A Politically Incorrect Guide to Antitrust Policy

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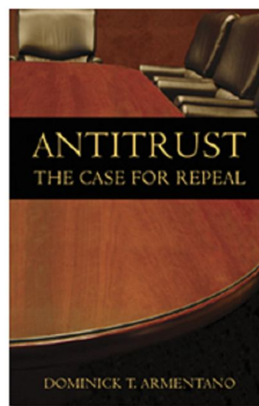

The United States has had antitrust legislation at the federal and state level for more than 100 years. (The Sherman Antitrust Act [1890] and the Federal Trade Commission Act [1914] are the basic federal statutes.) The laws make illegal "every contract, combination … or conspiracy in restraint of trade" and any attempt to "monopolize" through merger or acquisition; in addition, "unfair … and deceptive practices" are also forbidden. Given this broad regulatory mandate, antitrust law is arguably this nation's oldest ad hoc "industrial policy." But whether any of this regulation has ever made economic sense is entirely debatable.

Two recent legal developments illustrate the ongoing ambiguity of antitrust policy. The first involves the Supreme Court decision (*Leegin Creative Leather Products v. PSKS, Inc.*, 2007) to allow manufacturers to set and enforce minimum prices, a practice knows as resale price maintenance. This decision breaks with decades of precedent and has been hailed generally as a step toward a more rational antitrust policy.

The second development is the attempt by the Federal Trade Commission to block Whole Foods, Inc. from acquiring the Wild Oats company. But unlike the Supreme Court decision above, the FTC's action has been widely ridiculed as an exercise in pure regulatory nonsense. Indeed, a district court judge recently denied a preliminary injunction against the merger.

Actually, both public reactions miss the larger perspective. The Supreme Court did not really legitimize resale price maintenance; it simply ruled that the practice is no longer illegal per se but should be judged, instead, by a "rule of reason." Firms that make such agreements are still subject to antitrust scrutiny and unreasonable attempt to restraint trade will unleash the trustbusters. In short, antitrust continues to regulate so-called vertical price agreements.

And certainly the Federal Trade Commission's prosecution of Whole Foods *is* nonsense but it is hardly new or even novel nonsense. The FTC has a long history of litigating silly cases (Ready to Eat Cereals, 1981; Staples, 1997) based on illogical theories of monopoly power and totally irrational definitions of the "relevant market."

Indeed, the FTC's overall historical record of enforcement (especially in price-discrimination cases) is staggeringly anticonsumer. Yet despite the dismal enforcement experience, the antitrust establishment generally still supports vigorous enforcement of the antitrust laws.

In antitrust, the more things change the more they seem to stay the same.

MONOPOLY THEORY

The economic logic for having any antitrust regulation is fairly straightforward. Economists have developed theories that imply that business firms could find it profitable to eliminate competition and "monopolize in restraint of trade" and, thus, misallocate economic resources. In plain English, antitrust exists to prevent firms from restricting market outputs and raising prices to consumers or retarding the pace of technological change. This is the so-called "public interest" rationale for antitrust.

But are these theories correct? Is there really a free-market monopoly problem? Assuming that we can even define what we mean by a "free-market monopoly," it would certainly follow that firms in a free market would have the *freedom* to attempt to monopolize (control the entire supply of) some raw material, product or service. But whether they would be *able* to restrict market output for any reasonable period of time is debatable.

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First, such attempts (mergers, buying up available supplies of raw materials) can be prohibitively expensive, even unprofitable, and therefore unlikely.

Second, any other existing firm in the economy (or any new firm with access to capital) would be perfectly free to compete with any would-be monopolist, free to innovate, free to improve product, free to increase its own output, and consumers would be free to take advantage of that competition.

Thus, any firm that attempted to monopolize and restrict market output could lose sales and profits to any other business organization that found it profitable to cater to consumers and compete. Any alleged free-market monopoly supplier that attempted to "restrain trade" would create profitable opportunities for competitors and potential competitors, and these profitable opportunities would exist as long as markets are *legally* open to new suppliers and consumers are *legally* free to support alternative suppliers. It is not obvious, therefore, that attempting to monopolize

actually can restrain trade or misallocate economic resources.

Following the approach above, a free-market monopoly supplier is not theoretically impossible. For example, if a firm were substantially more efficient than all of its competitors and potential competitors, that is, if it were able to produce some product or service at the lowest cost and charge the lowest price to consumers, it could become (temporarily, perhaps) the only supplier in some well-defined market. The firm's "efficiency" would create a "barrier of entry" of sorts, totally benign of course, since the only competitors "excluded" would be relatively inefficient suppliers. Alternatively, consumers could always "monopolize" all of their choices for a specific product or service on only one company, making that company a momentary monopoly supplier.

But it is difficult to understand what is economically problematic with any of this. Clearly this circumstance is *not* the devilish monopoly problem envisioned by critics of the free market since low costs, expanded outputs, lower prices, and free consumer choice are the beneficial attributes of an open market process; they clearly enhance, not harm, any reasonable definition of consumer welfare. So a free-market "monopoly" supplier is theoretically possible but not necessarily harmful and would not rationalize any antitrust regulation.

CARTELS AND PREDATORY PRACTICES

Free-market cartels are possible theoretically but they would be inherently unstable. Cartels, unlike a one-firm supplier, would require inter-firm cooperation and coordination in order to achieve any market-output restraint. But how is market output for each cartel member to be reduced? How are the reductions to be monitored? Won't the firms attempt to cheat and won't the cheating lead to larger outputs and lower prices? Indeed, won't the higher cartel prices encourage new supply from outside the cartel, and won't that lead to lower prices? In reality, free-market cartels (absent governmental support) have proved notoriously short lived and unsuccessful, especially when courts refuse to enforce cartel price-coordination agreements.

Predatory practices are still another monopoly chimera. It is usually not rational for a dominant firm to attempt to eliminate all of its competitors through severe price-cutting since this practice is inherently expensive and uncertain, especially if the market is easily open to new supply. Even if a dominant firm were to succeed temporarily and eliminate some of its rivals, competitors would likely return when and if prices were increased to profitable levels. How, then, are dominant firms to profit from predation and how are consumers to be injured by price reductions?

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Lower prices, for whatever reason and for whatever length of time, are extremely proconsumer and are never to be regretted. Would critics of predation rather have dominant firms fix prices and not ever reduce them, or not respond to lower costs or the lower prices of rivals?

Consumers, of course, can always decide whether they prefer the lower prices of the dominant firm or not. If they prefer lower prices, then they buy more from the dominant firm; if they don't, then they continue to support the higher-priced rivals of the dominant firm. Either way, there is nothing whatever to be regretted about lower prices either initiated by (or matched by or undercut by) dominant firms. Again, no antitrust regulation is justified.

GOVERNMENT AND MONOPOLY

If we drop the strict free-market assumption, however, a real monopoly problem is easy to visualize. Government could license only one supplier (e.g., a taxi cab company) in some city market and restrict entry to all other suppliers; the market would then be monopolized *by law*. Or government could establish a legal monopoly in telecommunications, electricity generation, telephone service, first-class mail delivery, and in many other areas; indeed, government in the United States has historically done precisely this. And, curiously, these monopolies have always been legally immune from antitrust law!

Clearly this *is* a monopoly problem since consumers, regardless of their preferences, would then legally be tied to only one supplier. In addition, would-be entrepreneurs with lower costs or with new products would legally be prohibited from offering those benefits to willing buyers.

And with competition prohibited by law, the monopoly supplier would have few (if any) incentives to innovate, to expand output and to lower prices.

But this monopoly problem ought never to be associated with "free markets" since its explicit source is the power of government to prohibit new supply. Removing all legal barriers to entry and competition (deregulation, correctly understood) would end this monopoly problem without antitrust intervention.

ANTITRUST: SOME CLASSIC CASES

If firms in free markets can really monopolize in restraint of trade, the empirical evidence should reside in the many classic antitrust cases brought over the last 100 years. Yet an examination of some of the most famous of these classic antitrust cases reveals that the firms indicted and (mostly) convicted were generally increasing market output, lowering market prices, and innovating.

STANDARD OIL OF NEW JERSEY (1911)

One of the most famous (and misunderstood) antitrust cases in history is *US v. Standard Oil of New Jersey* (1911).

The popular explanation of this case is that Standard Oil monopolized the oil industry, destroyed rivals through the use of predatory price-cutting, raised prices to consumers, and was punished by the Supreme Court for these proven transgressions. Nice story but totally false.

First, Standard never even monopolized petroleum refining, let alone the entire oil industry (production, transportation, refining, distribution) which would have been an impossibility. Even in domestic refining, Standard's share of the market *declined* for decades prior to the antitrust case (64% in 1907) and there were at least 137 competitors (firms like Shell, Gulf, Texaco) in oil refining in 1911.

Second, although predatory practices were alleged by the government at trial, Standard offered rebuttal on all counts. Neither the trial court nor the Supreme Court ever made any specific finding of guilt on the conflicting charges of predatory practices.

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Third, petroleum market outputs increased and prices declined for decades during the alleged period of "monopolization" by Standard Oil. For example, prices for kerosene (the industry's major product) were 30 cents a gallon in 1869 and fell to about 6 cents a gallon at the time of the antitrust trial.

Finally, the Supreme Court broke up the Standard Oil holding company *not* because of any demonstrable harm to consumers (there was none) but because it discerned some vague "intent" to monopolize through Standard's many mergers, an "intent" that just as clearly never succeeded in producing any monopoly. Yet generations of economic and legal commentators have been misled about monopoly and the alleged efficacy of antitrust policy because of the "facts everybody knows" concerning the Standard Oil antitrust case.

American Tobacco (1911)

The antitrust case against the American Tobacco Company (*US v. American Tobacco*, 1911*)* is similar in many respects to *Standard Oil*. American Tobacco put together a large diversified tobacco company through merger with smaller specialty companies. Yet they were never able to monopolize the tobacco industry as the government alleged, nor were they able to raise prices of tobacco products. Outputs increased and prices fell for decades prior to the antitrust suit. Many thousands of cigarette, smoking tobacco, snuff, and cigar companies competed against the American companies and ease of entry and availability of raw materials (leaf tobacco obtained at auction) made vigorous competition inevitable. The American Tobacco holding company was broken up by the Supreme Court because of some vague intent to monopolize (again, as evidenced through mergers) but, like Standard Oil, there was a total absence of demonstrable (economic) injury to consumers of tobacco products.

Alcoa (1945)

US v. Aluminum Company of America (1945) is one of the most egregious anticonsumer antitrust cases on record. Modern trustbusters are forever offering apologies for *Alcoa*. And with good reason. The government pursued Alcoa in court for 13 years (between 1937 and 1950). Yet after a long and laborious trial that ended in 1939, Judge Caffey dismissed almost 150 separate government charges against the defendant Alcoa, including allegations that they monopolized waterpower sites (for producing electricity) and monopolized the raw material bauxite, from which aluminum ingot is made. Caffey also determined that Alcoa innovated rapidly, expanded aluminum refining capacity and outputs continuously, and had lowered aluminum ingot prices for 50 years, while taking a very modest return on its investment.

Yet an appellate court in 1945 (acting in lieu of the Supreme Court) decided that expanding outputs and lowering prices illegally *excluded* rivals from the opportunity to compete and thereby violated antitrust law. (Translation: if Alcoa had been less efficient in serving its customers there would have been more "competition" — read *competitors* — less exclusion, and no antitrust violation.) The *Alcoa* appellate decision confirmed that antitrust was hell bound: *economic efficiency* now counted as illegally exclusionary and ultimately a violation of law.

American Can (1949) and United Shoe (1954)

This trend was confirmed in *US v. American Can* (1949) and in *US v. United Shoe Machinery Corporation* (1953). In *American Can*, the trial judge determined that American Can held its dominant market position because it "coerced" its customers into signing long-term leases. How, in a free market, did it do that? Why, by offering generous and attractive terms to its customers such as generous price discounts for large orders of cans. So, as a part of his final decision in the case, the judge ordered American to *raise prices* to its can customers so that there could be more competition with less efficient can producers and can-closing machinery makers. Consumers of cans ultimately paid for this contrived increase in "competition."

In *United Shoe*, United had manufactured shoe machinery and leased its many machines to hundreds of domestic and international shoemakers. Its market share was always high (85%) because (as the trial court found) its machines were technologically superior to those of competitors, its leasing rates were reasonable, and it repaired machines promptly and at no extra charge to the customer. As a consequence of this superior economic performance, customers were extremely loyal and tended to renew leases when old ones expired; less efficient rivals had great difficulty convincing shoe companies to switch their business since the shoe companies were generally satisfied with United's terms. Several shoemakers testified for the defendant United Shoe at the trial.

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Yet the trial judge spied the illegality inherent in superior economic performance provided over many decades: smaller rivals were thereby "excluded" from competing and that fact violated the antitrust laws. The trial court then saddled United with restrictions that, it reasoned, would destroy its unique economic advantages and put it back in the same (less efficient) class as its competitors. But when the legal sanctions failed to really hamper United Shoe's efficiency, the Department of Justice appealed the lower court decision to the US Supreme Court (1968), which divested (and eventually wrecked) the company.

The wrong-headed theory being actualized in all of these cases is the notion that free consumer choice and business efficiency somehow restrain trade and violate the antitrust law, the exact opposite of the truth. Efficient firms such as Alcoa and United Shoe innovated new products and production techniques and lowered prices; they always did more business (while less efficient rivals did less) in order to keep and even expand their dominant market position. But this is precisely how free markets are supposed to work, such that scarce resources tend to maximize consumer value. Yet consistently throughout business history, antitrust regulation has been employed (by both government and business rivals) as a legal weapon to bludgeon aggressively competitive firms that innovate and lower costs and prices.

MICROSOFT (2001)

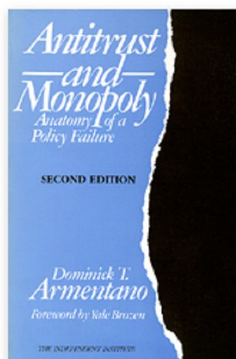
Despite so-called regulatory reforms, this pernicious trend in antitrust enforcement has continued. The best and most recent example is, of course, *US v. Microsoft (2001).* The heart of the antitrust case brought by the Department of Justice and 19 state attorney generals in 1998 was that Microsoft's decision to integrated its Web browser, Explorer, into its Windows 98 operating software system illegally excluded competitive browsers, such as rival Netscape's Navigator, and evidenced an intent to "monopolize" in violation of the Sherman Act.

Since Microsoft allegedly held a "monopoly" in operating systems and employed its monopoly power to exclude competitors unfairly, trial court judge Thomas Penfield Jackson, having agreed with the bulk of the government's argument, found the company guilty of illegal monopolization and ordered the firm regulated and divested. On appeal, however, important parts of this decision, in particular the divestiture order, were overturned and the lower court judge rebuked.

The government's charges were always baseless. The plaintiffs first argued that Microsoft held a monopoly in operating systems (a near 90% market share) and that they had leveraged that market power into the browser market to crush Netscape. But the government's market share numbers were grossly inaccurate. To arrive at a so-called monopoly market share, the trial court accepted a definition of the relevant market ("single user desktop PCs that use an Intel-compatible chip") that

conveniently excluded all of the computers and networking software made by Microsoft's major rivals such as Apple, Sun, Novell, and a host of other companies. In addition, counting only licensed systems allowed Judge Jackson to exclude arbitrarily all of the operating systems sold at retail, those downloaded from the Web, and all "naked" computers shipped without any operating system installed at all. These factual errors narrowed severely the actual competitive market and simply turned Microsoft into the "monopolist" the government required for its antitrust violation. If market share is meaningful at all in antitrust analysis (extremely doubtful), Microsoft's actual share of any realistic relevant market was less than 70% and not enough for any monopoly designation.

But if Microsoft had no actual monopoly, then its battle with Netscape over the browser market takes on a totally different perspective. When Microsoft first integrated its browser into its operating system software, it was Netscape that held the bulk of the browser sales. It was Netscape that held the "dominant" market position in browsers and it was Microsoft that was attempting to better compete by improving the terms of exchange for PC consumers. Microsoft proceeded to fully integrate its browser and effectively reduce its price to zero and consumers responded favorably; Microsoft's browser did more business and Netscape's browser did less. Nor was the Netscape browser ever unfairly "foreclosed" or "excluded" from the market; PC users downloaded *millions* of copies of Netscape's browser during the period of alleged exclusion by Microsoft. Thus, the entire government's case was an attempt to regulate innovation and consumer choice at the behest of ambitious attorneys and disgruntled competitors. That Microsoft eventually emerged victorious in this particular case at the appellate level (after a decade of litigation some of which involved the FTC) does not mitigate the absolute folly of this persecution.



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CONCLUSIONS

Antitrust theory and history are both a myth and a hoax. The laws were never intended to help consumers (Robert Bork's protestations to the contrary) and their long historical track record is that they have *not* helped consumers. They have, instead, punished innovative and efficient business organizations while protecting less efficient competitors and every state-sanctioned monopoly. They have tended to make consumers poorer and the overall economy less efficient and they deserve to be repealed, not reformed. That the antitrust paradigm still can find support among a majority of economists, lawyers, and the public is a testament to intellectual laziness, to the power of special interest, and to decades of successful myth making.

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Journal, *The Antitrust Bulletin, The New York Times, the London Financial Times and The Wall Street Journal.* He has presented talks to academic and business audiences in the United States and abroad. Between 1978 and 1985 he was a regular commentator on BYLINE, a nationally syndicated public affairs radio program. His books include *The Myths of Antitrust: Economic Theory and Legal Cases* (Arlington House, 1972), *Antitrust & Monopoly: Anatomy of a Policy Failure* (John Wiley, 1982 and Independent Institute, 1990) and *Antitrust: The Case for Repeal* (Mises Institute, 1999). Send him mail (mailto:armentano@irene.net) . Comment on the blog (http://blog.mises.org/archives/007148.asp) .