

The Failure of Antitrust Policy

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by D. T. Armentano

The recently proposed mega-mergers in the telecommunications industry may usher in a more activist period of antitrust regulation. This would be unfortunate since antitrust is a generally failed and discredited policy. The laws, allegedly enacted to protect consumers, have been used historically to harass efficient corporations that have increased market output and lowered market price.

How could a public policy allegedly designed to help consumers have come to hurt them instead? One explanation is that antitrust regulation was never intended to protect consumers. It was intended to shield some firms from the efficiency of other firms and, like tariffs, was fundamentally protectionist. This public-choice perspective on the origins of antitrust law is reinforced by recent historical research and by the fact that more than 90 percent of all antitrust litigation involves one private firm suing another. If it looks, walks, and quacks like a special-interest duck, it's probably a special-interest duck.

A second way to resolve the antitrust paradox is to argue that the regulators, the courts, and the academics that rationalized antitrust enforcement were fundamentally confused about certain basic economic concepts such as "competition" and "monopoly power." When a firm lowers its price, is that "competition" or is it an attempt to monopolize? When a firm gains market share, is that evidence of relative efficiency or is it an attempt to monopolize in restraint of trade? Is advertising pro-competitive or anti-competitive? Is research spending and innovation an important element of competition, or is it a "barrier to entry" that restricts competition and harms consumers? Clearly, theoretical ambiguities could contribute to a massively misdirected antitrust enforcement effort. Again, the antitrust paradox would be resolved.

Bad Theory, Bad Policy

To understand how theoretical confusion can lead to inappropriate public policy, that is, how bad theory can lead to bad policy, it might be useful to focus attention on the dominant micro-economic models and the generally accepted welfare analysis. The perfectly competitive equilibrium model dominated micro-economic theory in the 1940s, '50s, and '60s, and departures from that model's assumption or economic performance were often used to rationalize antitrust intervention. Generations of students who studied antitrust economics (or "industrial organization" as the subject came to be called) were told that "competitively" structured markets tended inevitably toward an equilibrium condition where price, marginal cost, and minimum average cost were all equal and where, by definition, consumer welfare was maximized.

According to this approach, consumer welfare could not be maximized if products were differentiated or if firms advertised; if some firms achieved economies of scale and scope that other firms could not achieve; or if high market share (or collusion) resulted in some "control" over market price. Firms with "monopoly" power "misallocated resources" (relative to perfect competition) and became legitimate candidates for antitrust prosecution.

The theoretical predictions of antitrust economics were accompanied by empirical research and by statistical (mostly regression) analysis. Early industrial organization economists were enthusiastic supporters of antitrust regulation because they believed that there were strong statistical correlations between market share and rates of return. Presumably "dominant firms" in concentrated markets tended to earn long-run monopoly profits; consumers could be made better off by an antitrust policy aimed at reducing market "concentration." Thus micro-economic theory and hard empirical evidence were alleged to have rationalized a vigorous antitrust (especially

anti-merger) enforcement effort.

Three important strands of criticism of the traditionalist industrial organization paradigm developed in the 1970s and they help explain a modest change in antitrust enforcement in the 1980s. First, "new learning" critics (mostly Chicago-school economists) challenged many of the older empirical conclusions concerning mergers, market concentration, and profitability. With appropriate adjustments for time and sample size, much of the alleged correlations between market concentration and profit disappeared. Second, revisionist case analysis demonstrated that antitrust regulation was often employed against firms that had increased their outputs and lowered their prices. Third, the basic theoretical paradigm itself--the static equilibrium models and their welfare analysis--was subject to important criticism. The best of that criticism was based on insights associated prominently with members of the Austrian School of Economics.

Austrian Theory

Austrian economists generally held that real-world departures from perfect competition were not necessarily examples of market failure, nor could such departures rationalize antitrust intervention. Products should be differentiated if consumer tastes are differentiated; firms should advertise if information isn't perfect; lower costs achieved by innovative firms should keep high-cost firms out of markets. All of these practices were elements of a rivalrous discovery process and were not resource misallocating. That they were inconsistent with the perfectly competitive equilibrium condition was irrelevant since that condition itself was entirely irrelevant for policy purposes.

Further, Austrian economists held that the empirical studies that attempt to measure monopoly power or social welfare loss were fundamentally misleading. The divergence of price from some measure of accounting cost was a disequilibrium condition and represented nothing sinister. Indeed, such divergencies were necessary in order to provide information and incentives to entrepreneurs to move resources to their highest valued use. Business organizations that made above-normal profits were simply more efficient at managing risk, discovering preferences, and reducing costs over the long run.

In addition, Austrian economists argued that the condemnation of the dominant firm in the industrial organization literature was thoroughly contrived. The source of that contrivance was the equation of the dominant firm with the textbook monopoly. Yet the textbook monopolist misallocated resources by definition, that is, because of strict equilibrium assumptions that ruled out the entry of other suppliers. In the absence of equilibrium assumptions--or legal barriers to entry--it was not even possible to define a monopoly price unambiguously, much less explain why such firms would have incentives to operate inefficiently. The dominant firm antitrust cases demonstrated that such organizations gain and hold market share by lowering prices and increasing outputs, precisely the opposite conduct and performance predicted by conventional monopoly theory.

Finally, costs and benefits for Austrian economists were always personal and subjective; they simply did not lend themselves to interpersonal aggregation or comparison. This basic Austrian insight obliterated all rule of reason and welfare analysis in antitrust regulation. For example, the conventional rule of reason approach assumes that regulators can promote the public welfare by permitting mergers whose social benefits outweigh their social costs, or by condemning price agreements whose social costs likely exceed benefits. For radical Austrian subjectivists, however, such utilitarian cost/benefit calculations were simply impossible since the data could not be known to outside observers and could not be aggregated across different individuals or firms.

It is clear, then, that the Austrian theoretical perspective is extremely skeptical of traditional antitrust economics and of so-called "vigorous" antitrust enforcement. In the current case of the proposed mega-media mergers, they should be allowed to succeed or fail on their own merits. Public policy should be essentially neutral with respect to inter-firm business cooperation,

mergers, and acquisitions.

The Essence of the "Monopoly Problem"

There is a "monopoly problem" in the U.S. economy but it is not to be found in purely private market activity such as business mergers. The essence of the monopoly problem is the existence of government legal impediments to rivalry or cooperation. Legal barriers to entry and prohibitions on inter-firm cooperation prevent the market from generating, disseminating, and using the information that the traders require for efficient plan coordination. Non-legal barriers and so-called restrictive agreements (such as resale price maintenance) simply don't have this effect on private plan coordination. Since antitrust regulations unambiguously lower the efficiency of the market process, and since they additionally restrict individual liberty and property rights, there's little reason to support the continuation of such regulation. In the name of efficiency and liberty, all antitrust law should be repealed.

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The Attack on Concentration

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by Yale Brozen

(Editor's Note: Yale Brozen, former member of FEE's board of trustees and a retired professor of business economics at the University of Chicago, died March 4. Reprinted below as a memorial is his article published in The Freeman, January 1979. It is especially timely because of the government's current legal action against Microsoft.)

Once we gave high regard to those who created great enterprises by designing desirable products, producing them at low cost, and offering them at such attractive prices that they won a large body of customers. Henry Ford, in his day, was looked upon as an industrial hero. Today, he would be regarded as a monopolizing fiend upon whom the antitrust prosecutors should be unleashed. The 1921 Ford Company, with its more than 60 percent share of the market, would today be called a dominant firm and charged with violating the antitrust laws.

Just a few months ago [1978], an antitrust complaint was served upon Du Pont because it developed a low-cost method for producing titanium dioxide pigments. There was no objection to the development of a lower-cost method of production, but Du Pont made the fatal error of passing enough of the cost saving on to buyers to win 40 percent of the market served by domestic producers. Not only did it do that but it is going on to enlarge its capacity, building a new plant at De Lisle, Mississippi, in order to serve even more customers (who also would like to obtain domestic titanium dioxide at low cost). Can you imagine that any enterprise would engage in such a nefarious activity? It should, according to the Federal Trade Commission (FTC), behave like a monopolist. It should restrict its output, instead of expanding, and charge higher prices (and let the business go to foreign firms).

Antitrust Upside Down

That is a total perversion of the intent of our antitrust law. If the FTC is not standing antitrust law on its head, then I simply do not understand what our antitrust law says. The words "every contract, combination, or conspiracy, in restraint of trade is hereby declared to be illegal" say that it is restraint of output that is in violation of the law. But the FTC contends that Du Pont is violating the law because it has "adopted and implemented a plan to expand its domestic production capacity."¹ That quite plainly says that the FTC regards Du Pont as breaking the law by expanding trade. Is that what the law says is illegal?

In whatever way I torture the phrases in the antitrust law, I simply cannot get it to say that expanding trade is illegal despite the thunder in the FTC complaint. Whenever anyone builds more capacity and uses it to produce more product, more trade must result. I can't believe that Du Pont is building a new titanium dioxide plant just because it wants a handsome monument at which to gaze and neither does the FTC. What the FTC is complaining about is that Du Pont intends to produce titanium dioxide in its new plant and increase its sales and it is nasty of Du Pont to have already built enough plant to take care of 40 percent of the needs of customers for domestic product. That makes Du Pont "the nation's dominant producer." There can hardly be anything more venal than a "dominant producer," unless it is a "shared monopoly."

"Brand Proliferation" Through Hypnotic Advertising

"Shared monopoly" sounds like a label for a conspiracy among several firms to monopolize a market and share the fruits of that monopoly. But that is not what the FTC means by the label. The phrase is FTC code for a few firms winning and holding a large share of the business in some product line. The FTC staff is currently prosecuting Kellogg, General Foods, and General Mills for "sharing a monopoly" of ready-to-eat (RTE) cereals. These three firms have managed to produce and distribute cereals that taste good enough and cost consumers little enough to win more than three-quarters of the RTE business. That is their crime.

Did these three firms conspire with each other to somehow force other firms out of the industry and then conspire to reduce supplies and raise prices? The FTC disavows any accusation of any such conspiracy. It says that the crime of which these firms are guilty is "brand proliferation." The heinous conduct of which it accuses these firms is that of trying to give consumers what they want. It is now a crime, that is, the FTC is trying to make it a crime, to follow that old merchandising maxim for success, "give the lady what she wants."

The cereal companies should have stuck to producing corn flakes. Never mind the demand for a bran cereal, or a high-protein cereal, or a vitamin-enriched cereal, or a presweetened cereal. Anyway, says the FTC in its complaint, there are no differences between cereals except those artificially created in the minds of consumers by hypnotizing them with advertising.² Of course, if the new brands offered by the three firms in the 1950s and 1960s had not won a large share of the market, nothing would have been wrong with "brand proliferation." But the new brands pleased consumers. They won for the three firms a large share of the market. That, at bottom, is the crime these firms committed. The RTE cereal industry has become "concentrated," that is, most of the sales in the industry are made by a few firms. That is a condition which neither the FTC nor the Antitrust Division intends to tolerate.

The FTC staff also has accused the eight major petroleum refiners of engaging in a "shared monopoly" in the petroleum-refining industry. It is asking that these corporations be broken into smaller companies. The major crime of which the Big Eight stand accused is that of maintaining a "noncompetitive market structure." This phrase is never cogently defined by the FTC staff, but "concentration" seems to be the nub of it. Complaint counsel says the eight companies "are well vertically integrated firms with substantial horizontal concentration at every level of the industry" (emphasis supplied).³ Counsel also says the eight "own and operate refineries accounting for approximately 65 percent of rated crude oil refining capacity in the relevant market." Even more damning, "This figure. . . understates concentration . . . because [the eight firms] . . . utilize more of their refining capacity than other refiners. Hence [their] share of production of refined petroleum products . . . is higher than their share of rated refinery capacity. . . ."

Again, here is the accusation that these alleged monopolists are not behaving like monopolists. Instead of restricting output and restraining trade, they push their capacity harder than do their competitors and expand output and trade. Apparently they are unaware of the fact that they are monopolists who can get higher prices by restricting output. Again, the FTC is displeased by efforts to expand trade and is standing antitrust law on its head by saying that the failure to restrict trade is a violation of the law. The FTC even accuses the companies of building pipelines

to provide themselves with "cheap transportation." Again, as in titanium dioxide, it is apparently illegal to reduce costs and pass enough of these cost savings on to customers to win an appreciable share of the market. (In the petroleum case, we cannot say a "large" share of the market has been won since no petroleum-refining firm sells as much as ten percent of the petroleum products sold in the United States.)

These three cases are cited to show the current state of antitrust doctrine at the antitrust agencies. The question remains of whether the courts will buy this upside-down view of antitrust law in view of its legislative history.⁴

Antitrust Not Intended to Fragment Industry

When federal antitrust policy began, with the signing of the Sherman Act in 1890, it was aimed at benefiting consumers. In the words of Senator John Sherman, the act was to outlaw arrangements "designed, or which tend, to advance the cost to the consumer." It was neither intended to fragment industry nor to prevent occupancy of a major share of a market by one or a few firms. When Senator George Hoar explained to the Senate the Judiciary Committee's final draft of the bill, he declared that a man who "got the whole business because nobody could do it as well as he could" would not be in violation of the Sherman Act. As Professor Robert Bork has pointed out in his examination of Sherman Act legislative history, "The statute was intended to strike at cartels, horizontal mergers of monopolistic proportions, and predatory business tactics."⁵ As the act itself says, "Every conspiracy in restraint of trade . . . is hereby declared illegal" (emphasis supplied).

Cost and price reductions and product improvements by a firm expand the trade of a whole industry. Since firms doing this frequently win a large share of the markets in which they operate, judges in the early days of antitrust litigation did not hold "concentration" of sales in the hands of a few firms or "dominance" by a single firm to be illegal in and of itself. Standard Oil and American Tobacco were broken up in 1911 because they had been built by a very large number of mergers of monopolistic proportions with wrongful intent and had then engaged in "acts and dealings wholly inconsistent with the theory that they were made with the single conception of advancing the development of business . . . by usual methods. . . ." The defendants failed to show that the intent underlying their mergers and their acts was the normal one of efficiency and expansion of trade they failed to show "countervailing circumstances" in Chief Justice Edward White's phrase. They were, therefore, subjected to antitrust remedies. The remedies were not applied because of their dominance but because they were formed and maintained by monopolizing acts and intent that is, by a desire to gain control of the supply of a product and to use that control to charge a monopoly price and thereby restrain trade.

Dominant Firms Do Not Control Supply and Price

There is a distinction between controlling the supply of a product and producing or selling most of the supply of a product. "Dominant" producers who sell a major portion of a product's supply usually have no control over the supply. They have no power to set any lower level of industry output and a higher price than that which would prevail in a market with many suppliers and no dominant firm. Usually, a dominant producer is the most efficient firm in the industry. Its large output is the result of its efficiency in supplying the market. The market price is as low as it would be with many producers frequently lower. Any attempt by a dominant firm to restrict its own supply and increase price after reaching a "dominant" position simply results in the expansion of output by other firms, the entry of additional firms, and loss of its dominance. A dominant firm can keep its dominance only by behaving competitively. The fact that there is a dominant firm, or small group of firms, in an industry is evidence of competitive behavior not of monopolization.

The lack of ability of a dominant firm (or group of firms) to control supply and price simply because it produces a major part of the supply of a product is illustrated by the experience of the automobile industry in 1927. From 1921 to 1925 the Ford Motor Company supplied more

automobiles than all other firms combined. The Ford Company was a dominant firm. It completely shut off its supply to the market for nearly the entire year in 1927 when it closed down to retool for the change from the Model T to the Model A. If the fact that a firm supplies the majority of a market gives it any power to control supply and price, then the complete withdrawal of that firm's supply should certainly cause a rise in price. Yet the prices of automobiles failed to rise when Ford shut down despite its having been the dominant producer. Other manufacturers increased their output and prices fell by mid-1927 despite the complete withdrawal of the Ford supply of newly manufactured cars from the market.⁶

The fact that a dominant producer has, at most, a very short-lived ability to influence the price of a product can be illustrated by numerous anecdotes. The American Sugar Refining Company merged 98 percent of the capacity for refining sugar east of the Rockies in 1891 and 1892. By cutting production it managed to raise refining margins by 40 percent in 1893 (which raised the price of sugar by 8 percent). Expansion of output in other firms cut sugar-refining margins in 1894 to a level little higher than the 1891 margins despite further reductions in output by American Sugar. By 1894, the entry of additional capacity had forced margins back nearly to 1891 levels and had cut American's share of the sugar business by one-quarter. American was still a dominant firm by today's FTC definition, but it had lost all influence over price and output despite its 85 percent share of capacity.⁷

In 1901, American Can merged 90 percent of all capacity in the can business. It raised prices by one-quarter and lost one-third of its share of market in short order despite additional buying up of competitors and their output. Prices returned to the pre-merger level in a very short time.

These are the most successful monopolizing cases I can find aside from the Air Line Pilots Association, the Teamsters, and similar labor unions.⁸ What they demonstrate is that a dominant firm quickly ceases to have any influence in the market if it charges a supracompetitive price. In some cases a dominant firm willing to restrict output greatly has no ability to obtain a supracompetitive price even in the short run.

Shifting Market Shares

Dominant firms, that is, firms which sell a major part of all product sold, remain dominant only if they charge the competitive price and are more efficient than other firms in their industries. If they are less efficient, they soon find their market share dwindling despite selling at competitive prices. The Big Four in the meatpacking industry, for example, has seen its share of the market dwindle from 56 percent in 1935 (and from an even higher share in earlier years) to 47 percent in 1947 to 38 percent in 1956 to 22 percent in 1972.⁹ The relative inefficiency of the Big Four showed in the 1920s when their rates of return on investment ran at one-third the rate earned by smaller companies.¹⁰ That situation continued up to at least 1972, and market share of these inefficient firms fell.

The Big Four meat-packers (the Big Five in the 1917 FTC investigation) originally achieved a large market share in meatpacking by their efficiency by instituting assembly-line methods with complete utilization of all by-products. They became known for using everything "but the squeal." Also, their development of refrigerated packing houses, cold storage, the refrigerator car, and an efficient distribution system created enlarged markets for meat supplied from cheaper livestock sources. They grew large by being innovative. Once their innovations were imitated by other packers, the decline of the Big Four began, accelerating with the spread of highways and the rise of trucking.

The "dominance" of the Big Four did not give them any power to restrict output or to control price. If anything, the rise of the Big Four decreased the dominance of local markets by local butchers who had to compete with fresh meat brought in by train by the Big Four,¹¹ especially after state laws prohibiting the sale of "foreign" meat were ruled unconstitutional. Nevertheless, the FTC filed one of its earliest "shared monopoly" suits in September 1948 against Armour, Cudahy, Swift,

and Wilson, accusing them of "conducting . . . operations . . . along parallel non-competitive lines." They had served consumers too well, thus incurring the hostility of local butchers in the late nineteenth century and the first quarter of this century. Long after local packers began outcompeting the Big Four, in the second quarter of the century, the FTC, in a flagrantly anticonsumer action, rode to rescue the fair maidens who by now had grown mustaches and larger biceps than the Big Four. The FTC demanded that Armour and Swift each be broken into five companies and that Cudahy and Wilson each be broken into two firms. The FTC reluctantly dropped the suit in March 1954, nearly six years and millions in legal costs after it was brought, but only because the court ruled that pre-1930 behavior was irrelevant in a 1950s proceeding.

Why Are Dominant Firms Being Attacked?

The attacks on concentration whether in the form of an attack on a "dominant" firm or a "shared monopoly," seem to be fairly episodic. The question to be asked is why large firms with a large share of the market are left undisturbed for long periods and then turned on at other times. It is not purely coincidental that the nation suffered a severe deflation from 1882 to 1890, prices dropping by 25 percent in that interval, and the Sherman Act was passed in 1890. At that time, the declining prices were blamed on "cutthroat" and "predatory" competition and this was also a time in which economies of scale in manufacturing, combined with a rapidly declining cost of transportation, led to centralization of production in enlarged facilities.

From 1867 to 1887, for example, sugar production doubled, from one-half to one million tons annually, and the number of refineries decreased from 60 to 27. In the same period, railroad freight rates fell by 60 percent.¹² The economies of centralized production together with reduced transport costs led to larger plants supplying more distant markets at lower prices than the smaller plants resident in those markets. So the myth of "cutthroat" competition and "predatory" pricing was born in this and many other industries. Antitrust cases were brought against dominant firms such as American Sugar, Standard Oil, American Tobacco, and others.

Another deflation in which prices again dropped by 25 percent, from 1929 to 1933, again led to animus against "Big Business" and especially against that rising innovation in marketing, the chain store. The investigations of the Temporary National Economic Committee once again directed the country's ire toward dominant firms and industrial concentration. Antitrust cases were brought against dominant firms such as Alcoa and A&P and against "shared monopolies" as in the Mother Hubbard case against the petroleum companies, the proceeding against the major cigarette companies, and the FTC case against the Big Four in meatpacking.

Currently, we are trying to find scapegoats for inflation.¹³ So we have brought cases against "dominant" firms such as IBM, AT&T, and Du Pont, and against the "shared monopolies" already described.

When we are troubled by deflation or by inflation, both brought on by the government's ineptness in operating our monetary and fiscal policy, the politicians export the blame to somebody else. Mr. Carter tells us in his speeches that the government is not at fault for our inflation it is up to business and labor to bring inflation to a halt.

In this modern day, we are no longer subject to the kind of superstitions that led the early colonists to hang witches when they were troubled by forces they did not understand. Instead, in this enlightened age, when we seek to rid ourselves of the causes of inflation and other mysterious ailments, we pillory dominant firms or the Big Fours in concentrated, and not so concentrated, industries.

The Potential Losses from Deconcentration

This absurd behavior by our politicians and its acceptance by the electorate as being something more than a hunt by politicians for witches to blame for their own mistakes might be tolerable if it

were nothing more than expensive entertainment of voters. But it is something more. It is counterproductive in terms of the ends we seek less inflation, higher rates of growth, and improved levels of living.

Prices have gone up less rapidly in our most concentrated industries than in others and productivity has grown more rapidly. From 1967 to 1973, prices in our most concentrated industries rose less than half as rapidly as prices in all manufacturing.¹⁴ From 1958 to 1965, prices in our most concentrated manufacturing industries actually fell while prices in other manufacturing industries rose. Yet it is our concentrated industries with a superior record for moderating inflation and a superb record for increasing productivity that are being cast in the role of economic villains.¹⁵

If this witch-hunt continues, the result will be economic disaster. If we deconcentrate all our manufacturing industries in which four firms produce and sell more than 50 percent of the product, the result will be a 20 percent rise in costs and a 10 to 15 percent rise in prices.¹⁶ If we want to hasten our decline to the status of a banana republic, the attack on concentration will contribute to that end.

1. FTC News Summary, April 14, 1978, p. 1. Emphasis supplied.
 2. FTC Docket No. 8883, April 26, 1972.
 3. Complaint Counsel's Prediscovery Statement, In the Matter of Exxon Corporation, et al., Docket No. 8934, pp. 7-10.
 4. The Court did accept this upside-down view in reversing the lower court in the Alcoa case. Yale Brozen, "Antitrust Out of Hand," *The Conference Board Record*, vol. 11, no. 3 (March 1974). [The government did not prevail in any of these cases. Ed.]
 5. Robert Bork, *The Antitrust Paradox* (1978), p. 20.
 6. Federal Trade Commission, Report on Motor Vehicle Industry (Washington, D.C.: U.S. Government Printing Office, 1939).
 7. Richard Zerbe, "The American Sugar Refinery Company, 1887-1914; The Story of Monopoly," *Journal of Law & Economics*, vol. 12 (1969), pp. 353-57.
 8. Yale Brozen, "The Consequences of Economic Regulation," *New Guard*, vol. 15 (June 1975).
 9. The 1956 and subsequent figures overstate the share of market retained by the original Big Four since Cudahy was displaced by Hormel.
 10. Ralph C. Epstein, *Industrial Profits in the United States* (New York: National Bureau of Economic Research, 1934), reports that 23 leading meat-packers earned 1.9 percent on equity in 1928 while 46 minor meat-packers earned 10.0 percent. In 1964, leading packers earned 3.7 percent while small packers earned 13.6 percent.
 11. Ambrose Winston, "The Chimera of Monopoly," *The Atlantic Monthly* (1924), reprinted in *The Freeman* (September 1960).
 12. The average rail rate fell from 19 mills per ton-mile to 7.5 mills.
 13. J. Cotlin, "Increased Corporation Antitrust Suits Prompt Industry Fears of New Federal Policy," *National Journal Reports*, September 15, 1973, p. 1371.
 14. Steven Lustgarten, *Industrial Concentration and Inflation* (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1975), Table 2.
 15. Shirley Scheibla, "Monopoly the Villain," *Barron's*, November 4, 1974, pp. 9, 18-20; "Economic Concentration: The Perennial Fall Guy," *First National City Bank Monthly Economic Letter*, April 1972.
 16. Sam Peltzman, "The Gains and Losses from Industrial Concentration," *Journal of Law & Economics*, vol. 20 (October 1977).
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“Predatory Pricing” Laws: Hazardous to Consumers’ Health

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by Donald J. Boudreaux

The local Wal-Mart in Conway, Arkansas, began selling pharmaceuticals in 1987. As with all of its other products, Wal-Mart sold high-quality medicines and health and beauty aids at rock-bottom prices. Not surprisingly, Wal-Mart's pharmacy business boomed. But rather than receive applause for its enterprising efforts, Wal-Mart was sued for violating antitrust law. In October 1993, an Arkansas trial court ordered Wal-Mart to raise its pharmaceutical prices and to pay treble damages to three local competitors who complained about Wal-Mart's low prices.

Unfortunately, harassment of firms that charge low prices is not unusual in the Alice-in-Wonderland world of American antitrust law. Although antitrust statutes are trumpeted as protectors of competitive markets and consumers, these laws in fact stifle competition and injure consumers. The pernicious nature of antitrust laws is nowhere more blatant than in so-called "predatory pricing" regulations, such as that used against Wal-Mart in Arkansas.

The "Logic" of "Predatory-Pricing" Prohibitions

"Predatory pricing" is said to occur when a firm seeking to monopolize a market sells its wares at prices below the firm's costs of production. Such below-cost pricing, it is said, unjustifiably inflicts losses on equally efficient rivals ("prey"). These losses force the prey eventually into bankruptcy, leaving the predator as the only seller in the market. The predator becomes a monopolist tomorrow by charging "excessively" low prices today. Thus, the benefit consumers get from today's low prices is more than offset (it is assumed) by the harm they suffer from tomorrow's monopoly prices.

If successful "predatory pricing" as described in the preceding paragraph occurred with some frequency, the case for legal sanctions against it would have a plausible basis. There is no good reason, however, to suppose that "predatory pricing" occurs. A vast amount of theory and evidence suggests that firms attempting to monopolize markets via below-cost pricing are almost sure to fail.¹ And profit-seeking firms are not prone to pursue strategies that consistently misfire. It follows that legal prohibitions against "predatory pricing" are, at best, unnecessary.

Why "Predatory Pricing" Is Not a Problem

While no one doubts that each firm wants to be a monopolist, economics shows that below-cost pricing is an especially futile method of achieving monopoly power. "Predatory pricing" will not work because a predator's prey have available several practical counterstrategies to ensure that they are not run out of business by "predatory pricing."

Suppose Predator, Inc., seeks monopoly power by charging a price below cost. Predator, Inc., must be willing to expand its output and sales at the below-cost price, for only then will it take customers away from its prey and, thereby, force its prey likewise to charge prices below cost. So, the predator inevitably suffers losses during the predatory period. Although the prey may also suffer losses from having to meet Predator, Inc.'s below-cost price, each prey suffers fewer losses than does the predator: Predator, Inc., must expand its sales at the below-cost price while each of the prey reduces its sales volume to loss-minimizing levels.²

The fact that predators would necessarily incur greater losses than their prey should be sufficient, standing alone, to demolish arguments in support of government prohibitions of "predatory pricing." Government serves no good purpose by policing against actions that no one has incentives to pursue. However, advocates of laws against "predatory pricing" reply that predators typically have "longer purses" than do prey--i.e., access to greater wealth to fund price wars. Accordingly, even though predators incur greater losses than do prey, predators are thought to have greater ability to withstand such losses.

This argument is unfounded. "Longer purses" are unlikely in economies with functioning capital

markets. In predatory-price wars, efficient prey with no spare funds of their own would be able to borrow the funds necessary to wage counterattacks against predators. After all, predatory pricers (by assumption) attempt to bankrupt firms that promise to be profitable once they've withstood the predation. Investors make their living by successfully identifying firms that can use money today to turn profits tomorrow.

But even if predators do have access to "longer purses" than do prey, it is doubtful that firms with funds on hand will invest in attempts to drive efficient rivals from business via below-cost pricing strategies. A much more profitable use of these funds would be to improve production efficiency or to enhance product quality. Not only does improved efficiency or product quality directly add to profits, but rivals cannot match such improvements as easily as they can match price cuts. Firms seeking enduring competitive edges over rivals will invest in ways that rivals find difficult to mimic. Moreover, unlike a predatory pricer, a firm that improves its efficiency or product quality typically suffers no greater expenses than its copycat rivals.

There are yet other reasons to doubt the reality of below-cost pricing as a monopolization scheme. Suppose Predator, Inc., somehow manages to run all of its rivals from the industry. What now? Predator, Inc., must jack its prices up to monopolistic levels in hopes of earning enough monopoly profits to more than offset the losses it incurred when it priced below cost. But nothing cures monopoly like excess profits. Predator, Inc.'s price hikes will attract rivals into the industry, squelching its ability to recoup its predatory losses. Predator, Inc., will find that it spent money in a failed effort to achieve a monopoly.

Of course, entry of new firms doesn't happen instantaneously--but neither does the exit of preyed-upon rivals. Predator, Inc., wants its prey to exit the industry quickly (so that its up-front losses are small) and new rivals to enter, if at all, only slowly (so it has sufficient time to recoup its predatory losses via monopoly pricing). Unfortunately for Predator, Inc., however, industries in which exit is quick are industries in which new entry is quick; industries in which new entry is slow are industries in which exit is slow.

The symmetry between rivals' exit-time and entry-time discourages reasonable firms from pursuing "predatory-pricing" strategies. This symmetry exists for a straightforward reason. Ignoring government-erected barriers, entry by firms into an industry will be slow only insofar as investments of capital goods in that industry are "industry specific"--that is, only if equipment for use in that industry has no good alternative uses. Investors are naturally reluctant to commit to projects requiring capital goods whose only other use is as scrap. They realize that once they commit their funds to industry-specific machines, tools, and buildings, they cannot easily go elsewhere for a profit if the industry proves to be unremunerative. (For example, once money has been used to build railroad tracks, the next- best use for railroad tracks is as scrap. Therefore, a railroad will not quickly be run out of business by a rival who charges unusually low rates. A predatory railroad would have massive up-front predation costs.) Thus, the only industries in which the entry of rivals will be slow are industries in which running existing firms out of business takes a long time. The huge up-front predation costs in such industries render "predatory pricing" foolish.

Conversely, industries in which the prey quickly exit are industries that use large proportions of capital having good alternative uses. In these industries, although exit of the prey may be quick, entry will likewise be rapid. The predator will have insufficient time to recoup its losses. In this case, recoupment of predatory expenses would be impossible in the face of rapid entry.

Conclusion: Policies Against "Predatory Pricing" Are a Problem

Economics suggests a number of other reasons why "predatory pricing" is unlikely to succeed (and, hence, unlikely to occur). Space does not permit a review of these additional reasons here. It is important to indicate, however, why laws aimed at stopping "predatory pricing" are themselves quite dangerous.

One way to see the folly of laws against "predatory pricing" is to ask: What would be the value of telling the police to protect citizens against, say, invasions of fire-breathing dragons? If dragons were real, and if these creatures posed a genuine threat to human safety, then such police actions might be appropriate. But, of course, fire-breathing dragons don't exist (although lots of folks have written about them). Whatever monies public agencies spend guarding against dragon invasions are wasted -- diverted from real and more pressing needs. So it is with laws against "predatory pricing." "Predatory pricing" is a mythical beast. Funds spent to hunt down and subdue the beast are wasted.

Unfortunately, there is another, more severe problem with laws proscribing "predatory pricing." "Predatory-pricing" prohibitions dampen vigorous competition. In the words of the U.S. Supreme Court, "cutting prices in order to increase business often is the very essence of competition." Consequently, mistaken inferences of predation--and, the Court might have added, the very ability to sue rivals for predation--"chill" healthy competitive rivalry.³

For example, Wal-Mart was sued by rival pharmacists, not by consumers fearful of future monopoly prices. These pharmacists sought shelter from competitive forces. Rather than suffer lower profits or the necessity of matching the new higher standard of responsiveness to customer demands set by Wal-Mart, the plaintiffs instead accused Wal-Mart of "predatory pricing." Their wish--granted by the trial court--was to make Wal-Mart less customer-friendly so that they, Wal-Mart's rivals, might avoid robust competition. At trial, one of the plaintiffs whined that he had to do "a lot of belt tightening" after Wal-Mart opened.⁴ Another plaintiff declared that he sued to make Wal-Mart raise its prices: "I want them to raise their prices. . . . I cannot compete with Wal-Mart."⁵

Fact is, Wal-Mart behaved just as firms in competitive market economies are supposed to behave. Wal-Mart charged lower prices because it pioneered more efficient retail-distribution methods. These efforts redounded to the benefit of both Wal-Mart (higher profits) and customers (lower prices). But the trial court effectively kicked consumers in the teeth by ruling for the plaintiffs. Firms everywhere now will more readily resort to the courts for protection against spirited competition. Consumers are the unambiguous losers under a legal regime recognizing the legal right of firms to sue rivals for so-called "predatory pricing." Sadly, there is much truth in columnist Llewellyn Rockwell's claim that "the long, sorry history of anti-trust shows that the policy is really about using government to create cartels, not enforce competition."⁶

1. See, e.g., Kenneth G. Elzinga and David E. Mills, "Testing for Predation: Is Recoupment Feasible?" *Antitrust Bulletin*, Vol. 34 (Winter) 1989, pp. 869-893.

2. Robert Bork summed up the case against "predatory-pricing" laws: "It looks like the best method of predation is to convince your rival that you are a likely victim and lure him into a ruthless price-cutting attack." Robert H. Bork, *The Antitrust Paradox* (New York: Basic Books, 1978), p. 152.

3. *Matsushita Electrical Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986), p. 589.

4. Testimony of plaintiff James Hendrickson, *Wal-Mart Stores, Inc. v. American Drugs, Inc., et al.*, p. 1634 of the trial record. This same plaintiff also admitted that the pharmaceuticals market became more competitive after Wal-Mart entered. See trial transcript at p. 1649.

5. Trial testimony of Dwayne Goode, *id.*, p. 1615.

6. Llewellyn H. Rockwell, Jr., "Mashing Microsoft," *The Washington Times*, Friday, July 22, 1994.

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The Rhetoric of Antitrust

by Thomas J. DiLorenzo

In theory antitrust regulation promotes competition in the marketplace but in reality its results are often anticompetitive. It is routinely used by businesses having problems competing as a tool to

keep their competitors from cutting prices, expanding production, and differentiating their products. In short, the conventional view that antitrust regulation is in the "public interest" is a myth. The rhetoric of antitrust is almost always emotional, but rarely logical. And emotion all too often dominates logic in matters of public policy.

One early example of antitrust rhetoric that was clearly harmful to competition was the charge by Judge Learned Hand in the 1945 case, *United States v. Aluminum Company of America*, that Alcoa violated the antitrust laws because of its practice of "exclusion." The judge explained Alcoa's guilt as follows: "We can think of no more effective exclusion [of competitors] than progressively to embrace each new opportunity as it opened, and to face every newcomer with new capacity already geared into a great organization having the advantage of experience, trade connections, and the elite of personnel."¹ By putting together a "great organization" whose products consumers voluntarily chose over others, Alcoa was found guilty of "anticompetitive" behavior. There are literally hundreds of examples of this type of "reasoning," which has been called antitrust upside down.²

Although there have been some exceptions, things apparently haven't changed significantly over the past forty years. Antitrust rhetoric continues to defy logic.

As one example, in 1985 the city of Long Beach, California filed a \$350 million civil suit against six oil companies, accusing them of "conspiring to depress the price of crude oil pumped from city tidelands in violation of state antitrust laws."³ The suit accuses the companies of "posting prices at unreasonably low and noncompetitive levels below fair market value," and of engaging in "reciprocal exchanges, swaps and buy-sells... designed to... eliminate... price competition of the marketplace." This is par for the antitrust course: lawsuits alleging that consumers are being harmed by lower prices.

The reality of this suit is that consumers would be harmed by higher energy prices; but Long Beach political authorities must feel that such harm is justified if the city can bring in more revenue (the rental fee for the tidelands is based on the market value of the oil pumped from them). Thus, the suit alleges that by dropping their prices the companies cost the city at least \$350 million in foregone revenues and seeks treble damages.

Although forty years apart, these cases have at least two things in common: 1) They contain rhetoric that is misleading, incomprehensible, or even insulting; and 2) the rhetoric is used to rationalize policies that impede competitive behavior and raise prices, all in the name of protecting consumers.

Such rhetoric appears to be the rule rather than the exception. Let us examine a few of the more common abuses that have become widely accepted and have helped establish the myth of antitrust.

Antitrust Rhetoric Versus Reality

Antitrust regulation has always been concerned with corporate mergers. An entire vocabulary has developed as a means of criticizing them.

The domino effect

Corporate mergers are often opposed to on the grounds that they sometimes lead to a "domino effect." That is, a successful merger spawns other mergers with the ultimate effect being a reduction in the number of firms in an industry and weaker competition. This is one reason why "merger waves," which have occurred periodically since the late 19th century, have been so widely criticized. According to this line of reasoning, an appropriate public policy is to nip the problem in the bud -- to legally prohibit the first merger from taking place -- rather than allowing an industry to become monopolized and then, after the fact, seeking a remedy such as

divestiture.

This is an appealing and popular theory, but upon close examination it suffers from a number of fatal problems. First, the mere number of business firms in an industry does not necessarily have anything to do with monopoly power. Research over the past two decades has shown that industrial concentration is most often caused by superior efficiency on the part of one or a few firms in an industry, not monopoly.⁴ Laws and regulations that prohibit mergers, therefore, have meant the sacrifice of efficiency and lower prices.

Big business is not necessarily bad, for substitute goods, international competition, and potential competition all limit the ability of an unregulated firm to charge monopoly prices. For example, even though the domestic automobile industry is composed of only a few firms, who would seriously accuse it of monopolizing its markets in light of fierce international competition?

A second problem with the domino theory is that the root cause of many merger waves is efficiency: one efficiency-enhancing merger encourages others. If one merger allows the newly-restructured firm to become more efficient due to economies of scale, for instance, other firms must follow suit to remain competitive.

A third problem is that the domino theory assumes that judges, regulators, economists, or politicians know something they cannot possibly know: the most efficient organization of an industry. That is, they presume to know whether three firms, thirteen firms, or thirty firms is the most "appropriate" number and to possess knowledge of the most efficient scale of each firm.

This knowledge can only be gleaned, however, by trial and error in the marketplace. Firms are constantly changing their size, structure, and methods of operation in order to discover the most cost-effective (and therefore profitable) procedures. To legally ban a merger on the grounds that it would lead to a "non-optimal" organization of industry is pretentious. To make such an argument is to claim to know what can only be discovered by allowing the merger (and entire market process) to take place. Such pretentiousness is at the heart of the U.S. Justice Department's arbitrarily-drawn "merger guidelines," whereby it threatens to legally block any merger that might result in any one firm making a certain (arbitrarily-chosen) share of market sales.

Foreclosure

One economist recently complained that by not challenging enough vertical mergers the Reagan administration was "discouraging competition" by "gutting the antitrust statutes."⁵ This view reflects the conventional wisdom regarding vertical mergers, which occur when a manufacturer merges with a raw material supplier or a distributor. Such mergers have often been banned by antitrust authorities because purchasing a raw material supplier would allegedly "foreclose" rivals (of the manufacturer) from the raw materials. To merge with a retailer is viewed as equally evil, for it purportedly cuts off competitors from channels of distribution.

The absurdity of this reasoning is the assumption that increased purchases of raw materials by one business means there is less (or none) for others. Economic activity, in other words, is a zero-sum game according to this view. But as long as there is a demand for the raw materials someone will supply them to whoever wants them. Consider the example of a steel manufacturer that purchases from a coal company. It will profit by having its own easily-accessible coal supply as well as by selling coal to others, including its rivals. After all, if it doesn't sell the coal, someone else will. It is not clear why vertically-integrated steel manufacturers or other coal producers should be expected to turn their backs on profit opportunities. Whenever there is a vertical merger nothing would prevent other coal companies from doing additional business, so that no one is "foreclosed" from anything.

What about a manufacturer that merges with a distributor? This sometimes occurs because it is

cheaper for some businesses to retail their goods through their own subsidiaries rather than independent distributors. It also gives the manufacturer more control over marketing strategies and procedures. This might "foreclose" other firms from using that particular distributor, but so what? Nothing is stopping them from integrating.

When a corporation runs to the antitrust authorities and requests that they block a vertical merger by a competitor it is a sure sign that the merger would permit lower prices or better product distribution. After all, if such mergers really were anti-competitive and caused higher prices one would hardly expect to observe competitors bringing antitrust suits. They would either be pleased that their competitor is raising his prices or would happily raise their own prices as well.

Squeezing

Vertical mergers between, say, a steel producer and a coal mine are sometimes objected to on the basis that nonintegrated steel producers are allegedly "squeezed" between (their own) higher coal costs and lower steel prices charged by the integrated producer. This is said to create a monopoly.

The problem with this argument is that there is nothing stopping any other steel producer from becoming vertically integrated if that is what it takes to become more efficient. Moreover, if "squeezing" causes lower costs and prices, what's wrong with that?

Antitrust complaints of squeezing are typically made by businesses who prefer not to compete by cutting costs and dropping prices. This charge is especially industries where there are many firms, close substitute goods, and international competition. The steel industry is a good example.⁶

Price discrimination

Section 2 of the Clayton Antitrust Act outlaws price discrimination, or charging different prices for goods "of like grade and quality" in different geographical markets if the effect is "to substantially lessen competition." Regulated or government-owned monopolies such as public utilities have long engaged in this practice as a way of exercising their government-sanctioned monopoly power.

The Clayton Act does not apply to these obvious monopolies but has been used to regulate the pricing practices of private businesses in markets where monopoly power is much less obvious, if not nonexistent. Even though price discrimination is, in theory, a means of exercising monopoly power, not obtaining it, in practice the enforcement of the doctrine is used as a regulatory tool against businesses where there is no good reason to suspect monopoly power to even exist.

The Clayton Act is a lawyer's dream, for it is left up to the courts to decide whether products are of "like grade and quality." This is inherently difficult, however, for consumers may view the quality of each item differently, depending on their own subjective preferences. For instance, even if two commodities are physically identical people may assign different quality levels to them because of the commodity's association with a popular brand name. It is not clear that such differences can legitimately be ignored. In the minds of consumers the products would not be identical. In short, deciding what constitutes "like grade and quality" is not as easy as it seems, even for items which can be graded chemically or by other physical means.

The Clayton Act does allow for price cutting in one geographical market if the price reduction occurs because of cost reductions or follows "in good faith" the price reduction of a competitor. The problem, however, is that if one's competitor initiates the price cutting, the competitor can be sued for price discrimination if the price was not cut "in good faith." Furthermore, a seller has no sure way of knowing that his competitor's price cut was in good faith without access to the competitor's cost data. A seller does not know whether the price reduction is about to meet itself

legal. Meeting an illegal discount has been ruled illegal.⁷

Thus, if one initiates price cutting one can be sued for violating the Clayton Act; if one raises a price in one geographical market, there is also the possibility of being sued; ordinary competitive practices like quantity discounts are sometimes ruled out;⁸ and if prices are held constant in all markets it is possible a price-fixing conspiracy case can be brought. No matter what a businessman does with his pricing policies he can be dragged into court for violating the Clayton Act. In the name of competition, "good faith," and "consumer protection" this act impairs price competition. It is only because of modest enforcement levels that the law hasn't eliminated more price competition.

Predatory pricing

This is where a business is said to have a "War chest" of monopoly profits that it falls back on while pricing its product below cost temporarily in order to drive its competitors out of the market. However, economists have had a difficult time documenting such episodes,⁹ and in theory it would appear unwise for any businessman to try to monopolize a market in this way. Even if a gas station owner, for instance, drove the station across the street out of business there is nothing preventing consumers from avoiding "monopoly prices" by going elsewhere. Moreover, if a "local monopoly" is established the monopoly profit would quickly attract new businesses, eventually eliminating any above-normal profits. There is also the possibility that a competitor will only temporarily shut down during the price-cutting period and then go back on the market when the higher prices are charged, thereby denying the "predator" any long-term gain. In short, predatory pricing guarantees a short-term loss of money, while the prospects of ever making long-term monopoly profits are bleak at best.

Furthermore, the reasoning behind the predatory pricing theory appears logically inconsistent. It assumes a "war chest" of monopoly profits to already exist which is used to finance the practice of temporarily pricing below cost. But how are the monopoly profits generated if the monopoly is supposedly created and maintained in the first place by predatory pricing?

The notion of predatory pricing has spawned endless litigation, and many of the subsequent judgments have been arbitrary, subjective, and damaging to competition. The problem is that if company A brings an antitrust complaint against company B it is known with certainty that, up to that point, consumers have benefited from company B's price cuts (and company A's as well if it followed suit). But for a court to deem such price cutting as "predatory" requires knowledge by the court of company B's intent Did it cut price just to compete or was it acting as a predator? This is impossible to tell with certainty. Despite all these problems, predatory pricing has become part of antitrust folklore. And the problems are empirical as well as theoretical. In the first (and probably most famous) predatory pricing case, Standard Oil of Indiana, operated by John D. Rockefeller, was found guilty of monopolizing the petroleum market through predatory pricing, among other means. However, John McGee¹⁰ has shown that no evidence was ever even submitted to the courts that Rockefeller even attempted it.

Concluding Thoughts

Much of the rhetoric of antitrust cannot withstand close scrutiny. Nevertheless, it has been employed for the past 95 years to rationalize policies that are increasingly recognized as counterproductive. This should have been expected, for even the rhetoric spoken during the Congressional debates over the first Federal antitrust law, the Sherman Act of 1890, reflect specious arguments. Contrary to the standard account of the origins of antitrust, the 19th-century trusts were cutting prices and expanding production rapidly.¹¹ But the Act's sponsor, Senator John Sherman, attacked them because he felt that such price cutting interfered with the government's protectionist trade policies. "The trusts have subverted the tariff system; they undermined the policy of government to protect.. American industries by levying duties on imported goods."¹² Congressman William Mason, who played an important part in the House

debates over the Sherman Act, condemned the trusts because even though they "made products cheaper," they "destroyed legitimate competition and have driven honest men from legitimate business enterprises."¹³ This is classic antitrust doubletalk: cutting prices is "bad" because it "destroys competition." Price cutting is, of course, the essence of competition and its chief benefit to consumers.

In short, we need to be more skeptical of antitrust rhetoric. A current example of the potential for emotive rhetoric to dominate discussion of the dangers of big business is the emerging public policy discussion about corporate takeovers. Just consider some of the rhetoric involved: raiders, poison pills, sharks, shark repellent, white knights, holden parachutes, greenmail, and so on. Such rhetoric tends to overshadow the real issues of consumer and stockholder welfare with arguments that often cannot be supported by either logic or factual confirmation.

In summary, it is instructive to recall what economist Alan Greenspan said of antitrust more than twenty-five years ago:

The world of antitrust is reminiscent of Alice's Wonderland: everything seemingly is, yet apparently isn't, simultaneously. It is a world in which competition is lauded as the basic axiom and guiding principle, yet "too much" competition is condemned as "cutthroat." It is a world in which actions designed to limit competition are branded as criminal when taken by businessmen, yet praised as "enlightened" when initiated by the government. It is a world in which the law is so vague that businessmen have no way of knowing whether specific actions will be declared illegal until they hear the judge's verdict -- after the fact. In view of the confusion, contradictions, and legalistic hairsplitting which characterize the realm of antitrust, I submit that the entire antitrust system must be opened for review.¹⁴

It is high time we followed this advice.

1. United States v. Aluminum Company of America, 148 F.2d 416 (2nd Cir. 1945), p.431.
2. See Dominick Amertano, *Antitrust and Monopoly: Anatomy of a Policy Failure* (New York: Wiley, 1982).
3. "California City Files Suit Against Oil Firms," *Washington Post*, March 5, 1985, p. D-2.
4. Such evidence is contained in H. Goldschmid, H. Mann, and F. Weston, eds. *Industrial Concentration: The New Learning* (Boston: Little, Brown, 1974); and Brozen, *Concentration, Mergers, and Public Policy* (New York: Macmillan, 1982).
5. Willard F. Mueller, "Toward Greater Economic Concentration," *St. Louis Post-Dispatch*, August 5, 1986, p. 3-B.
6. For a discussion of such cases see Eugene Singer, *Antitrust Economics* (Englewood Cliffs, N.J.: Prentice Hall, 1968).
7. Federal Trade Commission v. A.E. Staley Manufacturing Co., et al, 324 U.S. 746 (1945).
8. In a case in which the Federal Trade Commission accused the Morton Salt Company of price discrimination on the basis of volume discounts, the FTC argued that such practices harmed certain wholesalers (who did not receive the discounts) since they "must either sell at competitive prices and in doing so reduce their possible profits... or attempt to sell at higher prices...." See Federal Trade Commission v. Morton Salt Company, 334 U.S. (1940), p.43.
9. See John McGee, "Predatory Pricing Revisited," *Journal of Law and Economics*, April 1981.
10. John McGee, "Predatory Pricing: The Standard Oil (N.J.) Case," *Journal of Law and Economics*, April 1958.
11. Thomas J. DiLorenzo, "The Origins of Antitrust: An Interest-Group Perspective," *International Review of Law and Economics*, vol. 5, 1985, pp. 73-90.
12. Congressional Record, 51st Congress, 1st Session, Senate, June 20, 1890, p. 4100.
13. Congressional Record, 51st Congress, 1st Session, House, June 20, 1890, p. 2558.
14. Alan Greenspan, "Antitrust," in Ayn Rand, *Capitalism: The Unknown Ideal* (New York: New American Library, 1966).

The Ghost of John D. Rockefeller

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by Thomas J. DiLorenzo

At the Senate Judiciary Committee hearing on competitiveness in the computer industry last March, Microsoft chairman Bill Gates was compared to the infamous "robber baron" John D. Rockefeller and his company likened to the Standard Oil Company of the late nineteenth century. Federal Trade Commission chairman Robert Pitofsky made a similar analogy in a *Washington Post* op-ed, where he self-servingly argued for more money for antitrust investigations. Gates's competitors, too, are working diligently to implant the Rockefeller analogy in the public consciousness.

Even the *Wall Street Journal* has joined in this attack; reporter Alan Murray claimed in a page-one article that Gates supposedly enjoys "monopoly power" that "even John D. Rockefeller could envy."

Microsoft's critics are right. There are many similarities between Bill Gates's company and the old Standard Oil organization.

Like Gates, Rockefeller was the victim of a political assault for the "sin" of rapid innovation, a vast expansion of output, and rapidly declining prices just the opposite of what the antitrust laws ostensibly police. As with Microsoft, the political attack on Standard Oil was launched by less-efficient rivals who wanted to achieve through the political process what they failed to achieve in the marketplace.

There is indeed a lesson to be learned from Rockefeller's antitrust ordeal, but it is not the one Microsoft's critics have in mind.

Rockefeller's Economic Legacy

The firm of Rockefeller, Andrews, and Flagler was formed in 1865 and was a marvel of efficiency because of Rockefeller's penny-pinching ways and the managerial genius of his brother William.¹ Even Rockefeller's harshest critic, the muckraking journalist Ida Tarbell (whose brother's firm the Pure Oil Company was driven from the market by the more efficient Standard Oil), described the company as "a marvelous example of economy."²

The efficiencies of economies of scale and vertical integration caused the prices of refined petroleum to fall from over 30 cents a gallon in 1869 to 10 cents by 1874 and to 5.9 cents by 1897. During the same period, Rockefeller reduced his average costs from 3 cents to 0.29 cents per gallon.

The production of refined petroleum increased rapidly throughout this period of increasing dominance by Standard Oil as well, as increased competition was provided by Associated Oil and Gas, Texaco, the Gulf Company, and 147 independent refineries that had sprung into existence by 1911 the year in which the government forced the breakup of Standard Oil.

Contrary to popular mythology, Standard Oil's market share declined from 88 percent in 1890 to 64 percent by 1911. Because of intense competition the company's oil production as a percentage of total market supply had declined to a mere 11 percent in 1911, down from 34 percent in 1898.

Moreover, Standard Oil's decades-long price-cutting was not "predatory pricing" the theoretical practice of pricing below average cost to drive competitors from the market and establish a monopoly. Any business person would be a fool to intentionally lose money by pricing below average cost for decades. As economist John McGee concluded in his classic analysis of the Standard Oil case, "whatever else has been said about [it], the old Standard organization was

seldom criticized for making less money when it could readily have made more" through other means.³

Indeed, Standard Oil never came close to cornering the market; by the time the antitrust case against it was filed in 1906, it had hundreds of competitors. Nevertheless, Standard Oil was convicted of violating the antitrust laws in 1911 and partially dissolved, despite the fact that the courts conducted no economic analysis of its conduct and performance. That is, they completely ignored the effects the company had on prices, output, and innovation in the petroleum industry, just as Microsoft's critics tend to ignore that there are tens of thousands of software development firms in the world and that during the period of Microsoft's rise to dominance the cost of computing has fallen spectacularly while product quality has soared.

Standard Oil was convicted because of a general anti-business animus stoked by socialist intellectuals and journalists such as Henry Demarest Lloyd and Ida Tarbell and urged on by the company's higher-cost and higher-priced rivals. As a result the most efficient industrial organization of the time was crippled, weakening competition and pushing prices up.

The Protectionist Roots of Antitrust

From the very beginning, the antitrust laws have been a protectionist vehicle. While in theory they guard consumers against monopoly, in reality they politically protect uncompetitive (but well-connected) businesses. In a 1985 *International Review of Law and Economics* article, I showed that in the ten years before the 1890 Sherman Anti-Trust Act, the industries accused of being "monopolized" by trusts were all dropping their prices faster than the general price level was falling at that time and were expanding output faster than GNP was growing some as much as ten times faster.⁴ The late-nineteenth-century trusts were the most innovative and fastest-growing industries of their time, which is why they were unfairly targeted by antitrust laws.

Indeed, Congress at the time recognized the great advantages of the trusts for consumers. Congressman William Mason stated during the U.S. House of Representatives debate over the Sherman Act that the "trusts have made products cheaper, have reduced prices; but if the price of oil, for instance, were reduced to one cent a barrel, it would not right the wrong done to the people of this country by the trusts' which have destroyed legitimate competition and driven honest men from legitimate business enterprises."⁵ Senator George F. Edmunds added that "Although for the time being the sugar trust has perhaps reduced the price of sugar, and the oil trust certainly has reduced the price of oil immensely, that does not alter the wrong of the principle of any trust."⁶

Thus, members of Congress acknowledged that the trusts had caused lower prices to the great benefit of consumers, but objected that higher-priced businesses many of which were political supporters had lost market share or had been driven out of business.

The Sherman Act was a protectionist scheme in more ways than one. The real source of monopoly power in the late nineteenth century was government intervention. In October 1890, just three months after the Sherman Act was passed, Congress passed the McKinley tariff the largest tariff increase in history up to that point. The bill was sponsored by none other than Senator John Sherman himself. Sherman, as a leader of the Republican Party, had championed protectionism and high tariffs since the Civil War. In the Senate debate over his antitrust bill he attacked the trusts because they supposedly "subverted the tariff system; they undermined the policy of government to protect . . . American industries by levying duties on imported goods."⁷ That is, the price-cutting by the trusts undermined the manufacturing cartel that was created and sustained by the Republicans' high-tariff policies.

The Sherman Act was a political fig leaf designed to deflect attention away from the real source of monopoly power the tariff and the true price-fixing conspirators Congress and protectionist manufacturers. The *New York Times* saw through this charade when it editorialized on October 1,

1890, that the "so-called Anti-Trust law was passed to deceive the people and to clear the way for the enactment of this . . . law relating to the tariff. It was projected in order that the party organs might say to the opponents of tariff extortion and protected combinations, Behold! We have attacked the Trusts. The Republican Party is the enemy of all such rings."⁸

Economists were almost unanimously opposed to the Sherman Act because they viewed competition as Austrian school economists view it as a dynamic, rivalrous process of discovery.⁹ According to historian Sanford D. Gordon, who surveyed all professional journals in the social sciences and all books written by economists regarding the late-nineteenth-century trusts, "a big majority of the economists conceded that the combination movement was to be expected, that high fixed costs made large scale enterprises economical, that competition under these new circumstances frequently resulted in cutthroat competition, that agreements among producers was a natural consequence, and the stability of prices usually brought more benefit than harm to society. They seemed to reject the idea that competition was declining, or showed no fear of decline."¹⁰

The Myth That Antitrust "Saved" Capitalism

A popular argument made at the time was that antitrust was necessary to stave off something even worse the more extreme forms of regulation or outright socialism. Antitrust was adopted, but Americans were subjected to the more extreme forms of regulation and socialism anyway. As Milton and Rose Friedman pointed out in *Free to Choose*, by the 1970s the entire Socialist Party Platform of 1920 had been adopted in the United States. Socialism, F.A. Hayek pointed out in *The Road to Serfdom*, no longer meant nationalization of industry and central planning, but rather the institutions of the welfare and regulatory state. Antitrust did nothing to stop the spread of socialism in America.

Quite the contrary; the adoption of antitrust helped speed up the adoption of socialism. By weakening the competitive process, it has led to slower productivity growth and diminished prosperity. Government always reacts to slower economic growth, unemployment, and economic crises by adopting even greater economic interventions. The late-nineteenth-century proponents of antitrust had it all backwards. This is why it is so disingenuous, to say the least, of contemporary proponents of antitrust, such as the *Wall Street Journal's* Murray, to repeat this same discredited argument, urging Bill Gates to "place trust in trustbusters," or else "he may eventually find the Justice Department and Congress considering more-radical remedies."¹¹

The Real Robber Barons

John D. Rockefeller, like Bill Gates, achieved his economic success by offering the best products for the lowest prices on the free market. The real "robber barons" of the late nineteenth and the late twentieth centuries are the business people who, having failed to achieve competitive success in the marketplace turned to government and asked it to enact laws and regulations granting them special privileges and harming their competitors. A century ago, such immoral special pleaders included Leland Stanford, who became wealthy by using his political connections to obtain a government-created monopoly franchise in the California railroad industry; Thomas Durant and Grenville Dodge, who pocketed millions in government subsidies to build the Union Pacific railroad; Henry Villard, who "rushed into the wilderness to collect his [government] subsidies" to build the Northern Pacific railroad; and steel industry magnate Charles Schwab, who championed the disastrous 1930 Smoot-Hawley tariff.¹² Their modern-day counterparts would include many of Bill Gates's competitors, such as the chief executive officers of Netscape, Sun Microsystems, Novell, and other companies that have lobbied the federal government to use the antitrust laws to diminish or destroy the competitive efficiency of their most effective rival, Microsoft.

For over 100 years antitrust regulation has allowed politicians to deceitfully pose as "populists" while stifling competition with politically motivated attacks on the most innovative and progressive

companies. These attacks have been supported for over a century by socialist intellectuals and journalists who have taught many Americans to hate capitalism, to envy successful people, and to support government policies that undermine or destroy them both. Being the most successful businessman in the world, Bill Gates was an inevitable target of the anti-capitalistic crusaders. It's time we recognized antitrust for the protectionist racket that it is and repealed the antitrust laws.

1. The following information about Standard Oil is from Dominick Armentano, *Antitrust and Monopoly: Anatomy of a Policy Failure* (New York: Wiley, 1982).
 2. Ida Tarbell, *The History of the Standard Oil Company* (New York: Peter Smith, 1950), pp. 240-41.
 3. John S. McGee, "Predatory Price Cutting: The Standard Oil (N.J.) Case," *Journal of Law and Economics*, October 1958, p. 168.
 4. Thomas J. DiLorenzo, "The Origins of Antitrust: An Interest-Group Perspective," *International Review of Law and Economics*, 1985, pp. 73-90.
 5. Congressional Record, 51st Congress, 1st Session, House, June 20, 1890, p. 4100.
 6. *Ibid.*, p. 2558.
 7. *Ibid.*, p. 4100.
 8. New York Times, October 1, 1890, p. 2.
 9. Thomas J. DiLorenzo and Jack C. High, "Antitrust and Competition, Historically Considered," *Economic Inquiry*, July 1988, pp. 423-34.
 10. Sanford D. Gordon, "Attitudes Toward Trusts Prior to the Sherman Act," *Southern Economic Journal*, 1963, p. 158.
 11. Alan Murray, "It's Time Gates Placed Trust in Trustbusters," *Wall Street Journal*, March 9, 1998, p. 1.
 12. Burton W. Folsom, Jr., *The Myth of the Robber Barons* (Herndon, Va.: Young America's Foundation, 1991).
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Breaking Up Antitrust

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by Edward J. Lopez

In one of the most famous passages in *The Wealth of Nations*, Adam Smith cautions, *People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices. . . .*

Supporters of antitrust laws believe that Smith couldn't speak the truth more plainly. They deem this sort of anticompetitive behavior bad for consumers. Antitrust regulation, they argue, is necessary to protect competition and the well-being of society from these kinds of conspiracies.

But is Adam Smith right? He correctly warns of the natural incentive that businesses have to get the highest price possible for their products, and perhaps to monopolize their industry or collude with one another to increase prices. One might legitimately conclude that free markets cannot always be left free, and that government institutions like antitrust are necessary for the protection of society's interests.

As awful and ridiculous as this may sound, people who love freedom must take this claim seriously. Antitrust supporters generally have a strong foundation, not only in Adam Smith, but in much of the conventional economic theory of the twentieth century. Economists have at their disposal powerfully convincing ways of showing that monopoly is harmful, and that antitrust enforcement is the perfect remedy, at least in theory.

The real world also provides plenty of examples that support the claims of antitrust supporters. The kind of behavior that Smith describes does indeed occur. One such case was the notorious

fare-fixing telephone conversation initiated by American Airlines chairman Robert Crandall with Braniff president Howard Putnam in 1983.¹

The early 1960s gave us another infamous example. General Electric, Westinghouse, Allis-Chalmers, and I-T-E coordinated a pervasive price conspiracy in selling heavy electrical equipment to the government. A single company would enter a bid lower than all its competitors, all of whom would enter identical bids higher than the lowest. In one instance, seven different companies entered a bid of exactly \$198,438.24, and the contract was awarded to the single firm that bid lower. It was a very effective cartel.

These were supposed to be secret bids, and the conspiracy would never have worked if not for the cartel's ingenious enforcement strategy. The firm to enter the lowest bid was determined by the fullness of the moon. This phase of the moon strategy was foolproof for decades, and was only discovered in 1959 by a reporter in Tennessee, who noticed the peculiarity of the identical bids. The conspiracy is estimated to have cost consumers \$175 million in every year of its decades-long existence.²

These examples illustrate the creativity that businesses sometimes use in trying to monopolize a market. When cartel members can actually enforce the agreement, or when a firm actually succeeds in monopolizing a market, the result is almost invariably bad for consumers.³ Whether antitrust enforcement does the job or not, we still need to take the threat of monopoly seriously. And we still need to recognize and acknowledge that antitrust is, at least in theory, a way to deal with this threat.

But do classical liberals need to concede that antitrust regulation actually does the job? Do we need to agree that antitrust deals effectively with the threat of monopoly and that it is therefore good for society? The answer is clearly no. In fact, sober economic analysis can explain how antitrust policy fails to combat the monopoly threat, how it betrays the public interest it is pledged to protect, and how it therefore serves the private interests of the businessmen, politicians, and bureaucrats involved. In short, we need to voice the reasons why the antitrust laws should be repealed.⁴

Antitrust Enforcement: The Ideal Versus the Real

One would rightly be suspicious to discover that antitrust laws in this country are enforced by two separate federal agencies, the Antitrust Division of the Department of Justice and the Federal Trade Commission.⁵ Each agency is subject to Congress by way of budget appropriation, confirmation of appointees, and general oversight into agency activities. Because of this oversight, we can be fairly certain that the agencies enforce the statutes according to the wishes of the current Congress.⁶

In a perfect world in which Congressmen are public servants, antitrust should work the way it is supposed to. We should expect that once Congress allocates an amount to each agency, staff members there take an inventory of the monopoly inefficiency in the economy, make a list according to the costs to society, and bring cases against these monopolies in order of their importance until their budgets are exhausted. There might be some red tape and pre-investigation procedures to worry about, but overall this seems to be the way it should work. What better way to make society better off? How much better can a policy get?

Unfortunately, the naive assumption that there is a public-interest standard in government dominates discussions of antitrust and in so doing abstracts entirely from the existence and power of special interest groups. Policies that were introduced in the name of promoting competition have become tools to protect against competition. Congress, businesses, and the antitrust bureaucracy all have much at stake in the antitrust game. They form a triangle of private interests that drive antitrust enforcement at the expense of the general public.

The Antitrust Bureaucracy

First, consider the incentives of those who are in charge of enforcing the antitrust statutes. At the Antitrust Division, there are 331 attorneys and 50 economists, while the FTC maintains a comparable 435 attorneys and 63 economists. These agencies are hierarchical and experience much of the red tape that any government bureau does. But at some point, every decision is made by an individual, who has his own career agenda and objectives.

One study of the Antitrust Division⁷ found that the strengthening of the anti-merger laws (the 1950 Celler-Kefauver amendment), and especially the early cases brought to court, made antitrust expertise more valuable in the private marketplace. There was a clear increase in the demand for these skills so that a young lawyer had a great deal to gain by working in the Antitrust Division. What's more, he or she had even more to gain from the specific experience of arguing cases at trial in the federal courts. Lawyers at the Antitrust Division have every incentive to choose cases that will go to trial, and go to trial quickly, regardless of the efficacy of the action in combating monopoly, or its effect on consumer welfare.

A similar study focuses on the FTC.⁸ The study found that the ultimate career objective of most FTC lawyers was a job at a prestigious private law firm. Robert Katzmann writes that some cases threaten the morale of the staff because they often involve years of tedious investigation before they reach the trial stage.⁹ Therefore, the FTC opens a number of easily prosecuted matters, which may have little value to the consumer . . . in an effort to satisfy the staff's perceived needs.¹⁰ One FTC attorney is quoted in the study as saying, for me, each complaint is an opportunity, a vehicle which someday could take me into the courtroom. I want to go to trial so badly that there are times when I overstate the possibilities which the particular matter might offer.¹¹

It's clear from studies like these that the antitrust bureaucracy doesn't select cases to prosecute on the basis of their potential net benefit to society. Instead, the staff at FTC and the Antitrust Division use the discretion that they do have to further their own private interests and careers rather than those of the public at large. The antitrust bureaucracy cannot be counted on to uphold the public interest in enforcing antitrust laws.

The Congress

Although the antitrust bureaucrats would like to exercise complete control over their enforcement agendas, they are ultimately accountable to their congressional oversight and appropriations committees. Now, consider the incentives of members of Congress. The goal for most members is to get re-elected or ascend to a higher office. There is a much greater chance that this will happen if they support local or narrow interests rather than some vague notion of the national or public interest.

Antitrust is one of many pork-barrel programs that Congress uses to transfer wealth from large, unorganized groups of individuals to the narrow, organized interests of others. In many ways, antitrust is the perfect wealth-transfer vehicle. It is highly inconspicuous, covering the entire economy rather than just specific industries. It applies to specific business practices, and can therefore be used to protect less efficient companies from their more efficient competitors. Antitrust can therefore deliver potent benefits (directly limiting the competitiveness of one's rivals), while the costs occupy a tiny line on the federal budget and are hardly noticeable at all. The stockholders of the protected company gain at the expense of the stockholders of the more efficient, yet legally hampered, competitor.

The evidence on the matter is clear. Antitrust enforcement falls less stringently on companies headquartered in the congressional districts of members on the key committees with oversight and budget authority over the antitrust bureaus.¹² And if a committee's membership changes significantly, the antitrust bureaucracy changes as well. After the 1976 and 1978 elections, the

key oversight committees experienced rapid turnover of its members. Prior to that, the FTC had a very avid enforcement agenda. But the new committee members found their constituent interests demanded a different approach. Therefore, in 1979, the Congress blasted the FTC as a runaway and out-of-control bureaucracy. After a series of heated hearings, the FTC systematically watered down or simply halted most of its controversial activities. As the currents change in pork-barrel waters, so too does the antitrust bureaucracy.

Other aspects of antitrust also reveal private interests at work. While the original Sherman Act was ostensibly supposed to rein in the dangerous concentrations of wealth among the giant monopolies of the day, history reveals little monopoly power existed at the time. Prices were falling throughout the economy and output was surging.¹³ This only serves to benefit consumers, and Congress even recognized this as true.¹⁴ So why did Congress enact an antimonopoly law in such an apparently competitive climate? Because the law protected small or inefficient businesses from the rigors of competition, and it portrayed Congress as a champion of justice and freedom. Other studies find similar results for the Clayton Act.¹⁵ Still other studies show that antitrust not only fails to benefit consumers, but also harms them.

The conclusion from examining the incentives created by antitrust laws, and actions taken under them, is that antitrust laws do not serve the public interest as their supporters would claim. Antitrust does not combat the monopoly threat, but rather protects less efficient companies from their competitive rivals, bolsters the political capital of members of Congress, and furthers the careers of Washington bureaucrats. In short, the only thing that antitrust makes more efficient is the cozy triangle of special interests.

Conclusion

Classical liberals should take the threat of monopoly seriously. But the answer to this threat is not antitrust laws. Any potential monopoly must instead be exposed to the discipline of market competition. Economists have long made convincing arguments that a natural monopoly is rare. Most monopolies exist because of government intervention. By repealing antitrust statutes, and ending government-sponsored monopoly, we will allow the threat of monopoly to be dealt with in the most effective manner possible: the market process.

Adam Smith rightly warned us of the dangers of business conspiracies. But in the same famous passage quoted earlier, he went on to warn of the even greater danger of relying on government institutions to combat it:

It is impossible indeed to prevent such meetings, by any law which either could be executed, or would be consistent with liberty and justice. But though the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such assemblies; much less to render them necessary.

1. Howard Putnam taped this conversation. It was entered as evidence in the case brought by the government against American Airlines and Crandall. Quoted from Roger E. Meiners, Al H. Ringleb, and Frances L. Edwards, *The Legal Environment of Business*, 3rd ed., p. 401.

2. Dennis W. Carlton and Jeffrey M. Perloff, *Modern Industrial Organization*, pp. 181-183, and Richard A. Posner, *The Social Cost of Monopoly and Regulation*, *Journal of Political Economy*, 83:807-827.

3. Probably most successful monopolization is achieved through government protection.

4. A compelling case has been made along these lines by D. T. Armentano. See *Antitrust and Monopoly* (New York: John Wiley and Sons, 1982) and *Antitrust Policy: The Case for Repeal* (Washington, D.C.: Cato Institute, 1986).

5. This arrangement has been the subject of widespread and extensive criticism, which typically calls for the elimination of the FTC. See Richard S. Higgins, William F. Shughart II, and Robert D. Tollison, *Dual Enforcement of the Antitrust Laws*, in Robert J. Mackay, James C. Miller III, and

- Bruce Yandle, eds., *Public Choice and Regulation: A View from Inside the Federal Trade Commission* (Stanford, Calif.: Hoover Institution Press, 1987).
6. Barry R. Weingast and Mark J. Moran, Bureaucratic Discretion or Congressional Control? Regulatory Policymaking by the Federal Trade Commission, *Journal of Political Economy*, October 1983, 91:765-800.
 7. Suzanne Weaver, *The Decision to Prosecute: Organization and Public Policy in the Antitrust Division* (Cambridge: MIT Press, 1977).
 8. Robert A. Katzmann, *Regulatory Bureaucracy: The Federal Trade Commission and Antitrust Policy* (Cambridge: MIT Press, 1980).
 9. *Ibid.*, p. 83.
 10. *Ibid.*
 11. *Ibid.*, p. 61.
 12. Richard A. Posner, The Federal Trade Commission, *University of Chicago Law Review*, 37:47-89, 1969. Roger L. Faith, Donald R. Leavens, and Robert D. Tollison, Antitrust Porkbarrel, *Journal of Law and Economics*, 15:329-342, 1982.
 13. Thomas J. DiLorenzo, *The Origins of Antitrust: An Interest-Group Perspective*, *International Review of Law and Economics*, 5:73-90, 1985.
 14. *Ibid.*, pp. 80-81.
 15. Robert B. Ekelund, Michael J. McDonald, and Robert D. Tollison, Business Restraints and the Clayton Act of 1914: Public- or Private-Interest Legislation? in Fred S. McChesney and William F. Shughart, *The Causes and Consequences of Antitrust: The Public Choice Perspective* (Chicago: University of Chicago Press, 1994).

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