Breaking Up Is Hard to Do

Frank H. Easterbrook

I

Depending on how one looks at things, monopoly is either endemic or irrelevant in the economy. If markets are defined tightly enough (say, cotton shirts with crocodile emblems), almost every firm is a monopolist. If markets are defined broadly (say, all clothing sold anywhere in the world), no firm comes close to having a monopoly. Market definitions are such notoriously elastic constructs that anyone predisposed to worry about monopoly will not want for sources of concern, and anyone with a contrary inclination will sleep easily.

An economist places little weight on the definition of a market. A firm's ability to charge a monopoly price depends on the elasticity of the demand facing it, not on nice legal definitions or the particulars of product characteristics. In most cases monopoly power is self-correcting. If one firm discovers an inelastic demand for some product, so that it can charge a monopoly price, other firms will make the same discovery. There is nothing like self-interest to concentrate one's attention on such things. Other firms will enter the market (or expand their production) and erode the position enjoyed by the first. Persistent monopoly power should be rare indeed; rival firms should outstrip courts in rectifying monopoly.

Frank H. Easterbrook is professor of law at the University of Chicago Law School.

Antitrust law has given little attention to the market's self-correcting mechanisms. Courts and the enforcement agencies have been concerned that firms with monopoly power will fend off new competition by using "exclusionary practices"—predatory pricing, tie-ins, boycotts and refusals to deal, acquisitions of suppliers and customers in order to "foreclose" competitors, and so on—that set up "barriers to entry." What, they ask, other than exclusionary practices and barriers to entry, can account for persistent concentration?

The belief that exclusionary practices account for persistent concentration underlies the Federal Trade Commission's "shared monopoly" prosecution of breakfast cereal companies, which supposedly used advertising and new product introductions to set up barriers to entry. It underlies the long-running suits (by the Department of Justice and private litigants) against IBM, AT&T, and Kodak, which supposedly employed predatory pricing and product introductions to drive out rivals. It underlies the recommendation of the National Commission for the Reform of Antitrust Law and Procedure for the creation of "no fault monopolization," under which firms having substantial shares of the market would be dis-

solved unless they could show substantial economies of scale.

I bypass the question whether the practices attacked in these and other cases are indeed exclusionary and ask, instead, whether there is much point in using the antitrust laws to cope with the structural consequences of these practices. In other words, is it a good idea to use the courts as uncoordinated regulatory agencies for watching over industry structure and the associated prices, innovations, advertising, and other features? It is hard to credit the notion that 400-odd federal judges—lacking information, economic sophistication, and coordination—would be very good at the task. But perhaps this underestimates the legal process. To see whether it does, I ask, in turn, whether we can recognize competition when we see it, and whether we can restructure an industry to produce competition. The inquiry leads me to conclude that structural remedies (divestiture, dissolution, and the like) should be abandoned in all exclusionary practices cases. Judges and commissioners should stick to damages and injunctions against identified exclusionary practices.

II

What does competition look like? The economic model of perfect competition, with infinitely many firms possessing infinitely small market shares and all firms able to enter and leave an industry costlessly on a moment's notice, is a wonderful tool of scholarly inquiry but quite useless as a goal of antitrust policy. Many firms are large relative to the market, and entry is always costly and time-consuming. Economies of scale and the benefits of the division of labor —it may be best if, say, four management teams specialize in producing cereal while others specialize in steel and raisins—mean that most industries will hardly resemble the textbook model.

Robert Bork has argued that the appropriate goal of antitrust policy is not the creation of more competition in the sense of additional rivalry but is, rather, "any state of affairs in which consumer welfare cannot be increased by moving to an alternative state of affairs through judicial decree" (*The Antitrust Paradox*, 1978). The formulation is impeccable in theory, impractical in fact. Judges rarely take an overly modest view of their abilities. Many fall prey to the nirvana fallacy, the belief that if a cost or flaw in existing affairs can be identified, it must follow that some other state of affairs (the "remedy") is better. But it does not follow, as studies of judicial decrees or other forms of regulatory intervention have established. Judges and other regulators systematically overestimate their ability to determine the nature and extent of costs ("imperfections") in existing affairs and underestimate the costs involved in implementing a remedy.

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The nirvana fallacy is entrenched in antitrust law. It seems so natural to condemn concentrated markets; after all, we have a model of perfection against which to compare our imperfect world. To the extent the existing state of affairs diverges from atomistic markets, the argument goes, the difference must have been caused by exclusionary practices. If the firms are not using visibly effective exclusionary practices, this just shows that there are undetectable exclusionary practices. And even if there are no such practices, the argument concludes, the monopolists still have baneful economic power.

Phooey. This process of finding invisible practices and hypothesized power has the same validity as the argument that one can show that snapping one's fingers drives away elephants by doing a lot of finger-snapping and observing no elephants nearby. Concentration can be caused by efficiencies that consumers welcome, and even when there is no strong efficiency explanation for concentration there still may be no objection to the concentration.

Concentration May Be Caused by Efficiencies. I do not argue that large firms are, for that reason, efficient. More likely the causation is the reverse: firms become large because they find ways to make better products at lower costs,

and thus grow relative to their competitors. Sam Peltzman has shown that high concentration and high profits can be created by desirable efficiencies even when there are no economies of scale ("The Gains and Losses from Industrial Concentration," *Journal of Law and Economics*, 1977). If, for example, the minimum efficient firm size is 5 percent of industry production, there could be as many as twenty firms in the market. But if one of the firms suddenly finds a cheaper method of production, or just makes a better guess about consumers' wants, it will grow relative to its rivals. So long as it continues to satisfy the buyers' wants, it will stay large. But this growth cannot harm consumers; if the large firm raises its prices, its rivals will step in and supply consumers at the competitive price.

Peltzman found that concentration is highly beneficial to consumers. Reducing the four-firm concentration ratio of all industries from above 50 percent to that level, he concluded, would impose on consumers costs of approximately 9.6 cents per dollar of output. Other recent studies reinforce the point. One-time advocates of deconcentration, such as Paul MacAvoy and Leonard Weiss, have retreated from their positions in light of the mounting evidence that concentration and efficient production go together.

Large Firms May Lack Market Power. Static price theory suggests that as a firm's share of a market increases, so too does its ability to charge a supracompetitive price. This supposed ability to increase price is the source of the principal concern about high concentration. Again, though, static models do not always describe the operation of markets. Let us suppose that a firm such as Eastman Kodak learns how to make small cameras at a lower cost and then captures a larger share of the market. It owes its new market position to its pricing policies (customers do not care about costs, only prices). If Kodak then tried to exercise the market power supposedly conveyed by its market share, it would quickly find that it had neither power nor market share.

The constraint on pricing may come, in some cases, from existing rivals, but this is not the only source. Sometimes even a monopolist has no market power. In some markets firms compete to be the monopolist and, in the process of competing, bind themselves to charge the competitive price. This is easy to see at the smallest levels. General Motors may purchase all of its tires for a year from a single source, but this "monopoly" does not elevate prices. Because General Motors can choose to deal with one of several tire manufacturers, it is assured of getting a competitive price. Similarly, when a hospital signs an exclusive contract with a group of radiologists, the bidding among radiologists to win the contract fully protects the hospital and its patients from monopoly prices, even when the patients have no choice among hospitals.

This process of bidding continues, explicitly or implicitly, on larger scales. Boeing is quickly becoming the dominant seller of commercial jets, but in order to obtain this position it must promise—and somehow back up its promise—that it will not charge monopoly prices in the future. A customer of Boeing's jets is worried about the expected price of buying and maintaining a fleet over the years. If Boeing cannot find a way to assure customers that it will continue to charge the competitive price, customers will turn to Lockheed for jets today in order to keep it alive, even if Lockheed's prices are higher. In one notable antitrust case this pattern was quite evident (*Pacific Engineering & Production Co.* v. *Kerr-McGee Corp.*, 1977). Even after it became clear that economies of scale allowed but a single producer of ammonium perchlorate, customers gave "stay alive" orders to the higher-price seller in order to put pressure on the other firm.

In some markets, such as airframes, the bidding for position is implicit. In others, such as utility and cable television franchises and exclusive contracts, it is explicit. But the principle is the same: competition for the monopoly position protects consumers, and we cannot infer from the existence of a monopoly that consumers suffer any injury.

We Cannot Reliably Recognize Concentrated Markets. I have assumed so far that it is possible, at least, to identify concentrated markets and discuss the state of competition and prices in them. Things are not so easy. In many markets measures of concentration are highly misleading.

The important question for a seller, and thus for antitrust policy, is whether it can

charge a higher price without losing sales to such an extent that its profits decrease. The seller cares about whether consumers would switch to other things if price were to increase, and antitrust enforcers and courts have devoted considerable energies to evaluating consumers' ability to switch products or just quit buying. But this is only part of the story, and it is probably the least important part. Even when buyers will not switch or do without, the existing sellers are constrained by the ability of new firms to supply the consumers.

This influx of supply may well come from firms not even in the market—from potential competitors that would find entry profitable in the event of higher prices. Estimating the effect of potential competition is a nasty problem indeed for courts, which cannot know the future actions of these unidentified firms. Yet the prospect of entry may be all that is necessary to ensure competitive performance. A proper market definition would include the output of these potential rivals, but such a calculation is beyond the abilities of courts.

New entry may take time, and so does an increase in the production of existing rivals. More production also may entail higher costs. Yet other constraints on prices are quicker-acting. Often there is a source of supply that can be diverted from one place to another, quickly and at low cost. If, for example, Alcoa were the only producer of aluminum in the United States and a rival would take five years to enter the market, it still would not follow that Alcoa had monopoly power. Foreign producers could divert supplies from Europe to the United States on short notice and at low cost if Alcoa attempted to exploit its position. True, tariffs and shipping costs might hinder this diversion, but once we observe some imports we can assume that the hindrance is minimal, at least at the margin.

This analysis, elaborated by William Landes and Richard Posner in a 1981 article, suggests that many industries frequently believed to be concentrated should be treated as unconcentrated ("Market Power in Antitrust Cases," *Harvard Law Review*). International shipments of steel, automobiles, computers, airframes, cameras and film products, petroleum and petrochemicals, and so on are commonplace. It is no more sensible to say that there is a highly concentrated market in auto manufacture in the United States than to say that there is a highly concentrated market in aircraft manufacture in Long Island (the home of Grumman). Just as Grumman may have a "monopoly" of airframe production in New York and yet lack market power, so Kodak may have a monopoly of film and camera production in the United States and lack market power. There is no a priori reason to treat national borders with more respect than state or city borders in determining market power.

Now some products are not sold in international markets (local and long distance phone services are an example), and even when there are such markets the prospect of diversion may not establish effective constraints on the prices charged by domestic firms. Foreign production may not be large enough to counteract a reduction in output here, and when the United States is an exporter (as with mainframe computers), foreign competition is largely irrelevant to domestic prices. The fact remains, however, that without a good estimate of the response of other suppliers to a reduction in output by a given firm, it is impossible to determine whether that firm possesses the significant market power that should give rise to antitrust concern. A policy of attacking monopolies without regard to the "monopolist's" ability to set a monopoly price holds out the promise of destroying productive efficiencies without any countervailing gain.

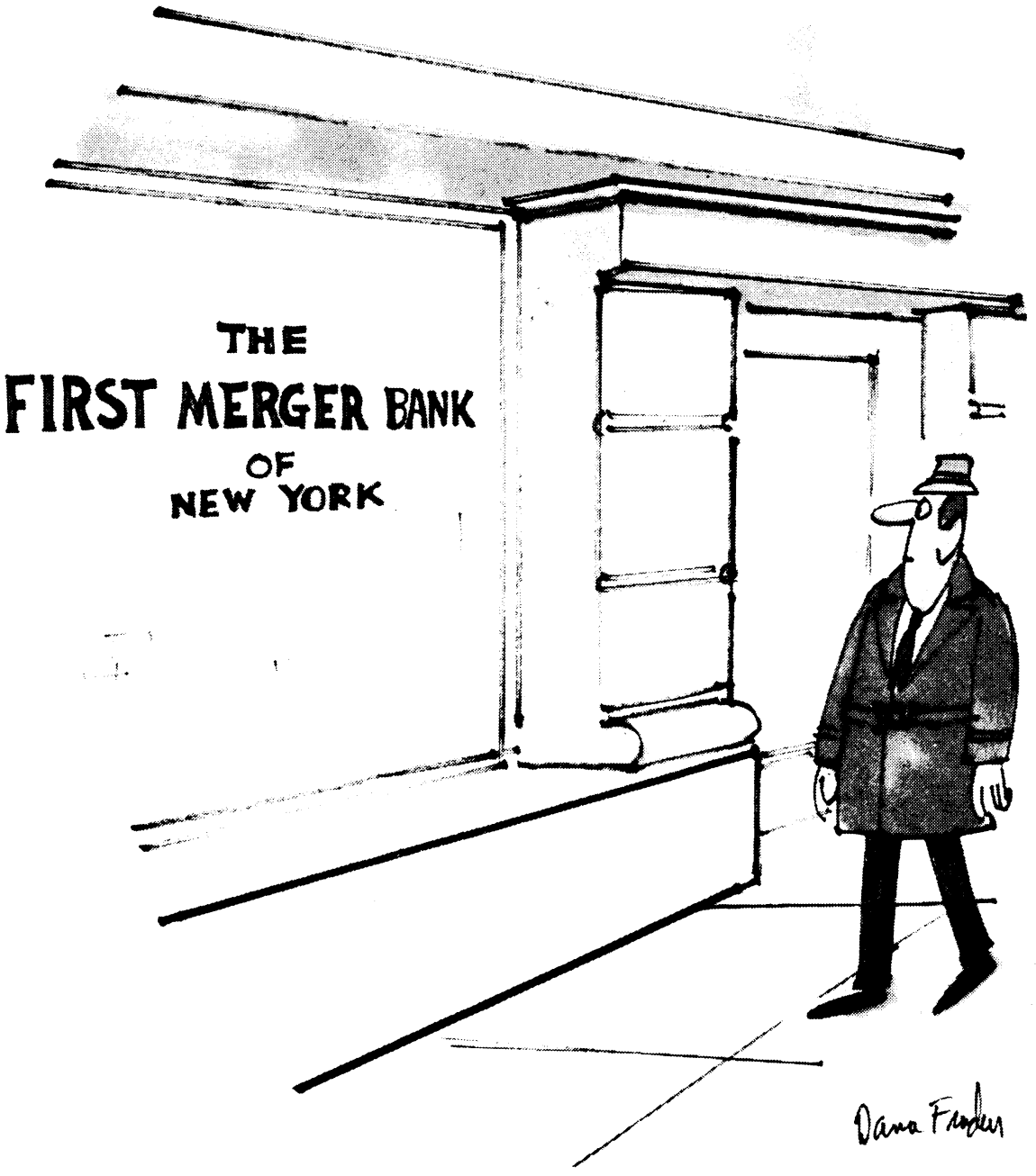
III

Let us assume, though, that courts can identify firms that possess undue market power, whatever the source of that power. What is to be done? One possibility is that the court could impose a fine equal to the harm caused by any unlawful exclusionary practices and ban future use of those practices. Competition then would deconcentrate the market in the ordinary course. If the courts can separate exclusionary practices from hard competition (which is doubtful, but possible), such a remedy would increase allocative efficiency.

In most of the interesting monopolization cases, however, the government has not been satisfied just with proscribing the anticompetitive practices. It has demanded "structural" relief. The Federal Trade Commission sought

an order that the cereal firms spin off assets to create new rivals; the Department of Justice seeks an order that AT&T place its regulated and unregulated operations in separate firms.

It is hard to find a monopolization case in which the government did *not* seek structural relief. On determining that United Shoe Machinery Corp. had engaged in exclusionary practices, the district court ordered it to stop. When, after a few years, the business remained highly concentrated, the government requested structural relief, and the Supreme Court ordered United Shoe to divest sufficient assets to reduce its market share to no more than one-third. It apparently never occurred to the Department of Justice, or to the Supreme Court, that United Shoe's persistently large market share might demonstrate that there were economies of scale or that the firm was an especially efficient producer.



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ity to design useful structural relief depends on courts' knowing what to shoot for and conducting the proceeding with reasonable dispatch and at low costs. The history of antitrust litigation suggests problems on all scores.

Do We Know What to Shoot for? Structural relief means that the offending firm will spin off assets to set up a rival. But how much should be spun off? Presumably enough to establish a new firm able to operate at the efficient scale of production but not enough to reduce the existing firm below that scale. All we need to know, then, is the optimal size of the firm under competition.

All we need to know, indeed! There is no reason to think that judges or commissioners are very good at making judgments about the efficient scale of production. The limited experience with cost computations in price discrimination and predatory pricing cases, and the more extensive experience with cost computations for regulatory ratemaking, suggests that regulators cannot even compute current costs, let alone costs under a dozen or so hypothetical future restructurings of an industry. And it is not enough to calculate future costs. The court must calculate future demand as well, under different assumptions about price, in order to determine whether a new firm with a given cost structure will be competitive in the future market.

The more possible remedies there are, the more numerous the hypothetical calculations required. Firms sometimes must make such calculations when deciding whether to enter a market, and markets reward managers who are good at such things. There is no similar reward structure for judges or commissioners, so we should expect them to do poorly. (When was the last time a judge's salary was reduced because he made a disastrous divestiture decision?) Military procurement provides some hints about how well governmental officials compute costs. Contracts for weapons systems involve estimates of the costs of production under to-be-established organizations and projected conditions. The initial estimates often are off by 100 percent or more, even though the people who make them control the demand. There is little reason to expect a court with less information about demand to do better at estimating the costs of new industrial structures.

All of this assumes that only economies of scale matter. That is a serious oversimplification. Often the quality of management is the most important determinant of costs. If a structural remedy removes assets from the control of high-quality managers who have special knowledge about the industry, the productivity of the assets will fall immediately. The value of the managers may lie in their knack for knowing what consumers want or how to organize teams of production. Such elements of value cannot be proved in litigation and thus are sure to be ignored in devising structural remedies.

Of course, if the management team stayed intact at one of the resulting firms, it might be able to rebuild that firm's position. But in the interim much of the industry's output would be produced at higher cost. Worse still, antitrust enforcement agencies would see the regrowth of one firm as proof that the structural remedy had failed and needed to be reinforced.

Good management is one application of specialized information. There may be others. In some businesses information is the dominant input into production. Kodak recoups its substantial costs of research and development over its full output. If Kodak were broken up, R&D would be less rewarding for the firm, because more of its value would escape as rivals copied the innovations without paying Kodak for them. It is fair to suppose that concentration conduces to innovation by enabling the innovators to capture more of the value of their work. As innovations and other forms of information become a larger and larger fraction of the cost of production, breaking up firms with substantial market positions imposes greater and greater costs.

Markets vs. Courts: The Hare and the Tortoise. The most striking thing about big monopolization cases is that the industry evolves during the litigation to make the case irrelevant. While

the government's monopolization case was pending against Alcoa (1937–51), the structure of the industry changed. Alcoa's share fell from 90 percent at the start to about 45 percent at the end, and the government ultimately abandoned a request for divestiture of any of Alcoa's U.S. properties. While the government's monopolization case against IBM has been pending (1969–8?), the industry has gone through two generations of computers, foreign competition has increased, and minicomputers able to handle almost all computing tasks have been developed. New vendors compete in swarms to supply the new equipment. While the government's monopolization case against AT&T has been pending (1972–8?), telecommunications technology has changed, and the market is no longer a natural monopoly. The Federal Communications Commission has responded by allowing entry of many other carriers. Communications satellites have won a large share of the market, and Congress has reviewed the industry's structure several times.

The market does not respond instantly to concentration, but antitrust cases persist longer in courts than concentration does in markets. The FTC's case against oil refiners lasted a decade (before being dismissed without a trial), while OPEC cartelized production, the government applied a series of price and industry structure controls, and other changes occurred. Foreign competition deconcentrated the steel and auto industries, which now face a world market in which U.S. firms hold an ever-shrinking share. Monopolization in the motion picture industry was undone by television and again by videotape. The sleeping car monopoly fell apart with the decline of rail transportation. The list could go on and on.

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Even when there is a genuine monopoly, the lumbering process of the law cannot have much effect. Courts can reach only the *most* persistent monopolies, those that last three decades or more. Yet it is just these monopolies that are most likely to rest on economies rather than exclusionary practices. Courts thus are confined by the passage of time to disestablishing only the *efficient* monopolies; the undesirable ones take care of themselves.

That a Case Is Worthless Does Not Make It Costless. Whether a durable monopoly rests on efficiencies or on exclusionary practices, it is profitable to its possessor, and the monopolist will spend large sums to protect it. The platoons of lawyers, accountants, experts, and staff deployed by IBM attest to this, as does the nearly $100 million a year AT&T has been spending to preserve its position. The larger the stakes, the more the parties will invest in litigating. In a $5 billion case, it is worth investing as much as $50 million to obtain a 1 percent increase in the chance of prevailing. And when the defendants invest more in litigating, the government must do so too.

Monopolization cases challenge the position of the nation's largest firms, so the stakes are large indeed. There are plenty of opportunities for litigating in an effort to change the odds by 1 percent here, even less there. The defendant will challenge the definition of the market, generate information about the costs of production under current and future conditions, contend that the challenged practices contribute to efficiency rather than exclusion, and on and on. It is not unusual for the parties to produce an index of several million relevant documents after examining many millions more. The cases become so sprawling that they overwhelm the critical senses of judges and juries, who can scarcely comprehend what the fuss is about. And the process of litigating monstrous monopolization cases diverts the resources of antitrust enforcers from cases likely to produce real gains—price fixing and other aspects of cartelization.

There is, fortunately, an easy way out. Forget about structural relief for anything except recent, large mergers (where the original competing firms can be reestablished). Exclusionary practices can be dealt with, if they must be dealt with at all, by fines and specific directives tailored to the problem at hand. That, at least, is a task within the competence of courts. Besides, taking this modest view of things would enable the enforcement agencies to spend their resources where benefits can be produced. ■