A LEGAL THEORY of ECONOMIC POWER

Implications for Social and Economic Development

CALIXTO SALOMÃO FILHO

NEW HORIZONS IN COMPETITION LAW AND ECONOMICS

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Preface

A book about forgotten realities. This is perhaps the best description of this work.

Its title, *A Legal Theory of Economic Power*, is very revealing in this sense. The old times of antitrust law, centered on market rationality, are gone. Economic power is pervasive in society and cannot be treated as a mere economic phenomenon, based on market rationality paradigms. There are many and very important 'forgotten realities' that stayed out of this treatment.

Therefore, a theory of economic power must be treated as such, as a general theory. The reference to antitrust law must nowadays be historical. This does not mean that, when treating power created in the market, the theoretical tools should not include classical 'antitrust' discussions, though in a revised and critical version. That is what this book tries to do.

Power with legal roots and social roots is also treated, however, with different theoretical paradigms. Through them, some of the 'forgotten realities' are included and treated. Through them, the reader can also understand another fundamental aspect of the concentration of economic power: its influence on social and economic development patterns.

An intended general theory of economic power. That is what the title says and that is what the book intends to be. Too pretentious? That is an answer to be given by a critical reader after reading the book, as long as he/she remains impartial, i.e., allows himself/herself to read the book free from the 'shadows of the past', the past of the old 'market rationality-based' antitrust law.

Calixto Salomão Filho
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1. A neo-structural legal perspective to economic power analysis

1. INTRODUCTION: THE INSUFFICIENCY OF THE ANTITRUST CONCEPTS AND INSTRUMENTS

For decades, antitrust theory has been moribund and read like an obituary. New ideas have been few and far between, and what little has come on the scene takes pride in having mere practical application, all foundational theories and justifications for antitrust having long since had their day.

In fact, the strong tendency toward simplification and doctrinal negativism has a double origin. In the first instance, it is based upon a superficial analysis of the economic landscape that leads to the belief that the effects of private economic power in society are limited to the manufacturer–consumer relationship.

Economic history, both in developing and developed countries, shows that the effects of monopoly power are much more pervasive than just the consumer–producer relationship, affecting development patterns and even distribution patterns in society.

In the second instance, there is a powerful and again simplistic faith in the ability of economic theory to predict results and, consequently, in our ability to identify the most efficient result in the consumer–manufacturer relationship.

This efficient result is, in its turn, the product of a rationality-based analysis of the market functioning. Therefore law and antitrust law in particular have been oriented to correct imperfections in the market functioning. Market power structures, in this (neoclassical)[1] view, are nothing more than the product of an imperfect functioning of the market.

Adding these two simplifications together leads to a belief in the possibility of identifying one unique theoretical objective in antitrust law, which consists of obtaining a certain economic result based on principles of rational functioning of the market. This analysis is, as will be demonstrated, too simplistic for various reasons.

[1] The word neoclassical has many different meanings in economic history and economic science. When used in the book, it is equivalent to the Chicago School microeconomic theory as applied to Antitrust Law.

First of all, because economic power cannot be considered a mere market phenomenon. As will be demonstrated, not all structures with economic power are created in the market, even if they have effects on it. Many of them are created by the law or by social relations. Their analysis in terms of market rationality is therefore impossible.

But this is not all. The exclusive (or predominant) market rationality paradigm can be criticized not only based on the source of economic power but also on its effects. The effects of economic power structures are not limited to the market. They are much broader, involving, as will be seen in the next sections, negative wealth distribution effects and negative social effects. Consequently, all structures, even those created in the market, are neither well perceived nor analyzed by market rationality paradigms.

If all this is true and economic power has not only market but also legal and sometimes social roots and on the other hand produces effects far beyond the market, economic rationality cannot be predominantly a market rationality but instead a rationality of power and power exercise. Evidently such a broad reality cannot be well perceived by traditional antitrust law.

2. ECONOMIC POWER AND ITS MULTIPLE EFFECTS ON THE SOCIAL AND ECONOMIC SPHERES: MONOPOLIES AND UNDERDEVELOPMENT

If this is true, then an analysis of the relationships and effects generated by economic power should originate not in mathematical assumptions about economic results but in the study of the economic history of countries in which this power is more structured and deeply rooted in social and economic structures. The reason is simple. It is first of all in these regions that these broader effects of economic power are easier to identify. As in all theoretical analyses, using examples with more pronounced characteristics helps to identify tendencies and demonstrate propositions. This does not mean that such results are invalid for countries in which economic power is less disseminated and less profound. It only means that the results obtained will likely be less intense.

The countries in which economic power is historically most concentrated and consolidated are former European colonies in South America and Asia. In those countries, economic power is a phenomenon that is historically part of society and, therefore, much easier to identify. This statement is not new, but its consequences for the economics and internal legal systems in place in developing countries were disregarded in the past and are still belittled.

There is no doubt that in the former colonies, as contrasted with today's developed countries, economic power was made up of economic relationships that were relevant factors even for the formation of the national states. The histories of most, if not all, of these countries are tightly intertwined with European colonization. This is an important element to be noted. The status of 'colony', far beyond external dependence, created internal power structures that marked and still influences many aspects of development (or underdevelopment) in these societies.

This is why it appears possible to revisit their development processes, starting from the structures of economic power and the structure of income distribution that follow them. The bonds of colonial dependence that motivated underdevelopment, even if the root cause, are not its ultimate cause. The explanation is simple, but must be well understood. The internal economic structures are what permit or inhibit, in the necessary moments, the breakthrough from dependency. As we all know, this rarely took place in the history of developing countries. Apart from rare and exceptional situations, in these countries the bonds of dependency are rarely counter-attacked and even less frequently broken. This is owing to internal power structures and income distribution that benefits, even if indirectly, from these bonds.

It is therefore on these structures that the analysis should be focused. In addition, the relationship between economic power and income distribution must be addressed in the light of historic evidence. This relationship is intense.

Traditional analysis tends to identify only certain superficial relationships between a monopolistic company and the consumer, to wit, essentially identifying it as the value of the monopolist's extraordinary profit, which is extracted from consumers through the imposition of monopolistic prices. As has been shown in empirical studies, this value may not be dismissed and accounts for a relevant portion of income concentration.

The fact is that this relationship between economic concentration and income distribution is much deeper and more extensive. This is especially true of structurally concentrated economies such as the former colonies. On the one hand, the relationship is much more extensive in the product market, affecting industrial organization itself. As well as the imbalance in relations between consumers and manufacturers, with the consequent inefficiencies in allocation and distribution, it leads to an absolute disproportion amongst economic sectors. The dynamic sector of the economy since colonial times is generally concentrated in primary products or low technology manufactured goods for export and in the durable consumer goods to be consumed internally by the high income segment of the population. These two sectors, monopolized or oligopolized, concentrate inversions and productivity gains. They therefore drain resources from the economic system either directly, through monopolistic profits obtained from suppliers, or indirectly, via the siphoning of investments that would otherwise be invested in other sectors (hereafter called peripheral economic sectors).

The effects are also deeper. As well as the consumer market and peripheral economic sectors, there is also strong interference in the labor market. Thus, in many, if not most, of these countries, income concentration ends up becoming a fundamental condition for economic growth. This is precisely because, based on the production of primary products and simple raw materials, be it for the domestic or foreign market, productivity gains in these economies cannot be obtained only through technological improvements (which are at times insufficient in such low technology sectors). Gains in productivity that are fundamental for economic growth should be based on an increase in workforce productivity, which can be achieved through reducing real salaries or through an effective reduction in the workforce (source of the first so-called economies of scale achieved with economic concentration). This movement is only made possible, however, via a high level of monopolization in the economy, which also creates great monopolistic conglomerates in the labor market. As previously mentioned, this state of affairs is explained not only by the fact that competitors in the relevant sector are scarce and hardly relevant, but also because, in such economies, the colonial monopolistic standard ensures that there is a lack of competition among economic sectors. Sectors with real economic dynamism, capable of accumulating capital and absorbing the labor force, are few and concentrated.

Only through such an absolutely concentrated growth standard is it possible to have capital accumulation and therefore productive investment that leads to growth. That said, such a growth standard requires, for its own existence, inverse income redistribution, with impoverishment (relative for employed workers and absolute for those who lose their jobs) of lower income groups and relative impoverishment of peripheral economic sectors.

Placing the spotlight on structures also implies that predominant sociological-individualistic explanations for underdevelopment are not accepted. These justifications are frequently incorporated into neo-institutional reasoning to explain underdevelopment and suggested solutions. Hence, according to these theories, with the individual motivation of colonizers of Latin America and Asia, colonial exploitation, different from that of immigrants to North America and Oceania, was reflected in the entire institutional structure of society. This kind of statement errs in being an under and overstatement at the same time. On the one hand, it exaggerates the differences in the individual spirit of colonizers. Interesting studies demonstrate that the colonial experience is richer than this distinction appears to suggest. Within the same colonies, there coexisted regions of mere exploitation with regions where colonizers considered settling and remaining. Both situations happened in colonized countries in Latin America, Asia and even Africa (South Africa, for example). In these countries, be they Argentina, Australia or India, the capitalist colonial spirit was similar.[2]

On the other hand, what these sociologic-individualistic theories fail to consider is precisely the study of economic structures created by exploitive colonization. These structures, and not individual motivation, are the main factors that lead to differences between economies based on exploitive monopoly and societies in which these structures do not prevail. They end up determining economic cycles and influencing the whole of a society's socio-economic system, prevailing over the similarities or differences that regions that experienced the definitive settling of populations, as opposed to those where populations were merely exploited, could have from the point of view of the motivations of explorers. Thus, regions of similar colonial spirit like Buenos Aires in Argentina and Sydney in Australia result in countries and regions of social and economic development levels that are absolutely different.

Structural concentration of economic power therefore produces effects on the entire system, concentrating income between industrial sectors and between social strata. This concentration of power and income also causes economic growth patterns to change substantially. The increase is strongly based, among other factors, in productivity gains resulting from the inverse redistribution of income from workers (both employed and surplus) to the great conglomerates (and their small number of shareholders).[3]

It is important to observe as of now that this hypothesis, once explained, can help solve two apparent paradoxes of contemporary economic history, which are, in fact, directly correlated.

The first consists of reproducing underdevelopment (with absolute or at least relative deterioration of the main social and income distribution indicators) even in countries that have had important economic growth rates. The hypothesis presented here can help explain this apparent paradox. If the hypothesis for concentration of economic power as a generator of inverse income distribution in the consumer, work and inter-industrial markets in the developing countries is admitted, it is possible to understand the reason for economic growth with deterioration of social indicators. This happens precisely because of inverse income distribution, in other words, owing to the fact that gains in productivity result from a loss in real salaries or more

[2] See D. Denoon, *Settler Capitalism: The Dynamics of Dependent Development in the Southern Hemisphere*, 1983, p. 18, *et seq.*

[3] For an econometric analysis of the relationship between market concentration (monopolies) and poverty in Brazil during colonial times see C. Salomão Filho, B. Ferrão and I. C. Ribeiro, *Concentração, estruturas e desigualdade – as origens coloniais da pobreza e da má distribuição de renda*, 2009.

recently from an increase in the exclusionary process created by unemployment.[4] The final result is the existence of constantly underdeveloped economies, in which the more economic power structures grow, the more poverty and social inequalities are produced.

The second apparent paradox is in the convergence of relative prices between developed and developing countries identified in empirical studies.[5] According to this research, it is possible to show a positive correlation between international convergence in prices of commodities and convergence of relative prices of production factors (principally wages and land prices, the wage–rental ratio). This convergence is followed, and thus the apparent paradox, by an increase in differences in living standards in the developed and developing worlds. Obviously it is not sufficient, as is done in these studies (see note 4), to identify technology gains to explain these results. The approximation of prices of commodities followed by an approximation in wage–rental ratios should also lead to smaller and not greater differences in living standards, even with various technologies. After all, commodity and

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[4] Whereas in colonial and early industrial time productivity gains were obtained from real salary reduction, in modern times productivity or 'efficiency' gains are obtained from cost reduction in concentration processes, specially through lay-offs. The problem is that the 'economic exclusion' created by this lay-off process is much more serious than just unemployment. Unemployment, when coupled with an environment where other people are included in the economic process, completely marginalizes the individual. Since he is incapable of paying any kind of prices or any kinds of goods (from food to real estate) that the non-marginalized pay, he is constrained normally into a parallel economic environment, of the excluded. Poverty, violence, gang formation and drug addiction create a vicious circle parallel to the economic process out of which it is difficult to take the individual. Although many developing countries like Brazil, experimented in latter times relevant growth rates coupled with improvement in many social indicators, this is due mainly to governmental anti poverty and inclusionary programs (as Bolsa Família in Brazil). Even in those countries, however, the above stated influence of economic structures in exclusion is an important reason why probably urban poverty has proved so much more difficult to eradicate than rural poverty through anti-poverty programs (*Bolsa Família* in Brazil, for example). For instance, see 'Brazil's Bolsa Família' in *the Economist*, 31 July 2010, p. 19. For recent data and analysis, see 'Gastos com a Política Social: alavanca para o crescimento com distribuição de renda', Comunicado no. 75, Comunicados do IPEA, February 2011, available in Portuguese at *www.ipea.gov.br*. The Institute for Applied Economic Research (IPEA) is a federal public foundation linked to the Strategic Affairs Secretariat of the Presidency of the Republic. It provides technical and institutional support to government for the formulation and reformulation of public policies and development programs in Brazil.

[5] See J. Williamson, 'Land, Labor and Globalization in the Third World, 1870–1940', in *The Journal of Economic History*, 62(1), March 2002, p. 55 (68); see also previous work by the same author, 'Globalization, Convergence and History', in *The Journal of Economic History*, 56(2), June 1996, p. 277, *et seq*.

land prices account for much of what is required to improve social and economic indicators of a region. Even with other important factors influencing these indicators, the full discrepancy can show only that there is a particular segment of the population taking advantage of the best wage–rental ratios.

In relation to different and successive economic phases typical of developing countries in which the primary products and raw materials industries are substituted for a rural economy, these results are in reality indicators of economic concentration and inverse redistribution of income and not improvements in quality of living. In these economies, in this particular historic moment of industrialization, the reduction of land prices is more than proportional to the reduction in real wages that, however, still exists. This is because the demand for land drops more in periods of industrialization than the demand for workers and also because, during this period, union organization begins in most developing countries, avoiding an even greater deterioration of real wages levels. What is actually happening is a concentration of wealth in the top segments of society, which can accumulate even more capital through the purchase of land. In addition to the association of better wage–rental ratios and worse social indicators, this also explains another peculiar characteristic of developing economies. It is a fact that 50 years after the start of the industrialization process in the majority of the developing countries, we are witnessing a re-concentration of agricultural property in the hands of large landowners and the marginalization of farm workers in such countries. The accumulation of capital, having happened in an unbalanced manner, is such that only the top layers of society can take advantage of reductions in land prices. For the working classes, employed or even unemployed, there is no access to agrarian property. This explains the prevalence and endemic character of the agrarian conflicts in these economies, in spite of the relative abundance of land.

What we are saying, in fact, is that the opposing positions of the classic theory of comparative advantages and the structural theory (in the initial version by Prebish) should be revised. Even with an approximation between the values of the production factors (in a certain period of time),[6] this approximation is not relevant for the economic development of these regions. This is because the central problem of colonialism is not in the structures of international commerce, but in the domestic structures of economic power (related or not to foreign economic and trade issues) whose establishment and implementation were very much favored by colonialism.

6 Approximation not completely shown. There is relevant data in the opposite sense – see on this issue J. Love, 'Economic Ideas and Ideologies in Latin America since 1930', in *Cambridge History of Latin America*, vol. VI, 1, 1994, p. 393 (p. 423, especially note 91).

Furthermore, as mentioned above, the history of colonialism and the monopolistic structures deriving from it impacts the societies of the Southern Hemisphere profoundly, to the point of constituting social and economic structures that will affect the entire future economic development of such societies. It is for this reason that this book begins with a recapitulation of the economic history of developing countries.

Mention of social and economic structures is intentional. It is not correct to start from a unilateral predefinition of human behavior, to wit, that people are moved exclusively by economic rationality as defined by G. Becker,[7] or by predominantly social motives, as was so passionately and effectively defended by K. Polanyi.[8] The definition between these two tendencies when studying development (underdevelopment) is therefore unnecessary.

In fact, colonization deeply affects not only economic structures but also social structures. Attachment to the cultures and living standards of developed countries and a certain contempt nurtured by the upper and even middle classes for their own civilization is a common characteristic in most developing countries. More importantly, the monopoly of economic knowledge introduced by the colonial monopolies roots itself in social structures, creating tension amongst the classes and worsening cooperation. These beliefs and structures create great impediments to development.

In the economic field, the effect of such structures is even greater. It affects, as seen above, the accumulation of capital and the distribution of its gains. Analysis of the means of addressing such serious economic structural problems should be more detailed. It demands analysis of the structures and economic behavior present in the economic order of developing countries resulting from monopolistic structures, as well as a legal proposition capable of offering a way out of the vicious circle of underdevelopment caused by them.

A last and very important point must be made. The central importance to underdevelopment of the monopolistic structure created in the colonies does not imply that it is always the opposite of what we are looking for, that is, the generalized existence of decentralized economic structures in the economy. It is a common and perhaps intentional mistake among neoclassic theoreticians: opposing the great monopolies with an economic structure of (inefficient, according to them) small and medium-sized enterprises.

Not even from the logical point of view are there only two alternatives. In fact, the real alternative to concentrated economic power is a balanced economic structure (in terms of information and bargaining capacity) between

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7 See G. Becker, *The Economic Approach to Human Behavior*, 1976.

8 K. Polanyi, *The Great Transformation*, 1957, esp. p. 46.

supply and demand. To address the correct organization of supply and demand and not only the best configuration of the industrial structure is the real objective of an economic system and the laws that aim to protect it.

This also does not imply that fighting monopolies is enough, on its own, for economic development. In particular, it should be emphasized that economic structures affect structural characteristics in society and not quantitative data. Therefore, singling out monopolies is not a very effective way to explain why, amongst the developing countries, there are differing degrees of relative growth. For this, there are other decisive factors such as population growth, the importance and relative value that each country's main product has in the international market,[9] and also varied institutional configurations.

3. THE ECONOMIC HISTORY OF MONOPOLISTIC COLONIAL SYSTEMS AND ITS EFFECT ON THE DEVELOPMENT PROCESS

The relationship between monopolies and underdevelopment is, however, not best seen through theoretical arguments. Its best demonstration lies in history.[10]

To achieve the objective of stressing the effect of monopolistic colonialism on underdevelopment, some examples of the operation of monopolistic structures in Latin America, Africa and Asia must be analyzed during three different historical periods: (a) the colonial period; (b) the industrialization period; and (c) the most recent economic internationalization period.

Colonial Monopolistic Systems

The colonial period is a long and particularly effervescent one in the history of capitalism. From the economic standpoint, it lasts four centuries, from the beginning of the sixteenth to the end of the nineteenth century. Throughout these many centuries, a constant economic pattern was maintained as a result of the connection with the metropolises: the monoculture, or the agriculture of

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[9] On this subject, see the interesting description of the many levels of growth obtained by Latin American countries in the nineteenth century owing to *commodity lottery* – V. B. Thomas, *The Economic History of Latin America since Independence*, 1994, esp. p. 43, *et seq.*

[10] Since it is not the primary objective of this study the historical description is in fact shortened. For a deeper description and analysis of the historical relationship between monopolies and underdevelopment see C. Salomão Filho, *Histoire critique des monopoles – une perpective juridique et economique*, 2010.

a single product over a very large area, usually covering whole countries, and the exploitation of a single natural resource, in both cases focused on exports. In conjunction with the monopolistic system, this economic structure provided the extraction of the highest possible economic value of the colony, because the focus on one single product reduced costs of export goods, while preventing the colonies from creating a domestic market, which would also guarantee high profits on imports from the metropolis.

This leads not only to say that such economic structures impacted the contemporary social organization of underdeveloped countries. It leads also to understand how the monopolistic colonial system managed to have such a diffuse and long-lasting influence over the economic and social systems of the colonies. This is best seen through the description and comparison of the two different modes of colonization implemented in what are now called underdeveloped countries: the public and the private monopolistic colonial systems.

The public monopoly regime may be described generally as the mode of colonization used by Portugal and Spain during the colonization of Latin America. It may be described as an absolute monopoly controlled by the metropolis of imported and exported products by the colony. The literature often disregards the effect of such tight control of the metropolises over the economic activities of the colonies when studying the contemporary levels of economic development of the countries that were subject to such colonial mechanisms. Some colonies were actually formally prohibited from having industrial activities.

For the purposes of their metropolises, they had to produce only agricultural goods, and import all industrialized products from Europe, always through the channels provided by the metropolis. Such structures actually produced a triple draining effect over the economy that prevented any kind of endogenous development. The purchase of basic consumer goods was subject to monopoly by the metropolis, therefore a monopolistic surplus was charged there; the labor market was subject to the same monopoly structure and dependent entirely on the product of the cycle of the moment, that is, workforce and labor was completely drained by the existing structures.

Finally, and that is the third draining, there were no dynamic sectors in the economy other than the monopolized sectors. Therefore sectors were economically drained into the monopolized ones (that varied according to the varying interests of the metropolis in exporting products such as sugar, gold, coffee, etc.) and the economy gained no autonomy or self determination.

The private monopoly regime implemented in Asia was somewhat different from the public monopoly in Latin America. It was a colonization system driven mainly by commercial interests, not really interested in controlling the whole economy of the regions (whose population was, by the way, significantly larger and much better organized from the economic point of view). As a result, colonization was limited to the products that their colonizers were interested in buying and selling.

After the seventeenth century, the newly-established system of royal privileges provided that only companies holding privileges granted by the metropolis, such as the East India Company, were allowed to trade certain specific goods. However, this was only a relative monopoly, because other companies could still trade products not controlled by the East India Company. There was also tolerance regarding local agricultural production. The interregional commerce of products that were not considered as priorities by the British were tolerated, and even stimulated, as means of generating income to local communities.

Considering such differences, it is easy to understand why there was less hurry in the decolonization of Asia than of Latin America. The industrial powers controlling Asian economies used to stimulate a local consumer market, based on endogenous economic growth. In contrast, in Latin America the colonial system was structured to protect products and markets for the metropolises, mostly Portugal and Spain, which, since the mid seventeenth century were not part of the dynamic center of the capitalist system. Hence the pressure coming from the great industrial powers of the nineteenth and early twentieth centuries for decolonization of Latin American countries, in order to allow the creation of new consumer markets, open to the big industrial powers and independent from the metropolises.

The comparison between Latin America and Asia in the colonial period reveals very different approaches to the export economy. In Latin America, the export economy is strictly monopolized. The absolute export monopoly is actually the main element of the colonization process. Under its shadows, nothing blossoms; neither the consumer market, nor any complementary economic sector, which remain continuously centered on subsistence activities and dependent on the great exporting entrepreneurship. Also the workforce (slaves) is not paid a salary and therefore there is no creation of rent inside the colonies. The slave or semi-slave work used in Latin America during colonial times guaranteed that no endogenous demand power could be created internally in the colonies.

In Asia, the landscape was significantly different. Colonization was driven by large commercial enterprises, in which concern with the exploitation of local resources was followed by interest in developing a local consumer market. As a result, small agricultural enterprise was stimulated and interregional commerce was tolerated. Autonomous economic dynamism was tolerated from the beginning.

Such economic characteristics, inherited from the colonial period, help to partially explain why certain Asian economies performed better in terms of economic growth based on exports than Latin American countries toward the end of the twentieth and beginning of the twenty-first centuries.