The Antitrust Penalties

A STUDY IN LAW AND ECONOMICS

Kenneth G. Elzinga and William Breit

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INTRODUCTION

On December 21, 1974, President Gerald Ford signed into law the first major reform in the nation's antitrust laws in almost twenty years, which provided the most significant alterations in the penalties for antitrust violations since the enactment of the Sherman Act in 1890. In his economic message to Congress on October 8, 1974, the president had requested key changes in the antitrust penalties as part of his program to combat inflation. When finally passed a little over two months later, the Antitrust Procedures and Penalties Act changed violations of the Sherman Act from misdemeanors to felonies; increased the maximum jail term from one year to three years; and raised the maximum fines from $50,000 to $1 million for corporations and from $50,000 to $100,000 for individuals.

The new law was approved with astonishingly little dissent. In the Senate the bill passed by a vote of 92 to 0, and in the House a unanimous vote was recorded. This display of concord on an issue once so controversial is indicative of the wide-ranging consensus that now exists about the necessity of maintaining a high degree of competition in the American marketplace, a belief adhered to not only by politicians but also by civil servants, legal scholars, and academic economists. The importance of antitrust enforcement is one of those rare issues that cuts across even the most formidable of ideological barriers.

Yet there are different methods for approaching the study of antitrust reform. The first and most common is to study the general intentions and results of our institutional arrangements and, if it seems warranted, propose reforms. The antitrust literature has been almost wholly devoted to this approach. There is by now a whole spate of books and articles concerned with such questions as: Do concentrated market structures yield monopoly power? Do tying contracts enhance or diminish economic efficiency? Did Judge Learned Hand stifle legitimate business expansion in the *Alcoa* decision? Does the price discrimination law have pro- or anticompetitive implications? Basically all of these inquiries have in common one issue: what are the anticompetitive implications of various business practices? Once the answer to this question has been determined, a rational criterion will have been established to direct enforcement officials in the selection of antitrust cases. While we do not deny the importance of having better benchmarks by which to appraise the appropriate choice of antitrust cases, the chapters that follow will have little to add to this literature.

The alternative approach we pursue accepts the general structure of present legal arrangements and studies whether or not the methods and instruments of their implementation are efficient. This route seems particularly attractive after the substantial refurbishing of our antitrust instruments that has recently occurred. It seems likely that a long period of quiescence will now set in to allow a testing period for the updated weapons of antitrust. After all, the new legislation, although enacted swiftly in response to the urgent appeal in the president's economic message at the end of 1974, followed two decades of discussion before congressional committees and debates on the floor of Congress, during which there were no fundamental alterations in the penalties for antitrust violations. Because it is highly probable that there will now be a hiatus in legislation involving these penalties, an economic analysis of the inventory in the entire antitrust arsenal, both of the old and tested weapons and the newer deterrents, seems both timely and sensible.

Therefore we are not here concerned with the question of whether, for example, a particular tying arrangement or merger lessens competition. Our focus is on the efficient deterrence of antitrust violations—however these violations may be defined. And since deterrence is a function of the penalties imposed on violators, our analysis takes the form of a technical examination of the weapons that comprise the antitrust arsenal. The most rational criteria by which antitrust cases might be selected are useless if the violation is neither deterred nor remedied, an example perhaps of what Justice Jackson meant in his cryptic comment about the government having "won a lawsuit and lost a cause." It is curious that students of antitrust should be almost wholly preoccupied with the first approach virtually to the total neglect of the second.

Regardless of the approach taken, any proposal for reforming our antitrust arrangements must ultimately be based on a theory of government action. Should government be concerned with the achievement of competition and how much antitrust activity should be undertaken to bring it about? Chapter 1 provides a rationale for antitrust intervention in the marketplace and attempts to establish the limits beyond which such activity should not be carried.

We are persuaded that a legal and economic analysis of the deterrence issue in antitrust cannot be undertaken without an understanding of the historical context of the antitrust penalties. Since previous experience with these tools is the only evidence available for predicting the relative merits of alternative arrangements, chapters 2 and 3 discuss these instruments and place them within the setting of the American experience. In particular, chapter 3 surveys the public action penalties of incarceration, structural relief, and fines. Both the current status of these penalties and proposed alterations in their design are described and evaluated.

In chapters 4 and 5 the celebrated second barrel of the antitrust shotgun, treble damage suits, comes under scrutiny. First the historical background of reparations-induced, multiple damage actions is adumbrated. Then a thoroughgoing examination of the economic implications of the treble damage penalty is undertaken. Our use of the economic theory of property rights leads to conclusions that will seem surprising and new, we believe, even to specialists.

Chapter 6 tackles the question of trust-busting itself by examining the economic considerations of dissolving ongoing firms. Here too our treatment is rather unconventional, especially when compared to the portrayal of this instrument typically found in the antitrust literature.

Of necessity the longest chapter in the book is devoted to what we consider to be the efficient approach to antitrust enforcement. Chapter 7 begins with a discussion of the reciprocal nature of the monopoly problem. We analyze the psychology and incentives of corporate managers as they consider engaging in antitrust violations and show the crucial bearing that managerial risk attitudes have on the efficacy of alternative penalties in deterring anticompetitive activity. The chapter ends with a proposal for streamlining the tools of antitrust enforcement.

In chapter 8 we compare the relative merits of public versus private use of the antitrust weapons. The vehicle for this discussion is a series of questions that must be faced by anyone proposing sweeping change from a private action approach to sole reliance on public enforcement. Chapter 9 provides a statement of our conclusions.

CONTENTS

PART I: THE SETTING

1

ANTITRUST AS A PUBLIC GOOD

Monopoly as Market Failure

The orthodox rationale for the antitrust laws is that they promote competition and prevent "undue limitations on competitive conditions."[1] From the point of view of economic analysis, however, public policy to promote competition can be explained as an attempt to come to grips with "market failure." Market failure occurs when voluntary exchanges do not sustain desirable activities or eliminate undesirable ones.[2] The spillover effects of production (or consumption) that are not taken into account through markets are called externalities and are usually associated with "public goods."

The two distinguishing features of a public good are indivisibility and nonexcludability. Indivisibility means that the consumption of the good by one person does not diminish the possibility of its consumption by another as well; that is, a public good permits simultaneous consumption. Nonexcludability means that once an indivisible good is provided, it is not possible economically to exclude others from its enjoyment.

National defense is a traditional example of a pure public good. Not only is it indivisible since one person's consumption of its services does not preclude others; it is also nonexcludable since it is not economical to prevent the enjoyment of this service by excluding those who refuse to pay for it.

1. U.S., Justice Department, Attorney General's National Committee to Study the Antitrust Laws, *Report*, at 1 (1955).

2. For a technical discussion of market failure, see Francis M. Bator, "The Anatomy of Market Failure," *Quarterly Journal of Economics* 72 (August 1958): 351; reprinted in William Breit and Harold M. Hochman, *Readings in Microeconomics*, 2d ed. rev. (New York: Holt, Rinehart, and Winston, 1971), p. 518.

Whenever a public good as just defined exists, it is unlikely that the optimal amount of it will be provided privately, because individuals have an incentive to behave strategically, dissembling their preferences in the hopes that others will provide the service. Since everyone has an incentive to "free ride," not enough public goods will be provided through a system of voluntary exchanges and market failure will occur. In such cases, government provision of the good or service is given consideration. Market failure has become the central explanation or justification for much government activity.

When seen in this setting, the antitrust penalties are simply an attempt to provide a public good, although the problem is not conventionally handled this way in the literature. Milton Friedman, for example, gives two *different* justifications for government intervention: (1) the existence of public goods and (2) monopoly.[3] But that is a distinction without a difference. In fact the elimination of monopoly is a public good in the purest sense. It is both indivisible and nonexcludable. One person's enjoyment of the services of a noncollusive market does not preclude others from that enjoyment; nor is it economical to exclude others. In other words, changes in market behavior affect all consumers simultaneously. It is not possible to have some consumers purchasing in a market with only a single producer while others purchase the same product in a market with many sellers.[4]

To illustrate, consider a simple case in which a firm that is operating in a perfectly competitive market enters into a collusive arrangement whereby it agrees with its former rivals to charge a higher price and to produce at a lower rate of output. Assuming that the cartel is successful, figure 1 illustrates the damage done to society by this individual firm. At competitive price P_0 the firm produces output Q_0, and the firm is economically efficient since the condition of efficiency is that price must equal marginal cost. After joining the cartel, the firm adjusts its output to

3. Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962), p. 28.

4. It would not be advantageous for a monopolist to sell at marginal cost to some and not to others because those who buy at the lower price would sell to others at a higher price (but one lower than the price the monopolist would be charging). Moreover, under the antitrust laws such price discrimination might be illegal.

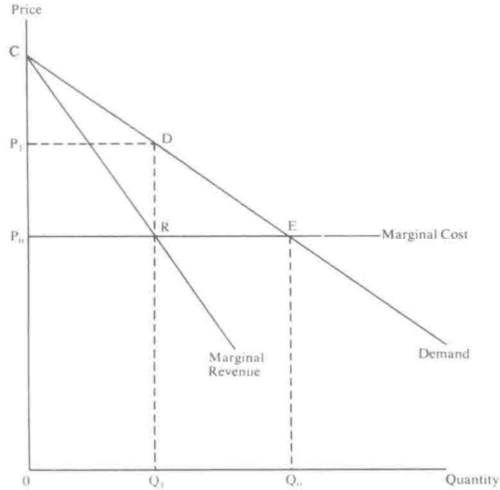

Figure 1

Q_1 and charges the price P_1, which is higher than marginal cost and violates the efficiency condition. The loss to consumers (called consumers' surplus)[5] is represented by the area of the trapezoid P_1DEP_0. Part of this loss, however, is a transfer of revenue to the cartel—the transfer being measured by the rectangle P_1DRP_0. This area must be subtracted from the trapezoid in order to get the net loss to society

5. Consumer's surplus is the difference between how much a consumer pays for a commodity and how much he would have been willing to pay rather than go without it. This surplus is an index of well-being. If it could be measured accurately, it would provide a test of the amount of welfare our economy generates for consumers. All that would be required is a list of the maximum prices a consumer would be willing to pay for each unit of a good, compared with the price he actually pays. In figure 1, consumer's surplus at price P_0 for Q_0 units of commodity X would be approximated by the triangular area CEP_0. This area is only an approximation to consumer's surplus unless it is assumed that the marginal utility of money is constant. It is assumed that such a small amount of money is spent on each commodity that changes in money's marginal utility can be ignored. Under this assumption the area under the demand curve and above the price line represents precisely the amount of consumer's surplus. On the more technical aspects of consumer's surplus, consult George J. Stigler, *The Theory of Price,* 3d ed. (New York: Macmillan, 1966), pp. 78–81.

caused by this individual member of the cartel. The net loss is represented by the area of the triangle DER. This is often referred to in the economics literature as the "welfare triangle" and is used to indicate the net loss to society from monopolistic behavior.[6]

Assume that the firms in the cartel are all alike, in the sense that they have identical cost curves and are of the same size. It is then possible to multiply the welfare triangle area by the number of firms to get the total loss to society from this particular price-fixing activity. If we could perform this calculation for every firm in the economy that is engaged in illegal monopolistic behavior, we would have a rough approximation of the total benefit to be gained from the elimination of monopoly power and the restoration of competition.

Note that in a world of no transactions or information costs (and one in which people did not attempt to act as free riders), the benefits of competitive markets would be readily secured. The customers of any monopolist would find it to their advantage to get together and bribe the monopolist to behave like a competitive firm, producing at an output where price is equal to marginal cost.[7] By so doing, the gain to consumers (in the form of increased consumers' surplus) would be larger than the firm's reduction in monopoly profits (and the amount of the bribe) and consequently (in principle) any monopolist could be com-

6. In this book, the primary goal of antitrust is taken to be allocative efficiency. There are, of course, other goals; for example, an equitable distribution of income and a rising growth rate. However, as Ward Bowman has pointed out, neither of these goals necessarily conflicts with the goal of economic efficiency and they can be achieved by more direct means (e.g., a progressive tax system combined with a negative income tax; programs encouraging savings and investment) than antitrust enforcement. For a fuller discussion of these issues, see Ward S. Bowman, *Patent and Antitrust Law: A Legal and Economic Appraisal* (Chicago and London: University of Chicago Press, 1973), pp. 5–14. Most economists now agree that the welfare triangle underestimates the actual loss in efficiency, because it does not take into account the investment of resources in the activity of monopolizing and in policing the cartel agreement. On this point, see Gordon Tullock, "The Welfare Costs of Tariffs, Monopolies, and Theft," *Western Economic Journal* 5 (September 1967): 224; and Harvey Leibenstein, "Allocative Efficiency vs. 'X-Efficiency,'" *American Economic Review* 56 (June 1966): 392.

7. It should be noted here that we are assuming a single price monopolist in the classical sense.

pensated sufficiently to induce him to forego monopolizing and to instead provide a greater supply of his product at lower prices. Both the monopolist and its customers could be made better off.

But one reason such behavior does not occur in the marketplace is the existence of an incentive for individuals to feign indifference to the possibility of having the monopolist produce where price equals marginal cost. Given the free rider problem, the establishment of competitive markets is a public good in the classical sense.

However, where there are significant costs of exchanging information between the parties actually damaged by the monopolist, and substantial negotiation costs as well, the free rider problem is compounded. For even in the unlikely case that all the customers of a monopolist shunned free riding (that is, everyone was willing to pay his share), the costs involved—assembling the potential customers, collecting their payments, and negotiating with the monopolist—could exceed the benefits derived from competitive behavior. In such a case, government intervention to provide the public good of competitive markets becomes explicable; the antitrust penalties can be seen as an attempt to eliminate the public bad of monopoly.

How Much Antitrust Enforcement Is Optimal?

Theorems on Antitrust Enforcement

It might seem that antitrust policy should be directed toward the elimination of all anticompetitive inefficiencies so that each and every welfare triangle could be captured for society. Economic theory, however, provides two traditional objections to the perfectly competitive model as a guide to public policy. One is the theory of "workable competition" proposed by J. M. Clark; the other is the theory of "second best" associated with J. E. Meade.[8]

8. J. M. Clark, "Toward a Concept of Workable Competition," *American Economic Review* 30 (June 1940): 241; reprinted in *Readings in the Social Control of Industry*, ed. E. M. Hoover and J. Dean (Philadelphia: Blakiston, 1942); J. E. Meade, *The Theory of International Policy* (London: Oxford University Press, 1955), vol. 2, *Trade and Welfare*.