INDUSTRIAL ORGANIZATION AND ANTITRUST POLICY

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Revised Edition

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Preface

Since this book was first published, as *Economic Theory and the Antitrust Dilemma* in 1970, some substantial changes in pertinent areas of both economics and law have occurred. During the past decade there has been a significant expansion of the empirical evidence bearing on the organization, conduct, and performance of firms and markets. Not only the quantity of this evidence but also its quality have enabled economists to understand better a number of relationships that carry important public policy implications.

Legal developments in antitrust during the same period have been uneven, but their cumulative effect is substantial and suggests that business managers are subject to somewhat different "rules of the game" than they were just a few years ago. During the decade of the 1970s there have occurred also some changes in government enforcement activities and apparently in national opinion about the proper role of public regulatory programs.

This edition reflects these changes, primarily through a revised and somewhat expanded discussion of empirical evidence, and a thorough updating of legal case doctrine. In revising this book, all of my old debts remain intact, and new ones have been incurred. I have benefited from the comments of Roger D. Blair, Robert J. Carbaugh, Robert M. Feinberg, Albert N. Link, James W. McKie, David Sappington, Edward L. Sattler, Lawrence J. White, and many students past and present. In addition, I owe a special debt to Malcolm R. Burns for a painstaking and perceptive critique of the entire manuscript and to Rosalind S. Seneca for pointing out to me numerous ways of improving both the substance and exposition of the original version. The usual disclaimer, however, applies most emphatically. All the shortcomings of this edition are my own doing, and have emerged in most instances over the strenuous objections of the persons named.

Peter Asch

October 1982

Preface to the First Edition

Economists are sometimes a critical, even cantankerous, lot. We are especially prone to complain about public policies formulated in ignorance of the lessons of economic analysis or, worse yet, based in "bad" economics. Antitrust policy has thus been forced to compete with other areas for its share of criticism, but, all things considered, it has more than held its own.

The main purpose of this book, of course, is not to complain. Instead, it is to survey and analyze the important issues in American antitrust from an economic viewpoint. Antitrust decisions invariably affect the structure and behavior of firms and industries, and rational decision processes must take account of these influences. It is here that economic analysis can prove most useful.

The precise role of economics in antitrust is often misunderstood. Consider the case of huge corporations in the United States. These firms, by their very existence, enrage some and enchant others. There is no objective way to determine who is right or wrong—if, indeed, these words have meaning here. Yet there is a good deal of pertinent information to be had. The enraged should know, for example, that big companies may contribute significantly to our national output and living standards; and the enchanted should know, for example, that there is a sense in which large and powerful concerns may adversely affect society's welfare. Both costs and benefits are associated with large firms (or with the absence of such firms). Economics, as such, *cannot* define the socially appropriate level of firm size, because it cannot tell us what we *ought* to desire. It *can*, however, help to define the costs and benefits associated with policy decisions that affect size. What we, collectively, do with this information depends on the results we want. But the information itself is vitally important. Without it, neither the enraged nor the enchanted can hope to reach judgments that are rational from their own point of view.

The purpose of this book, then, is not merely to "cover" antitrust materials, but to indicate something about the potential and actual contribution of economic analysis to policy formulation. The organization of the book reflects my own biases. I do not believe that any sensible discussion of antitrust can proceed without some knowledge of relevant economic theory and measurement. These topics thus receive substantial attention, although in retrospect it appears that they might have been pursued even further. I hope that this book will be useful not only to students in courses dealing with antitrust but also to those individuals (policymakers included) who have a general interest in the area. The theoretical and empirical sections assume relatively little background on the part of the reader. Although some previous exposure to microeconomic theory is helpful, it is not absolutely necessary.

Like most writers, I owe a very large debt to others. I have benefited immeasurably from a critique of an earlier draft by Franklin M. Fisher, and from many acute criticisms by Burton G. Malkiel, Matityahu Marcus, Jesse W. Markham, David McFarland, R. W. Pfouts, Richard E. Quandt, and Joseph J. Seneca. And also I have been greatly helped on a number of specific points by the comments of Gary W. Bowman, John F. Graybeal, and Stanley H. Masters. Any weaknesses in the book remain despite the best efforts of these individuals. Sometimes an author just cannot be saved from himself.

I am most grateful to Mrs. Geraldine Dructor, who typed successive drafts of the manuscript with care and skill, and to the Rutgers University Research Council for generous financial support.

Finally, I owe a real debt to my family. My wife Rita not only provided the necessary moral support but helped with the thankless tasks of reading and editing the final manuscript. My children, Eric and David, are also to be thanked and congratulated for tolerating the past months cheerfully, if not silently.

Rutgers College
1970

P. A.

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INTRODUCTION

The antitrust laws of the United States encompass a large, and sometimes bewildering, group of provisions designed to encourage competition. The rationale for these laws is complex, involving social and political as well as economic motives. But it is clear from the written record that the presumption in favor of competition—both within economics and without—is deeply ingrained in American life. A free society tends to distrust concentrations of power, whether private or public; and competition, although subject to varying definitions, often is associated with the absence of dominance by one or a few interests.

Anyone taking even a superficial glance at our modern economy may be struck by an apparent gap between the competitiveness that we advocate and the centralization of power that we tolerate. Most corporate wealth and income is accounted for by the 200 largest firms. Many of our major markets are dominated by a few large companies,[1] and the growth of major conglomerate enterprises whose activities span many industries has been dramatic.

No reasonable observer, however, could term the American economy "monopolistic." With a very few exceptions,[2] markets are characterized by some meaningful competition. Virtually no corporation seeking to sell its goods has the luxury of ignoring rivals, actual and potential. Our largest firms are indeed powerful in traditional economic terms, but whether they are **secure** in their power is quite a different question.

Such observations raise the fundamental questions about our economic system and the priorities of society. How strong is our commitment to competition? Does the existing concentration of economic power imply that the antitrust laws have failed in their stated purpose? Is the absence of "true" monopoly an indicator of success? Or is the notion of competition itself ambiguous, defined by individuals in different ways? These are some of the general questions to which this book is addressed.

[1]This is especially true in the manufacturing sector. In such important markets as automobiles, computers, cigarettes, detergents, and most primary and fabricated metal products, the four largest firms account for more than 50 percent of total production and sales.

[2]The main exceptions are found in the publicly regulated industries, for example, electricity, gas, and water.

COMPETITION: THE ECONOMIC RATIONALE

If one accepts the writings of Congress and the courts at face value, an important motivation for antitrust legislation and enforcement has been economic.[3] Here the antitrust rationale rests on a number of familiar propositions: that producers and sellers put forth their best efforts when threatened by effective rivals; that the economic desires of society are fulfilled when no individuals or groups within the marketplace possess the power to exploit; in short, that competition as a market force compels the best economic results.

The intuitive sense of these propositions can be illustrated simply. Consider, for example, an individual stranded in an automobile, out of gas on a country road. If a second motorist should come along and offer to supply him with enough gas to reach the next town, we may expect that some transaction will occur. But what will be the terms of this transaction? If the second motorist happens to be a Good Samaritan, the gas may be offered free of charge or at cost; but suppose instead that he behaves as a "rational" business manager, seeking to extract the maximum possible profit. The price that he can obtain for his gasoline cannot be specified without more information: for example, how anxious the stranded driver is to get going, how repugnant to him is the idea of walking to the next town. It is quite likely, however, that the price paid for the gas will be, in some sense, abnormally high. Why? In simplest terms, because the stranded driver has no alternative except to forego the gasoline. The seller has no competitors and is thus under no compulsion to offer a particularly attractive bargain; indeed, the price he can obtain is limited only by the buyer's desires and ability to pay.

It may be objected that there is a missing element here, that the abnormal price paid for the gasoline may be due not simply to the presence of a monopolistic seller but also to the unusual circumstances in which a gallon of gasoline may be valued more highly by the buyer than it ordinarily would be. This is a valid observation; yet the fact remains that the transaction might have been quite different if, for example, four motorists had appeared simultaneously, each offering to sell the required gasoline and each willing to compete for the sale, or if the motorist had run out of gas near an intersection containing several service stations. The seller's power, deriving from the absence of competitors, does influence the terms of the exchange.

Examples of monopolistic exploitation are commonplace. Prices charged at a "24-hour" general store, located some distance from shopping centers, are likely to be relatively high because the store enjoys a partial monopoly in both location and time. The price of a soft drink at a theater intermission or a glass of beer at a ballpark may similarly reflect a degree of monopoly power. This is not to imply, incidentally, that the entire differential between these and more "ordinary" prices is attributable to monopolistic control. The general store, for example, may well incur higher unit costs than a supermarket, and its best (profit-maximizing) price may thus tend to be higher for reasons of cost as well as because of its monopoly position.

[3] The distinction between "economic" and "noneconomic" motivations is not always clear-cut, and is discussed shortly.

Freedom from competition, however, does make a difference. The ability of the store, or the ballpark or theater vendor, to charge more depends upon the difficulty customers encounter in going elsewhere.

It should be made clear at this point that the economic argument in favor of competition does not rest simply on intuition or homey examples of exploitation. As we shall see, economic analysis demonstrates in a formal and rigorous fashion the inevitable superiority of competitive market results. It concludes, in other words, that there is some sense in which competition always benefits society more than partial or complete monopoly.

Despite the clarity of this conclusion,[4] our competition-promoting antitrust policies reside today in a state of some disarray. What is confused in part is the legal status of complex and somewhat ambiguous provisions. But the more basic confusion—and a major source of policy dilemmas—concerns the relationship between what the law does, on the one hand, and what economic analysis might suggest, on the other.

This is not to imply that antitrust legislation generally has run contrary to the lessons of economics. Much, and perhaps most, public competition policy possesses a cogent economic rationale, and antitrust policy very likely has had a positive effect on the competitiveness of the American economy. The problem is rather that some apparently straightforward theoretical conclusions have not provided a clear basis for policy action. We have a highly developed economic theory of competition but an ambiguous policy for its maintenance and encouragement. A primary task of this book is to explore the reasons that it has proved difficult to move from a theory of competition to a policy toward competition. Once these reasons are recognized, it may be possible both to define limitations to the relevance of theory to policy and to suggest ways in which policy might be brought into closer accord with economic analysis and its implications.

COMPETITION: ECONOMIC DESIRABILITY AND NONECONOMIC OBJECTIVES

Economists have long recognized the benefits of competitive markets; yet public policies toward competition are not motivated solely—perhaps not even primarily—by economic objectives. Social and political factors also are important, and although these are not our direct concern here, it would be myopic to pretend that they do not exist. Interestingly, the presumption in favor of competition that is made on noneconomic grounds is closely related in some ways to economic arguments.

As we discuss in Chapter 1, the economic "case" for competition is in effect an argument that competitive markets are the most efficient form of industrial organization. Efficiency, however, is defined in a rather specific way: The competitive market is said to be efficient because it most accurately reflects and executes the desires

[4]The conclusion of competitive superiority is at this point nothing more than an assertion. Its validity is discussed in Chapter 1.

of individuals as consumers, that is, the desires of the community as a whole. In a free society, a premium is placed on democratic decision making. If competitive markets make economic decisions efficiently in the above sense, then such decisions are made in an essentially democratic fashion. That is, the decisions reflect the desires of the community without the distortions that powerful interest groups can impose.

The competitive market may thus appeal to us in two rather different ways. Economically, it provides efficient **results.** Socially (or politically), it gives us a democratic **process** under which our economizing decisions can be made. There are, however, some important reasons for not carrying the economic optimality argument too far into the noneconomic or social realm.

It is true that competitive markets do an efficient job of allocating resources and that the allocations may be democratic in the sense that the "dollar votes" of consumers are accurately translated into the desired output decisions. It may be, however, that the "dollar votes" are themselves distributed among consumers in a pattern that one would regard as "unfair," "unjust," or even "undemocratic." Most societies, ours included, are characterized by highly unequal distributions of income and wealth. Simply stated, some consumers have many more "votes" than others.

Even if such a situation is itself considered undesirable, resources may still be allocated efficiently by a competitive market system; but the desirability of the resulting allocations would be subject to question in light of the initially poor distribution of spending power.[5]

COMPETITION: THE GAP BETWEEN THEORY AND POLICY

Whether or not one considers economic objectives to be paramount, there can be no question that they provide a relevant motivation for antitrust action. It therefore follows that the general formulation of antitrust policies must take account of economic implications, even though these implications may not always be the controlling factor in policy decisions. Much of the economics literature of the past 30 years has attributed policy failure and confusion to a gap between theory and action. Some observers have contended that policymakers frequently ignore or fail to understand the economic implications of what they are doing. It has long been argued specifically that there is a legal–economic dichotomy in approaches to antitrust problems and that policymakers sometimes act in an economically illiterate fashion.

Some of these statements are accurate; but if we ask why there is a gap between economic theory and public policy, there is a large variety of possible answers, each with some claim to truth. Many of the arguments familiar to students of industrial organization rest on a common point: For one reason or another, it appears that we

[5]One might suggest (as many have) that efficiency and equity ("fairness") are separate considerations that ought to be pursued independently. Thus, if efficiency is a worthwhile objective, it remains so whether or not society also contains elements of unfairness. This position has some logical appeal; yet in practice the two considerations can be very difficult to keep apart.

cannot decide whether theoretical conclusions about competition are fully **relevant** to policy formulation.

This ambivalence is not too surprising. There often is a question in economics as to whether theoretical conclusions apply directly to problems of the "real world." In the area of competition policies, this question is acute because the conclusion of competitive superiority is derived under a number of rather restrictive assumptions. If the abandonment of some restrictive assumptions could alter the conclusions, then there would be no firm a priori basis for determining an appropriate public policy.

A second source of ambivalence lies in the imperfect nature of real markets. The conclusion of competitive optimality rests on a comparison between the economist's strict definition of a purely or perfectly competitive market and other market forms. Policy decisions, however, do not involve choices between perfection and imperfection but, rather, between various kinds of imperfection. Theoretical bases for such choices are relatively weak, and even if we could decide as a rule to opt for "more competitive" markets, there is serious difficulty in defining and measuring what this means.

Although theoretical conclusions may be quite meaningful, there are some real difficulties in moving from theory to policy. To the extent that objective analysis falls short of providing full prescriptions for policy, it becomes necessary to look at empirical evidence: that is, to examine what actually happens in different kinds of markets. As we shall see, a good deal of information on market behavior has been gathered. The data yield a number of useful clues about the ways in which performance patterns vary with the structure of industry. It is not clear, however, that this evidence brings us much closer to unequivocal statements about the kinds of policies that will yield particular ends.

If both theory and evidence are inconclusive, we cannot accurately predict the effect of policy changes. It is not appropriate to be too pessimistic at this point, however. We may be able to say a good deal about the likely effects of alternative policies, even if such statements cannot be made with complete precision or confidence. Moreover, improved predictions in the future, based especially on new empirical clues, may occur quite rapidly.

It must be pointed out that, whatever the current status of economic theory and measurement, even perfect predictions of policy effects might not be conclusive. The question of what public competition policies ought to be adopted obviously depends upon the effects of the alternatives; but it depends as well on **society's evaluation** of these effects. This statement appears self-evident, but it is not trivial. Society has numerous objectives. We would be pleased to have, for instance, an equitable distribution of income, efficient resource allocation, rapid innovation, and wise resource conservation. But even assuming that we could agree on the meaning of these noble aims, the appropriate policy for their implementation might be unclear.

The objectives conflict, because a policy that emphasizes one (or more) must also deemphasize one (or more). The question then becomes: how does society assign priorities, that is, decide which goals are more important than others? This kind of question cannot be answered on the basis of economic analysis or empirical evidence. Such information is helpful in delineating society's alternatives, but it cannot tell us what sorts of policies are desirable or undesirable.

ORGANIZATION OF THE BOOK

This book is divided into three main sections. The first part, Theoretical Underpinnings, examines competititon, monopoly, and—most important—intermediate markets, in which elements of competition and monopoly coexist. We consider here the economic argument for competitive markets that justifies a public antitrust program.

Part Two, Empirical Problems and Evidence, reviews what we are able to observe about firm and market structure and behavior. Does the evidence support the theoretical expectations developed in Part One? Can it provide clearer guides to policymaking than analytical constructs alone? In discussing these questions, we attempt to define what policy officials should know as they make decisions that affect the nature of competition in markets.

In the third part, Antitrust Policy, we look in detail at our public treatment of market competition. We examine the legal rules that have been developed with regard to conspiracy, monopoly power, mergers, price discrimination, and a variety of potentially restrictive business practices. In addition, we consider the regulatory approaches employed in those sectors in which competition may be impractical. Part Three ends with some evaluations of public policy. By that point, however, it is hoped that most readers will be prepared to render their own judgments.

PART ONE

THE THEORETICAL UNDERPINNINGS

This section sets forth the economic theory that contains the pure economic justification for American antitrust poilcy. The economic rationale of antitrust policy rests in the traditional body of price theory and, specifically, in the theory of market behavior. Although it is rather easy to argue intuitively that "competition" may benefit consumers more than "monopoly," the casual demonstration leaves a number of questions unanswered. It does not tell us, for example, whether a competitive market **inevitably** yields superior results or whether economic problems at times may be better resolved under "imperfect" or "monopolistic" conditions; nor does the casual, common-sense approach tell us whether **all** economic problems are best solved by competition.

Therefore, it is useful to examine in a more precise fashion the analytical basis of statements about competition, monopoly, and intermediate market forms. This investigation will clarify the meaning of our presumption in favor of competition and will make it easier to evaluate actual policies in light of their economic implications. The first task in this examination of market theories is to define the exact nature of competitive market results. We shall see that competition yields an **optimal** solution of the fundamental economic problem; that is, a solution that is not only preferable to a "monopoly" result but is, in some sense, the **best possible** outcome. It is necessary, however, to append a number of significant qualifications; for the conclusion of competitive optimality rests upon certain assumptions that, although perfectly legitimate from a theoretical standpoint, may cast doubt on a policy that single-mindedly pursues "more competitive" markets.

It is also useful to analyze in some detail the working of "imperfectly competitive" and "oligopolistic" markets, which contain elements of both competition and monopoly. Policy decisions dealt most frequently with these intermediate markets, and they are therefore of considerable practical interest. It is also in this area, however, that theories of market behavior have proved at least satisfactory, and some of the reasons for fundamental policy difficulties should become quickly evident.