

## *Economic Analysis*

# **Antitrust: An Austrian View**

The Contrarian Investor's Newsletter

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The standard account of the rise of U.S. antitrust law is as follows. It is found in most American history textbooks and embraced and taught by most non-economic history and law professors:

*During the 1880s and 1890s there was a great deal of merger activity in the U.S. Small and large firms alike combined to form trusts in which they colluded to restrict output and raise prices. In some industries huge firms assumed monopoly-type dominance, often as a result of openly predatory behavior toward rivals. The Age of the Robber Baron was ushered in. One incident illustrates the mindset of some of the businessmen of the day. Jay Gould ran a railroad monopoly in the North. A small company owned a line that Gould wanted and he tried to get the competitor to sell it. When the competitor refused his offer, Gould had his house blown up. Other businessmen of the time engaged in shady practices as well: Rockefeller, Vanderbilt, J.P. Morgan, Carnegie, Mellon, etc.*

*J.P. Morgan owned U.S. Steel which supplied 60 to 70% of American steel and was the first billion-dollar company. Morgan owned one third of American railways and 60% of the volume traded on the U.S. stock exchange (his firm transformed Wall Street and became Drexel Morgan.) Some said he "owned the U.S." He bailed out the United States federal government on two separate occasions when it ran out of money. Although common law forbade monopoly and collusive behavior, further legislation was needed if the growth of monopoly was to be contained and competitive markets maintained. Thus the need for the Sherman Antitrust Act of 1890 and the Clayton Act of 1914.*

Even after ignoring what are now known to be mythical components (Jay Gould blowing up a competitor's house or J.P. Morgan owning the U.S. government--stories no doubt still told in classrooms to keep history interesting), the above account more or less outlines the standard historical justification for antitrust laws. Antitrust laws, at least in stated purpose, are for making markets more competitive. Their three objectives are usually presented as:

1. outlaw collusion
2. outlaw attempts to achieve a monopoly
3. ban mergers when the union of two or more companies would limit competition

Three statutes are the basis for antitrust enforcement in the U.S. Very briefly they are:

**1. Sherman Antitrust Act (1890)** - outlawed agreements to fix prices, limit output, or share the market. Declared both monopolies and attempts to create them illegal.

**2. The Clayton Antitrust Act (1914)** - forbids mergers between competitors where the result would be to substantially lessen competition. Outlaws practices such as "tying" contracts.

**3. Federal Trade Commission Act (1914)** - created the Federal Trade Commission (FTC), and authorized the newly created agency to initiate and decide cases involving "unfair competition." The Act also declared "deceptive practices" and "unfair methods of competition" to be illegal.

How are antitrust laws successfully enforced? Usually by criteria formed by legal scholars and attorneys that states:

*If a firm has more than 60% of the market and there is evidence that it has used abusive conduct to achieve or maintain market dominance, then the firm is charged, penalized, and in some cases broken up.*

Remember this criterion, as it will be recalled below for readers who have come to believe that there is consistency in antitrust enforcement in the U.S.

### **How Could Antitrust Laws Possibly Be Misguided?**

Thus far we've briefly surveyed the conventional view of antitrust law embraced by historians, attorneys, and journalists. It stands in stark contrast to a contrarian view that has become ascendant in recent years among a younger generation of economists in the U.S., many of whom are part of, or fellow travelers of the Austrian school of economics which was named in honor of some economists originally from Austria such as Carl Menger, Ludwig von Mises, and Friedrich Hayek (Nobel Prize, 1974). *Again, to counter some common misconceptions, the Austrian school's resurgence and strongest following today is in the U.S. The school has nothing to do with the present-day European country of Austria or its economy in any way.*

The Austrian school believes that the conventional view of antitrust involves not only a misunderstanding of long-term market dynamics, but arrives at the surprising conclusion that antitrust actions in many cases have created more harm than good over the long run.

Before proceeding, it must be strongly emphasized that the Austrians do not advocate monopoly or that business transactions involving deception, fraud, negligence or intentional harm, or breach of contract go without legal recourse. Such actions themselves undermine consumer property rights and markets, both of which Austrians champion as first principles. They emphasize that legal redress could easily take the form of single- and class action lawsuits in the courts.

Here are their arguments:

#### **1. A Flawed View of Which Interests Antitrust Truly Serves.**

The conventional view embraces what is known as the **public-interest hypothesis of antitrust enforcement**. In plain English, this means that *antitrust laws are primarily pursued to promote the public's economic interest and well-being*. The **private-interest hypothesis of antitrust enforcement** is embraced by the Austrian school. This hypothesis states that *antitrust laws are primarily enforced to promote the economic interest of established firms in a particular industry*.

In other words, established firms in an industry see regulation as a way to economically hinder newer, smaller, and politically un-connected competitors. Antitrust in this view is a legal weapon to raise the cost of potential competitors.

### Case 1: Microsoft

Microsoft was accused of using its Windows standard to put competitors such as Sun Microsystems, Oracle, RealNetworks, and Netscape at a competitive disadvantage. These allegations were very prominent in the press and formed the basis of federal action against Microsoft in the 1990s (click [here](#) for a timeline of the case). Meanwhile IBM, BEA Systems, and SilverStream were making the same complaints in 1999 against Sun Microsystems with respect to its control of the Java standard. While Sun didn't write the software code behind a version of Java known as J2EE, it insisted that firms using J2EE in their software pass compatibility tests and pay a royalty of 3 percent of their sales to Sun. An outraged IBM, which produced 80 percent of J2EE, refused to pay the royalty.<sup>1</sup>

Why was antitrust action taken against Microsoft but not Sun? Economists such as Thomas W. Hazlett believe that *at the time*, Sun had more and better-funded lobbyists to the U.S. state and federal governments to fend off regulatory action. Keep in mind that Microsoft, although widely known as a profitable company with a fabulously wealthy and famous CEO, at the time of antitrust actions against it was seen as politically inept and naive, and throughout the 1990s had nowhere near the force of lobbyists it has in Washington D.C. today.

### Case 2: The Railroad Industry and the ICC

The Interstate Commerce Commission (ICC) was created in 1887 to oversee the railroad industry, an industry thought to have considerable market power. The railroad industry surprisingly seemed to welcome the regulation. Why? In the end it was able to use it to restrain price competition *inside* the industry which it had long sought but was unable to obtain because it had more competition than the government realized. The competition that the government overlooked was *outside* the industry in the form of trucking, water, and air transport. By 2002, trucking carried 75% of the value and 67% of the weight of all freight in the U.S.<sup>2</sup> Eventually recognized as obsolete, the ICC was slowly disbanded in the 1990s.

### Case 3: Market Power, Microsoft and Beyond

The following are public and private firms which have national market shares greater than or close to that of Microsoft (95%) in operating systems, yet the Justice Department has taken no action against them or numerous regional, state, or local monopolies such as hospitals, utilities, phone, or cable companies.

Table 1		
Firm	Product	Market Share
U.S. Postal Service (USPS)	first and third-class mail	100%
U.S. Federal Reserve System	control of the money supply	100%
Federal Deposit Insurance Corporation (FDIC)	bank deposit insurance	100%

Tennessee Valley Authority (TVA)	electricity generation	100% in regions of Alabama and Tennessee
Rawlings Sporting Goods	baseballs for Major League Baseball	100%
American Medical Association	admissions to and accreditation of medical doctor (M.D.) education programs, control of state medical boards	100%
U.S. Democratic and Republican Political Parties	state and federal legislative, executive, and judicial elective offices in the U.S.	99% of elective offices. A cartel (actually duopoly) that uses state ballot access laws to stifle competition from third parties.
Blue Cross-Blue Shield	health insurance	90% in states such as Alabama.
U.S. Government	K-12 public education	89%
Western Union	money transfers	81%
U.S. Airways	air travel	81% of flights to Charlotte, N.C.
Air Canada	air travel	80% of Canadian market
Intel	computer processors	80%
Brannock Device Company	foot measuring devices in shoe stores	80%
DeBeers	diamonds	72%
Eastman Kodak	35 mm film	69%

Source: "Go to Jail." *Forbes*. May 29, 2000. p. 62.

Keep in mind the above table is just the tip of the iceberg in terms of all national, state, and local monopolies. Also, notice how the top four monopolies are federal-government institutions. Here's one private firm, Kraft Foods, and the respective markets it competes in:

<b>Product</b>	<b>Market Share (percent)</b>
Velveeta	88%
Kool-Aid	85%
Macaroni & Cheese	82%
Philadelphia Cream Cheese	67%

Source: Copple, Brandon. "Shelf Determination." *Forbes*. 15 April, 2002.

pp. 131+. See exhibit "Category Killers," p. 138.

Again, keep in mind the 60% threshold legal scholars state is legally actionable.

## **2. The Perfect Competition Model of the Textbooks.**

The second problem Austrians have with antitrust law is that it is based on what they view as a fundamentally flawed notion of competition, namely the perfect (pure) competition model currently taught in microeconomics textbooks. Austrian economists Friedrich Hayek (Nobel Prize, 1974) and Israel Kirzner point out that, ironically, there is really no competition at all in the textbook competitive model. There are many buyers and sellers, but one price and an identical product, which hardly sounds like competition as most people conceive of it.

Competition to Austrians is *rivalrous behavior*, whether it takes the form of price cutting or product differentiation (product differences in quality, features, style, versatility, length and nature of warranty, etc.). Thus the number of firms in an industry or relative market share may or may not necessarily imply anything negative for consumers. Antitrust law, based on a static view of markets, still places emphasis on the number of firms in an industry and relative market shares. To Austrians such as Hayek and Kirzner, this is counterproductive and particular industries (e.g., computer operating systems) may naturally have room for only a few firms because they constitute the establishment of a standard (like a computer operating system) while others (e.g., farms and fisheries) may have thousands of firms in operation throughout the world because they sell different grade commodities at extremely high volumes where a number of standards is beneficial for consumers.

### **Microsoft**

Austrians argued against Microsoft as a monopoly in either operating systems or browsers. In operating systems, they argued that Microsoft competed with Linux and Apple OS 9. They pointed out that throughout the 1980s, consumers preferred Apple's platforms to IBM's user-unfriendly DOS. The problem was that Apple chose to keep its profit margins high and its prices in the \$1,500+ range (high back in the 1980s when dollars had greater purchasing power), and as a result irreparably lost out in the early to mid-1990s to relatively inexpensive IBM clones equipped with Windows. The Windows systems weren't superior to Apple's, just cheaper and user friendly enough to make them more attractive.

In terms of browsers, the major competitors to Microsoft's Internet Explorer today are Firefox ([here](#)), Opera ([here](#)), Apple's new version of Safari for Windows ([here](#)), and Google's Chrome ([here](#)). Firefox in particular is gaining popularity because of its more secure interface. Austrians add that, for a supposed monopoly, Microsoft has been aggressive and rivalrous--not what one thinks of as monopoly characteristics. True monopolies, like the average big-city department of motor vehicles, tend to be laid back and slow to address customer concerns.

**3. Antitrust laws and actions are based on a static as opposed to a dynamic view of market power. Thus they ignore international competition and have hampered U.S. companies in competing internationally throughout history.**

The following table lists a few antitrust cases that Austrians feel support their point.

<b>Table 3</b>	
<b>CASE</b>	<b>RESULT</b>
<i>U.S. Department of Justice v. United Shoe</i> (1918)	United Shoe was eventually bought by an unrelated British company, United Machinery.
<i>U.S. Department of Justice v. U.S. Steel</i> (1920)	U.S. Steel eventually won, but long hampered by the case, it and most of its industry died to foreign competition.
<i>U.S. Department of Justice v. Schwinn Bicycle</i> (1967)	Schwinn went bankrupt in 1992 from foreign competition. Its name is now stamped on Chinese-made bicycles.
<i>U.S. Department of Justice v. IBM</i> (1969)	IBM in 1969 had sales of 65% of the mainframe computer market. Its competitors were Burroughs, Sperry, GE, Honeywell, and Control Data. In 1982 the Department of Justice dropped the case since mainframe computers were rapidly becoming obsolete and replaced by foreign-made personal computers (PCs).
Source: Gordon, John Steele. "Read Your History, Janet [Reno]." <i>Forbes</i> . February 23, 1998.	

#### **Four Additional Austrian Points:**

1. For years GM could easily have obtained 45% of the U.S. auto market but its lawyers cautioned against it for fear of antitrust action. This timidity made it easier for Japanese automakers to capture market share in the 1970s and 1980s. In 2004, Toyota surpassed Ford as the second largest automaker in the world,<sup>3</sup> and on April 24, 2007 it surpassed GM as the largest automaker in the world.<sup>4</sup> GM headed in the opposite direction: on June 1, 2009, it declared bankruptcy.<sup>5</sup> This is not to imply that antitrust was the sole factor in GM's demise, but clearly it played a role in the Austrian view.

2. Antitrust action by the federal government essentially gave the U.S. consumer electronics industry to Japan, Korea, and Taiwan in the 1970s:

<b>Table 4</b>	
<b>CASE</b>	<b>RESULT</b>
<i>U.S. Department of Justice v. Radio Corporation of America (RCA)</i> (1931)	Established in October 1919, RCA dominated radio manufacturing since the late 1920s and TV manufacturing since the 1950s. The U.S. Department of Justice made RCA license all its technologies and prohibited it from making

	any royalties in the U.S. Japanese firms bought up the licenses and since the 1980s went on to dominate consumer-electronics markets in radios and televisions. This put them in better position to maintain dominance in VCRs, today's DVD players and recorders, and HD televisions.
Source: Gordon, John Steele. "Read Your History, Janet [Reno]." <i>Forbes</i> . February 23, 1998.	

3. There has historically been little consistency on the issue of market share:

<b>Table 5</b>	
<b>CASE</b>	<b>RESULT</b>
<i>U.S. Department of Justice v. ALCOA (Aluminum Company of America) (1945)</i>	Alcoa had 90% market share in aluminum. It was broken up despite the fact that aluminum was competing with wood, iron, and steel as a structural material.
<i>Brown Shoe Company v. U.S. (1962)</i>	In 1955, Brown Shoe had 4% of the market and its competitor Kinney had 0.5% of the market. Despite such small shares, their merger was forbidden because of fears that they would eventually both dominate the U.S. market where many firms each had very small shares. <sup>6</sup>
<i>United States v. Von's Grocery (1966)</i>	Von's Grocery Company acquired Shopping Bag Food Stores in 1960. Both were Los Angeles, California stores whose combined sales in 1960 only accounted for 7.5% of the Los Angeles grocery market. Von's Grocery lost and was ordered to divest itself of all Shopping Bag stores it purchased. <sup>7</sup>
Firms listed in the first table of this article with 69-100% market shares.	No antitrust action.
Source: Gordon, John Steele. "Read Your History, Janet [Reno]." <i>Forbes</i> . February 23, 1998.	

### 5. The Austrian Price/Quality Test of Monopoly

For the firm's product, does its real price (price adjusted for inflation) steadily rise, its quality steadily fall, or both occur over time? If price steadily rises, quality steadily falls, or both, then the firm has at least some degree of monopoly power. In other words, *if neither price rises nor quality falls, nor both occur, then the firm is almost certainly not a monopoly.*

Does Microsoft pass or fail this test? From the Austrian view, the progression from Windows 3.1 to Windows 95 to Windows XP to Vista displays more features, greater stability, and shorter boot times. Quality and features seem to be increasing over time, not falling. Price is roughly the same to slightly lower when adjusted for inflation. Microsoft seems to fail the Austrian test of monopoly. (In more good news for consumers, Google [recently announced](#) that it will be producing a competitor to Windows that, like its browser, will also be named Chrome.)

Does the U.S. Postal Service (USPS) seem to pass or fail the Austrian test? USPS formerly had twice-a-day delivery, now delivery is just once per day with recurring proposals to eliminate Saturday delivery. The price of first-class mail (rising to 42 cents on May 12, 2008 after rising to 41 cents on May 14, 2007) has increased faster than inflation for the past 20 years. For first-class mail, the USPS seems to pass the Austrian price/quality test, and thus for Austrians is classified as a monopoly.

## **Conclusion**

Regardless of whether one agrees or disagrees with the Austrian perspective on antitrust law and action, it will undoubtedly be intensely debated for years to come.

## **Reference Footnotes (sources Web linked where available)**

- 1 Manes, Stephen. "Will History Repeat Itself?" *Forbes*. 1 August, 2001.
- 2 [U.S. Department of Transportation, Bureau of Transportation Statistics, Commodity Flow Survey 2002, December 2004.](#)
- 3 [Naughton, Keith. "Red, White & Bold." \*Newsweek\*. 25 April 2005.](#)
- 4 [Associated Press. Toyota overtakes GM in global vehicle sales. MSNBC.com. 24 April 2007.](#)
- 5 [Clark, Andrew. "General Motors Declares Bankruptcy." \*Guardian UK\*. 2 June 2009.](#)
- 6 [FindLaw. \*Brown Shoe Co. v. United States\*, 370 U.S. 294 \(1962\)](#)
- 7 [FindLaw. \*United States v. Von's Grocery Co.\*, 384 U.S. 270 \(1966\)](#)

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## **Part B. Questions**

1. Please answer each question in complete sentences. Please do not "copy and paste" material from the article but use your own words. For fill-in-the-blank-and-explain questions, you can use the exact words from the article for the blank(s) portion of the question, but you must use your own words for the explanation part.
2. Put your question answers for Part B below your two concepts for the week for Part A on a single posted page (remember: post-first rules are in effect, plus posting two separate pages is more work than necessary. Highly recommended: the copy and paste-able template provided on the assignment sheet.
3. On more subjective questions there is no right or

wrong answer, just make sure to support your position in detail, whatever it is.

1. Of the three (3) statutes (laws) forming the basis of antitrust enforcement, what role does the Clayton Antitrust Act (1914) supposedly serve?
2. Consider section 1, "Case 2: The Railroad Industry and the ICC." How did ICC regulation of the railroad industry backfire and end up hindering competition? What was the industry's competition that the government overlooked?
3. Choose one of the four (4) cases found in Table 3, name it, and summarize its results.
4. Consider the cases of Schwinn Bicycle (Table 3) and RCA (Table 4). How do Austrians believe that both firms gradually changed over time from U.S. factories to mere brand names stamped on non-U.S. goods?