William G. Shepherd

PUBLIC POLICIES TOWARD BUSINESS

Eighth Edition

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PUBLIC POLICIES TOWARD BUSINESS

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To Theodora B. Shepherd
and to the memory of Geoffrey S. Shepherd,
peerless scholar and fearless critic.

PREFACE

For about 90 years, from 1888 to 1978, the United States developed a unique set of policies toward business. Antitrust and regulation covered most markets in ways that this book describes. Since then, the policies have been altered drastically, and American industry is still absorbing the aftershocks. The 1980s' merger boom, the divestiture of the Bell Telephone System, the de-regulation of airlines, railroads, and banking—these and other changes have transformed much of this book's subject.

Accordingly, this edition has been revised extensively to reflect the changes. The new material includes the free-market doctrines of the Chicago-UCLA school, which were applied by the Reagan administration during the 1980s. Part One, "The Setting for Policies," covers the contending economic schools more thoroughly than previous editions.

Part Two gives extended coverage of antitrust policies, even though they have been cut back drastically during the Reagan/Chicago-UCLA years. De-regulation and regulation are recast in Part Three to reflect the major experiments in de-regulation and the reduced scope of traditional utility regulation. Public enterprise and special cases have been condensed in Part Four to two chapters.

As before, the aim of this book is to develop the skill of analyzing complex economic issues with an independent mind. Concepts, facts, and cases are provided, but they are only the raw material. Long after you may have forgotten the details, I hope you will retain the method of objective evaluation that this book encourages.

Throughout, you are taken beneath the surface details to the economic effects of policies. They are controversial, of course, but the economic questions must be asked nonetheless. What are these actions really doing? Are they worth their costs? What alternatives might be better?

The book is designed to fit a one-semester or two-quarter treatment of business and government at the upper college level. It is also intended to be useful in law and business courses that deal with competitive issues and with the economic content of antitrust and regulatory law. Although the book's format gives a natural sequence, it can be used flexibly.

The book was started by Clair Wilcox of Swarthmore College, going through four editions during 1955–71. On Wilcox's death, I provided a form of joint authorship for two editions. Wilcox's spirit lives on in the present edition, though I am listed as the sole author.

The text is an outgrowth of many years of teaching by Wilcox at Swarthmore College and by myself at the University of Michigan, the University of Massachusetts, Yale University, and Williams College. It also reflects our service in various public agencies and our research on many issues, sectors, and policy effects, in all parts of the subject.

I owe debts to many people for help in preparing this volume. Richard Hellman and Alan Nichols provided helpful detailed advice about needed revisions throughout the book. Many colleagues' advice and support over many years have also shaped the book. They include Walter Adams, William J. Adams, William J. Baumol, Maxwell Blecher, Kenneth D. Boyer, Richard E. Caves, William S. Comanor, Henry de Jong, Donald J. Dewey, Kenneth Elzinga, Alfred E. Kahn, H. Michael Mann, Charles E. Mueller, Takeo Nakao, James R. Nelson, Richard R. Nelson, Eli Noam, Shorey Peterson, Almarin Phillips, F. M. Scherer, Leonard G. Schifrin, John B. Sheahan, Harry M. Trebing, Don C. Waldman, Leonard W. Weiss, and Oliver E. Williamson. Their generosity and skill are a continuing source of pleasure.

At Irwin, I have benefited from the thoughtful supervision and fine editing of Elizabeth Murry and Karen J. Murphy.

Accordingly, the book's limitations are entirely my responsibility. As always, I invite your help in improving further editions. Your advice will be warmly welcomed.

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Introduction

For a century, the United States has employed a unique pair of public policies to deal with market power in its economy: antitrust and regulation. In contrast, other countries have relied mainly on mixtures of government support, informal influence, and ownership in various sectors.

By using its complex and evolving set of antitrust policies, the United States has sought to promote competition as the guiding force in most markets. The Sherman Act of 1890 serves as a magna carta of economic freedom, and it has deeply affected the American economy by maintaining greater competition and economic progress.

Toward certain basic utility sectors, the United States has applied the second type of policy: regulation. Unique by world standards, regulation (1) permits monopolies to exist in certain "natural monopoly" industries, but then (2) seeks to restrain their pricing and profits to reflect competitive patterns. Most other countries have put their utilities under government ownership.

The United States also has developed several other lesser policies toward business, including public enterprise (instead of private control), patents for inventions, "social regulation" of safety and pollution, and methods of buying military weapons.

Market power is the main problem that all of these policies try to solve. As economists have long analyzed, market power tends to reduce efficiency, retard innovation, cause unfairness, and introduce other distortions. Monopoly has many forms and effects that arise in a variety of market settings, and so the policies to constrain monopoly need to be adapted carefully, case by case.

The policies are important and fascinating in themselves, dealing with the central character of free market, competitive capitalism. If the policies are well designed and wisely applied, then the economy will be more efficient, innovative, and fair. But the actual policies are hammered out in the rugged political process, rather than calmly perfected, and so they often turn out to be quite imperfect.

How imperfect, and in what ways, is intensely controversial. Antitrust, regulation, and the other policies have always been both denounced and defended, and the debates are often bewildering. Moreover, the policies frequently change and go through swings between strictness and leniency.

The task in this book is to learn (1) the economic criteria of "good" policies, and then (2) the policies' actual design, history, and economic effects, as they have developed since the 1880s. From that basis, you can then judge for yourself how effective the policies, with their specific strengths and faults, have been.

FROM 1890 TO THE RADICAL 1980s

During the nine decades from 1890 to 1980, the policies toward business evolved into the U.S. government's unique approach, combining strong antitrust toward most of the economy with the direct regulation of prices of certain utilities.[1] No other country had these policy tools, and they seemed to work well and to promote long-term growth and innovation in the United States.

Then came a dramatic break during 1975–85. Several regulated industries were briskly de-regulated, especially airlines, railroads, and trucking. During 1981–89, the Reagan administration sharply reduced the scope and strength of antitrust enforcement, and it extended de-regulation even further to telephones, broadcasting, finance, and other sectors. After 1980, America's distinctive policies—particularly the deeply rooted reliance on antitrust policies to curb monopoly—were cut back deeply, amid intense controversy.

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[1]On antitrust's early history, see Hans Thorelli, *The Federal Antitrust Policy* (Baltimore: Johns Hopkins Press, 1954); William Letwin, *Law and Economic Policy in America* (New York: Random House, 1965); and A. D. Neale and D. G. Goyder, *The Antitrust Laws of the United States of America*, 3d ed. (Cambridge: Cambridge University Press, 1980). More recent summaries include F. M. Scherer and David Ross, *Industrial Market Structure and Economic Performance*, 3d ed. (Boston: Houghton Mifflin, 1990); Richard A. Posner, *Antitrust Policy* (Chicago: University of Chicago Press, 1976); and Harry First, Eleanor M. Fox, and Robert Pitofsky, eds., *Antitrust for Its Second Century* (Westport, Conn.: Greenwood Press, 1990).

On regulation, see Alfred E. Kahn, *The Economics of Regulation*, 2 vols. (Cambridge, Mass.: MIT Press, 1989); and Richard Schmalensee, *The Control of Natural Monopolies* (Lexington, Mass.: D. C. Heath, 1979).

Reagan officials candidly favored big business. They argued that large enterprises are superior in efficiency and innovation to small firms; any dangers of monopoly power would be restrained by the power of competition from little rivals and the entry of new competitors; most of the antitrust restraints on monopoly were no longer necessary in the new, tough global markets where foreign firms applied tight pressures; and antitrust would merely interfere with the rising competition.

This shift in thought and policy was similar to a change in the 1920s, when the Harding-Coolidge administrations favored big business and cut back deeply on antitrust enforcement. But the 1980s' views also reflected a range of "new" economic doctrines, particularly what is called "Chicago-school" economic analysis (actually they are Chicago-UCLA ideas, because some leading members of the school are at the University of California in Los Angeles).[2]

Chicago-UCLA doctrines hold that virtually all markets are effectively competitive already and that government actions tend only to interfere with competition. They say that state actions cause harm even when trying to do good. Therefore, laissez-faire is the correct course; markets should be trusted and government policies ought to be dismantled, according to free market, Chicago-oriented economists and legal scholars.

They found enthusiastic acceptance in the Reagan administration. In virtually all policies covered in this book, the 1980s brought cut-backs toward minimal levels of policy action. In some cases, such as the deregulation of the savings and loan industry, the results are universally recognized to have been disastrous. But in most others, Chicago-UCLA-school economists and officials still believe that their minimalist policies have been successful. The previous moderate antitrust and regulatory policies are said to have been mistaken and extreme.

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[2]Leading Chicago-UCLA writings include George J. Stigler, *The Organization of Industry* (Homewood, Ill.: Richard D. Irwin, 1968); Yale Brozen, *Concentration, Mergers and Public Policy* (New York: Macmillan, 1982); John S. McGee, *In Defense of Industrial Concentration* (Seattle: University of Washington Press, 1971); McGee, *Industrial Organization* (Englewood Cliffs, N.J.: Prentice-Hall, 1988); and chapters by John S. McGee and Harold Demsetz in Harvey J. Goldschmid, H. Michael Mann, and J. Fred Weston, eds., *Industrial Concentration: The New Learning* (Boston: Little, Brown, 1974).

Less moderate versions are in Robert H. Bork, *The Antitrust Paradox: A Policy at War with Itself* (New York: Basic Books, 1978); Dominick T. Armentano, *Antitrust and Monopoly: Anatomy of a Policy Failure* (New York: John Wiley & Sons, 1982); and William J. Baumol and Janusz Ordover, "Use of Antitrust to Subvert Competition," *Journal of Law and Economics* 28 (May 1985), pp. 247–65. For a parallel criticism of antitrust, see also Franklin M. Fisher, John J. McGowan, and Joen E. Greenwood, *Folded, Spindled and Mutilated: Economic Analysis and U.S. vs. IBM* (Cambridge, Mass.: MIT Press, 1983).

For perceptive comparisons of the Chicago-UCLA and mainstream approaches, see Eleanor M. Fox and Lawrence A. Sullivan, "Antitrust—Retrospective and Prospective: Where Are We Coming From? Where Are We Going?" *New York University Law Review* 62 (November 1987), pp. 936–88.

The new Bush administration officials promised during 1989–90 to temper these changes by reviving antitrust to some degree and avoiding further hasty de-regulation. However, the Reagan patterns remained largely intact through 1990, and the many judges appointed by Reagan officials during the 1980s make it likely that judicial decisions will continue to reinforce the minimalist antitrust and regulatory approaches.

The readers of this book are entering the field at a particularly fascinating time, when the Reagan legacy is widespread and also ripe for reassessment. The actions of the Reagan administration were often stark, and some of them had clear effects. The debates are sharp and wide-ranging, and they provide unusually clear contrasts between the established policies and the new treatments.

Indeed, the policies merely reflect the larger debates between mainstream economists on the one hand and Chicago-UCLA-school economists and other related "new" theorists on the other. This book will present those debates and policy changes since 1900. Within that broad framework, it will focus on the dramatic 1980s' changes and their lessons. Contrasting views and schools will be presented and compared so that you can learn to make your own judgments. To illustrate the main issues, only the most important leading cases will be covered.

The focus of this book is on the policies' economic content. This content can be different from the legal forms of the policies and official rulings. For example, antitrust law continues to prohibit all price fixing among competitors. However, since the enforcement agencies have limited resources, they are able to discover and prosecute only some of the price fixing that occurs. Moreover, the officials can choose to go lightly on some offenses, using their "prosecutorial discretion" just as a local police officer decides whether to arrest all speeders or jaywalkers. In addition, the courts may punish the offenders only mildly or possibly, instead, too harshly.

As you can see, the intensity of actual enforcement is often highly variable and difficult to assess, and the exact economic effects of what has been done are not certain and are inevitably controversial. Is most price fixing stopped, or only a little of it? Should more resources be applied to enforcement? How much more? What are the yields to the economy?

Every public policy deserves such skeptical analysis, where attempts are made to judge its effects and yields. This book prepares you to do that by developing your ability to identify and judge the actions and their effects. In each case, the analysis is on two levels: (1) What is the underlying economic problem, and (2) how well do the actual policies fit economic criteria? Actual policies, regrettably, often reflect economic mistakes or calculated deceptions. Occasionally, they are quite excellent in design and details. By sifting complex arguments and evidence, this book equips you to judge the policies for yourself.

DIAGNOSIS AND TREATMENT

There are parallels between the study of public policy and the study of medicine. Medical students first learn how the healthy human body functions. Likewise, you will learn here how healthy, competitive markets function. Medical students then learn how to *diagnose* what is wrong when there is disease or injury; likewise, you will learn how to assess the causes and effects of monopoly.

After diagnosis, medical students turn to *treatment,* learning how to fit the methods of treatment to the specific disease, for each patient. For economists, the best policy solution for each situation depends on the market's specific conditions. There is usually a range of alternative methods and controversy about the choices as illustrated by the following two examples.[3]

Should AT&T have been split up in 1984? Should AT&T still be regulated in long-distance telephone service markets? It had 70 percent of the market in 1990, while MCI had only 12 percent and US Sprint had 8 percent. AT&T urged immediate de-regulation of itself so that it could set any prices it chose. The rivals and many outside observers insisted instead on the need to wait until competition was more balanced and widespread.

Another good example is the airlines; they were de-regulated during 1978–83 and were intensely competitive. But then a series of major mergers made them more concentrated after 1984. Some say monopoly power is again a serious problem; others disagree. Should the airlines be re-regulated? If so, how much, and in what ways? In each case, Chicago-UCLA-school economists favored less regulation, while other experts called for more restraints on dominant firms.

These two cases will actually be given extensive coverage in later chapters, because they pose two of the most interesting and important current policy controversies. The two industries are probably familiar to you already to some degree from personal experience in telephoning and traveling. The discussions will extend that initial understanding and fill it out with technical detail. Many of the other cases also deal with familiar products and companies, such as breakfast cereals, automobiles, computers, and newspapers.

THE FORMAT

The subject is "real," not just theoretical, but it involves a number of general concepts. The next two chapters set the stage by reviewing the

[3]More details and references about them are given in Chapter 3 and later in the book.