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U.S. Antitrust's Greatest Misses

Oft-Cited Cases Do Not Support Antitrust Advocates' Claims

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Today's advocates for expanding antitrust regulation often cite famous antitrust cases of the past to suggest that stricter antitrust enforcement can enhance consumer welfare, increase competition, or even lead to new broader goals like protecting democracy from corporate influence or creating more equity in society.[1] However, these antitrust legal "greatest hits" are often remembered inaccurately. This paper seeks to illuminate the fundamental errors and problematic consequences of the common misreading of four of these frequently referenced antitrust suits.

- *Standard Oil Co. of New Jersey v. United States* had a defendant that was cutting prices while increasing output. The case also lacked evidence of either predatory pricing or consumer harm.
- *U.S. v. American Telegraph and Telephone Company* (AT&T) broke up a monopoly that was created by government, not the market. The case illustrates how regulatory capture—regulated entities' influence over the regulatory process—works to create and maintain monopolies.
- The *U.S. v. International Business Machines* (IBM) case lasted for 13 years before the Department of Justice (DOJ), which brought the suit, deemed it "without merit" and dropped it. The multi-million-dollar litigation inadvertently raised prices for IBM customers.
- Finally, *U.S. v. Microsoft* illustrates how technological innovation moves faster than litigators.

The flawed nature of these cases and the inaccuracy with which they are remembered recommend against increasing enforcement and expansion of antitrust regulations. These antitrust prosecutions did not benefit consumer welfare. Regulators are poor substitutes for the creative destruction and price signals of the marketplace. That was as true then as it is now. There is no reason to repeat the mistakes of the past.

Standard Oil. *Standard Oil Co. of New Jersey v. United States*, from 1911, was the first big case in U.S. antitrust litigation.[2] Today, it is often invoked to support breaking up current "big tech" companies. But the case against Standard Oil made as little sense then as breaking up Amazon, Apple, Google, or Facebook would make now. Antitrust action did not help consumers in 1911 and will not help tech customers today.

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The Standard Oil litigation is often referred to as an effort to combat the practice of predatory pricing, the concept in early antitrust theory that spurred the passage of the Sherman Antitrust Act in 1890.[3] The theory warns that a market leader will tend to cut prices to drive competitors out of business and afterward raise prices to enjoy monopoly profits. For this to be an effective strategy, the monopolist must be able to raise prices above competitive market rates long enough to recoup all the losses incurred during the initial undercutting phase. But those are the very conditions that create incentives for new firms to enter the market. Without some type of barrier to entry, the monopolist's scheme is doomed.

Interestingly, even in the court record of the 1911 Standard Oil case, some scholars see little to no evidence of predatory pricing.[4] In the 1870s, oil refining was experiencing a surge of technological change that required greater capital and benefited from economies of scale. This left Standard in a position to offer consumers lower prices than its rivals and, in many cases, to acquire competitors that were not able to scale up on their own.

The decade was a difficult time for speculative businesses, due to deflationary monetary policies. This was especially true in the overbuilt oil refinery industry. Standard Oil had the foresight and resources to invest in crude supplies, tank cars, pipelines, barrels, and storage facilities that made the firm the most efficient and successful producer of its day. Economics professor and antitrust expert Dominick T. Armentano writes that these keen business decisions "lowered the costs of production and the price of the product and raised the profits of the Standard Oil Company."[5]

This was all good news for consumers, making the eventual court-ordered breakup of Standard Oil a curious remedy to a problem that did not seem to exist. Armentano summarizes:

> Between 1870 and 1885, the price of refined kerosene dropped from 26 cents to 8 cents per gallon. In the same period, the Standard Oil Company reduced the average costs per gallon from almost 3 cents in 1870 to 0.452 cents in 1885. Clearly, the firm was relatively efficient, and a good share of that efficiency was transmitted profitably to the consumer in the form of lower prices for a much improved product.[6]

Consumers were not harmed by Standard Oil's dominant position in the industry. No evidence of predatory pricing was presented at trial. In fact, by the time of the trial, Standard Oil's market share had fallen and it had to compete against 150 other companies, including Texaco and Gulf, both of which are still operating.[7] With the case for predatory pricing, consumer harm, and monopoly itself being so poor, it is time to stop citing this case as an antitrust victory worthy of being replicated.

AT&T. The *U.S. v. American Telegraph and Telephone Company* suit is frequently held up as both a case of government addressing problems associated with a natural monopoly and, in reference to the company's eventual breakup, an example of consumer benefit derived from antitrust regulatory action.[8] Neither is an accurate account of the facts. AT&T's monopoly was, in fact, government-created and -protected. The burst of energy after its dismantling

was due to the opening of the telecommunications market, not to the intervention of antitrust regulation.

The Organisation for Economic Co-operation and Development defines a natural monopoly as existing, "in a particular market if a single firm can serve that market at lower cost than any combination of two or more firms."[9] Before government intervened in order to achieve the goals of universal service and preventing network duplication in the industry, competition was humming right along in the telephone sector. After AT&T's initial technological patents expired in 1893 and 1894, independent competitors begin to spring up in areas underserved by AT&T and eventually began to compete with the market leader in their established territories. There was no natural monopoly. Adam Thierer, then of the Heritage Foundation, writes:

> By 1907, non-Bell firms continued to develop and were operating 51 percent of the telephone businesses in local markets. Prices were driven down as many urban subscribers were able to choose among competing providers. AT&T's profits and prices during this period began to shrink due to increased competition.[10]

Thierer goes on to quote industry historians summarizing the period: "It seems competition helped to expand the market, bring down costs, and lower prices to consumers."[11]

What changed to strangle competition was AT&T becoming willing to be regulated as a government-protected monopoly. Thierer explains:

> Although AT&T undoubtedly encouraged the monopolization of the industry, it was the actions of regulators and federal and state legislators that eventually led to the creation of a nationwide telephone monopoly.[12]

AT&T enthusiastically supported government regulation in exchange for government granting and protecting its telephone monopoly. But that monopoly could not have been sustained by the firm on its own. Thierer lays out three government policies that thwarted competition and created the AT&T monopoly:

1. The intentional elimination of what was considered wasteful or duplicative competition through exclusionary licensing policies, misguided interconnection edicts, protected monopoly status for dominant carriers, and guaranteed revenues for those regulated utilities;
2. The mandate for universal telephone entitlement, which implicitly called for a single provider to easily carry out regulatory orders; and
3. The regulation of rates (through rate averaging and cross-subsidization) to achieve the social objective of universal service.[13]

The combined effect of these policies was enough to kill telephone competition just as it was gaining momentum. All were the result of Theodore Vail's leadership of AT&T beginning in 1907. Securing beneficial arrangements with regulators, he sought a monopoly by regulation and used the goal of universal service as a bulwark against competition. Vail's

language about competing networks' wastefulness and redundancy caught on with regulators and politicians. Soon they began to refuse requests by potential competitors to erect lines in areas already served by AT&T.

The myth of natural monopoly became a regulatory self-fulfilling prophecy. Competing networks were deemed wasteful, so they were banned. Observers then concluded that the lack of competing networks meant there was no incentive for competition. Ergo, telephone networks were a natural monopoly.

Vail's commitment to universal service was no less influential with politicians and regulators. AT&T happily accepted state and federal rate regulation that subsidized rural customers by charging higher rates, set by regulators, in more populated areas. All of this was done in the name of universal service. Amusingly, AT&T's commitment to universal service took physical form in its New York City headquarters, as described by Steve Coll in his book, *The Deal of the Century: The Breakup of AT&T*:

> The lobby interior was modeled after an Egyptian temple, containing a five-foot relief sculpture of Alexander Graham Bell and a marble floor inlaid with two bronze medallions, each eight feet in diameter. The medallions showed Mercury bearing the messages of the gods and were inscribed with the motto, "Universal Service."[14]

As politicians and regulators gained control and influence over the telephone market, AT&T became increasingly protected from competition in rates. In fact, AT&T's cozy relationship with government officials would be difficult to overstate. As Coll also notes in an anecdote from 1976:

> Once during the Bell Bill fight [a failed AT&T-supported bill to restore its monopoly], Representative Tim Wirth, a Democrat from Colorado and then a majority member of the House Communications Subcommittee, found himself at a crowded hearing where an AT&T executive was testifying. Wirth asked the executive to identify any of his colleagues who were in the room. After five minutes of introductions, only one small corner had been identified. Wirth then asked in desperation, "Will everyone associated with AT&T just stand up?" Everyone in the room stood, laughing nervously.[15]

AT&T's regulatory capture was so complete that the Franklin Roosevelt administration created the Federal Communications Commission (FCC) in 1934 to oversee the regulatory regime that had grown up under Vail's tenure. It would continue to carry out the symbiotic relationship between the government and AT&T that had been well established by then: AT&T instituted the FCC's regulatory agenda and the FCC protected the firm from any competitive threats. Examples include the repression of property rights in radio spectrum and the thwarting of the cable industry. New York University Law Professor and antitrust scholar Richard Epstein describes AT&T's monopoly:

> The company was organized as a government-protected monopoly subject to direct regulation by the FCC, so it is difficult to decide whether an antitrust remedy should

> be piled on top of that existing arrangement. The strongest argument for [antitrust regulatory] intervention was that the rapid strides in technology meant that it was preferable for the courts to intervene quickly rather than wait of a balky administrative process to run its course—assuming that it would eventually see the importance of competition.[16]

United States v. AT&T began in 1974. Its 1982 remedy was merely to break one heavily regulated national monopoly into seven heavily regulated regional monopolies.[17] That is not much of an improvement for consumers. However, in the years following the case, the technological revolution in wireless phone technologies, not antitrust regulation, would upend the entire industry and solve problems that eight years of litigation could not.[18]

The AT&T monopoly was not natural. It was created and maintained by government regulation and protected by AT&T's regulatory capture. The explosive innovation in telecommunications, which occurred after the monopoly was dismantled in 1984, was not the result of antitrust enforcement, but of the end of the government-erected monopoly and of market-driven technological change.

IBM. The folly of the case *U.S. v. International Business Machines Corp* is most starkly illustrated by its being dropped.[19] The Department of Justice filed suit against IBM in 1969 for "monopolizing the general-purpose mainframe computer market in violation of section 2 of the Sherman Act." Thirteen years later, in 1982, the DOJ admitted that the suit was "without merit."[20] Assistant Attorney General William F. Baxter, then in charge of the DOJ antitrust division, acknowledged that the case against the computer giant was "flimsy" and that dropping the suit was "the only sensible thing to do."[21] Baxter added that the case had cost millions of taxpayer dollars and there was not sufficient evidence to even obtain a settlement from IBM.

That the case against IBM was weak or flawed does not seem to be in dispute. Many, like Columbia Law Professor Tim Wu, argue that the mere threat of antitrust action cracked open the market for competitors to create an independent software industry, and created a net benefit.[22] That theory is hard to prove. What seems more likely is that the suit unintentionally incentivized IBM to raise its prices and thus harmed consumers.

The IBM case is often cited as evidence that the free market's creative destruction is insufficient to spur innovation and ensure competition and therefore needs help from antitrust regulation to achieve those goals. But it is not clear that the looming threat of antitrust prosecution was the main driver of IBM's decision to unbundle software sales and pricing from sales of its IBM/System 360 mainframe computer hardware in 1968. As Economics Professor Edward Steinmueller, of the University of Limburg in the Netherlands, notes, IBM was facing rapidly increasing costs in its software support. He notes that "the costs of developing the System/360 operating system software had proved a major trauma for the company, and seemed to foreshadow still further cost increases."[23] With no hard evidence that IBM was motivated by potential regulatory action, it is just as likely that these market conditions led the company to unbundle its products. There is no

way to be absolutely sure of IBM's motivation, but the emerging market conditions of the time certainly cast doubt on solely attributing the shift to the threat of antitrust action.

If the case for the IBM antitrust suit's benefits is weak, the evidence for its harmful unintended consequences for consumers is strong. The threat of government-forced reduction of market share likely resulted in IBM raising consumer prices. As David Levy and Steve Welzer explained in *Regulation* magazine:

> The threat of antitrust action is likely to affect the target firm's pricing strategy by changing the firm's perception of how large its future market share will be allowed to be. By threatening the firm's right to achieve a future market share, an impending anti-monopolization suit reduces the firm's potential for future profits. The suit thereby encourages the firm to take short-run profits by raising its price toward the monopoly level. More specifically, the filing of an antitrust suit aimed at reducing a firm's market share will impel that firm to increase prices if it sees a reasonable probability of losing the suit.[24]

After a period of improvement and reform beginning in the late 1970s and early 1980s, U.S. antitrust case law, at least for now, centers around consumer harm. In his influential 1978 book, *The Antitrust Paradox*, Robert Bork revolutionized how judges would come to treat antitrust cases in the U.S. He and the Chicago School infused antitrust theory with economics and refocused its aim from protecting smaller inefficient firms to ensuring consumer welfare.[25]

The 1969 IBM case is an example of how antitrust enforcement can *create* consumer harm. In seeking to protect consumers from a monopolist, the DOJ inadvertently harmed them by giving the alleged monopolist incentives to raise prices.

The real lessons from *U.S. v IBM* are not that antitrust regulation can help create new markets. Hobbling an industry leader does not cause a new industry to spring forth, fully formed, from nowhere. Instead, the case highlights the potential waste of resources to taxpayers and private firms, the superiority of market responses over government action, and the harmful, unintended consequences to consumers of antitrust regulation.

Microsoft. In *U.S. v Microsoft Corporation*, the government accused the software company of illegally maintaining its monopoly position in operating systems by bundling its Web browser, Internet Explorer, with its Windows operating system.[26]

By the time the trial began in 1998, consumer harm was firmly established as the U.S. standard for antitrust action. The case fails in that regard, because the consequence for consumers of Microsoft including Explorer free of charge with its Windows operating system was that the cost of a browser went from $39 for Netscape Navigator to zero. That was bad news for Netscape, but good news for consumers.

The merits of the case against Microsoft were also called into question by real-world market developments during the course of the trial. As the trial went on, the relevant market outside

the courtroom continued to evolve and innovate, largely past the point of desktop computing's relevance. Market forces acted faster than litigation proceeded.

The computing world was indeed shifting online, but the browser's importance in getting there was no longer what prosecutors had made it out to be. Data and advertising were quickly becoming far more significant than the impact of Microsoft including a free browser with its operating system. The move to mobile devices constituted another paradigm shift for the industry that neither antitrust litigators nor Microsoft foresaw.

The rise of search, monetized advertising, the Internet of things, voice-controlled technology, social media, widespread wireless Internet access, and online commerce all make the desktop "browser wars" look like something market forces would have resolved. Which, of course, they did, with no help from a costly antitrust suit that eroded private property rights, expanded the regulatory reach of government, and gave future entrepreneurs cause for worry that their innovations might fall afoul of antitrust authorities.[27]

Conclusion. The above are examples of antitrust actions undertaken to protect competitors rather than consumers. They illustrate the unintended and harmful consequences that antitrust litigation often has for consumers, the government-created nature of monopolies, and the inferior ability of antitrust enforcement actions to foster competition and encourage innovation compared to that of market forces.

At the heart of antitrust regulation's poor track record is a fundamental inability to distinguish between competitive and anticompetitive behavior. As CEI's founder Fred L. Smith put it:

> The anticipated efficiency gains that motivate innovative corporate behavior are often subtle and complex, and usually only dimly perceived even by the innovator. They are likely to be misunderstood by those outside the firm, and they are almost certain to be misunderstood by those already skeptical of markets.[28]

Ronald Coase, the 1991 economics Nobel laureate, also blamed a lack of creativity and a lack of humility among antitrust advocates:

> [If] an economist finds something—a business practice of one sort or another—that he does not understand, he looks for a monopoly explanation. And as in this field we are very ignorant, the number of ununderstandable practices tends to be very large, and the reliance on a monopoly explanation, frequent.[29]

Regulators have no real tools for parsing which internal business decisions are beneficial and which ones are not. That is what price signals do. The creative destruction of the marketplace is a more impartial and swifter judge for protecting consumers than politicians and bureaucrats could ever hope to be.

When businesspeople are distracted from addressing consumers' wants by regulatory threats, a gray area of speculation about motives, politicized antitrust enforcement actions, and regulatory capture overwhelm market competition. This may benefit competitors, regulators, and even sometimes those being regulated, but it almost certainly harms consumers.

Notes

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[2] *Standard Oil Co. of New Jersey v. United States*, 221 U.S. 1 (1911), https://supreme.justia.com/cases/federal/us/221/1/.
[3] Sherman Antitrust Act, https://www.law.cornell.edu/wex/sherman_antitrust_act.
[4] John S. McGee, "Predatory Price Cutting: The Standard Oil (N.J.) Case," *Journal of Law and Economics*, Vol. 1 (October 1958) pp. 137-169, p. 153, https://www.jstor.org/stable/724888?seq=1. However, there has been some pushback on this scholarship. For instance, see, Christopher R. Leslie, "Revisiting the Revisionist History of *Standard Oil*," *Southern California law Review*, Vol. 85 (2012), pp. 573-603, https://southerncalifornialawreview.com/wp-content/uploads/2018/01/85_573.pdf.
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[12] Thierer, p. 267.
[13] Ibid.
[14] Steve Coll, *The Deal of the Century*: *The Breakup of AT&T*, (New York: Atheneum, 1986), p.33.
[15] Ibid, p. 105.
[16] Richard Epstein, "Beware of Populist Antitrust Law," *Forbes*, January 23, 2019, https://www.forbes.com/sites/richardepstein/2019/01/23/beware-of-populist-antitrust-law/?sh=1fc6f0ab586b.
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