Microeconomics for Managers

Chapter 13

Competition Again: Antitrust Policies

Competition and Antitrust: The Legal Parameters of the Firm’s Environment

Let’s return to Smith’s Formula one more time. Smith argued that markets would work well in channeling self-interest into serving the public interest, *if* there was sufficient competition in markets. We have characterized the ongoing debate in economics and public policy circles as a 200-year-old dispute over whether there is or is not sufficient competition to warrant a laissez-faire policy. Proponents of laissez-faire generally point to there being more, rather than less, competition to support their position. They advocate only minimal government intervention to establish the infrastructure necessary for markets to work. They also seek to confine antitrust policy to laws that restrict specific anti-competitive practices. It should be pointed out that these proponents of the market and limited government intervention are not anarchists – they advocate restricted intervention, not an absence of government involvement.

On the other side, those who see too little competition generally advocate more rather than less antitrust intervention. Again, the question is degree – few advocate socialism or an end to markets.

The 200-year-old question has gone hand in hand with these policy debates. In this last chapter, we will look at the legal product of this debate that has unfolded over the last century.

Antitrust: The Issues

Antitrust law often confuses students because it is usually presented as a bunch of laws and court cases without any meaningful context. This is especially the case when one drops in "cold" on a complicated case such as the Microsoft case. To remedy this, a short discussion of five laws and fourteen court cases follows. This shortlist (and it is the short, short list) chronicles the development of U.S. antitrust law. This discussion of statute and case law is preceded by an equally important discussion of the economic and historical background. The Microsoft case is presented last.

This discussion primarily deals with U.S. antitrust cases and laws. The goal is not to make you a legal scholar (or worse, a lawyer). The goal is to give you a solid background on the legal and economic issues in the ongoing policy disputes over maintaining competition in markets.

In addition, there is nothing uniquely American about these issues. Historically, the U.S. took the initiative in antitrust legislation and case law, and U.S. antitrust laws remain the most stringent in the world. Today, more than 60 countries around the world have antitrust laws on the books, many patterned on American law. Most importantly, the

European Union is in the process of creating European antitrust laws and Russia is also enacting antitrust laws needed to maintain competition in post-Soviet markets. The Europeans and the Russians have built on U.S. antitrust experience and they have had to contend with the same issues encountered below. Looking further down the road, it is likely that China will also have to address these issues as the Chinese economy grows and develops.

Background: The Common Law

English common law serves as a base for American antitrust laws. From the English common law, the role of case law in creating a body of law was established. Case law is based on court rulings in specific cases that are then held to be applicable to everyone else.

The common law also established the principle that a contract in restraint of trade was unenforceable. As the discussion of the German wood pulp cartel case (below) illustrates, this has often not been the case in other countries.

In addition, English common law outlawed three specific practices as restraint of trade: forestalling, regrating, and engrossing. Forestalling was meeting suppliers outside of the marketplace, usually on their way to market, and buying up the supply before it reached the market. Regrating was buying in the market with the intent to remove supply and profit from sales at a higher price. Engrossing was buying up stocks of goods to "corner" the market. These illegal practices are clearly more relevant to an earlier day of rural village markets. However, the precedent that the law could disallow certain types of practices to keep markets competitive was established under common law. In addition, American statute laws of the late nineteenth century are basically an elaboration and extension in the common law tradition.

Background: Seeking Relief from "Destructive Competition"

Common law established the precedent for government intervention to promote and maintain competition, but it was the rise of big business enterprises in the nineteenth century that established the need for such policies. The practices specifically addressed by the common law are rather antiquarian and not readily applicable to modern industry. To understand antitrust issues and the evolution of government regulation, it is necessary to briefly look at the problems of big business from a business perspective. Andrew Carnegie provided such a perspective and coined a term, "destructive competition," that summarized his view of the competitive environment after the Civil War. It is important to emphasize that "destructive competition" is not the same as "creative destruction," a completely different concept.

Carnegie emigrated to the U.S. when he was thirteen and worked his way up from menial jobs to become the leader of one of the largest steel companies in the world. He was renowned for his managerial skills and his willingness to expand during recessions and depressions. He was ruthless in a day when ruthlessness was a requisite for survival.

Later in life, he retired by selling his interests in the public offering that created U.S. Steel in 1901. He spent his retirement fishing and engaged in philanthropy.

Carnegie was also an astute and articulate business spokesman. Philosophically, he supported the social ideal of competition, but he also understood the problems created by the large-scale enterprise. In particular, he gave a perceptive description of the rationale and evolution of the various forms of combination and collusion that were typical of the late nineteenth century.

Carnegie observed that a condition of excess supply in a market drove down the price, usually to levels below cost. Profits were thus eliminated. At this point, Carnegie observed that the reaction of large-scale enterprises was very different from the scenario envisioned by Adam Smith. Regarding the low prices and lack of profits during periods of excess capacity, Carnegie wrote:

> *"... Political economy says that here the trouble will end. Goods will not be produced at less than cost. This was true when Adam Smith wrote, but it is not quite true today. ... As manufacturing is carried on today, in enormous establishments with five to ten millions of dollars of capital invested,…. it costs the manufacturer much less to run at a loss per ton or per year than to check his production. Stoppage would be serious indeed. The condition of cheap manufacture is running full. Twenty sources of expense are fixed charges, many of which stoppage would only increase. Therefore the article is produced for months and, in some cases I have known, for years, not only without profit or without interest on capital, but to the impairment of the capital invested…"*
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> *(A. Carnegie, "The Bugaboo of trusts," North American Review, Vol. 148 (February, 1889), as quoted in C. Hession and H. Sardy, The Ascent to Affluence, (Boston: Allyn and Bacon, 1969) p. 465.)*

Carnegie went on to describe how gentlemen's agreement, pools, trusts, etc all grew out of efforts of business owners to find relief from this destructive competition. These, as well as the holding company and combinations through mergers that were to follow, were merely different organizational forms undertaken to address the problem of destructive competition. In many respects, the history of big business trusts or monopolies in the late nineteenth century is the story of the quest for an organizational form that worked and avoided the antitrust laws.

Antitrust Statute Law

Statute laws are passed by Congress and signed by the President (or allowed to become law without presidential signature or veto). Our most important federal antitrust laws are:

- Sherman Antitrust Act (1890)
- Clayton Act (1914)
- Federal Trade Commission Act (1914)
- Celler-Kefauver Act (1950)
- Hart-Scott-Rodino Act (1976)

Each of these laws will be briefly described, emphasizing their principle contribution to U.S. antitrust policy.

Sherman Act (1890)

In the 1870s and 1880s, public resentment of trusts and the fears of businessmen of having to deal with separate state antitrust prosecutions resulted in the passage of the federal Sherman Act in 1890. The core of the act is embodied in two major provisions:

> "Sec. 1. Every contract, combination in the form of a trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states, or with foreign nations is hereby declared to be illegal…."
>
> "Sec. 2. Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any person or persons, to monopolize any part of the trade or commerce among the several states, or with foreign nations, shall be deemed guilty of a misdemeanor…."

The Sherman Antitrust Act made monopoly and "restraints of trade" (e.g., collusive price-fixing or the dividing up of markets among competitors) criminal offenses. Either the Department of Justice or parties injured by monopoly or anti-competitive behavior could file suits under the Sherman Act. The Sherman Act also provided for fines and/or imprisonment for offenders.

The Sherman Act is one of the few statutes that non-lawyers have little problem reading and understanding. Therein was the problem. While the law appears to be simple and straightforward, it proved to be anything but in case law application. Cases such as the E.C. Knight case (below) sought to limit its application and most other cases have sought to establish what the Sherman Act meant.

The Road Not Taken: German vs. American Approaches to Antitrust

The United States was one of the first countries to develop strong antitrust laws and today retains the most stringent laws in the world. Historically, most European countries have either not had any meaningful antitrust laws, or have actively sought to suppress competition rather than foster and promote it.

Germany is often cited as an example of this different approach. Indeed, the difference between the United States and much of the world can be seen in the divergent paths taken by Germany and the United States in the 1890s. The Sherman Act established the basic approach to antitrust that would, with twists and turns, create the U.S. antitrust policy that we know today.

In 1893, a German court case established a very different foundation for German policy toward competition and monopoly. A Wood Pulp Manufacturers Cartel was established in Germany in the 1890s. The cartel members formally joined the cartel in a contract that called for the cartel members to fix prices and adhere to output quotas. In effect, the cartel created a joint monopoly that eliminated competition.

After joining the cartel, one firm decided to quit the cartel and compete for business in the market. The cartel sued the firm for breach of contract in a German court.

Under American common law, this case would have resulted in the court refusing to uphold the contract because it was clearly in restraint of trade. Under the Sherman Act, evidence of such a contract to fix prices would have amounted to self-incrimination; that is, it would have been proof of a violation of the law. In all likelihood, the cartel would never have filed the suit in an American court in the first place.

However, the German cartel took the wayward firm to court. The German court held that the departing firm was in breach of contract. It ruled that a cartel contract was not illegal unless its terms were so extreme as to be injurious to the public interest. The court ruled that that was not the case here. In addition, the German court went on to declare that "ruinous competition" was not in the public interest, and that a cartel, by eliminating ruinous competition, could be "especially useful for the economy as a whole." According to the court, it was a good policy to promote socially responsible cartels.

The effect of this and other German rulings was to embrace restraint of trade as good public policy. In addition, "ruinous competition" is remarkably close to Carnegie's "destructive competition." The difference lies primarily in how the two doctrines were treated in the U.S. versus Germany. German cartels grew in importance before World War II, reaching a peak during National Socialism. Cartels continued to be the norm rather than the exception in post-war Germany. In addition, until the recent development of a vigorous EU antitrust policy, the German approach rather than American policies held sway in Europe. In fact, the European Union can trace its roots to the European Coal and Steel Cartel in the 1950s. While the European Union is currently pursuing an antitrust policy more similar to American policy, the roots of cartels and protectionism run deep in Europe and are not likely to be easily purged.

The Clayton Act (1914)

In 1914, the Clayton Act sought to address specific anti-competitive practices. Specifically, the act outlawed:

- Price discrimination with the intent to restrict competition.
- "Tying contracts" that require a buyer interested in one product to also buy another of the firm's products as a condition of sale.
- Acquisition of stocks of competing corporations when the effect is to lessen competition.
- Formation of interlocking directorates (where a director of one firm is also a board member of a competing firm).
- Paying a broker's fee for which no broker services are rendered.

Perhaps most importantly, the Clayton Act introduced "illegal per se" into antitrust enforcement. Illegal per se activities are practices that are illegal regardless of intent or consequences (for example, the degree to which competition is reduced). A practice that is illegal per se needs only be proven to have occurred to obtain a conviction. Motive and the extent of injury are not relevant. On the other hand, some practices are not illegal per se, but can be illegal if the intent is to restrict competition or the effect is to significantly restrict competition.

For example, price-fixing and tying contracts are illegal per se under the Clayton Act. In contrast, price discrimination is not illegal per se. A successful antitrust prosecution for price discrimination would have to demonstrate intent and/or the effect of significantly reducing competition. "Exclusive contracts" (for example, exclusive dealerships, authorized service reps, etc.) also illustrate the distinction. Exclusive contracts are not illegal per se but could be violations of antitrust laws depending on motive and consequences.

The Federal Trade Commission Act (1914)

In 1914, the Federal Trade Commission Act created a five-member Federal Trade Commission (FTC) and charged it with the responsibility of enforcing the antitrust laws, in particular the Clayton Act. The FTC was given the power to investigate unfair competitive practices on its initiative or at the request of injured firms. The Commission could hold public hearings on such complaints and, if necessary, issue cease and desist orders when "unfair methods of competition in commerce" were discovered. The act both broadened the range of illegal business behavior and established an independent antitrust agency with the authority to investigate and initiate court cases.

The Celler-Kefauver Act (1950)

The Celler-Kefauver Act (1950) prohibited a firm from acquiring the physical assets (e.g., buildings and equipment) of competitors when the acquisition would reduce competition (the Clayton Act outlawed mergers through stock acquisition). This closed a loophole in the antitrust laws relating to horizontal mergers. However, the most important part of the Celler-Kefauver Act was its deletion of language from the Clayton Act that effectively limited antitrust laws to horizontal monopoly. (Section 7 of the Clayton Act had made mergers illegal where the effect may be to "substantially lessen competition between the corporation whose stock is acquired and the corporation making the acquisition," that is, reducing competition between horizontal competitors. By eliminating this language, antitrust laws covered vertical and conglomerate mergers that might substantially lessen competition anywhere.) When firms use vertical acquisitions to eliminate competition, economists call it "vertical market foreclosure." The Celler-Kefauver Act effectively made vertical market foreclosure illegal.

The Hart-Scott-Rodino Act (1976)

The Hart-Scott-Rodino Act (1976) made a significant change in antitrust policy by requiring pre-merger notification and approval by the Justice Department and the FTC prior to the merger. The law covers mergers regardless of business ownership status (for example, the law covers proprietorships and partnerships, not just corporations). The threshold (the size of the deal involved) is very low, so most mergers must comply with the Hart-Scott-Rodino requirements. Approval must be received from both regulatory bodies prior to the merger. Approval may be conditional on modifications in the merger or divestitures of overlapping assets.

Before the Hart-Scott-Rodino Act, antitrust policies were usually applied reactively. Firms merged or were well into the process of merging when the government reacted with a suit to block or undo the merger. The Hart-Scott-Rodino Act made antitrust policy more proactive by requiring pre-merger notification, review, and approval.

The Hart-Scot-Rodino Act requires notification and approval of both the Justice Department and the FTC. There is a similar notification and approval requirement imposed by the European Union. This is not based on the Hart-Scott-Rodino Act, but rather on newly created European Union antitrust laws that cover firms operating in Europe. Today, any merger involving an American firm with business dealings in Europe must provide pre-merger notification and obtain the approval of the Justice Department, the FTC, and the European Union's Competition Commission.

Recent Considerations

In recent years, the analysis of proposed mergers has shifted from counting the number of firms in a market to predicting how a particular merger will affect the price. For example, in 1994, Microsoft tried to purchase Intuit, the maker of Quicken (a personal finance software package that was a substitute for a Microsoft product). The government blocked the merger because it would have reduced the competition in the personal finance software market. The government does not oppose all corporate mergers, however. It allows mergers leading to a new firm that would combine production, marketing, or administrative operations to lower costs. In 1997, the Justice Department and the FTC released new guidelines for proposed mergers. Companies that present evidence of a merger to reduce costs and lower prices, better products, or better service (i.e., greater efficiency), might be granted permission to merge. Since 1994, the Justice Department has been particularly interested in vertical market foreclosure cases involving foreclosed technology. In other words, they are particularly keen to prevent new technologies (not simply competing firms) from being foreclosed from the market.

Antitrust Case Law

Statute law is only part of our law. Laws are applied, clarified, and modified in court cases. Rulings in court cases set precedents, or standards, as to what the law means and how it is to be administered. Case law is as important, and often more important, than statute law.

The following cases illustrate the contribution of case law to creating antitrust law. The narratives are deliberately brief, focusing in most instances on one or two critical points. While there are thousands of cases, and many addressing other important aspects of antitrust law, these cases generally give students a solid grasp of antitrust issues. They also afford a good example of the interplay between statute and case law that extends well beyond the economic question at hand.

E.C. Knight (1895) and Northern Securities (1904)

The American Sugar Refinery was charged with violating the Sherman Act when it sought to acquire four Pennsylvania sugar refiners. The acquisitions gave American Sugar Refinery 95 percent of the nation's sugar refining business. The Supreme Court acquitted American Sugar because it held that the Sherman Act only applied to Interstate Commerce, strictly defined. According to the Court, manufacturing was, by its very nature, not interstate commerce (that is, moving goods across state or national boundaries).

The E.C. Knight case effectively made all industry exempt from the Sherman Act. A wave of mergers ensued. The 1900 Census found manufacturing dominated by 185 manufacturing combinations with a combined investment capital of $3,093 million. The nation's entire invested capital stock was $8,975 million. The 185 combinations thus owned about 34.4 percent of the nation's capital. Only 18 of the combinations had been created before 1897, attesting to the size of the wave of mergers that followed in the wake of the E.C. Knight ruling. In the merger movement that followed the Knight case, 1,800 firms disappeared in 93 consolidations. Seventy-two of these consolidations acquired more than a 40 percent market share. Of these, 42 acquired more than a 70 percent market share.

The courts reversed itself in a series of cases, culminated by the Northern Securities case in 1904. In this case, the court upheld the applicability of the Sherman Act to manufacturing, choosing to give a very different interpretation of Congress' Constitutional powers to regulate "interstate commerce." The result of this reversal was the abrupt ending of the Merger Movement (1897-1904). While the court reversed its position, it did not try to undo the mergers that had occurred in the wake of the E.C. Knight case.

It should be noted that reversal of case law is not unique to antitrust or economic policy. For example, in Plessy v. Ferguson (1896), the Supreme Court declared "separate but equal" to be constitutional, supporting legal segregation. This ruling was reversed in Brown v. Board of Education of Topeka (1954).

Standard Oil (1911) and American Tobacco (1911)

John D. Rockefeller's Standard Oil Trust was formed in 1882 when Rockefeller got the owners of 40 oil companies to turn over control of their refineries to him in "trust." A trust was a very old legal form under English common law that had traditionally been used to establish a trustee to oversee the affairs of minors, widows, and incompetents. Rockefeller's genius was in his new and innovative use for this old practice. The trust controlled over 90 percent of the market for refined petroleum products, with the trustees (Rockefeller) running the trust like a monopoly. In 1911, the government ordered the breakup of Standard Oil. (Before the suit, Standard Oil had converted from a trust to a corporation.) The Supreme Court found that Rockefeller had used "unnatural methods" to maintain monopoly power and to drive rivals out of business. For example, he had coerced railroads into giving him special rates for shipping and spied on competitors. The government broke up Standard Oil into 34 separate companies (among them were such giants as Exxon, Standard Oil of California, Standard Oil of Ohio, etc.).

The Standard Oil Case also introduced the "Rule of Reason" into antitrust enforcement. Under this doctrine, large firms and their practices were to be subjected to a “reasonableness” criterion, that is, there was reasonable vs. unreasonable restraint of trade. In the case of Standard Oil, the courts held that their tactics and "unnatural methods" had been very unreasonable.

The American Tobacco Company had bought out 30 of its competitors and acquired control of about 95 percent of the U.S. cigarette market. The Supreme Court found that American Tobacco maintained its monopoly power by driving its rivals out of business and by forcing exclusive contracts on wholesalers that prevented them from purchasing cigarettes from other companies. The court upheld the "Rule of Reason" established in the Standard Oil case earlier in the year, found American Tobacco "unreasonable," and ordered a breakup of the company in 1911.

United States Steel (1920)

The United States Steel Company was formed in 1901 when Morgan Bank acted as an underwriter in forming the giant company around Andrew Carnegie’s steel company. Carnegie wanted to retire and Morgan used the window afforded by the E.C. Knight case to market the new U.S. Steel shares as an investment in a steel monopoly. At its inception, U.S. Steel had about 64 percent of the steel market. (Note: the United States steel market was already larger than the entire European steel market.) It was arguably the largest manufacturing company in the world.

Morgan retained influence at U.S. Steel through his backing of U.S. Steel's Board Chairman, Judge Gary. Judge Gary did not believe in competition, preferring what he considered to be fair pricing. Gary argued that "price should always be reasonable. The mere fact that demand is less than supply does not justify lowering prices. What we want is stability - the avoidance of violent fluctuations" (I.M. Tarbell, The Life of Elbert H. Gary (New York: Appleton, 1925) p. 206).

Judge Gary was able, through his efforts to bring stability to his industry, to maintain price discipline in the steel industry. For example, from May 1901 to April 1916, the price of steel rails was set at $28 per ton, despite wild fluctuations in business conditions. Judge Gary was able to accomplish this through collusive business practices that were well known inside and outside of the industry. For example, Judge Gary began holding weekly dinners during the recession of 1907. Guests at the dinners were other steel company executives. Steel prices remained fixed during the recession. The dinners came to an abrupt halt when the government filed its antitrust suit in 1909 (before the passage of the Clayton Act).

U.S. Steel was thus born as a monopoly, resorted to anti-competitive practices to maintain collusive prices, and retained a commanding share of the steel market. In its 4-3 ruling, the Supreme Court chose to ignore the monopoly practices of the company and focus on the size issue. The court held that size alone was not a compelling criterion in antitrust. Since the courts ignored the restraint of trade practices, U.S. Steel was acquitted.

The U.S. Steel case threw antitrust prosecution into disarray. The government dropped many cases and antitrust enforcement seemed to be gutted. It will be recalled that the Standard Oil case had established the "Rule of Reason." The U.S. Steel case ruled that size alone was not unreasonable and U.S. Steel's business practices were declared reasonable. With U.S. Steel's notorious reputation for price-fixing, it was hard to imagine any company ever being found "unreasonable." A wave of mergers followed the U.S. Steel case, just as a wave of mergers had followed the E.C. Knight case. This was the second great wave of mergers in American economic history.

The U.S. Steel case needs to be put in historical context. It appeared to many observers that the court was doing little more than looking for a reason to acquit. This may not be too far from the mark when one considers other developments at the time. There has always existed a desire to promote cooperative market power and collusion that has run counter to antitrust policy. For example, the U.S. government encouraged firms to cooperate during World War I and the belief that cooperation was better than competition persisted into the interwar period. In 1933, President Roosevelt called upon many of these same government planners to impose industry cooperation. Roosevelt's first New Deal, the National Industrial Recovery Administration, established industry associations (cartels). American companies were forced to participate in these associations and were required to draft codes of "fair" competition (i.e., cooperation) and coordinate their prices. In 1918, the Webb-Pomerene Act exempted American firms from antitrust laws in the international market and encouraged American firms to join international cartels. In addition, wartime cooperatives were extended and promoted during the 1920s. Antitrust rulings exempted trade associations from antitrust laws so long as they did not <u>explicitly</u> seek to coordinate prices. In the 1920s, the prevailing attitude in the country and the courts seems to have been more akin to Andrew Carnegie's views than those of Adam Smith. Consequently, the U.S. Steel ruling may simply reflect this counter tendency to embrace monopoly rather than fight it.

Alcoa (1945)

The government filed an antitrust suit against Alcoa in 1937, alleging that it had monopolized the aluminum refining market. The judge in the case found that Alcoa had more than 90 percent of the market for virgin aluminum (i.e., aluminum refined from scrap was excluded from the market). The remainder of the market was supplied by imports. However, most imports were from Alcoa's wholly-owned Canadian subsidiary.

The most important point in the case stemmed from the judge's ruling that Alcoa's market share was "enough to constitute a monopoly." The judge found that Alcoa had done nothing illegal or unethical in acquiring its monopoly. It had simply undertaken a policy of anticipating growth in aluminum demand and then building the capacity needed to supply the increase in demand ahead of time. This created a significant barrier to entry for other firms who found it hard to enter a market where Alcoa seemed to always have more than enough capacity to satisfy the market. It was clear to the judge that Alcoa was not building the capacity as an anti-competitive tactic, but was rather simply doing an outstanding job of anticipating growth in their industry.

However, while the judge exonerated Alcoa of criminal intent, calling Alcoa one of the cleanest companies that he had ever encountered, he nonetheless ruled that Alcoa was a monopoly by virtue of its size alone. The judge suggested that any company of similar size would be found guilty of monopoly in his court. It made no difference that Alcoa had not used its monopoly power, or had done nothing illegal in acquiring its monopoly position. According to the court ruling, the threat of monopoly abuse is inherent in a monopoly and therefore a violation of the Sherman Act.

The precedent in the Alcoa case was watered down slightly by subsequent case rulings, but it remains a significant factor in antitrust enforcement. Many firms such as Microsoft and Intel have had to consider the prospects of an antitrust conviction based solely on their size. It is also interesting to note that the Alcoa ruling is, in many respects, a reversal of the United States Steel case in 1920. U.S. Steel was a "dirty" company acquitted of both illegal practices and of being a monopoly. The courts ruled that size alone was not a factor. In the Alcoa case, the company was markedly different in its behavior, and size was the only factor in its conviction.

DuPont (1956)

The DuPont Company was charged with attempting to monopolize, conspiring to monopolize, and monopolizing the market for cellophane. The government did not pursue the allegations of attempting or conspiring to monopolize, choosing to concentrate on the allegation of monopoly. DuPont directly accounted for 75 percent of the cellophane market. Its licensee, Sylvania, accounted for the remaining 25 percent of the market. Consequently, DuPont and its licensee held 100 percent of the cellophane market. In the shadow of the Alcoa Case, the numbers did not bode well for DuPont.

In its defense, DuPont argued that there was no such thing as a market for cellophane. Instead, it argued that the relevant market was the "flexible packaging materials" market. This market, DuPont argued, comprised such products as aluminum foil, wax paper, butcher paper, pliofilm, parchment paper, glassine, and other products which customers could substitute for cellophane. In this broader market, DuPont held an 18 percent market share.

To substantiate its claim, DuPont introduced cross elasticities of demand. Large positive cross elasticities are indicative of substitutes. Substitution is the basis for product competition. DuPont's use of cross elasticities sought to confirm the presence of substitution and product competition and to define the relevant market based on such product competition.

The court sided with DuPont, determining the market to be "flexible wrapping materials" and acquitting DuPont. The case set the precedent for defining the relevant market as encompassing all commodities that are "reasonably interchangeable by consumers for the same purpose." It further established the precedent of using cross elasticities to establish the boundaries of the market. The precedents established in this case have been subsequently refined by other cases, and not all cases have required the use of cross elasticities. However, the DuPont case remains a precedent-setting case on the critical issue of defining the relevant market for antitrust cases.

Pabst Brewing (1966)

Pabst Brewery sought to acquire Blatz Brewery. The combined companies would have had about 4.5 percent of the national beer market, but more than 24 percent of the Wisconsin beer market. The government sought to block the merger on the grounds that the merger would consolidate the relevant market and restrict competition. The issue would clearly turn on how to measure the size of the combination vis-à-vis the relevant market. The courts held that since beer was primarily sold in a regional market, the relevant market was the regional market. The merger was blocked.

IBM (1982)

This case never resulted in a court decision. The Justice Department in the early years of the Reagan Administration dropped it. The decision to drop the case had less to do with Reagan's politics than with the crucial question as to the relevant market in the antitrust case.

The government charged IBM with monopolizing the market for "large mainframe computers." In this market, IBM held about 85 percent of the market. This presented the company with a potential "Alcoa problem."

IBM sought to counter the suit with a two-part strategy. First, IBM used the same strategy used by DuPont in the cellophane case. IBM argued that the relevant market was not "large mainframe computers," but rather "business computing machines." Included in this larger market were computers of all sizes, calculators, adding machines, and cash registers. In this broader market (especially with the inclusion of cash registers) IBM's market share was below 30 percent. The definition of the market would therefore be a critical matter in the case and IBM was prepared to use cross elasticities and other evidence to establish their definition of the market.

The second part of the strategy had IBM dragging out the court proceedings until the judge died (he was already old and in questionable health). If the case dragged on and the judge died, the process of appointing a new judge and the time needed to familiarize the new judge with the case could easily push the decision off for a decade or more. The entire matter might involve a moot point by that time. (Part of IBM's effort to delay the case involved the submission to the court of virtually any and every piece of paper generated by IBM employees and officials.)

The Reagan Administration did not file the IBM suit but it did request a review by the Justice Department of the merits of the case and its prognosis. The review concluded that while the court was not likely to completely accept IBM's definition of the market, it was likely to rule that the relevant market was closer to IBM's definition than to the government's definition. Most private economists familiar with the case concurred, predicting that the government would lose the crucial battle of defining the market. Given the delays, costs, and unlikely success of the case, the Justice Department dropped the case.

DuPont/General Motors (1961)

This case was one of the first to apply the Celler-Kefauver Act and one of the few major divestitures (along with the 1911 Standard Oil and American Tobacco cases) ordered by the courts. DuPont had acquired a controlling interest in General Motors in 1921 when it bought 25 percent of the company from GM-founder Willie Durant. DuPont’s purchase kept General Motors from bankruptcy. However, it also precluded all other paint companies from selling paint to General Motors for the next four decades. General Motors was obligated to buy all of its paint from DuPont. This was "vertical market foreclosure" because a vertical acquisition was the means to exclude horizontal competitors (that is, the other paint companies).

DuPont was found in violation of antitrust law on the basis of its vertical market foreclosure and was ordered to dispose of its General Motors stock. Due to the size of the stock holdings, the courts allowed DuPont to set up a company, the Christiana Company, to take control of the stock and dispose of it in an orderly manner to not depress the price of General Motors' stock.

Brown Shoe/Kinney Shoe (1962)

This is another of the early cases seeking to enforce the Celler-Kefauver Act. Brown Shoe manufactured shoes and Kinney Shoe was the largest shoe retailer in the country. Brown Shoe sought to acquire Kinney Shoe in a merger. The market shares in manufacturing and retailing were not very important issues in the case. Instead, the government sought to block the acquisition on the grounds that Brown Shoe was using the vertical merger to vertically foreclose the market to other shoe manufacturers. This case is a good illustration of vertical market foreclosure because foreclosure took the form of actually removing the shoes of its competitors from Kinney stores and replacing them with only Brown Shoes (that is Brown, not brown). The competitor shoemakers were excluded (foreclosed) from this part of the market. Brown Shoe lost the case and the merger was terminated.

Staples/Office Depot (1997)

In 1997, the government examined pricing data to predict the price effects of a merger between two office supply chains, Staples and Office Depot. The FTC examined the prices and quantities of each item sold by the two chains and found that the prices charged by Staples were lower in cities where Office Depot also had a store. The FTC used this logic to convince the court that the proposed merger of Staples and Office Depot would lead to higher prices by eliminating Staples' most significant (and often only) rival. Approval required by the Hart-Scott-Rodino Act was denied and the merger was blocked.

GE/Honeywell Merger (2001)

General Electric proposed to acquire Honeywell and sought pre-merger approval from the Justice Department, the FTC, and the European Union. Both companies are U.S. multinational companies with considerable business dealings in Europe and other markets around the world.

The Justice Department and the FTC both approved the merger with minimal stipulations. However, the European Union rejected the merger outright, citing a reduction in competition. While the decision was couched in terms of maintaining competition, the real issue in the case was an antitrust criterion called "portfolio power." The Europeans have embraced "portfolio power" as a legitimate criterion. However, the U.S. government and most U.S. economists dismiss "portfolio power" as bogus and contend that it is merely disguised protectionism (similar in deception to a "soft loan").

Portfolio power is, according to the Europeans, a power that transcends horizontal or vertical market power. It is a power that would accrue to a large firm with a well-rounded portfolio. It is interesting to note that the criterion was first introduced in a European merger case involving Guinness and Grand Metropolitan. The combined company became Diageo, the largest liquor distributor in the world. There was very little overlap in the liquor distribution businesses of Guinness and Grand Metropolitan, but the European Union held that Diageo would, by virtue of its full product offerings, enjoy unfair "portfolio power." Diageo did not pose a threat to any individual market (horizontal power) or pose a danger of vertical market foreclosure (vertical power) or the alcoholic beverage industry as a whole (it was a large firm, but did not enjoy a monopoly). However, the merger was blocked until the firms agreed to divest themselves of two brands of whiskey (including the Dewers label) to reduce their "portfolio power."

As noted above, American economists, both inside and outside of the government, see no logic in this position. They argue that blocking a merger simply because it would improve the competitive position of the consolidated firm is anti-competitive and unfair. The GE/Honeywell merger was blocked because of the formidable portfolio power that would have accrued to the consolidated firm. The fact that two American firms had received permission from two American regulatory bodies was not the salient feature of the case, but it has heightened tensions across the Atlantic. The case has highlighted the current disparity between American and European policy and the confusion that it creates.

European Union antitrust policy is still a work in progress and there may as yet be a change in portfolio power. In addition, there have been persistent rumors that GE may revive its bid for Honeywell and seek a re-hearing from the European Union. Whether this occurs or not, the issue of portfolio power is unresolved; it is likely to be a point of controversy in future antitrust cases.

Microsoft (2000, and continuing)

Microsoft has been the subject of numerous antitrust proceedings. In 1994, the courts declared illegal the tying contracts that Microsoft had with computer makers. These contracts gave Microsoft royalties from computer makers that installed the Microsoft operating system on their computers. However, the original (illegal) agreement stated that Microsoft was to receive a royalty for every computer made by the firm, even if the firm installed another operating system on some of its computers.

In the 2000 case, the court found that Microsoft stifled competition in the software industry through the following:

- Microsoft's contracts with computer manufacturers required them to install Microsoft's Internet Explorer (an Internet browser) on their computers. When Compaq Corporation announced plans to substitute Netscape's Navigator (then used by 87 percent of the people browsing the Internet) for Internet Explorer, Microsoft told Compaq that it had to install Internet Explorer or lose the license to install the Microsoft operating system.
- Microsoft's contracts with computer manufacturers prohibited them from altering the Windows desktop by removing Microsoft's desktop links to the Internet.
- Microsoft's bundling of Internet Explorer with Windows 95 and its inclusion as part of Windows 98 tied the operating system to the browser.
- Microsoft used its virtual monopoly in operating systems (more than 90 percent of the market) to gain a monopoly in the browser market. It also used illegal practices to protect its monopoly in the market for operating systems.
- Through its market share, monopoly power, and tying contracts (bundling), Microsoft was able to effectively foreclose competitors (e.g., Netscape) from the market as well as foreclosing a competing technology (recall the emphasis on technology foreclosure announced in 1994).

The Microsoft case is a complex case involving many of the statute and case law points developed above; market share (Alcoa), illegal per se tactics (tying contracts), and vertical market foreclosure. In addition, a bit of background is necessary to understand the government's insistence on breaking up Microsoft. (At this juncture, it does not look like this will happen). The government's experience with Microsoft in the earlier 1994 case led it to conclude that Microsoft could not be relied upon to honor a consent decree. Finally, it must be emphasized that the final verdict in the Microsoft case is not yet in, especially regarding the charges brought by the European Union.

Concluding Observations

Remedies

The courts can order firms found in violation of antitrust laws broken up. This is called divestiture. This remedy is the most extreme action and courts have used it sparingly. There have only been a handful of large divestitures ordered by the courts. Firms found guilty of anti-competitive practices can be ordered through court injunction to stop the practices deemed unlawful. Fines and imprisonment are also possible sanctions. An antitrust suit brought against a firm by the government usually involves criminal charges. Private parties injured by illegal combinations and conspiracies can also bring an antitrust complaint in a civil suit. In this case, the private firm would have to prove the case itself. Under English common law, firms injured by anti-competitive practices could sue for triple damages. This remedy remains in effect today. For example, Al Davis and the Oakland Raiders won a civil suit against the NFL and the City of Oakland following their move to Los Angeles and collected triple damages.

Most antitrust complaints involving allegations of illegal practices end in a "consent decree." In a consent decree, the firm agrees to stop the offending practice but does not admit guilt. In exchange, the government agrees to drop the case. The incentive for the firm to end a case in this manner stems from its ability to avoid possible triple damage claims. A criminal conviction would immediately leave the firm open to triple damage claims from injured parties in civil suits. Following a conviction in the government's case, the private firms would not have to prove the antitrust case. They would only have to prove the number of their monetary injuries. Microsoft now faces the prospect of numerous civil suits in the wake of its conviction in the suit brought by the government.

The Relevant Market

Defining the relevant market is crucial in most antitrust cases involving allegations of monopoly. It is not important in complaints involving practices that are illegal per se under the law. However, the relevant market is again important in cases involving practices that are not illegal per se, but illegal when they restrict competition.

When a suit alleges monopoly or restraint of trade, the first question is: Monopoly or restraint of trade in what market? The size of the firm can only be meaningfully understood in relation to its market.

Determining the relevant market was the critical point in many of the cases considered above. In the DuPont cellophane case and the IBM case, the firms successfully challenged the definition of the market and had favorable outcomes to their suits. Cross elasticities were instrumental in defining the markets in these cases. In contrast, the judge in the Brown Shoe case ruled early in the case that the shoe market had three distinct components: men's shoes, women's shoes, and children's shoes. He refused to hear evidence to the contrary (including stories of men wearing women's shoes).

The importance of defining the relevant market can also be seen in the Alcoa case. Alcoa may have lost its case when the judge opted for a very narrow (and perhaps erroneous) definition of the market. The judge ruled that the aluminum market encompassed only newly refined aluminum and excluded from the market aluminum scrap. Since aluminum from scrap competed directly with virgin aluminum, it is hard to see the wisdom in the judge's decision. However, it is easy to see the significance of the exclusion. If scrap had been included in the relevant market, Alcoa's market share would have been only 60-64 percent. If Alcoa's internal consumption of aluminum had also been eliminated from the relevant market, Alcoa's share of the open market for aluminum (from both virgin production and scrap) would have been only 33 percent. These alternative definitions of the market, in a case where the size of the firm was the critical factor, could have had a dramatic effect on the outcome.

A Final Run at Smith's Formula

Smith raised the relevant question more than two centuries ago, but a definitive answer has not been forthcoming. Is there sufficient competition to enable markets to channel self-interest into promoting social welfare? Or do we need more antitrust laws and policing to effectively assure desirable social outcomes?

It should be clear that this question does not have a simple 'yes' or 'no' answer, nor did Smith ever suggest that it did. Smith was not an anarchist and he always saw a legitimate role for government to play in establishing markets and in providing the groundwork, property rights, and legal infrastructure that markets need. The question was always a matter of where to draw the line?

We cannot resolve this issue here – this should remain a question that you visit repeatedly in the future as the economic environment changes. But as a final take on this issue, let's consider the question from the perspective of firms that have tried to seek their fortune by eliminating or restraining competition. While some have enjoyed limited success at eliminating competition, most have found it far more difficult than imagined. Most have abandoned their quest for monopoly in favor of concentrating on making their firm a stronger competitor.

Adequately supporting this historical observation would consume the remainder of this course; however, let us consider the experience of one company – Nabisco.

Example: Nabisco Gives Up on Creating a Monopoly

The following is an excerpt from the 1901 Annual Report of the National Biscuit Company (Nabisco). It has been reprinted from Alfred D. Chandler's Strategy and Structure, pp. 32-33.

"This Company is four years old and it may be of interest to shortly review its history. . . . When the Company started, it was an aggregation of plants. It is now an organized business. When we look back over the four years, we find that a radical change has been wrought in our methods of business. In the past, the managers of large merchandising corporations have thought it necessary, for success, to control or limit competition. So when this company started, it was believed that we must control competition, and that to do this we must either fight competition or buy it. The first meant a ruinous war of prices and a great loss of profits; the second, constantly increasing capitalization. Experience soon proved to us that, instead of bringing success, either of those courses, if persevered in, must bring disaster. This led us to reflect whether it was necessary to control competition. . . . We soon satisfied ourselves that within the Company itself we must look for success.

We turned our attention and bent our energies to improving the internal management of our business, to getting the full benefit from purchasing our raw materials in large quantities, to economizing the expenses of manufacture, to systematizing and rendering more effective our selling department, and above all things and before all things to improving the quality of our goods and the condition in which they should reach the customer.

It became the settled policy of this Company to buy out no competition. . . "

The word "biscuit," as used here, is an old American (and British) term for a cracker. Nabisco was created in 1898 through the merger of the American Biscuit and Manufacturing Company (created out of the merger of 40 Midwestern bakeries), the New York Biscuit Company (created from 7 Eastern bakeries), and the United States Baking Company. Nabisco was a merger designed to create a U.S. cracker monopoly that operated 114 bakeries across the United States. Nabisco was the product of the E.C. Knight case that ruled that the Sherman Act did not apply to manufacturing. This is also why the annual report - written in 1901 – could be so straightforward about the companies monopoly strategy. Industrial monopolies were perfectly legal.

However, the main point is that Nabisco concluded that a monopoly was difficult, if not impossible, to attain. Note that, in 1901, the E.C. Knight case had not yet been overturned and Nabisco was free to pursue its quest for monopoly. The problem was that it was simply not able to eliminate competition. The excerpt above is the company telling its shareholders that its monopoly strategy was not working.

What is equally important was Nabisco's new strategy – forget about trying to monopolize the market and instead direct the firm's resources to:

- Building its distribution network – it stopped selling in bulk to distributors and began selling in smaller quantities to retailers
- Expanding and promoting its brand names
- Increasing its advertising
- Reducing costs by buying inputs such as flour in bulk
- Improving the layout and efficiency of its manufacturing plants
- Centralizing the operations and management of the firm

In other words, Nabisco decided that its future lay in taking care of business first – it was going to concentrate on building better products and a better company. Regarding brands, one of Nabisco's first successes with a brand-named cracker was its "Uneeda Biscuit" line (get it: 'U-need-a-biscuit'). While this early attempt at brand naming is a bit hokey, the company got better at it and later introduced the phenomenally successful Ritz Cracker in 1934. Today, Nabisco is a part of Kraft Foods and features such well-known brands as: Chips Ahoy! Cookies, Fig Newton Cookies, Mallomar Bars, Oreo Cookies, Premium Saltine Crackers, Triscuits, and Wheat Thins.

One example does certainly not resolve the issue, but firms have usually found that eliminating competition is not very easy and not very productive – it is simply too hard and they are better off concentrating on the basics of making better products and making a more competitive firm.