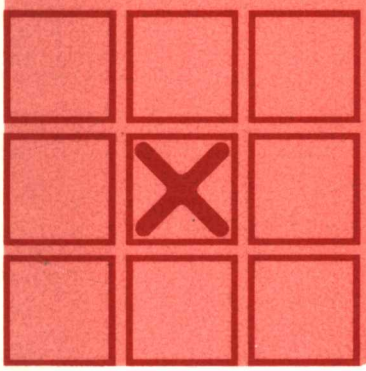
ANTITRUST ECONOMICS AND LEGAL ANALYSIS



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PREFACE

More than a decade has passed since the publication of my first book, *Antitrust Economics: Selected Legal Cases and Economic Models* (1968). In the interim, I have been an economic consultant to law firms on antitrust cases. My life has been spent visiting plants, meeting executives of companies, discussing the pricing, manufacturing and distribution of products, and theorizing with lawyers on the economic defense materials which could be presented in litigation in a courtroom or in a memorandum to the staff of the Department of Justice, Antitrust Division or the staff of the Federal Trade Commission.

I have tried to write a book in which the reader can feel some of the enjoyment I have had in the practice of antitrust economics. This book represents the reflections of the author, and is not intended as a survey of antitrust legal or economic literature.

I have urged as a theme in this book that antitrust policy cannot be determined solely or even in large part from economic models. Economic theory with its strong assumptions concerning "other things being equal," resource availability, knowledge, and foresight can reach a single solution. But I do not believe antitrust policy has, or should have, singular answers. There should be a rule of reason and a flexibility in antitrust policy which depends on a wide spectrum of legal and economic factors.

There does not have to be a single goal which all must be directed to in order for our nation to have an effective antitrust policy. Antitrust policy is not directed simply to further "competition," "efficiency," the "welfare of the consumer," or to perpetuate "an organization of small units which can effectively compete with each other." It is all of these things and more. Antitrust policy need not be blind to the conservation of resources, the employment of workers, the defense of the nation or the economic needs of a community.

A question in antitrust economics is seldom resolved by the data. Data can be presented, honestly and fairly, in a wide variety of formats. Numbers can be as effective as rhetoric provided the integrity of the argument is maintained. The major economic findings in a large number of antitrust cases can be repositioned, with the result that an opposite conclusion to the case can be justified. Therefore, analysis of antitrust economics should not be expected to yield unique answers from data; rather, the analysis of data should contribute, along with political ideology and social consciousness, to the formation of flexible answers for a changing world which keeps asking many of the same questions.

EUGENE M. SINGER
HARRISON, NEW YORK
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INTRODUCTION

Economists can contribute with lawyers to the analysis of market facts in an antitrust case. Both come to the same problem with different training and discipline; both are highly educated individuals; and both should have the requisite ability to think and analyze a set of facts with logic and a spirit of humanism. A model, an equation, a market share, or a rule is too mechanical and simplistic for the professional.

The structural approach to antitrust is questioned in the first three chapters. Those urging a structural type antitrust policy have generally sought to establish rules and guidelines which would restrict the growth of larger companies and limit their levels of profits. Advocates of the structural approach to antitrust have sought to establish three critical propositions which would justify their using an indicator of structure, such as a market share or profit rate, as a sufficient basis for finding a violation of the antitrust laws.

The first proposition states that the model of pure competition, composed of small competing business units, is a suitable goal for achieving an optimum economic position for consumers. Chapter 1, Antitrust Policy and Economic Models, casts doubt on this proposition as a single policy in an economy which is simultaneously dedicated to other broad objectives, such as conservation of resources, product improvement, and full employment.

The second fundamental proposition which those advocating the structural philosophy have tried to establish is that industrial concentration is rising in the United States. "Big business" is alleged to be growing more rapidly and thus becoming more concentrated than the medium- or smaller-sized firms. If it can be established that there is a "rising tide of economic concentration" and economic concentration is bad for the country, a foundation is laid for breaking up big business or for stopping any further increases in industrial concentration through a strict merger policy.

The second chapter, Industrial Concentration, explains why the question whether industrial concentration is rising in the United States cannot be readily answered. There are problems in measuring industrial concentration and in defining products and industries.

As products change in our country, the compilation of sales data by the government is refitted into new product categories. Some industries which are becoming more important are split into new sub-groups, and other product categories of declining importance are combined. Therefore, studies of industrial concentration can only include data from a limited number of older industries with products which have not significantly changed. The dynamic and more interesting industries with rapidly changing products and technology have the greatest impact

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on the ultimate well-being of consumers, yet they are precisely the industries which have to be excluded from the tabulations of industrial concentration since no data exist for the earlier years being studied.

The third proposition which those advocating the structural philosophy in antitrust have sought to establish is that economic concentration results in non-competitive behavior reflected in higher prices and, consequently, high profits. Chapter 3, entitled Profits, explains some of the problems in calculating comparable profit rates for companies in different industries, or companies in the same industry with different types of capital equipment and various levels of vertical integration. Apart from all the numerical difficulties with profit data, there is a basic objection to criticizing earnings of the more profitable companies on the grounds that their high earnings *might* reflect monopoly power rather than superior skills. In terms of public policy, a standard which finds average profits or average size desirable will ultimately settle for average performance as a goal. There is also an interrelated concern in the study of industrial concentration: the larger or the more profitable firms may be stronger with the result that the weaker firms may be unsuccessful in the competitive struggle. If the smaller firms are unsuccessful, we must ask ourselves the profoundly difficult question, what is the price of economic growth and the cost of economic freedom?

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ANTITRUST POLICY AND ECONOMIC MODELS

Since the Sherman Act was passed in 1890, there has been a similarity in the types of antitrust images that have been created. Many of the images were founded in the laissez faire political economy of the nineteenth century and were surrounded with the fears of "big business" and "big government." One of the most articulate expressions of an image of competition was stated by Judge Learned Hand in the Alcoa case in 1945:

> Throughout the history of these (antitrust) statutes it has been constantly assumed that one of their purposes was to perpetuate and preserve, for its own sake and in spite of possible cost, an organization of industry in small units which can effectively compete with each other.[1]

This is a powerful image. It pictures the United States economy as an organization of industry in small units and urges us, under the banner of antitrust, to perpetuate and preserve in spite of possible cost an economy of only small firms. It may be wise to question allegiance to this standard, especially if economic objectives such as conservation of resources, full employment, and product diversity are deemed more important to society. If these economic objectives are sufficiently important to us, we will have to reject as outmoded the imagery associated with the model of pure competition.

Although many of the classic images in antitrust have remained constant, the economic environment associated with these images has changed. Prior to the turn of the century the economic effects of the railroads interconnecting formerly protected markets accounted for a substantial amount of the sentiment of groups seeking to curb the distribution and market power of larger companies. Concepts such as "competition" or "industry concentration" were viewed in terms of an economic region, not on a national basis. Some economic corrections were undoubtedly considered to be in order, but the central theme of the proponents of the Clayton Act in 1914 was to protect the existing economy from lessening of competition, not to change the industrial structure of the economy. Since a free

enterprise system was defined in terms not too different from the existing economy, the cost for obtaining such a system was not particularly great. Antitrust questions concerning economic concentration were being asked in an environment marked by a Federal Government of minor size, a trade union movement just under way, and unimportant foreign trade.

Today many of the same antitrust questions are being asked. But the environment has changed with the advent of intercontinental information and transportation systems; an economy in which federal, state and local government purchase over 20 percent of the annual goods and services; and regulated industries which account for over 30 percent of the annual new plant and equipment expenditures in the economy. Finally, in recent years we have seen, at least on a temporary basis, wage and price controls or guidelines affecting most of the private sectors of the economy.

CLASSICAL ECONOMIC MODELS IN ANTITRUST

The traditional starting point in antitrust economics has been the model of "pure competition." Before discussing the assumptions and implications of this particular model, it may be helpful to comment in general terms on what an economic model is, and what it purports to do. Basically, an economic model is used to analyze the cause and effect between two or more variables. It is assumed that except for the variables under consideration, everything else in the world is held constant. Examination of an economic model will not yield a ready answer with regard to a specific course of action for antitrust policy. Furthermore, an economic model can suggest almost any alternative with regard to price or output depending upon which terms are treated as variables or constants. The phrase "economic theory suggests" can therefore be used by either side of any argument in industrial organization. Like a helicopter, an economic model can go in any direction depending upon which levers are moved and which are held constant.

The assumptions of the pure competition model reflect the basic structure of an undeveloped agrarian economy: standardized products, numerous firms in markets, each firm with a small share and unable by its action alone to exert significant influence over price, no barriers to entry, and output carried to the point where each seller's marginal cost equals the going market price.

The classical economists took considerable care to state their assumption that there would be not only perfect mobility of resources within the industry under consideration, but for all input and output industries in the economy. Thus, the firm in the model of pure competition could not encounter any raw material shortages; labor unions, regulated industries, national defense, social security systems, or any other constraint. Finally, the purely competitive firm had the advantage of perfect foresight of the types of products which consumers would demand. Most importantly, the term "optimal" for the classical economists implied merely that the supply-and-demand equation for the economic model could be solved within their theoretical framework. It did not purport to indicate that consumers would be happy or satisfied with their level of income, standard of living, or the quality of goods and services distributed in their economy.[2]

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THE INADEQUACIES OF THE MODEL OF PURE COMPETITION FOR ANTITRUST POLICY

Antitrust statutes have not been directed to the narrow task of eliminating all monopolistic elements in our economy. Variations in products, advertising, and brand names give product diversity to our economy in contrast to the standardized products found in countries not operating within a free enterprise system. These monopolistic elements would not exist in a world of pure competition where a large number of firms manufacture a homogeneous product, and no one firm can materially affect the market price. To eliminate these monopolistic elements would destroy the distinctive traits and individuality of firms with respect to their services, products, and price policies. The basic point is that a belief in the value of competition does not require each and every move in antitrust policy to be made in the direction of a pure competition model. The pure competition model is neither a description of reality nor a normative standard toward which antitrust policy makers should strive.

Professor Edward Chamberlin, in describing his term "monopolistic competition," reaches basically the same conclusion:

> Now if pure competition is the ideal, the direction in which we should move is very clear. For it is easy enough to show that the actual economy is shot full of monopoly elements, and hence that any move to get rid of them or to diminish their importance is in the right direction. The main point I want to make is that the welfare ideal itself (as well as the description of reality) involves a blend of monopoly and competition and is therefore correctly described as one of monopolistic competition. If this is true, it is no longer self-evident which way we should move, for it is no longer self-evident on which side of the ideal lies the actuality for which a policy is sought. It is possible that the economy should be made 'more competitive' but it is also quite possible that it should be made 'more monopolistic' instead.[3]

An encouragement of some monopolistic elements does not require an advocacy of monopolies.[4] It is rather a recognition that the term competition encompasses a vitality of interacting market forces that are not always provided by moving in the direction of pure competition. The term "competitiveness" should not be shackled with the connotation that unless the market conditions simulate those of a theoretical model containing a large number of firms no one of which has any influence on price, and all of which produce a standardized product, the market structure lacks the vital rivalry and stimulus associated with a free enterprise system.

In a world of pure competition an optimum allocation of resources is determined only after the consumer preferences or the demand conditions of a community are known. The assortment of goods which maximizes the total utility of a community has presented economists with insuperable difficulties because of the incomparability of the utilities of different individuals. There is no economic or objective solution for finding a "bliss point" which maximizes the satisfaction of consumers.[5] Resort must be made to value judgments as to the favorability of income distribution and individual and social preferences. Thus, models dealing with optimum allocation of resources have not met the problem of determining the ideal product mix of the economy.

The unique features of products and services are emphasized by advertising. To the extent that consumers accept these differences as important, a differential in value is created between related products. Individualism becomes the keynote. Individualism in product encourages each company to manufacture, not an identical product, but a better product than its competitor. Individualism in service encourages each company to try harder to please customers. Individualism in price means that a company has some limited degree of price flexibility. These features are not present in a model of pure competition. However, each of these forms of individualism has been recognized as fundamentally important to the free enterprise system of the United States.

There are several reasons for rejecting the proposition that an image of competition such as that suggested by the economic model of pure competition is a suitable guide for a public policy directed toward the entire United States economy. The assumptions of the model of pure competition reflected the basic economic structure of an undeveloped agrarian economy with country stores selling plain soap, butter, flour and other undifferentiated products. Competition meant that if each farmer or producer maximized his output, the economy would achieve the best allocation of resources. Today this philosophy is being challenged.

First, conservation of natural resources. It is not clear that the economy is always better off if the output of any scarce natural resource industry is expanded. Nor is it clear that the members of an industry composed of many small units will be able to comprehend the responsibility, and exercise the necessary discipline, required to conserve the resources of our basic industries. Indeed, many companies lack the capital, financial resources, and research and development facilities required to redesign products with the objective of long-term conservation of resources. Misallocation of resources can occur not only with respect to other industries, but with respect to the future use of scarce resources. By deconcentrating one particular industry, the relative bargaining power of the deconcentrated firms will be weakened with regard to their suppliers and customers. Their marginal costs for raw materials may increase or the prices received for their output may be lowered. Resources will be reallocated to relatively stronger industries. A similar problem exists in allocating scarce resources between the present and future economy.

If the United States continues to maintain price controls, guidelines or regulations, the critical economic variable will become output. The energy crisis of the 1970's depicts the massive complexities inherent in the government's attempting to regulate both price and the allocation of petroleum output among industries with various levels of priorities. It has also dramatized the interdependence of the network of industries in the United States economy for basic natural resources. The nation realized after the Arab oil embargo that the curtailment of any basic input industry, such as petroleum, paper, lumber, aluminum or plastic, could slow down virtually every manufacturing and distribution facility. As a result of the interrelations of our industries, the regulation of any single natural resource industry increases the potential for not only further direct regulation of closely related industries, but indirect regulation of almost all industries which depend on this resource.

The reconciliation of our antitrust statutes with conservation needs may require joint industry cooperation which may have direct or indirect effects on price and output. A major objective of our antitrust statutes, and especially Section 1 of the Sherman Act, is to encourage and insure independence of competitive action. The

public policy problem is that total independence of action will prevent some solutions from ever being reached where the outcome would benefit both industry, the consumer and free enterprise. For example, a joint warehouse distribution system open to any member of an industry could contribute to minimizing fuel, overhead and transportation costs. Such a system may not be able to be developed unilaterally. But the implications for competition are significant if there is a likelihood that smaller sized companies, which might not otherwise survive, would become more competitive by utilizing joint facilities. Similarly, joint research efforts of companies on resource conservation, or the building of joint recycling facilities may encourage the survival of companies by minimizing the threat of resource shortages.

Second, full employment. The problem of a nation attempting to maintain full employment would not be relevant to classical economic model builders. Social security, unemployment insurance, trade union collective bargaining, wage and price controls were not permitted in the calculation of the simple ratios of marginal costs and prices. External social and economic factors such as these were assumed away with the Latin rubric *ceteris paribus*, namely, "other things being equal." Unlike the classical economists, we cannot call forth the *ceteris paribus* rubric. Alteration of any industry structure to render firms unable to raise prices, without simultaneously modifying existing collective bargaining relationships and government controls, may misallocate resources. Furthermore, it is not clear that advocates of deconcentration would like the classical adjustment of output rather than price. Since no firm in a purely competitive market could affect price, the only variable which a firm could adjust was output. But the classical adjustment of a firm's output implies changes in employment levels, which may not be a desirable public policy.

The late Senator Philip Hart proposed an "Industrial Reorganization Act" (S.3832), which sought to "restructure industries dominated by oligopoly or monopoly power," by making them come closer to a model of pure competition.[6] Senator Hart believed that under his bill "competition would make prices and profits the variables — not production and employment." But there will always be changes in output as consumer demands change, and resources are reallocated. Any bill to restructure industry therefore will be self-defeating if it tries to bring industries closer to a model of pure competition and make price, not output, the variable. To predicate a restructuring of the American economy on a premise of eliminating changes in output is to follow a course of action which assumes that the American consumer will exhibit no change in consumption patterns, and industry will offer no product innovation.

Third, product diversity. Product diversity and brand differentiation were not present in classical models of pure competition. The output was always a standardized product. Again, there can be seen a corollary between the model of pure competition and an agrarian economy producing fungible commodities such as wheat and corn. A hallmark of the present United States economy is product diversity. Variations in products, advertising, and brand names give an individual identity to firms and products in our economy. This individuality of product can be contrasted to the standardized product found in countries not operating within a free enterprise system.

If a number of different varieties of a product are preferred by our society over a single standardized product, it is possible that our economy may have to maintain a greater number of plants, some of which may operate at higher cost levels than

would result if society consumed standardized products. But this state of the economy is not one of misallocation of resources — if consumers prefer a wide diversity of sizes, shapes, and types of products. For example, there probably would be lower plant costs per unit of output if all garments were made of a standard black cloth and everyone drove a black Model T Ford. New car model changes or alterations in fashions which outmode last year's garments are not misallocations of resources if society prefers continually changing products and style.

The Federal Trade Commission has taken a different view of product differentiation. In a major structural case brought against the four major manufacturers of ready-to-eat breakfast cereals, the FTC charged that "brand proliferation" and "artificial product differentiation" were illegal methods of competition which serve to create "barriers to entry" for alleged oligopolists.[7] The remedy sought by the FTC was to break up the three major breakfast cereal manufacturers into smaller independent units with the expectation that this would result in less advertising, fewer brands and products, and lower prices. It is the contention of the FTC that the preferences of consumers for a wide variety of taste, colors, shapes, and forms of a given product type are irrational since many of the product differences, in the opinion of the staff of the FTC, are insignificant.

It is not clear how a company producing wide variations of a type of product with different brand names can create "barriers to entry." If consumers are accustomed to seeing a wide variety of brand names on a shelf, the marketing appeal of any single brand is weak. In short, proliferation of brands lowers barriers to entry by reducing consumer brand loyalty to any given trade name. Of course, if one company introduces many new products and another company introduces only a few products, the likelihood of continued product success might appear to be greater for the first company. In actuality, the strategies resemble those of roulette players that use chips all over the board versus others that play a few selected numbers. Unlike the model of pure competition, which assumes perfect knowledge and certainty, firms in our economy do not know which numbers to play on the roulette table, and which products will meet the taste-buds and fancy of the American public. A firm that correctly gambles on where the demand is going to be for a specific type of product with a particular style, fashion, or taste, will show low unit costs and high profits, even if it has no advantage over other firms in its industry in producing an identical product at an identical output level.

Fourth, profits. The classical economists had no reason to be particularly concerned with profits. None of the small firms in their model of pure competition had any advantages in physical location; nor were firms confronted with any scarcities of resources or constraints on capital. In the absence of barriers to entry associated with patents, know-how, capital, and management, new small firms could easily enter and erode the short-term profits of the older firms in an industry up to the limit of demand. In short, in classical economics all firms in an industry were created equal and were endowed with the same knowledge, management and availability of resources.

The environment of the classical model builders was clearly not one of high technology, or extensive research. In the last few years we have seen examples of staggering losses for individual companies in not entering, but withdrawing from research-oriented fields such as computers and aerospace. With the hindsight of today, consider the "attractive" level of profits anticipated by these firms a decade ago. At what point of time should we calculate the profits of one of these

firms: (1) when the firm is succeeding in an entirely different product line and building a profit base for future expansion into possibly unrelated fields; (2) during the next stage, when the firm may be incurring losses in a new division while attempting to build a prototype or develop its own technology; (3) during the next five or ten years, when the firm may be earning attractive profits depending on the success of the product; or (4) during the subsequent years when their earlier technological advantage is copied by others, as product cycles change and as past technologies become outmoded? Alternatively, do we want the firm which has consistently succeeded for ten, twenty, or thirty years to bow out of the race and attempt to retire as the champion merely because he has been too good a player for too long?

The selection of an arbitrary profit level applicable to all industries as a presumptive measure of monopoly power is highly questionable. How can we meaningfully compare the rate of profit for an industry which has low capital requirement and primarily markets a product, possibly door to door, with a major chemical or metal industry requiring substantial capital outlays for production facilities? The company or industry which is primarily in distribution is labor intensive and will reflect a low net worth; the capital intensive industry will show larger net worth as a result of its capital needs and equity financing. The same dollars divided by different amounts of net worth will show different rates of return. Consider other companies which may sustain large current deductions as a result of sporadic advertising programs or research and development expenditures associated with the introduction of new products. Since accountants have no assurance that these types of expenditures will ultimately yield a profitable product, the common practice is to write these expenses off in the current year rather than capitalize them over many years. This accounting practice causes widely different levels of profits as a percent of net worth. If the product succeeds, the firm no longer has the earlier costs to offset the current profits. In other words, we cannot meaningfully interpret current accounting profits as economic profits without examining the years of incurred costs during the development of a product.

There is a basic problem in using accounting values for depreciated assets rather than replacement values in computing economic profits. If the production process has not changed greatly for manufacturing or processing a commodity or a basic product, a plant which was built twenty years ago may have approximately the same output as a plant built this year even though a new plant may cost five or ten times more than the older plant. Furthermore, the new plant would have high depreciation charges offsetting its current profits. With high plant equipment and capital costs, the rate of profit for the new plant would be low. The industry therefore would not be particularly attractive for a potential new entrant. In contrast, the rate of profit for the older, more fully depreciated plant would be higher. It is erroneous to argue that the old plant has monopoly profits and the new plant has competitive profits. If the older plant were valued at replacement cost rather than the accounting book value, both plants would have the same low profit rate. The conclusion therefore is that if management has enough foresight to enter an industry which will not encounter major capital or technological changes for a period over 20 years, and if inflation persists, and if demand for the product continues, the company may be rewarded with higher profits than received by more recent entrants with higher capital costs.

CONCLUSION

Antitrust policy should be appraised in an economic environment in which regulated industries occupy a substantial segment, full employment goals are requisite, and product diversity is responsive to consumer tastes and preferences. To sacrifice these standards for the purpose of obtaining an organization of small units is to pay an immeasurably high price. There is a place in our economy for both larger and smaller sized firms, both of which can successfully develop new products and services.

Antitrust policy should not be oversimplified by fading images such as the economic model of pure competition. Reconciliation of the competition between and within concentrated and unconcentrated industries, between the smaller and larger sized firms, and between regulated and unregulated industries has historically raised difficult antitrust questions. These questions probably will become even more difficult to answer in the years ahead. Easy answers will not remove these difficult questions. Free enterprise will always be marked by disparities — in the size of firms, in profits, and in products. These are not differences to fear. These disparities are the basis of competition and the economic strength of this nation; and they are the basis on which we can build a meaningful antitrust policy.

ENDNOTES

1. *United States* v. *Aluminum Company of America* , 148 F. 2nd 416 (2nd Cir., 1945).
2. See J. M. Henderson and R. E. Quandt, *Microeconomic Theory* (New York: McGraw-Hill Book Company, 1958), pp. 202-8; T. Scitovsky, *Welfare and Competition: The Economics of a Fully Employed Economy* (Homewood, Ill.: Richard D. Irwin, Inc., 1951); R. H. Leftwich, *The Price System and Resource Allocation* (New York: Holt, Rinehart & Winston, Inc., 1956); A. Lerner, *The Economics of Control: Principles of Welfare Economics* (New York: The Macmillan Company, 1944).
3. E. H. Chamberlin, *Towards A More General Theory of Value* (New York: Oxford University Press, 1957), p. 93.
4. Monopolists, in their attempt to maximize profits, restrict output. Therefore, in an economy mixed with monopolies and competitive industries resources will tend to be over-allocated to competitively produced commodities and under-allocated to monopolistically produced commodities. However, in a world of monopolies, where no industries are competitive, a misallocation of resources does not necessarily result. Professor William Baumol makes this point with an interesting metaphor: "Given the level of employment of resources, a misallocation can arise only if the demand for inputs of one set of industries (the monopolists) is low in comparison with that of the remaining industries. If each of a number of runners slows down, none of them need come in ahead of the others, and if each industry is weak in its bidding for resources, no lopsided allocation of these resources need result. We see, then, that some competition may conceivably be worse than none!" *Economic Theory and Operations Analysis*, (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1961) p. 257 Cf. J. S. Bain, *Price Theory* (New York: John Wiley & Sons, Inc., 1966) p. 240-47; and Lipsey and Lancaster, "The General Theory of Second Best," p. 12.
5. Professor Paul Samuelson states, ". . . the new welfare economics is a body of doctrines which attempts to go as far as possible in preparing the way for the final a-scientific step involving value judgments . . ." See his "Evaluation of Real National Income," *Oxford Economic Papers*, New Series, Vol. II (1950), pp. 1-29. Also see T. C. Koopsman's "Allocation of Resources and the Price System," the first of *Three Essays on the State of Economic Science* (New York: McGraw-Hill Book Company, 1957), pp. 41-66; M. W. Reder, *Studies in the Theory of Welfare Economics* (New York: Columbia University Press, 1947); I. M. D. Little, *A Critique of Welfare Economics*, 2nd ed.

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