

## Cato Institute Policy Analysis No. 169: The Myth of Predatory Pricing

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### Executive Summary

The attempt to reduce or to eliminate predatory pricing is also likely to reduce or eliminate competitive pricing beneficial to consumers.

-- *Harold Demsetz*

Predatory pricing is one of the oldest big business conspiracy theories. It was popularized in the late 19th century by journalists such as Ida Tarbell, who in *History of the Standard Oil Company* excoriated John D. Rockefeller because Standard Oil's low prices had driven her brother's employer, the Pure Oil Company, from the petroleum-refining business.[1] "Cutting to Kill" was the title of the chapter in which Tarbell condemned Standard Oil's allegedly predatory price cutting.

The predatory pricing argument is very simple. The predatory firm first lowers its price until it is below the average cost of its competitors. The competitors must then lower their prices below average cost, thereby losing money on each unit sold. If they fail to cut their prices, they will lose virtually all of their market share; if they do cut their prices, they will eventually go bankrupt. After the competition has been forced out of the market, the predatory firm raises its price, compensating itself for the money it lost while it was engaged in predatory pricing, and earns monopoly profits forever after.

The theory of predatory pricing has always seemed to have a grain of truth to it--at least to noneconomists--but research over the past 35 years has shown that predatory pricing as a strategy for monopolizing an industry is irrational, that there has never been a single clear-cut example of a monopoly created by so-called predatory pricing, and that claims of predatory pricing are typically made by competitors who are either unwilling or unable to cut their own prices. Thus, legal restrictions on price cutting, in the name of combatting "predation," are inevitably protectionist and anti-consumer, as Harold Demsetz noted.[2]

Predatory pricing is the Rodney Dangerfield of economic theory--it gets virtually no respect from economists. But it is still a popular legal and political theory for several reasons. First, huge sums of money are involved in predatory pricing litigation, which guarantees that the antitrust bar will always be fond of the theory of predatory pricing. During the 1970s AT&T estimated that it spent over \$100 million a year defending itself against claims of predatory pricing. It has been estimated that the average cost to a major corporation of litigating a predation case is \$30 million.[3]

Second, because it seems plausible at first, the idea of predatory pricing lends itself to political demagoguery, especially when combined with xenophobia. The specter of a foreign conspiracy to take over American industries one

by one is extremely popular in folk myth. Protectionist members of Congress frequently invoke that myth in attempts to protect businesses in their districts from foreign competition.

Third, ideological anti-business pressure groups, such as Citizen Action, a self-styled consumer group, also employ the predatory pricing tale in their efforts to discredit capitalism and promote greater governmental control of industry. Citizen Action perennially attacks the oil industry for either raising or cutting prices. When oil and gas prices go up, Citizen Action holds a press conference to denounce alleged price gouging. When prices go down, it can be relied on to issue a "study" claiming that the price reductions are part of a grand conspiracy to rid the market of all competitors. And when prices remain constant, price-fixing conspiracies are frequently alleged.

Fourth, predatory pricing is a convenient weapon for businesses that do not want to match their competitors' price cutting. Filing an antitrust lawsuit is a common alternative to competing by cutting prices or improving product quality, or both.

Finally, some economists still embrace the theory of predatory pricing. But their support for the notion is based entirely on highly stylized "models," not on actual experience.

### **The Irrationality of Predatory Pricing**

The classic article on predatory pricing was written by economist John McGee in 1958.[4] McGee examined the famous 1911 Standard Oil antitrust decision that required John D. Rockefeller to divest his company. Although at that time popular folklore held that Rockefeller had "monopolized" the oil refinery business by predatory pricing, McGee showed that Standard Oil did not engage in predatory pricing; it would have been irrational to have done so.

Judging from the record, Standard Oil did not use predatory price discrimination to drive out competing refiners, nor did its pricing practice have that effect. Whereas there may be a very few cases in which retail kerosene peddlers or dealers went out of business after or during price cutting, there is no real proof that Standard's pricing policies were responsible. I am convinced that Standard did not systematically, if ever, use local price cutting in retailing, or anywhere else, to reduce competition. To do so would have been foolish; and, whatever else has been said about them, the old Standard organization was seldom criticized for making less money when it could readily have made more.[5]

McGee was the first economist to think through the logic of predatory pricing, laying aside the emotional rhetoric that had always surrounded it. He concluded that not only would it have been foolish for Standard Oil to have engaged in predatory pricing; it would also be irrational for any business to attempt to monopolize a market in that way.

In the first place, such practices are very costly for the large firm, which is always assumed to be the predator. If price is set below average cost, the largest firm will incur the largest losses by virtue of having the largest volume of sales. Losing a dollar on each of 1,000 widgets sold per month is more costly than losing a dollar on each of 100 widgets.

Second, there is great uncertainty about how long a price war would last. The prospect of incurring losses indefinitely in the hope of someday being able to charge monopolistic prices will give any business person pause. A price war is an extremely risky venture.

Standard Oil was not the only trust accused of predatory pricing; antitrust folklore has it that virtually all of the late-19th-century trusts were guilty of the practice. However, as I have shown elsewhere, the industries accused of becoming monopolies during the congressional debates on the 1890 Sherman Antitrust Act all dropped their prices more rapidly than the general price level fell during the 10 years before the Sherman Act.[6] It would certainly have been irrational for those businesses to have engaged in predatory pricing for an entire decade in the dim hope of someday being able to charge prices slightly above the competitive market rate.

Third, there is nothing stopping the competition (or "prey") from temporarily shutting down and waiting for the price to return to profitable levels. If that strategy is employed, price competition will render the predatory pricing strategy unprofitable--all loss and no compensatory benefit. Alternatively, even if the preyed-upon firms went bankrupt, other firms could purchase their facilities and compete with the alleged predator. Such competition is virtually guaranteed if the predator is charging monopolistic prices and earning above-normal profits.

Fourth, there is the danger that the price war will spread to surrounding markets and cause the alleged predator to incur losses in those markets as well

Fifth, the theory of predatory pricing assumes the prior existence of a "war chest of monopoly profits" that the predator can use to subsidize its practice of pricing below average cost. But how does that war chest come into being if the firm has not yet become a monopoly? That part of the theory is simply a non sequitur.

Finally, the opportunity cost of the funds allegedly used to try to bankrupt rivals must be taken into account. For predatory pricing to seem rational, the rate of return on predation must be higher than the market rate of interest; in fact, it must be higher than the expected rate of return on any other investment the predator might make, including "investment" in lobbying for protectionism, monopoly franchises, and the like. Predation is unlikely, given the great uncertainties about whether it would have any positive return at all.

### **Predatory Counterstrategies**

The theory of predatory pricing has always assumed that a dominant firm is able to manipulate its smaller rivals. But the potential use of predatory counterstrategies by the smaller rivals makes the likelihood of successful predatory pricing extremely remote. Frank Easterbrook has produced a taxonomy of predatory counterstrategies that has led him to conclude that "the antitrust offense of predation should be forgotten." [7]

The predator can recoup its losses only if consumers cooperate. That is, the strategy will fail if consumers are able to stock up during the low-price predation period. If they do so, there can never be a post-predation recoupment period for the predator. And if the predator responds by limiting quantity, its rivals can step in and make up the difference by supplying additional quantities at a higher price. "A predator that puts a cap on sales thus [preys] against itself." [8]

Admittedly, consumer stockpiling is not always possible, and there is another problem related to the predator's ability to recoup his losses: the "victims" have strong incentives to ride out the price war, as discussed above, because of the lure of monopoly profits when the war is over. The capital markets, moreover, should be willing to finance the victims because they, after all, are not incurring as large a loss as is the predator. There is a risk, of course, in providing capital to the victims, but that risk can be attenuated by charging an appropriate interest rate. As George Stigler once described it, the victim of alleged predation, such as that supposedly engineered by Standard Oil, could go to a lender and say:

There is a threat of a three-month price war, during which I will lose \$10,000, which unfortunately I do not possess. If you lend me \$10,000, I can survive the price war--and once I show your certified check to Rockefeller the price war will probably never be embarked upon. Even if the price war should occur, we will earn more by cooperation afterward than the \$10,000 loss, or Rockefeller would never embark upon the strategy. [9]

Thus, lenders may have a financial incentive to aid the prey. There is also the possibility that larger firms, which have their own "deep pockets," will acquire the victims if it seems profitable to do so. [10]

Even if the victim goes bankrupt, the predator is by no means guaranteed a monopoly. The bankrupt firm's resources do not simply disappear; they may be acquired by another firm (possibly at fire-sale prices). Because the acquiring firm has lower fixed costs than the predator, it may be able to underprice the predator.

The victim could also approach its customers and arrange for long-term contracts at a price above the predatory price. The customers would be willing to enter into such contracts if they realized that the current low price was to be followed by a monopolistic price.

Finally, it should be kept in mind that the anticipated monopoly profits of the predator must be discounted to their present value. The predator firm may realize that possible monopoly profits in the future are not worth lost profits

today.[11] If that is the case, predatory pricing clearly does not pay.

## **Predation or Competition?**

The theory of predatory pricing fails to recognize that price cutting--even below average cost--is a normal activity in competitive markets. That is because the theory is derived from the so-called perfect competition model of economic theory. In an ideal, or "perfectly competitive," market, every firm charges an identical price, and in equilibrium that price is equal to average total cost. Deviations from that benchmark are viewed as market "imperfections."

The perfect competition theory has its uses, but a more realistic way of thinking about competition--especially for public policy purposes--is that of the Austrian economists who view competition as dynamic rivalry. As Nobel laureate Friedrich Hayek has stated, "Competition is by its nature a dynamic process whose essential characteristics are assumed away by the assumptions underlying static analysis" (i.e., perfect competition theory).[12] Competition "is the action of endeavoring to gain what another endeavors to gain at the same time." [13] Thus, price cutting, product differentiation, and advertising are all important elements of a competitive market according to the Austrian view, but those elements "are all excluded by definition" from perfect competition theory. Perfect competition means the absence of all competitive activities." [14]

Once one thinks of competition as rivalry, the notion of predatory pricing seems bizarre. Cutting prices below cost is an important way for newer businesses to break into a market or for older, more established businesses to grab a larger market share. The former case is exemplified by the local pizza parlor that tries to lure customers away from older, more established businesses with a "two-for-one" special. It may lose money in the short run, but such temporary losses should be viewed as an investment in future business. The pizza parlor is using lower prices today to increase its clientele tomorrow. (USA Today lost money for years before it got off the ground.) The latter case--an established business that becomes more entrepreneurial and makes a grab for larger a market share--is exemplified by Henry Ford.

When Ford declared in 1908, "I will build a motor car for the great multitude" and produced the Model T, he at first lost money and market share to Buick, Oldsmobile, and other competitors.[15] The year 1910 was a good one for the automobile industry, and Ford's advisers told him to follow Buick and Oldsmobile by raising the price of the Model T significantly. Rather than take their advice, however, Ford dropped his price by 20 percent to \$780, which was below his average total cost. He gambled that the lower price would greatly expand his sales volume and reduce his per unit costs, thereby enabling him to make a profit. The gamble paid off. As George Gilder explained:

Ford set his price not on the basis of his existing costs or sales but on the basis of the much lower costs and much expanded sales that might become possible at the lower price. The effect in the case of Henry Ford in 1910 was a 60 percent surge in sales that swept the Model T far ahead of Buick. . . . In the recession year of 1914, he cut prices twice, and sales surged up while other companies failed. By 1916, he had reduced the price of a Model T to \$360 and increased his market share from 10 percent to 40 percent. . . . After cutting prices 30 percent during the 1920 economic crisis, Ford commanded a 60 percent share of [the] market.[16]

Ford became the dominant firm in the automobile industry by offering a high-quality product at the lowest price available. Ford may have "harmed" his competitors by "preying" on them, but it was all to the benefit of consumers.

If Tarbell and other muckraking journalists had waged the kind of propaganda campaign against Henry Ford that they did against John D. Rockefeller, the Model T might never have been produced. Ford did not always receive favorable publicity, but neither was he sued for predatory pricing and forced to divest his company.

It is not an exaggeration to say that all of Henry Ford's success may have been linked to his below-cost pricing strategy. In his own words:

Our policy is to reduce the price, extend the operations, and improve the article. You will note that the reduction of price comes first. We have never considered any costs as fixed. There- fore we first reduce the price to the point where we believe more sales will result. Then we go ahead and try to make the prices. We do not both- er about the costs. The new price forces the costs down.[17]

Ford went on to note that "the more usual way is to take the costs and then determine the price," but he believed his way was better.[18] "No one knows what a cost ought to be," he said, but "one of the ways of discovering [it] . . . is to name a price so low as to force everybody in the place to the highest point of efficiency. The low price makes everybody dig for profits. We make more discoveries concerning manufacturing and selling under this forced method than by any method of leisurely investigation." [19]

As Hayek has said, competition is a "discovery procedure," and below-cost pricing has long been an important element of that procedure and of the benefits it produces for consumers.[20] Competition provides numerous reasons for price cutting. Sellers may be meeting their competitors' price cuts. They may be discounting their prices as a way of introducing their new and unknown products to consumers. The goods may be perishable or obsolescent and must therefore be sold at any price to avoid losses. The seller may have built a large-capacity plant that is more efficient because of higher volume; he charges low prices to stimulate demand, as did Henry Ford. Or there may be excess capacity in the market that prompts the seller to charge a price that minimizes losses until demand increases again.

Businesses that accuse their rivals of predation are simply unwilling or unable to produce efficiently enough to meet their rivals' lower prices.

### **The Futile Search for a Predatory Pricer**

Even though predatory pricing was part of the theoretical underpinning of the original federal antitrust laws, and there have been hundreds of federal antitrust cases based on claims of predatory pricing, economists and legal scholars have to this day failed to provide an unambiguous example of a single monopoly created by predatory pricing. (In contrast, no such ambiguity exists in the case of government-sanctioned monopolies created by protectionism, exclusive franchising, grandfather clauses, occupational licensing, and other government-imposed barriers to competition.)

The theory of predatory pricing is no longer widely accepted by economists, but it was the conventional wisdom before McGee's 1958 article. The economics profession--and antitrust practitioners--accepted the notion as a matter of faith even though no one (before McGee) had conducted a systematic economic analysis of predatory pricing.

By 1970 more than 120 federal (and thousands of private) antitrust cases in which predatory pricing was alleged had been brought under the 1890 Sherman Act. Yet in a 1970 study of the so-called gunpowder trust--43 corporations in the explosives industry--Kenneth Elzinga stated, after an extensive literature search, that "to my knowledge no one has ever examined in detail, as McGee did, other alleged incidents of predatory pricing." [21] Elzinga found no evidence that the gunpowder trust--which had been accused of predatory pricing--actually practiced it.

Shortly after Elzinga's work appeared, Ronald H. Koller examined the "123 federal antitrust cases since the passage of the Sherman Act in 1890 in which it was alleged that behavior generally resembling predation had played a significant role." [22] Ninety-five of those cases resulted in convictions, even though in only 26 of the cases was there a trial that "produced a factual record adequate for the kind of analysis employed" by Koller. [23] Apparently, many of the defendants decided it was cheaper to plead guilty than to defend themselves.

Even though no systematic analysis of predatory pricing was performed in any of the 123 cases, Koller established the following criteria for independently determining whether a monopoly was established by predatory pricing: Did the accused predator reduce its price to less than its short-run average total cost? If so, did it appear to have done so with a predatory intent? Did the reduction in price succeed in eliminating a competitor, precipitating a merger, or improving "market discipline"?

Koller's criteria give predatory pricing theory more credit than it deserves. As was explained earlier, below-cost pricing per se is not necessarily a sign of predatory behavior; it is a normal feature of competitive markets. Moreover, determining predatory intent is an exercise that is far beyond the capabilities of any economist and for which mystics might be better suited. And "eliminating a competitor" is the very purpose of all competition.

Employing those criteria for determining predatory behavior, Koller found that below-cost pricing "seems to have been at least attempted" in only seven cases. [24] That, of course, proves nothing about monopolizing behavior, given the

fact that below-cost pricing can be just as easily construed as competitive behavior. Koller claims that in four of the cases low prices seemed to have been motivated by the desire to eliminate a rival. One would hope so! The entire purpose of competitive behavior--whether cutting prices or improving product quality--is to eliminate one's rivals.

Even in the cases where a competitor seemed to have been eliminated by low prices, "in no case were all of the competitors eliminated." [25] Thus, there was no monopoly, just lower prices. Three cases seem to have facilitated a merger, but mergers are typically an efficient alternative to bankruptcy, not a route to monopoly. In those cases, as in the others, the mergers did not result in anything remotely resembling a monopolistic industry, as defined by Koller (i.e., one with a single producer).

In sum, despite over 100 federal antitrust cases based on predatory pricing, Koller found absolutely no evidence of any monopoly having been established by predatory pricing between 1890 and 1970. Yet at the time Koller's study was published (1971), predatory pricing had long been part of the conventional wisdom. The work of McGee, Elzinga, and other analysts had not yet gained wide recognition.

The search for the elusive predatory pricer has not been any more successful in the two decades since Koller's study appeared. The complete lack of evidence of predatory pricing, moreover, has not gone unnoticed by the U.S. Supreme Court. In *Matsushita Electric Industrial Co. v. Zenith Radio* (1986), the Court demonstrated knowledge of the above-mentioned research in declaring, effectively, that predatory pricing was about as common as unicorn sightings.

Zenith had accused Matsushita and several other Japanese microelectronics companies of engaging in predatory pricing--of using profits from the Japanese market to subsidize below-cost pricing of color television sets in the United States. The Supreme Court ruled against Zenith, recognizing in its majority opinion that

a predatory pricing conspiracy is by nature speculative. Any agreement to price below the competitive level requires the conspirators to forgo profits that free competition would offer them. The forgone profits may be considered an investment in the future. For the investment to be rational, the conspirators must have a reasonable expectation of recovering, in the form of later monopoly profits, more than the losses suffered. [26]

The Court also noted that "the success of such schemes is inherently uncertain: the short-run loss is definite, but the long-run gain depends on successfully neutralizing the competition." [27] The Court continues, "There is a consensus among commentators that predatory pricing schemes are rarely tried, and even more rarely successful." [28]

In that case, Zenith and RCA were obviously attempting to use the antitrust laws, via their accusation of predatory pricing, to eliminate some of their foreign competition. The Court determined, for example, that "two decades after their conspiracy is alleged to have commenced, petitioners appear to be far from achieving their goal: the two largest shares of the retail market in television sets are held by RCA and . . . Zenith, not by any of the petitioners." [29] Moreover, the share of the market held by Zenith and RCA "did not decline . . . during the 1970s," which provides further evidence that "the conspiracy does not in fact exist." [30]

The Court concluded by warning potential litigants of the folly of bringing predatory pricing cases.

Cutting prices in order to increase business often is the very essence of competition. Thus, mistaken inferences in cases such as this one are especially costly, because they chill the very conduct the antitrust laws are designed to protect. [31]

Since predatory pricing schemes "require conspirators to suffer losses in order eventually to realize . . . gains," the Court concluded that "economic realities tend to make predatory pricing conspiracies self-detering." [32]

What predatory pricing comes down to is a theory and a legal doctrine that are still used by inefficient firms to try to get the coercive powers of government to attain for them what they cannot attain in the marketplace. As former Federal Trade Commission chairman James Miller has written, government has all too often used predatory pricing as a vehicle for instructing businesses to "stop competing, leave your competitors alone, raise your prices." [33]

## **"Dumping" on Competition**

Even though predatory pricing is vacuous in both theory and reality, and has been viewed as such by the Supreme Court, the doctrine lives on. Special-interest groups that wish to undermine competition have no incentives to pay attention to the theory and reality of predatory pricing. In fact, as economist Gordon Tullock has written:

Special interest groups normally have an interest in diminishing the information of the average voter. If they can sell him some false tale which supports their particular effort to rob the treasury, it pays. They have resources and normally make efforts to produce this kind of misinformation.[34]

Thus, the myth of predatory pricing will continue to be perpetrated in the courts and in the legislature. So-called anti-dumping laws are an example. In the context of international trade, "dumping" occurs when a foreign manufacturer sells a product in the United States at a lower price than is charged in the home market. Such price differentials can be easily explained by competition: New entrants in a foreign market must offer low prices to induce consumers to try their products. Fierce competition in the domestic market is also a reason for price differentials.

Anti-dumping laws ignore the competitive aspects of price cutting and invoke predatory pricing as a rationale for protectionism. For example, in November 1987 the U.S. Department of Commerce ruled that "Japanese companies violated international trade laws by failing to increase their prices to match the sharp rise in the value of the yen." [35] With the rise in the value of the yen, Japanese goods sold in the United States became relatively more expensive. The Japanese producers responded by cutting their costs, prices, and profit margins to remain competitive, to the great satisfaction of American consumers. According to the Commerce Department, Japanese export prices declined by 23 percent between 1985 and 1987.[36] Despite significant benefits to American consumers, the Reagan administration's Commerce Department attempted to "force" Japanese companies to raise their prices.

Such a policy is absurd not only because it obviously harms American consumers but also because, under it, the American government effectively enforces a cartel pricing arrangement that benefits foreign manufacturers. The Japanese companies may have wanted to raise their prices and earn monopolistic profits, but competition prohibited it. Being prosecuted under the anti-dumping laws achieved for them what they were not able to achieve for themselves in the marketplace.

The same anti-consumer policies prevail today. In June 1991 the Bush Commerce Department launched an investigation of alleged dumping of Japanese minivans in the American market. If successful, the investigation could lead to "forcing up prices of Japanese . . . cars." [37] The Big Three domestic automakers were advocating Japanese price increases, which they hoped would "blunt the Japanese advance" in the minivan market.[38] The Big Three at that time controlled 88 percent of the minivan market, but they complained that their sales were "weakened by the unfair pricing." [39] They accused Japanese automakers of charging prices in the United States that were 30 percent lower than those charged in their home country. There could not be a more specious argument for using the coercive powers of government to thwart competition and to harm consumers.

On December 20, 1991, the Bush Commerce Department ruled in favor of the Big Three. It charged Mazda with the "crime" of selling minivans in the United States for 7.19 percent less than in Japan; Toyota was "guilty" of selling its minivans in America at 0.95 percent less than in Japan.[40] Because of that ruling, which is being appealed, the U.S. government will impose tariffs on Japanese products, which will enable the domestic automakers to charge even higher prices. Consumers will unequivocally be harmed.

Unfortunately, such anti-consumer policies, all adopted to punish "predatory pricing," are becoming increasingly prevalent. The United States Business and Industrial Council, a collection of protectionist businesses, is organized to "demand a tougher trade stance with Japan by raising tariffs on Japanese cars and electronic products." [41] A similar sentiment was voiced by Patrick J. Buchanan in December 1991 when he announced his candidacy for the Republican party's presidential nomination. In his announcement Buchanan spoke of "predatory traders of Europe and Asia who have targeted this or that American industry for dumping and destruction" and promised that, if he is elected, "they will find themselves on a collision course with the President of the United States." [42]

Regardless of Buchanan's personal political fate, special-interest groups seem to be increasingly dependent on the discredited predatory pricing argument for advancing the cause of protectionism. The national Democratic party is also

stepping up its Japan-bashing efforts by proposing ever more restrictive trade legislation.

The myth of predatory pricing also threatens consumer welfare via the domestic policy route. One recent example is the latest of a long line of attacks on the oil industry by the self-described "consumer" group, Citizen Action. In a September 1991 report that warns ominously that "Big Oil" has allegedly "taken control of America's gasoline markets," Citizen Action singles out the Arco Oil Company for some unexpected praise. Arco, the report claims, is now "the dominant force in the refining and marketing of petroleum on the U.S. West Coast" because of "a combination of unexpected risk-taking, shrewd corporate planning and investment, [and] aggressive leadership." [43] The company "eliminated its credit cards, expanded its gasoline sales per station, created a chain of convenience stores on many of its gasoline station sites in order to maximize profits. . . . All of these actions made good economic sense. They reduced costs, increased efficiency and maximized profits." [44]

But Citizen Action's "praise" is not genuine. Rather than applauding its efficiencies, Citizen Action ascribes diabolical motivations to Arco, alleging "a ruthless determination to weaken, intimidate and eventually eliminate the independent refiners, wholesalers and marketers" with its low-cost, low-price strategy. [45] Arco is guilty of using its organizational efficiencies to "sharply lower the wholesale and retail price of gasoline," thereby "squeezing both independent refiners and marketers." [46]

The end result of the alleged monopolization of the West Coast market was that, according to Citizen Action's own data, "by 1990, Arco [was] number 1 with 19 percent of the market." [47] In other words, Arco was (and is) nothing close to a monopolist. Its efficiencies allowed it to become more competitive and improve its market position over the positions of Shell, Chevron, Unocal, and myriad other competitors, but it still has less than one-fifth of the market.

There are no entry barriers in the gasoline market; competition remains vigorous; and real gasoline prices have been falling. Citizen Action's claim that Arco has gained a monopoly through predatory pricing is simply preposterous. By Citizen Action's own admission, Arco's increased market share is due to its enhanced efficiency and lower prices. Nevertheless, Citizen Action tries to convince the readers of its report that black is white and white is black with the following horror stories.

Arco stations in two California towns north of San Bernardino are selling gas 20 [cents] below the market.

Motorists are queuing up at four recently-opened Arco stations in Victorville and Hesperia, Calif.

Arco's remodeled am/pms post street prices of 58.9 [cents] for regular leaded; 68.9 [cents] for regular unleaded; 78.9 [cents] for premium unleaded.

Closest competition from a major: Shell whose regular leaded sells for 79.9 [cents] for premium unleaded--21 [cents]/gallon above Arco's. [48]

Worse yet, says Citizen Action, Arco's super-efficient, low-price strategies are being "quickly emulated by the other major companies." [49] One could only hope that all industries would emulate such strategies!

The Citizen Action report also warns that similar price-cutting strategies are being employed in Nevada and urges congressional action to put an end to them, all in the name of consumer protection! Oddly, there is very little mention of the impact on consumers of Arco's price cutting; the primary concern is "market share." The report reveals virtually no understanding on the part of its authors of the economic literature that shows that industrial concentration per se is by no means anti-competitive. [50] Becoming a "dominant" firm or rendering an industry more "concentrated" by cutting prices and improving product or service quality is desirable and should be encouraged. Citizen Action seems more concerned with ideological assaults on "big" business than with consumer protection, its ostensible purpose.

The logic and evidence of the Citizen Action report are laughable. But such "logic" has also been used by members of Congress who wish to protect businesses in their districts from competition. The proposed Petroleum Marketing Competition Enhancement Act (H.R. 2966), for example, claims to be designed to "prevent unfair competition," but eliminating the word "unfair" would probably reveal the true intent of the act.



Gasoline marketers who do not wish to compete in a free market and who want government to intervene to protect their profit margins are lobbying for that act. Ostensibly a response to alleged predatory pricing by the major oil companies, the act would make it "unlawful for a refiner to sell motor fuel, to any customer for resale, at a price which is higher than the refiner's adjusted retail price for the same or similar grade or quality of motor fuel from a direct operated outlet in the same geographic area." It would also make it "unlawful for a refiner to enter into any scheme or agreement to set, change, or maintain maximum retail prices of motor fuel provided, that this . . . shall not apply to a refiner's retail sales at its direct operated outlets."

By making it unlawful for a refiner to write a contract to maintain maximum retail prices, that provision would tend to increase prices. The objective of the bill is to "guarantee" the profit margins of gasoline middlemen by trying to isolate them from the forces of supply and demand, a futile objective if ever there was one. The effect of the law would be higher prices for consumers and a system of price controls. Any law that guarantees profit margins would have to do so by setting prices by governmental rules and regulations rather than by market forces. Price controls were, of course, a disaster when last implemented in the 1970s.

The purpose of this discussion is not necessarily to evaluate in detail the probable effects of the misnamed "Petroleum Marketing Competition Enhancement Act" but to make the point that the whole idea that gasoline middlemen need and deserve governmental protection from competition is rooted in the idea of predatory pricing. Similarly mischievous policies are found in many other industries.

## **Conclusion**

The government's alleged right to tell citizens how they may use their legally and peacefully acquired property, and at what prices they may sell it, should be questioned. The question is, What right does government have to interfere with a business person who is peacefully striving to earn a living by cutting, raising, or maintaining stable prices? Are private property and individual freedom of choice desirable social institutions, or aren't they? To advocate a law regulating or eliminating "predatory" price cutting is to answer that question in the negative: Any proposal to interfere with voluntary market pricing arrangements is simply a denial of the legitimacy of private property rights and individual freedom of choice. From a natural rights perspective, laws designed to regulate predatory pricing--or any other kind of pricing--are improper. As Armentano has eloquently stated:

This [natural rights] theory holds that individuals have inalienable rights to life, liberty, and property. These rights imply the liberty of any person or persons to enter into any noncoercive trading agreement on any terms mutually acceptable, to produce and trade any factor or good that they own, and to keep any property realized by such free exchange. This perspective would hold that it is right to own and use property; it is right to employ that property in any manner that does not infringe on anyone else's property rights; it is right to trade any or all of that property to anyone else on any terms mutually acceptable; and that it is right to keep and enjoy the fruits of that effort. . . . Consequently, it would be wrong . . . to outlaw or regulate certain types of business contracts, organizational structures, or business cooperation.[51]

That perspective has a long history. In one of the most famous passages of *Wealth of Nations*, Adam Smith warns of the pervasiveness of business conspiracies: "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices." [52] But in the very next sentence Smith added: "It is impossible indeed to prevent such meetings by any law which either could be executed, or would be consistent with liberty and justice." Smith clearly recognized the potential for business conspiracies; but whether they were likely or not, he believed that any government regulation of them was improper.

Harold Demsetz is right. The attempt to reduce or eliminate so-called predatory pricing will only eliminate competitive pricing, which is beneficial to consumers.[53] Predatory pricing is simply illogical, although there are some highly stylized economic models that claim that it is feasible under certain assumptions. Other research has shown, however, that predatory pricing cannot even be replicated under laboratory conditions by "experimental" economics.[54] In either case, an unambiguous example of a free-market monopoly that was established as a result of predatory pricing has yet to be found.

Unfortunately, the doctrine of predatory pricing still motivates antitrust suits and other protectionist pleadings.

Significantly, it is legislation and regulation enacted in the name of predatory pricing (not predatory pricing itself) that are truly monopolizing. Government--not the free market--is the source of monopoly.

## Notes

- [1] Ida Tarbell, *The History of the Standard Oil Company* (New York: Peter Smith, 1950). Tarbell's brother, William, was treasurer of Pure Oil Company.
- [2] Harold Demsetz, "Barriers to Entry," *American Economic Review* 72 (May 1982): 52-56.
- [3] Frank Easterbrook, "Predatory Strategies and Counterstrategies," *University of Chicago Law Review* 48 (1981): 334.
- [4] John McGee, "Predatory Price Cutting: The Standard Oil (N.J.) Case," *Journal of Law and Economics* 1 (April 1958): 13769.
- [5] *Ibid.*, p. 168.
- [6] Thomas J. DiLorenzo, "The Origins of Antitrust: An Interest Group Perspective," *International Review of Law and Economics* 5 (Fall 1985): 7390.
- [7] Easterbrook, p. 337.
- [8] *Ibid.*, p. 269.
- [9] George Stigler, "Imperfections in the Capital Market," *Journal of Political Economy* 75 (June 1967): 116.
- [10] Easterbrook, p. 269.
- [11] *Ibid.*
- [12] Friedrich Hayek, "The Meaning of Competition," in his *Individualism and Economic Order* (Chicago: University of Chicago Press, 1974), p. 94.
- [13] *Ibid.*, p. 96.
- [14] *Ibid.*
- [15] Quoted in George Gilder, *The Spirit of Enterprise* (New York: Simon and Schuster, 1984), p. 155.
- [16] *Ibid.*, p. 157.
- [17] *Ibid.*, p. 159.
- [18] *Ibid.*
- [19] *Ibid.*
- [20] Friedrich Hayek, "Competition as a Discovery Procedure," in his *New Studies in Philosophy, Politics, Economics and the History of Ideas* (Chicago: University of Chicago Press, 1978), pp. 17990.
- [21] Kenneth G. Elzinga, "Predatory Pricing: The Case of the Gunpowder Trust," *Journal of Law and Economics* 13 (April 1970): 223.
- [22] Ronald H. Koller, "The Myth of Predatory Pricing: An Empirical Study," *Antitrust Law and Economics Review* 4 (Summer 1971): 110.

[23] Ibid.

[24] Ibid., p. 112.

[25] Ibid., p. 113.

[26] Matsushita Electric Industrial Co. v. Zenith Radio 475 U.S. 590, Supreme Court Reporter, 1986, p. 1357.

[27] Ibid.

[28] Ibid.

[29] Ibid., p. 1358.

[30] Ibid., p. 1359.

[31] Ibid., p. 1360.

[32] Ibid.

[33] James C. Miller and Paul Pautler, "Predation: The Changing View in Economics and the Law," Journal of Law and Economics 28 (May 1985): 502.

[34] Gordon Tullock, Welfare for the WelltoDo (Dallas: Fisher Institute, 1983), p. 71.

[35] Stuart Auerbach, "Japanese Companies Violated Trade Laws," Washington Post, November 20, 1987, p. D1.

[36] Ibid.

[37] Eduardo Lachica and Joseph B. White, "Washington Is Expected to Investigate Alleged Dumping of Japanese Minivans," Wall Street Journal, June 20, 1991, p. B3.

[38] Ibid.

[39] Frederick Standish, "Big Three Charge Japanese with 'Dumping' Minivans," Washington Times, June 7, 1991, p. G4.

[40] "Japanese Dumping Minivans," Chattanooga Times, December 21, 1991, p. B8.

[41] Stuart Auerbach, "Conservative Group Attacks Free Trade," Washington Post, November 26, 1991, p. C1.

[42] Hobart Rowen, "Forward into the Past," Washington Post National Weekly Edition, December 30/January 5, 1992, p. 5.

[43] Citizen Action, "Destroying Competition and Raising Prices: How Big Oil Has Taken Control of America's Gasoline Markets," Washington, September 1991, p. 58.

[44] Ibid., p. 59.

[45] Ibid.

[46] Ibid.

[47] Ibid., p. 60.

[48] Ibid., p. 61.

[49] Ibid., p. 60.

[50] Works they ignore include Yale Brozen, *Concentration, Mergers and Public Policy* (New York: MacMillan, 1983); John McGee, *In Defense of Industrial Concentration* (New York: Praeger, 1971); Harvey Goldschmidt, Patrick Mann, and Fred Weston, *Industrial Concentration: The New Learning* (Boston: Little, Brown, 1974).

[51] Dominick Armentano, *Antitrust and Monopoly* (New York: Wiley, 1982), p. 8. See also Roger Pilon, "Corporations and Rights: On Treating Corporate People Justly," *Georgia Law Review* 13, no. 4 (Summer 1979): 1245-1370.

[52] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Indianapolis: Liberty Fund, 1981), p. 145.

[53] Demsetz, pp. 4757.

[54] R. Mark Isaac and Vernon L. Smith, "In Search of Predatory Pricing," *Journal of Political Economy*, April 1985, pp. 32045.