic, prices might be higher than they would be in the absence of the MFN clause. Second, if some other on-line platform cuts costs for the seller, the Amazon MFN clause will limit the seller from passing that cost saving on to customers via prices on that platform (though the seller might be able to lower prices across all platforms). This might limit competition between Amazon and other platforms *as platforms* which might lead to consumer harm in the long term.

On the pro-competitive/consumer side, one might analogize Amazon to a shopping mall where the ability of a retailer to bring customers "in the door" helps all of the sellers. People might come to Amazon looking for Nike and then see lots of other stuff they are interested in. These big-name sellers are already generating significant traffic, so much like the "anchor store" in a mall, these sellers might be treated better by Amazon (better cost terms, no restrictive clauses, etc) much like the mall owners charge the anchor stores a lower rent. For the no-name sellers, they are not generating the same kind of positive externalities. One might imagine Amazon charging different fees to these sellers to reflect this (like the mall charging progressively smaller/less popular stores proportionately higher rents). It does not do this (for the most part) perhaps because the transactions costs of coming up with specific deals for each of the thousands of sellers are prohibitively high. Perhaps an intermediate solution is to ensure that each of the customers of the small sellers is implicitly directed toward Amazon by knowing that the seller cannot offer a lower price elsewhere. More customer flow benefits all of the sellers on Amazon.

Relatedly, much of Amazon's comparative advantage comes from its cost advantages related to logistics (cheaper/faster shipping, etc) which likely exhibits economies of scale, so, again, more customers/transactions are likely to lead to lower overall costs for Amazon which might be passed on to consumers. Search costs might also be reduced for consumers if they know they will always get a seller's best price at Amazon (no need to comparison shop across platforms) while being able to more cheaply comparison shop across sellers on Amazon's single best price platform.

As for testing, since much of what Amazon provides is convenience and other non-price benefits (as well as price benefits), this likely is a context where whatever test one performs, it should probably involve looking at Q (total across all platforms) rather than (or at least in addition to) P. The earlier decision to get rid of MFN clauses in Europe provides a potential natural experiment/difference in difference type study. Comparing the change in Q by product before and after in Europe against the background trend of Q in America might give us a sense of whether MFN hurt or help consumers (if Q went down in Europe relative to its baseline and relative to contemporaneous changes in the US, MFN would seem to be helpful; if it went up, MFN clauses would seem to be hurtful).

Some people suggested using an event study. While the natural experiment discussed above is sometimes referred to as an event study, the more common usage of the term refers to changes in stock prices/returns associated with an event. In this case, it is not clear how such a stock price based study could be helpful. First, if Amazon stock went up upon some event, would that imply the event was good or bad for consumers (theoretically ambiguous); the same is true if one looked at the stock price of the sellers. Further, using stock prices would disallow the possibility of doing a US/Europe comparison (since there is not a US-specific stock price to be compared to a Europe-specific stock price).

2. There are 6 million car accidents in the US every year and estimates suggest the average driver will be in an accident once every 20 years. Most accidents involve insured drivers. Insurance steering is a practice whereby an insurer directs its customers to a particular body shop when a covered accident occurs or in some cases even requires that the customer gets work done at the body shop if insurance pays for the work. In some cases, the body shops pay the insurers money to be included among the set of body shops suggested to customers. In other cases, the body shop commits to offering a lower price to the insurer's customers if the insurer steers them to the shop. A majority of states have laws restricting insurance steering. Provide arguments that steering harms consumers. Provide arguments that suggest steering can benefit consumers. How might you test these arguments?

The impetus behind banning insurance steering largely rests on the intuition that it restricts competition between body shops and that it limits consumer choice. The former hurts consumers because it might lead to increased prices or reduced quality (which could include the quality of the underlying work, wait times, how nice the waiting room is, how good the calendar the bodyshop gives out during the holidays is, etc). The latter is harmful because of its effects on competition as well as its general effects on consumer autonomy.

Steering might help consumers, however. Given the facts listed above, most consumers will have very little experience with bodyshops (most consumers will have never needed one before) and it is very hard for a non-expert to judge the quality of body work. Insurers, however, will have lots of

information since they deal with bodyshops on a regular basis. Along the same lines, the particular practice of paying an insurer to be included in the list of approved shops might serve as a Klein & Lefler type bond. The bodyshop pays a cost that is only recouped if it keeps getting business from the insurer. If the insurer later discovers that the shop is doing bad work (perhaps through complaints from its insurance customers), it can simply remove the shop from the list. Because an individual driver will not have enough interaction with the bodyshop (s/he may only need the service once in her/his life), the individual could never enact the bond, but the insurer could.

As for the restricted competition point, perhaps, the relevant competition will happen at the insurer level (customers stay away from insurers who do a bad job picking good bodyshops) and so the "kickbacks" paid by the garages to the insurer actually end up leading to lower cost insurance (as the kickbacks get competed away as insurers compete with each other) as well as better body work. On the other hand, if the insurance market is not competitive, this need not be the case.

The fact that different states have banned this practice allows for potential natural experiment/difference in difference type studies. The tricky part here is figuring out the right outcome variable to look at. As with any product that involves quality elements, prices will be insufficient as outcome variables. However, our usual approach of then looking at quantities is also problematic here (I don't necessarily buy more body work because it was especially good – many people only get body work when an accident occurs). Perhaps one approach could be to look at used car value; if steering is good for consumers, used cars in states that have banned the practice might be lower value, whereas if it is harmful, used cars might improve in price in states where the practice is banned. Surely this is not straightforward since cars can cross jurisdictions, but something along these lines might be the best approach to testing.

3. Please choose one question (1 or 2) to count double or indicate you want each question to count equally. Please be clear in your choice.