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ANTITRUST POLICY IN A FREE SOCIETY

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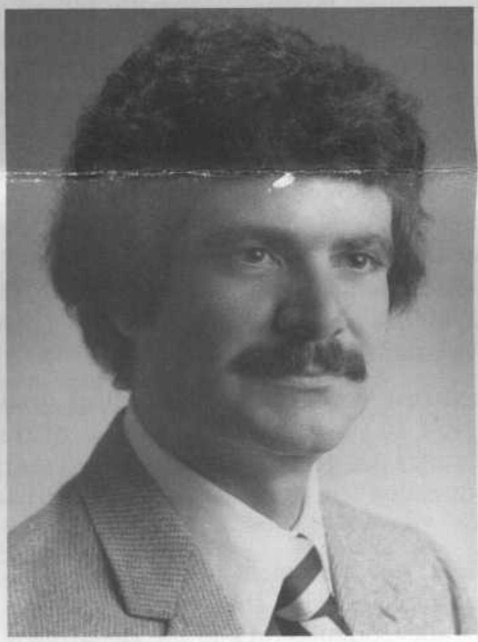

Editor's Preview: The original antitrust legislation, as a child of Progressive era, was prompted by a genuine reformist impulse. In the early 20th century, business consolidation reached a peak, making it the main target of criticism from Progressives who feared the potential for the immoral and irresponsible exercise of power in the industrial age. They did not, however, believe that trusts were inherently evil. Rather, they genuinely desired, like prominent jurist Louis Brandeis, to restore a greater degree of competition in the marketplace, or, like Presidents Theodore Roosevelt and William Howard Taft, to regulate large corporations and to ensure the stability of the economy.

In this essay, Professor Dominick T. Armentano observes that the Progressives' intentions have been left far behind in the trail of antitrust prosecution, and cites landmark decisions from the *Standard Oil* case of 1911 to the *Alcoa* case of 1945 to demonstrate that corporate efficiency and success, not collusive business practices, are equated with "restraint of trade" in the courts.

Furthermore, Professor Armentano asserts that, whether it has been misinterpreted or not, antitrust policy is itself the culprit which creates "restraint of trade" by favoring some businesses and attacking others. He says of the past history of such policy that while antitrust advocates were "blasting away at efficient firms in openly competitive markets, the 'real' monopolists were quietly restraining trade under the full sanction and protection of governmental power."

Armentano notes encouragingly that during the past decade antitrust policy has finally been brought into question. Whereas it was once practically immune from serious criticism and assumed to be based on solid theoretical foundations, it is now under rigorous and well-deserved scrutiny academically, politically, and legally.

Professor Armentano calls for an entirely new policy which would eliminate government protectionism and industrial planning. Noting that antitrust law prohibits the right of "voluntary association," he rejects it as a solution to the problems which faced the Progressive era and which continue to challenge us now. Instead, Armentano would rely on the logical and orderly power of genuine competition combined with the informative and self-regulating function of prices to inform and benefit both producers and consumers.

The primary concern of political economy is the appropriate role of government in social affairs. The debate, in brief, is whether the economy should be left free to establish a "spontaneous order," or whether government regulation is necessary to maintain efficiency and economic welfare.

Some liberals, most conservatives, and all libertarians would argue that government regulation of industry generally tends to reduce efficiency and economic growth and should be avoided. Since the late 1950s, and at an accelerated pace since the 1970s, free market economists

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and others have repeatedly argued that many governmental policies are unworkable, and that these policies often tend to achieve results that are the opposite of those intended. Indeed, theoretical and empirical criticisms of government regulation in industries such as transportation, telecommunications, and banking have been the primary rationale to deregulate these markets, and to allow free competition to determine the allocation of scarce resources.

Antitrust Deregulation

Antitrust policy has now joined the growing list of government "regulations" subject to theoretical and empirical revisionism. It wasn't always so. Indeed, for most of the 20th century, antitrust policy was relatively immune from serious criticism. Its intentions and (apparent) results enjoyed wide academic and political support. It was generally assumed that the antitrust laws were based on solid theoretical foundations, and that vigorous enforcement was necessary to preserve business competition. What muted criticism there was of antitrust policy concerned the blatantly anti-consumer Robinson-Patman Act (1936). But aside from Robinson-Patman, the rest of the antitrust laws were seen by most as necessary to "preserve competition."

The antitrust world has changed rather dramatically over the last 10 years. The enforcement of traditional antitrust policy has generally been curtailed sharply, and a "new direction" in antitrust enforcement has clearly emerged.

We might take a moment to contrast traditional enforcement policies with the current practices of the Federal Trade Commission and the Department of Justice. Traditional antitrust concern over the growth of "big" companies has been sharply reduced. Business arrangements whose sole probable effect is to expand market output and reduce market price can safely be excluded from antitrust prohibition. Conglomerate and vertical mergers (rarely a threat to any restriction of market output), and even many horizontal mergers (within certain reworked merger guidelines) can be permitted. Price discrimination and many vertical business agreements are now generally seen as part of the competitive market process and not as elements of monopoly power. Finally, and most importantly, antitrust enforcement efforts have been initiated recently against certain state and local regulations and ordinances that *legally* restrict entry and competition.

Why has antitrust policy changed? Is the new direction correct? Do we still require antitrust prohibition of certain "horizontal" agreements? Are antitrust supervision of trade association activity and rate bureaus necessary? Is there a rationale for *any* antitrust policy in a free society?

Monopoly Theory and Antitrust Policy

The most important reason for the collapse of traditional antitrust policy is the absence of any intelligent theory that would explain how private monopoly power could exist and be harmful to consumer welfare. Assume, for instance, that we have some industrial market with no legal barriers to entry. Business organizations will enter that market and prosper if they can allocate resources in generally efficient ways to consumers. The firms that grow and accumulate market share will have *earned* their market positions through exceptional performance, and holding or advancing their position will depend upon a continuously exceptional performance.

On the other hand, firms that misallocate resources (from a consumer perspective) would likely lose market position relative to more efficient business organizations. Organizations, for example, with relatively higher costs, restricted outputs, higher prices, poor quality products, repressed innovation and generally restrictive practices would likely lose profit and market share to rivals.

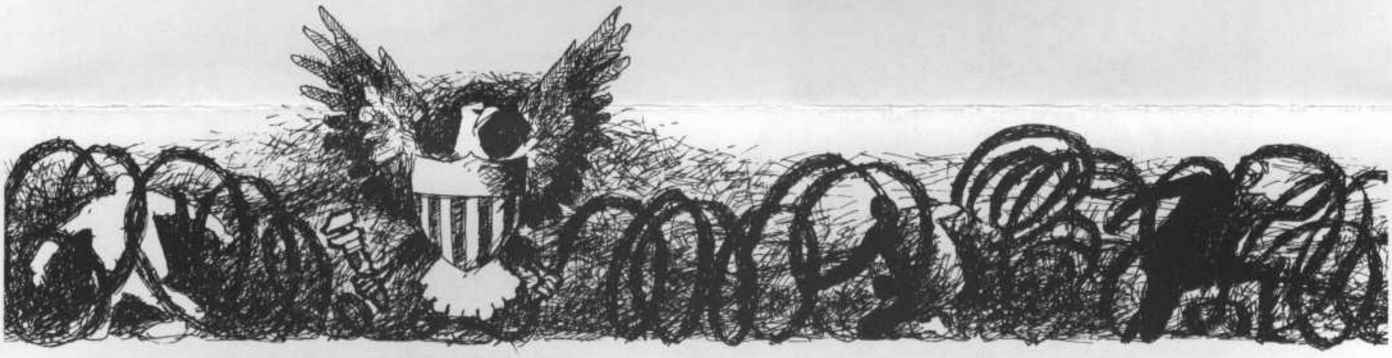
What useful role could antitrust policy play in this open market process? To employ antitrust against the successful firms would be anti-consumer and destructive to industrial efficiency. Yet to employ antitrust against firms that perform poorly would be unnecessary since strong economic incentives exist for such firms to change their behavior or, given failure, for the market process to reallocate resources away from such organizations. Any government action would be either premature or redundant. Thus in the absence of any intelligent theory of how resources could continue to be misallocated in open markets, the theoretical justification for traditional anti-monopoly enforcement tends to evaporate.

In a last-ditch effort to save traditional enforcement, it was argued that certain non-legal "barriers to entry" protected large firms from competition. On analysis, however, the "barriers to entry" doctrine self-destructed. Most of the so-called "barriers" turned out to be *economies and efficiencies* that leading business organizations had *earned* in the marketplace. For example, certain large firms enjoyed economies of scale that often permitted low-cost production and sale. Certain firms enjoyed an excellent reputation for high quality products and service. Certain firms successfully differentiated their product, successfully advertised their product, and successfully engaged in uncertain research and development to keep a flow of products available to accommodate the ever-changing tastes of consumers.

From a *competitor's* perspective, all of these achievements represented economic "barriers" that served to "limit" competition. It should be obvious, however, that from the relevant *consumer* perspective, these so-called barriers represented economic values that consumers willingly supported and sustained. Attack these values with antitrust policy and you attack the very economic virtues that the competitive process serves to discover and perpetuate. The non-legal barriers-to-entry discussion represented the final bankruptcy of conventional anti-monopoly theory.

Antitrust History and Policy

The second major reason for the collapse of conventional traditional enforcement was the accumulation of empirical evidence that antitrust policy had been employed to attack industrial efficiency and to protect firms unable to compete. This evidence clearly shows that antitrust was "regulation" in the same sense that tariff policy was regulation: it misallocated resources, protected competitors, and injured consumers. And, ironically, most of the empirical evidence to support this contention was itself buried in the classic antitrust cases. The cases, far from demonstrating the legitimacy of antitrust policy, tended to support the notion that antitrust was a long-running policy failure.



It is not possible to recount all of the economic and civil liberty injustices associated with antitrust enforcement, both public and private. Many hours of lecture (and many volumes of cases and analysis) would be required to bring out the full impact of the irrationalities buried deep in antitrust history. What follows is only a brief sketch of several important antitrust cases in business history. If you are offended by the attack on efficiency that these cases represent—and you should be—just remember that there are *hundreds* of other cases of similar tragedies. *Antitrust in practice has been no "paradox," but a rather consistent policy of attack on entrepreneurial success and business plan coordination.*

Standard Oil (1911)

The most celebrated example of monopoly and antitrust enforcement is probably the *Standard Oil* case of 1911. How, people ask, could we have done without antitrust policy in the 19th century petroleum industry? Did not the Rockefeller company (Standard Oil of New Jersey) drive its competitors from the market through ruthless predatory practices, buy up its competitors, and then raise the price of kerosene to consumers? Didn't the government and the courts divest Standard Oil at the height of its monopolistic control, and restore "competition" to the petroleum industry?

The answer is that most of the legend surrounding the activities of the Standard Oil company is highly inaccurate. Standard lost the antitrust decision in 1911 because a lower court in 1909 determined that the formation of its holding company in 1899 (in New Jersey) was *prima facie* illegal since it ended the potentiality of rivalry between the now-merged firms. The Supreme Court, while announcing a "rule of reason" approach in 1911, simply reaffirmed the unanalytical decision of the lower court. The economic *facts* in the case played no role whatsoever in this classic antitrust decision.

An objective study of the petroleum industry between 1859 and 1911 reveals that Standard Oil did *not* plunder consumers or its competitors. The price of kerosene, the industry's major product, dropped over 50 cents per gallon in the early 1860s to less than six cents per gallon in the late 1890s. While Standard always held a large share of the industry's business, business rivals always existed. When they were dissolved in 1911 for monopolizing in restraint of trade, there were at least 147 independent petroleum refineries selling products in competition with Standard Oil.

American Tobacco (1911)

The American Tobacco Company was ordered dissolved by the U.S. Supreme Court in 1911. Legend says that American Tobacco ruthlessly raised cigarette prices, drove down the price of leaf tobacco, engaged in predatory wars with rivals, and generally acted out the abusive monopoly of antitrust theory.

The legend is sheer fantasy. None of these accusations were ever proven. 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 reveals 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 a large organization and had a large percentage share in some tobacco markets, but it never 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 that it did have active competition, that the competitors were growing faster than U.S. Steel, that essential raw materials were not being monopolized, and that the prices of steel products dropped on average between 1901 and 1911. 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) escaped divestiture under the Sherman Act.

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 a special Court of Appeals admitted that secondary aluminum (scrap) competed pound for pound with primary ingot, the court steadfastly refused to include it when measuring Alcoa's share of the market. Without scrap, Alcoa was capturing approximately 90 percent of the aluminum ingot business, and that was enough to constitute a monopoly and a violation of the Sherman Act. 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. 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 indictment. In addition, Alcoa had not illegally excluded competition, charged "exorbitant" prices, or earned an "exorbitant" rate of return. Aluminum ingot prices had fallen from over $2.00 per pound in the 1890s to less than 22 cents per pound at the time of the trial—and Alcoa's average rate of return for 50 years topped 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 in this case. It helped convict the company. 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.

The past irrationalities of antitrust enforcement have not been confined to the classic monopoly cases. Business mergers that would have increased efficiency and 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 in the thousands of *private* antitrust cases (where one corporation sues another), that the law serves to restrain and restrict the competitive process. Blatantly, protectionism reveals the essence of antitrust regulation as an attack on efficiency.

Government as the Source of Monopoly

None of the discussion above is meant to infer that there is (or was) an absence of abusive "monopoly" in the American economy. Far from it. Indeed, while the government trustbusters were indicting—and the courts were convicting—firms engaged in rivalrous market activity, the government itself was creating and protecting business monopolies throughout the economy. Interestingly, such monopolies were all but immune from antitrust.

The theory of market monopoly (reviewed earlier) fails because free markets are open to rivalry and competition. But if government *legally* restricts entry and competition (as was the case in the trucking industry between 1935 and 1980) then it creates "monopoly power" for the business organizations protected from competition. Government licensing, certificates of public convenience, quotas (both foreign and domestic), legal franchises, and other legal barriers are the essence of resource misallocating monopoly. The firms protected from competition enjoy the advantages of legal monopoly, and the customers and shut-out suppliers are "injured" by this monopoly.

Even a cursory historical examination of the American business experience would indicate that the United States has had a good share of this sort of monopoly, most of it advocated by business and professional interest groups anxious to restrict competition when they felt their own pecuniary interest would be advanced by legal restrictions. This process of "monopolization" was often whitewashed with "public interest" rhetoric, such as a concern for "safety" or eliminating "duplication," or ensuring that consumers receive a high quality product or service at some "fair price." Yet the empirical evidence now confirms that the movement to monopolize markets by restricting entry had little to do with any legitimate concern for consumer welfare. *The actual motivation and result was to restrain commerce legally, to stabilize industry prices and profits, to preserve existing market shares and, most importantly, to keep emerging entrepreneurs with newer technologies out of the marketplace.*

This affected antitrust policy in two ways. First, traditional antitrust policy misdirected attention from the real monopoly problem in America. While antitrust blasted away at efficient firms in openly competitive markets, the "real" monopolists quietly restrained trade under the full sanction and protection of governmental power.

Second, and more importantly, the declining emphasis on the theory of private monopoly and growing acceptance of the legal-barriers-to-entry theory of monopoly made an entirely new antitrust policy possible. Resources could be shifted from prosecuting efficient firms that were cutting prices to prosecuting (or threatening to prosecute) *governments* that, say, restricted entry into the taxi-cab business, or prohibited competition between cabs. Removing legal barriers would *permit* competition to develop in some spontaneously efficient manner. Thus antitrust policy (especially policy developed by the FTC) could be made compatible generally with the movement to deregulate certain industries in order that a competitive market process might then serve consumers. *If* we are to have any antitrust policy at all, surely this is the only rational approach.

Antitrust and Restrictive Agreements

That's the good news concerning new directions in antitrust policy. The bad news, however, is that a significant amount of antitrust policy is *still* regulation—still "industrial planning" of the worst sort. For example, the Justice Department and the FTC still enforce arbitrary and intellectually indefensible merger guidelines that restrict business planning and coordination. A new intensity exists in antitrust circles to prosecute business agreements that restrict rivalry. In this last area, certainly, antitrust has not been sufficiently reformed.

There are at least three positions to adopt to defend the legality of so-called "restrictive agreements" between firms. The first is the notion that if agreements are truly anti-consumer in effect, then there will be strong incentives for specific firms to break them and restore competitive rivalry. Historically, it would appear that price agreements (unenforceable in the courts) naturally break apart and generally prove unworkable in the long run. Antitrust is unnecessary to dissolve agreements that would tend to dissolve naturally.

The second position on restrictive agreements is that there *may* be significant efficiencies and economies associated with horizontal agreements. Market division agreements may end costly cross-hauling and advertising. Rate bureau activity in the trucking industry may reduce information and transactions costs for the firms that employ its services. Cooperative inter-firm agreements on research and development may lower costs and improve efficiency. Indeed the Department of Justice is taking a much more relaxed position on such cooperation recently. Since the government cannot know beforehand which agreements will reduce costs—that information is determined through the cooperative process itself—any antitrust prohibition of horizontal agreements is unwise.

Antitrust and Liberty

The most important reason for permitting so-called collusive business agreements was outlined briefly by Adam Smith in *The Wealth of Nations* more than 200 years ago. Although Smith was confident that businessmen often gathered to fix prices and conspire against the public interest, he was just as confident and insistent that no law "consistent with liberty and justice" could prohibit such activity. The simple fact remains that antitrust law prohibits voluntary agreements *that do not in themselves* involve any violation of property right. Within a natural rights framework, individuals have the right to make any contract or agreement for the exchange of property on any terms mutually acceptable. Indeed, the law violates rights since it directly interferes with the liberty of property owners to make such agreements or contracts. From a libertarian perspective, therefore, antitrust law is inherently unjust, quite apart from any strict economic considerations.

In addition, antitrust law is unusually vague and fluid, and its arbitrary enforcement over the years has consistently violated acceptable principles of due process. What, for instance, does it mean to "reduce competition substantially?" What are "reasonable" and "unreasonable" restraints of trade apart from what any court has said in any particular case? Can anyone know the "relevant market" in any antitrust legal action *prior to* the initiation of such legal action? Can prices that are high, low, and equal all be illegal under the antitrust laws? Most students of antitrust enforcement—especially the enforcement of the Robinson-Patman Act—will agree that the law has been a civil liberties and due process nightmare, and that Smith's insight into the dangers to liberty inherent in such law was sadly prophetic.

Conclusion

Both the normative and economic case for free markets and against any antitrust law is impressive. Since the law inevitably interferes with both rivalry and cooperation, it must tend to make the economy less efficient. And since the law inevitably interferes with individual rights and with peaceful exchange, it must tend to make the social system less fair and just. In short, the law appears to have lost any claim to legitimacy. We have reached a stage in the discussion of antitrust policy where the burden of proof is now on those who would retain the law, to demonstrate why all antitrust law should not be promptly abolished.

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