Executive Summary

The current wave of business mergers raises the specter of increasing corporate monopoly power in the economy. Critics of industrial concentration claim that current merger trends are worrisome and that vigorous enforcement of the antitrust laws is necessary to preserve competition.

The critics are especially annoyed with antitrust chief William Baxter who, they argue, has essentially adopted a laissez-faire attitude toward monopoly. Although Baxter was the major catalyst in the historic divestiture of the American Telephone and Telegraph Company, his critics contend that his policies in general have meant a less-active antitrust policy.

What is existing antitrust policy and does it make economic sense? Is a vigorous enforcement of the antitrust laws necessary to preserve competition? Or would we all be better off without any antitrust policy?

The Theory Behind Antitrust

The economic case for free markets is said to depend on the existence of business competition. According to the conventional wisdom, the existence of competition ensures that scarce resources will be put to their most efficient use. Competition keeps costs low and induces firms to innovate and engage in technological development. Competition is the institutional vehicle through which private business self-interest is said to promote the public interest.

Business monopoly is seen as the antithesis of competition and has little utilitarian justification. The existence of monopoly and monopoly power misallocates economic resources and makes the economy less efficient than under competition. Monopolies reduce production and charge higher prices for their products. Moreover, monopolies are said to engage in socially wasteful product differentiation, and some restrict the pace of technological activity. When monopolists pursue their own business self-interest, they injure the public interest.

One important source of business monopoly is legal barriers to entry. It has been well recognized that government regulation can foster business monopoly by legally restricting entry and competition.[1] Government licensing, franchises, certificates of public convenience, and other legal restrictions can be a source of monopoly power for the firms that are protected from open competition. The social cure for this monopoly is deregulation.

It is also believed, however, that business monopoly can arise in a free market without any government support. The origin of this monopoly power is traced to certain economic barriers to entry that insulate existing firms from potential competition.[2] Product differentiation, economies of scale, predatory practices, and advertising are often identified as important barriers that limit competition and misallocate economic resources. In addition, collusion that restricts
market output is said to be socially inefficient. And it is this private, anti-social monopoly power that the antitrust laws were allegedly intended to control.

**Old Directions in Antitrust Policy**

Antitrust law, especially the Sherman Antitrust Act of 1890, has always enjoyed widespread political and academic support in America. The existence and enforcement of the antitrust laws has rarely been a partisan political issue; Democrats and Republicans have endorsed the laws and have advocated "tough" enforcement. In addition, the bulk of the academic economists have always supported the Sherman Act and a vigorous enforcement policy.[3] While some scholars have written critically of the application of the law in specific areas, there has been little enthusiasm in the academic world for a complete repeal of the antitrust statutes.

Yet the actual history of antitrust enforcement has never warranted this widespread academic and political support. There is little in the classic antitrust cases to convince anyone -- much less an economist -- that monopoly power is a free-market problem, or that the firms indicted (and convicted) under the antitrust laws were damaging the public interest. Indeed, the cases often demonstrate that the firms involved were reducing costs and prices and engaging in an intensely competitive process, and that the antitrust laws -- whatever their alleged intent -- were employed to restrict and restrain the competition process.[4]

Standard Oil (1911). For example, in the classic Standard Oil case (1911), it is still widely believed that Standard of New Jersey was convicted because it had restricted production, raised prices, and engaged in ruthless predatory practices to destroy competition. Yet none of this was ever proven at court. Standard lost the decision in 1911 because a lower court in 1909 had determined that the formation of its holding company in 1899 was prima facie illegal since it ended the potentiality of competition between the (now) merged firms.[5] The Supreme Court, while announcing a rule of reason, simply reaffirmed the unanalytical decision of that lower court.

An objective study of the petroleum industry between 1859 and 1911 would reveal that Standard did not plunder consumers or competitors. The price of kerosene -- the industry's major product -- dropped from over 50 cents a gallon in the early 1860s to less than six cents in the late 1890s. While Standard always did a large share of the industry's business, they always had competition. When they were dissolved in 1911 for monopolizing in restraint of trade, there were at least 147 independent petroleum refining companies selling products in competition with the Standard Oil Company.[6] The industry was not monopolized.

American Tobacco (1911). The American Tobacco Company (the Tobacco Trust) was ordered dissolved by the Supreme Court in 1911. Again, legend has it that American Tobacco ruthlessly raised cigarette prices, drove down the price of leaf tobacco, engaged in "predatory" wars with rivals, and generally acted like the abusive monopoly of antitrust theory.

The legend is sheer fantasy; none of this was ever proven.[7] The Supreme Court did not rule specifically on these charges, and the lower court, which had discussed the charges in some detail, concluded that they did not occur. Even a casual reading of the lower court decision would reveal that the prices of tobacco products were not arbitrarily increased (cigarette prices fell between 1895 and 1907), that leaf tobacco prices rose substantially, and that American Tobacco did not "dragoon" competitors into bankruptcy or merger with itself. There were hundreds of companies selling cigarettes in the market, and many thousands more selling smoking tobacco, plug, snuff, and cigars. The American Tobacco Company was large and had a high percentage share in some tobacco markets, but it had not obtained a coercive monopoly position in the tobacco industry.

U.S. Steel (1920). The United States Steel Company, the largest corporation in the country when it was formed as a holding company in 1901, was indicted by the Department of Justice in 1911. The corporation, however, was found innocent of monopolizing in 1915 and again in 1920. With the Supreme Court's newly enunciated rule of reason actually in effect, U.S. Steel demonstrated to a majority of judges and justices that it did have active competition, that the competitors were growing faster than the U.S. Steel Company, that essential raw materials were not being monopolized, and that the prices of steel products had fallen on average between 1901 and 1911.[8] Although U.S. Steel admittedly was of impressive size, the Supreme Court declared that "its power over price was not and is not
commensurate with its power to produce." Since its economic conduct and performance were judged reasonable, and since mere size was not to be a legal offense, U.S. Steel (and many other large corporations in very similar trials) was declared innocent of any economic wrongdoing.

Alcoa (1945). The 1945 Alcoa decision reversed the rule-of-reason approach and again made high market share a legal offense. Alcoa was convicted of monopolizing an artificially defined relevant market: primary ingot aluminum. Even though the special Court of Appeals admitted that secondary aluminum (scrap) competed pound for pound with primary ingot, they steadfastly refused to include it when measuring Alcoa's share of the market. Without scrap, Alcoa was doing almost 90 percent of the aluminum ingot business, and that in and of itself was enough to constitute a monopoly and a violation of the law. Alcoa may have been a "good trust," but the Congress had not meant to condone good trusts, said the court in 1945.

Alcoa was, indeed, a good trust, as the lower court decision of 1939 had clearly demonstrated.[9] District Court Judge Caffey had found Alcoa innocent of more than 140 separate government charges. Caffey had laboriously determined that Alcoa had not monopolized bauxite, water power sites, aluminum ingot, castings, pistons, or many other items as the government had charged in its long-winded indictment. In addition, Alcoa had not illegally excluded competition, engaged in conspiracy, and charged "exorbitant" prices, or earned an "exorbitant" rate of return. Aluminum ingot prices had fallen from over $2.00 a pound in the 1890s to less than 22 cents a pound at the time of the trial, and Alcoa's average rate of return for 50 years was just over 10 percent on invested capital. Yet all of this was suddenly irrelevant in 1945. To maintain a high market share for a long period of time -- an extraordinary business achievement -- was to monopolize in violation of the antitrust law.

Actually Alcoa's efficient performance was legally worse than irrelevant and immaterial; it helped convict the company. Circuit Court Judge Learned Hand explained that it was Alcoa's "skill, energy, and initiative" that "excluded" competitors in aluminum production. If Alcoa had been less efficient there would have been "more competition" and no violation of the antitrust law. In one of the most outrageous statements in antitrust history, Alcoa's industrial virtues were condemned as an illegal restraint of trade.

It was not inevitable that it [Alcoa] should always anticipate increases in the demand for ingot and be prepared to supply them. Nothing compelled it to keep doubling and redoubling its capacity before others entered the field. It insists that it never excluded competitors; but we can think of no more effective exclusion than progressively to embrace each new opportunity as it opened, and to face every newcomer with new capacity already geared into a great organization, having the advantage of experience, trade connections and the elite of personnel.[10]

The past irrationalities of antitrust enforcement have not been confined to the classic monopoly cases. Business mergers that would have increased efficiency and likely intensified competition have been legally prevented in the name of concern over increasing "concentration." Price discrimination, an important element of a rivalrous competitive process, has been vigorously and mistakenly prosecuted by the Federal Trade Commission since the early 1930s. And it is only too clear that in the thousands of private antitrust cases (where one corporation sues another), the law serves to restrain and restrict the competitive commercial activities of the defendant corporation. In these latter cases, at least, there is no pretense that the concern is "monopoly," or that the interest that is being served is the public interest.

New Directions in Antitrust Policy

Within the last 10 years the widespread support for traditional antitrust enforcement has eroded considerably. There is now an important group of scholars and policy officials that seriously doubt the wisdom of conventional enforcement. Antitrust critics such as Robert Bork, Yale Brozen, Harold Demsetz, and Robert Tollison are often associated with the view that much of our traditional enforcement has been misplaced and may have served to restrict competition and not enhance it.[11] Most of these critics tend to see a competitive process where antitrust enthusiasts saw monopolization and increasing concentration. Most would allow liberal amounts of price discrimination and tying agreements and would not impede conglomerate mergers or vertical integration in most markets. Internal growth that results in increasing concentration would generally be defended as efficient. In short, the critics would substantially reduce traditional enforcement efforts, and there is abundant evidence that most current policies and enforcement efforts reflect the "new directions" of the critics.[12]
It is clear that the recent abandonment by the Justice Department and Federal Trade Commission of landmark antitrust cases against IBM and the leading ready-to-eat cereal companies is entirely appropriate from the perspective of the antitrust critics. IBM was not a monopoly when the Department of Justice brought its antitrust suit in 1969, and it is certainly not a monopoly today. Likewise, the cereal industry personifies a condition of rivalrous competition, and the leading companies never "shared a monopoly" as the Federal Trade Commission had boldly asserted.[13] Both of these cases were premised on the misguided notion that efficiency ought to be attacked since it is exclusionary of potential competitors and results in substantial market share. Yet the defendants in these cases had earned their shares (and expanded them) through a rigorous competitive performance. Occasionally, smaller competitors found such a rigorous competitive process difficult. But the antitrust laws were not intended to protect less efficient competitors (or potential competitors) from the rigors of open competition. Almost 20 years of litigation was wasted on these cases.

Antitrust Revisionism: Theory and Evidence. The collapse of the intellectual support for traditional antitrust enforcement can be traced to a number of different developments. Most important is the disenchantment with the orthodox "barriers to entry" doctrine.[14] It is now widely admitted that most of these so-called barriers were in reality economies and efficiencies that business organizations had earned in the marketplace. Economies of scale only "limited competition" with high-cost firms -- hardly a good reason to prosecute such barriers in the name of consumer welfare. Product differentiation only limited competition with firms unable to match the products and the experience of the existing firms. If advertising limited competition, it did so by reducing the cost and price of the product advertised. Advertising expenditures that increased costs and price would act as an invitation to entry and not as a barrier. In every instance efficiency broadly conceived, not market power, excluded the less efficient business organization.

Complementary to this theoretical revisionism have been numerous empirical investigations of the collusion/concentration/high profits hypothesis. The early work in this area had appeared to discover a slight positive correlation between high concentration and above-normal rates of return.[15] These studies assumed that barriers to entry limited competition in the concentrated industries, and that this restriction explained the persistence of monopoly profits. Critics of these early studies maintain, however, that persistently high profits can be more easily explained by greater efficiency on the part of the faster growing, high-market-share companies.[16] Moreover, the critics hold that the positive correlations between concentration and profit disappear with a longer time period under investigation and a larger industry sample size.[17] Finally, Yale Brozen has argued recently that the weight of the new empirical evidence is now overwhelming that market share and concentration reflect efficiency and not monopoly power.[18]

Antitrust and Output Restriction

While the current critics of antitrust policy favor a substantial reduction in traditional enforcement, they do not oppose all enforcement or favor a total repeal of the antitrust laws. Indeed, the critics generally see a continued need for constant surveillance and enforcement in the one area where they believe that antitrust can promote the public interest: the prevention of horizontal agreements that might restrict production. This, according to some of the critics, was the original mission of antitrust policy and the only mission consistent with sound economic analysis.[19] Enforcement that would prevent price fixing, large horizontal mergers, and division-of-market agreements would be consistent with this perspective.

Admittedly, current antitrust enforcement is slightly more rational than traditional enforcement, but the "output restriction" hypothesis on which current policy is founded is seriously flawed and cannot support even this minimalist antitrust policy. Conventional monopoly theory holds that an "artificial" reduction in market output is inefficient and can lead to a reduction in consumer and social welfare. The antitrust laws are necessary, therefore, to prevent such restrictions. But is such an approach theoretically sound?

The Output Restriction Hypothesis. What is socially inefficient about a cooperative and voluntary market output? A traditional response to this question is that the reduction is inefficient when compared to the output level under perfect competition. In the traditional economics literature the perfectly competitive (equilibrium) output is widely regarded as the socially optimum level of production, and restrictions from that output are seen as inefficient.[20] Thus, any "collusion" that reduces market output reduces social welfare.

There are several difficulties with this position. The first is that the perfectly competitive equilibrium is a notoriously
static framework from which to make welfare judgments concerning various levels of output. The perfectly competitive output is efficient only if perfect information is assumed, and only if preferences and technological information don't change. In a changing and dynamic world with imperfect information, it is unclear that outputs that are less than the static benchmark level are inefficient in any meaningful sense. All real-world outputs are "restricted" and all firms (even those that are not expressly colluding) produce less than they would if the world were perfectly competitive. This approach to output "restriction" could be employed to prosecute all firms regardless of whether their collusion was explicit or not. Yet this is an absurd policy position and serves to highlight the difficulty of this theoretical approach to monopoly power.

If the perfectly competitive output is not the relevant welfare benchmark, then what output level is the relevant one? If firms collude and restrict production, then we simply have less production after the collusion than before the collusion. Why is this an inefficient state of affairs? If buyers pay the higher prices associated with less production and if this generates -- or promises to generate -- higher profits for the producers, why is the "restriction" socially undesirable? On the other hand, if the higher prices generate -- or promise to generate -- lower profits for the producers, the restrictive agreement will likely be abandoned. In either case, it is the revealed preferences for the buyers that determine the socially optimum output level. What is the justification for regulation in either case?

It is important to note that consumers are sovereign over the entire length of their theoretical demand function. Higher prices are just as compatible with full consumer sovereignty as are lower prices. It is the buyers at each theoretical point on their demand curve that determine the "correct" level of production. Knowledge of that level cannot be known beforehand by economists who wish to assert that an output restriction must reduce consumer welfare (assuming for the moment that we could even measure welfare).

Some of the support for making horizontal agreements illegal is the belief that such agreements typically work to raise prices above previous levels and increase the profits of the conspirators. Yet there is accumulating theoretical and empirical evidence which suggests that market division agreements (in the absence of explicit government support) are tenuous at best, and tend to break apart naturally in open markets. Restrictive agreements appear to be short-run, unable generally to withstand changing market conditions. If the markets are legally open to competition, entry and competition will normally defeat any long-run agreement to restrict production.

The public is easily misled about the effectiveness of price conspiracy since it often accepts indictment and conviction in price-fixing antitrust cases as evidence of effective restriction. This inference, however, is entirely mistaken. Price agreements are illegal per se; to have an agreement is enough to violate the law. Whether the outputs have been successfully restricted or whether the prices have been increased is irrelevant and immaterial in the federal legal action (though not of course in the private treble damage suits). Firms indicted under the Sherman Act in this area often plead nolo contendere since they are aware that the existence of the agreement is sufficient for conviction. Yet it should be obvious that a federal conviction alone is insufficient evidence that there has been an actual output restriction or any higher prices in the marketplace.

Another difficulty with a flat prohibition on restrictive agreements is that such arrangements -- even from the theoretical perspective of the critics -- may lead to a net increase in social efficiency and welfare. The easy assumption has always been that the costs of collusion greatly outweigh the benefits (if any) that might flow from the agreement. Yet it is no longer obvious that such an assumption is valid. Market division agreements may end costly (and wasteful) cross-hauling and advertising. In the trucking industry it is argued that agreements among "competitors" through rate bureaus actually reduce information and transactions costs and allow the services to be provided more efficiently. Cooperative research and development, though it may limit competition in the traditional sense, may reduce future costs. Since even the critics admit that economies are often subtle and subjective, it is unclear -- even from their own perspective -- why they support a flat prohibition on restrictive agreements.

The Subjectivist Criticism. It has been assumed up to this point in the analysis, consistent with standard neo-classical theory, that social costs and benefits are measurable objective phenomena that are knowable to independent observers. Restrictive agreements are said to increase inefficiency, lower consumer welfare, and generate more net costs than benefits to society as a whole. Yet all of this calculation and measurement is open to serious criticism. The costs of an action are the subjective opportunities forgone by the person who makes the decision; the benefits are the subjective
satisfactions. Certainly individuals can ordinally rank their own costs and benefits and choose, ex ante, an appropriate (efficient) course of action, but the costs and benefits cannot be known to any outside observer.[26] Further, since costs and benefits are subjective they are not cardinally measurable. There is no standard unit of value that would allow the summing up of individual costs and benefits into social aggregates for comparison.[27] Thus, it is misleading to suggest that a rational antitrust policy can weigh the costs against the gains of restrictive agreements and decide which are socially efficient and which are not. Although this approach pretends to be rigorous and scientific, such social calculations misconstrue the fundamental nature of economic information.

A Coordination Theory of Efficiency. There is an alternative approach to social efficiency that does not depend on interpersonal utility comparisons or on cost aggregation. This approach would regard all voluntary agreements, including so-called restrictive agreements, as socially efficient since they aim ex ante to coordinate the respective plans of the participants to the agreement. Social efficiency is to be associated with a society that allows full scope for all free and voluntary agreements. Social arrangements are efficient if they tend to provide the widest opportunity for private plan fulfillment and coordination.[28]

This theory of social efficiency has several advantages over the standard neoclassical approach. The first -- as already mentioned -- is that it does not depend on objective measurements of fundamentally subjective phenomena such as utility and cost. The second is that it can encompass all voluntary agreements -- horizontal as well as vertical -- as promoting efficiency, even if such agreements prove unworkable in the long run. Many marriages are not workable in the long run but this does not imply that such agreements were ex ante inefficient, or that a case can be made for government regulation. We can always look back with hindsight and say that a contract was unwise, but hindsight (with more information) is not the proper perspective for acting man. The fact remains that at the moment of decision the agreement appeared, ex ante, to be efficient and coordinating. Thus, the ultimate failure of (restrictive) agreements is no reason for their social prohibition or regulation. All voluntary agreements are efficient in a plan-coordinating sense and ought to be allowed in order that the relevant individual costs be minimized and relevant individual values maximized.

It should be apparent that we have now developed an economic justification for open markets and that we have made an economic condemnation of legal barriers to entry. Legal barriers are socially inefficient in a scientific sense since they artificially reduce the scope of mutually advantageous exchanges and plan coordinations for potential consumers and suppliers. Legal monopoly is harmful not because we can measure the welfare loss in a neoclassical sense, but because all such legal restrictions limit and restrict voluntary plan coordination. From this perspective, to remove such legal restrictions to coordination through deregulation would be the only appropriate antitrust policy.

Antitrust and Civil Liberties. A final argument against any antitrust regulation is that all such policies violate basic civil liberties,[29] which allow individuals to speak freely, associate freely, and make contractual agreements. Yet a flat prohibition of restrictive agreements is inherently invasive of these fundamental rights.

It might be argued that business people forgo their right to liberty when they collude and restrict production, since such behavior violates the "rights" of the buyers. But such a perspective on rights is misguided. Producers own their property and have all of the rights to it; likewise, consumers own their income, and they have all of the rights to that property. The rights of neither party can be violated by a refusal to deal or a partial refusal to deal. A consumer boycott of a manufacturer's product will not violate the property rights of the manufacturer; the manufacturer has no right to the consumer's income in the first place. Likewise, a restriction of production on the part of the manufacturer (a producer boycott) cannot violate the rights of consumers since they have no rights to the product. Thus, restrictive agreements, though unpopular, are not invasive of anyone's rights; indeed, a flat prohibition on their existence or enforcement must violate basic civil liberties.

The civil liberties issues become especially important in conscious parallelism antitrust cases where there may be no explicit evidence of any conspiracy to reduce production. In these cases the government infers illegal behavior from the fact that firms may have followed similar patterns of business behavior.[30] Company A lowered its prices; Company B followed. Company A innovated some new cereal brand; Company B introduced a similar brand a week later. If Company B adopts the delivered pricing system of Company A, this imitation may well be construed as an illegal conspiracy in restraint of trade with appropriate fines and jail sentences. Yet it should be clear that any such
prohibition must violate the basic civil liberties of individuals to meet, associate, talk, and make agreements that do not involve fraud or violence against the person of another. Even Adam Smith did not favor such a law against price agreement since in Smith's cogent view, such a law could not be "executed... in a manner consistent with liberty and justice."[31]

Let us reiterate the criticism of antitrust policy discussed above. We maintain that the standard neoclassical monopoly theory is not internally consistent; that the standard cost/benefit methodology employed to calculate the social inefficiency of restricted agreements is inherently flawed; that legal barriers to entry do misallocate resources since they explicitly prevent voluntary plan coordination; and finally, that aside from purely scientific considerations, any antitrust policy is invasive of basic civil liberties.

Recent Issues in Antitrust

As an illustration of these criticisms and of the current ambiguity in antitrust policy, it might be appropriate to examine the recently announced merger guidelines and a recently concluded historic antitrust consent decree involving American Telephone and Telegraph Company.

The Department of Justice has issued revised guidelines on permissible horizontal mergers based on the so-called Herfindahl Index of market concentration.[32] Mergers that raise the Herfindahl by more than some stated numerical amount, or push the industry index beyond some stated number, will in all probability trigger legal action by the government in opposition to the merger. The guidelines have already been employed to restrain specific mergers in the beer industry and in the petroleum industry.

Aside from the accuracy of the Herfindahl Index, the fact remains that any measure of market concentration is irrelevant to the actual source of monopoly power in the economy: legal barriers to entry. Concern over specific levels of market concentration creates the misleading impression that private firms can control markets, restrict production, and injure consumers. But these impressions are erroneous and are based on theoretical notions that we have already examined -- and rejected.

There are additional problems with the merger guidelines. The first is that since there is no unambiguous way to define any relevant market in the first place (used goods? foreign imports? inter-product competition?), all concentration ratios and indexes are arbitrary and subject to much statistical manipulation. Secondly, the Justice Department limits on concentration are themselves totally arbitrary numbers with no theoretical or empirical significance whatever. Finally, to legally limit mergers in markets already concentrated can serve to protect the market positions of the established firms. Certainly Anheuser Busch and Miller Brewing -- the dominant beer companies -- can now breathe easier knowing that the government will prevent consolidations large enough to threaten their market position.[33] In this instance the merger guidelines serve not to protect consumers from monopoly but to protect some firms from the competition of other firms.

The recently concluded antitrust case against AT&T provides an excellent illustration of the continuing confusion over monopoly theory. AT&T held monopoly power in precisely those areas where entry and competition were restricted by state public utility authorities and the Federal Communications Commission. In addition, and ironically, a 1956 consent decree had legally frozen AT&T out of certain markets. Government regulation, not vertical integration, was the problem in the telecommunications industry, and deregulation, not divestiture, should have been the appropriate public policy remedy. Divestiture of the local telephone companies will leave the real source of monopoly power unaffected, and will create the mistaken impression that Bell's corporate size or the likelihood of cross-subsidization somehow restricted competition. Further, as has already been widely admitted, the breakup of AT&T will tend to increase the cost of local telephoning, and these increased costs will be passed along, under utility regulation, to residential users. Antitrust will have served, again, to obscure the issue of monopoly power in the economy.

Bad theory always results in inappropriate public policy. The most rational antitrust reform would be a thorough and complete business deregulation and the immediate repeal of the antitrust laws.

FOOTNOTES


[12] In the GTE Sylvania (1977) case, for example, the court was explicitly mindful of the views of the critics. See 433, U.S. 36. See also Edward Meadows, "Bold Departures in Antitrust," Fortune, October 15, 1981.

[13] The FTC complaint (Docket No. 8883) filed in 1972 against Kellogg, General Mills, General Foods, and Quaker Oats was dismissed without merit by the FTC in 1982.


