ECONOMICS U$A
LESSON #19

Announcer: Funding for this program was provided by the Annenberg CPB Project.

(MUSIC PLAYS)

Stasio: Economics U$A, one of a series of programs designed to explore Twentieth Century micro and macro economic principles. The subject of this edition is monopoly. Our guest is Doctor Thomas Kratinaker, Law Professor at Georgetown University. I'm Frank Stasio.

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Stasio: Eighteen Sixty-five, the Civil War has ended. Slavery is abolished. In the south, plantation owners start from scratch grappling with the realities of a new economy, but in the north where the industrial revolution had begun to reshape the economy a generation earlier, the end of the war meant a return to unfettered growth driven by technological changes. In the twenty-five years after the Civil War the railroads laid more than one hundred thirty thousand miles of track stretching America's frontiers and expanding the reach of individual businesses and industries. Now it was possible for a single manufacturer to transport goods cheaply and quickly almost anywhere in the country. With the prospect of expanded sales, a business could step up production and take advantage of the cost savings enjoyed at higher levels of output. These are known as economies of scale. Then going beyond economies of scale these growing firms merged

to become giant trusts. Many would gain almost complete control of their market. Thomas Kratinaker is a Georgetown University Law Professor specializing in anti-trust law.

Kratinaker: As the economy was getting bigger, it was becoming possible to reap great rewards if you could form a trust, because instead of monopolizing say a thousand units a year, you might be able to monopolize say, ten thousand units a year or more.

Stasio: This was also a time when cities began to attract growing numbers of people. The urban population grew by four percent a year just after the Civil War. By Eighteen Eighty the growth rate was six percent. At the turn of the century two-fifths of the nation's population lived in cities. As the population consolidated so did business. It was now possible for one or two big firms to meet demands that at one time required dozens or even hundreds of companies, so little firms were swallowed up by big companies, and big companies became giant trusts. U.S. Steel had absorbed more than two hundred companies and picked up nearly seventy percent of the steel market in the process. America Tobacco took control of ninety percent of the market after buying out more than a hundred fifty independent firms. American industry tumbled into a new order with mergers taking place at an astonishing rate. There were nearly twenty times as many mergers in Nineteen Hundred as there were just three years earlier.

Kratinaker: So we saw during the Eighteen Eighties the creation of a whole bunch of Trusts, many of which sound somewhat whimsical today. I mean there was the Sugar Trust, then the Whiskey Trust. You can probably empathize with those, but there was

also a Paper-bag Trust and there was an Envelope Trust, and an Oil Cloth and Painting Pitch Trust.

Stasio: By 1904, forty percent of the nation's industrial output was produced by less than one percent of all the businesses in the country. Companies like U.S. Steel, American Tobacco, and Standard Oil had eliminated virtually all the competition in their fields. It was a dream come true.

Kratinaker: Competition is good for consumers but it's bad for businesses. Competition has the effect of driving prices down. Anybody who's in business would rather be a monopolist than a competitor. The point of a trust or a…which is really just one way of creating a one-firm monopoly or merging all the competitors in one industry, is to enable them to gain control of all the output so that they can cut back on what's being produced and raise prices to consumers.

Stasio: Notice that Professor Kratinaker doesn't simply say the monopolist dictates prices. He said that once a firm gains complete control of a market, it will cut back on production. It's only by keeping output artificially low that the monopolist can command higher prices.

Kratinaker: The whole concept of a monopoly is to try to restrict the amount that's being supplied in order to charge higher prices and try to be making…trying to charge prices that substantially exceed the costs of production. Even a monopolist has always got a choice between expanding output and raising prices. He doesn't usually have the opportunity to follow both those course of action. I mean, the reason it's assumed that you'll sell more when you lower price is that then people will substitute away from some

other product to your product. And similarly if you raise price, you're likely to lose customers because they'll find something else to substitute. I guess the Paper-bag Trust when it raised its prices found that people were going back to…back to cloth sacks.

Stasio: So, under a monopoly output is usually less than it might be under a perfectly competitive system, but how does the monopolist know when the ideal output level has been reached. To find this, the monopolist looks at the cost of making each additional unit and the revenue he'll receive from the sale of those additional units.

Kratinaker: The uh, monopolist wants to look at how much additional costs it will have to bear in order to produce more of a good and compare that to the additional revenue it will…it will derive from producing that good, and it's only where those two come into balance or as the economists would say at the equilibrium that the monopolist will stop. At that point it will stop expanding output and will…and will charge a price where its marginal costs as we've just defined equal its marginal revenue as we've just defined them. At that point it will turn out that the monopolist is in fact charging more total price than it is expending in total cost for the output.

Stasio: Clearly the monopolist has an advantage over other businesses in more competitive fields.

Kratinaker: If you're in a competitive market, maximizing your profits means cutting your costs and selling as much as you can, because in the competitive market you don't have much influence over price. Um, there are so many firms out there that your decision as to how you produce doesn't really affect the total price that the commodity fetches in the marketplace. A monopolist following the same incentives, that is, maximize its

profits, faces a different set of conditions. A monopolist knows that if it restricts output price will rise because it's the only supplier of that good. So that what a monopolist is trying to do is to find that point at which it makes the largest total profits. What that means is it wants the highest gap between its costs of production and the price at which it sells the good.

Stasio: Because it doesn't have to worry about competition, a monopolist can earn a higher profit margin than firms that have to compete for their share of the market. The higher return on a monopolist investment is called economic profit. Professor Kratinaker explains the difference between economic profit and simple profit.

Kratinaker: If you're operating a bowling alley, it's not true that your profit is all the money left over after you buy the pins and the balls and the machines. If you have ten dollars left over, maybe instead of buying bowling alleys you could have bought a Certificate of Deposit and made eleven dollars. If so, you shouldn't be owning a bowling alley, you ought to have the Certificates of Deposit. It was a cost to you to a cost of capital to make the average rate of return in society. So that for a lay person profit is just what's left over after costs, but for an economist and the notion of economic profit is that amount of money which you make which is above and beyond the ordinary rate of return made in average capital markets. In a sense, the whole definition of a monopoly is that that's a firm which has the option to earn economic profit.

Stasio: We've already seen how economies of scale and mergers help to create monopolies. There are other reasons as well. One way is to control the technology in an industry through patents.

Kratinaker: The patent that the government gives to the discoverer of an invention gives that discoverer the right to exclude anyone else from making the product. That individual then has a monopoly. But the purpose here, at least the stated purpose isn't to protect existing manufacturers or some other rationale that might be given for other kinds of monopoly protective devices but to encourage people to invent, and the patent has been a more or less time-honored device for trying to encourage invention.

Stasio: Another way to build a monopoly is to get control of the inputs, that is, the raw materials or products needed to manufacture a particular product.

Kratinaker: Uh, this is much what…like what the firms try to do in the Standard Oil case, which was one of the large early Sherman Act cases. That is, they tried to gain monopoly over the sale of gasoline and other refined oil products by gaining control of the oil fields and of the pipelines that were sending oil from the oil fields to the refineries.

Stasio: It wasn't long before the market power exercised by the industrial giants produced resentment and mistrust. Farmers were the first to feel the pinch when they tried to ship their goods or borrow money. Many joined the Farmer's Grange and other organizations so they might pressure government to restrain the colossal trusts. Soon small businesses claimed they were squeezed out by unfair competition, and finally consumers felt the trust kept prices artificially high. The government responded quickly. In 1890, Congress passed the Sherman Anti-Trust Act.

Kratinaker: The Sherman Anti-Trust Act is somewhat obscured in history today. To tell you precisely why it was passed would be a very difficult thing, but some things I think we could still say with a fair degree of certainty. First of all, it certainly was a response

to popular pressure. There isn't any question that large numbers of American people whether it was fifty percent or eight percent or forty-two percent I can't say, but large numbers of just ordinary regular American citizens thought that the problem of monopolies or as they were referred to in those days as the trust was a large problem that was threatening the American economy and was threatening to wreak great harm on American consumers. Um, and that was principally the impetus behind the Sherman Anti-Trust Act. And if you read the Act you could almost see that because the Act says almost nothing. The Sherman Anti-Trust Act simply says it's an offense to engage in a restraint of trade and it's an offense to monopolize. Um, that's literally what it says. As a matter of practice what it's saying is, federal courts, we got a problem. We hereby declare that, in general, we are opposed to monopoly and we prefer competition, will you please figure out a solution to it.

Stasio: While the Sherman Act was vague about what would and would not constitute a monopoly, Kratinaker says the legislation reinforced a uniquely American economic tradition.

Kratinaker: What the Sherman Act did was not so much respond to the grangers or respond to the trusts as to re-express in ways that are in many other places in the American political economy such as the First Amendment a belief in marketplace, a belief in individual control of our own destiny. Uh, most other civilized countries in response to a phenomenon like the trusts would have imposed a form of regulation that would moderate disputes between the trusts and consumers. The trusts would have kept some of their profits, and the consumers would have gotten somewhat lower prices. This it would have perceived that, well, they've got their business and there are consumers out

there, we've got to just make sure that nobody's completely ripping off somebody else, but if they want to form a trust that's okay by us. Um, that wasn't the American reaction. With the American reaction was to stress consumer sovereignty.

Stasio: As a restatement of American values, the Sherman Act is an interesting piece of legislation but as a tool for breaking up monopolies and preserving competition, it was considerably less important. The Act never spelled out what practices were illegal nor did it give the government any new powers to prosecute suspected wrongdoers.

Kratinaker: The courts responded to the anti-trust law in ways that you might expect confronted with this very short, very vague statute. They started off in about five different directions at once, and some judges told us that every time anybody restrains trade that violates the Sherman Act. Other judges realized that if I were to sell a watch to you that might be characterized as a restraint of trade because now someone else can no longer buy that watch from me, so in that sense there's a restrain of free trade in the watch. He said, well it can't be that the Act literally means what it means. Perhaps it depends on the size of the company involved. Perhaps other courts might have suggested it depends on the purpose for which they act. Uh, others suggested it might depend on trying to guess what effect was going to occur. Are consumers gonna suffer higher prices or are competitors gonna be driven out of business? Um, we saw all these starts as time went by and as courts had more experience and more time to think about the job they'd been given, they began to refine the inquiry a bit, so that for example we no longer talk about any kind of literal reading of the statute. Um, the courts will by and large tell you that the Act is designed to protect competition, not competitors. That is, we worry about

consumers being hurt. We’re not too worried about an action that only has the effect of injuring a business.

Stasio: In effect, there were two ways to look at trusts. The courts could focus either on the firm’s market performance or its market structure. Market performance centers on the company’s behavior whereas Kratinaker says the company has formed a monopoly just to make excessive profits which would be illegal or because of technological innovations or business efficiencies which the courts might permit. The court could then look at whether the firm is charging a fair price for it product. The other way of examining trusts, the market structure approach, ignores all of that and simply looks at whether or not the firm has taken complete or near complete control of the market. The case against Standard Oil in Nineteen Eleven established the market performance criterion as the standard for deciding anti-trust cases for more than thirty years.

Kratinaker: In that case the court said, look, what we have is a rule of reason. That which unreasonably restrains trade is unlawful and that which does not unreasonably restrain trade is not unlawful, and so people stopped worrying about the precise language of the anti-trust laws and started worrying about what’s a reasonable and what’s an unreasonable restraint of trade.

Stasio: The rule of reason was modified somewhat in Nineteen Forty-five when a federal judge ruled that the Alcoa Aluminum Company was an illegal monopoly even though it was not found to be engaging in any practices that would be considered illegal under market performance guidelines.

Kratinaker: That decision seemed to establish the proposition that the Sherman Act's prohibition on monopolies went beyond its prohibition on unreasonable restraints of trade. Uh, a firm that acquired a monopoly was to be broken up or to be punished in some way whether or not it had engaged in any illegal acts along the way. Uh, now at the same time the author of the Opinion, Judge Leonard Hand, said that he was not saying that someone that invents a better mousetrap is to be consigned to Haiti's, but was trying to walk some kind of a fine line between the firm that gains a monopoly by what he described as maneuvers honestly industrial or superior skill foresight in industry on the one hand. Those would continue to be lawful monopolies, but on the other hand those monopolies who acquired a position of dominance but not by means that were as he put it, economically inevitable, were to be treated as unlawful monopolies.

Stasio: It has taken decades to develop a meaningful interpretation of the Sherman Act. In the year shortly after its passage few trusts were ever taken to court. The great trust buster himself, Teddy Roosevelt, prosecuted only sixteen cases during his administration. The generally mixed record of enforcement under the Sherman Act led to passage of tougher legislation in Nineteen Fourteen. The Clayton Anti-Trust Act and the Federal Trade Commission Act.

Kratinaker: The Clayton Act or something like it was part of Wilson's platform when he ran for the Presidency in Nineteen Twelve and one of the principle…there were two principle themes that were being expressed both of which grew out of the vagueness of the Sherman Act. To consumers and to consumer action groups Wilson was saying there are certain kinds of practices that are pernicious that we ought to be condemning them out of hand, and the Sherman Act doesn't admit of that kind of treatment 'cause the

courts are always asking about purpose and effect. So we've got to tighten up the anti-trust laws by specifically defining certain kinds of things like pie in arrangements, price discrimination and mergers that are inherently harmful to consumers. This was an idea that was largely the brainchild…of… the brainstorm, excuse me of…of Louis Brandeis. Um, the second thing that Wilson was saying was directed at businesses. This was not Brandeis's idea. Um, others had it but it was the vagueness of the Sherman Act means that business people are every day at risk as to whether or not they're violation the Sherman Act. They deserve to have more specific guidance. Why don't we create an expert administrative agency that can use fact-finding and rule-making procedures to specify under what circumstances a restraint of trade is unreasonable or wonder what circumstances this behavior might be deemed to be an attempt to monopolize? These two ideas give guidance to business and let's put some teeth behind certain kinds of prescriptions of anti-trust activity coalesced in the joint enactment…I mean, they occurred at virtually the same time…of the Federal Trade Commission Act and the Clayton Act.

Stasio: Even with the Clayton Act, however, the government never tried to outlaw monopolies completely. There are some industries where you and I recognize we are better served by one large company than several smaller ones all competing for our business. In many cases, these businesses are called natural monopolies. One of the ways to determine if a firm is a natural monopoly is to see whether costs will continue to decline as production increases. If a firm can lower costs by serving an entire market as in the case of public utilities, it's considered a natural monopoly. But left to its own, a natural monopoly would act like any other company with complete control of the market.

It would restrict output to keep prices and therefore, profits high. But as we've heard it would be in no one's interest to force competition of these industries, so rather than break up a natural monopoly, the government often decides to regulate it.

Kratinaker: Usually what the government does is to try to force that company by detailed regulation to not to cut its output but to continue to expand its output to the point where it would be producing if it were in a competitive situation. That means continuing to sell so long as all of its costs are covered by the total receipts that its…that it's gaining from consumers.

Female: I urge you to deny the rate increase in total and deny the request to restructure rates.

Male: These proposals are a blatant attempt to simply gauge the public, the taxpayers, those who work for a living, and those on fixed incomes.

Stasio: There are regulatory commissions at every level of government that oversee natural monopolies. These commissions set prices by allowing the firm a fair rate of return on its investment. That is, a fair profit based on the total costs and output. Public regulation has its critics. Some people charge that regulatory commissions get too close to the industry they oversee and often allow higher profits than necessary. Others complain that the cost of regulating an industry exceeds the benefits.

Kratinaker: There's a school of thought that when you add in the cost of regulation, the cost of the lawyers, the cost of the regulatory agency, the court costs that are consumed in judicial review…you're lucky if you wind up with a net plus.

Stasio: Another criticism of regulated monopolies is that they offer little incentive for innovation or efficiency. As long as it's guaranteed a profit, the firm is not penalized for letting costs get too high.

Kratinaker: As one wag put it I wish I could take credit for it, one of the rewards of a monopoly is the quiet life. A monopolist may not only raise price but may also be lax in controlling costs. You may decide you can afford to put your nephew on the payroll, and you can…and you can pay your brother-in-law the stockholder-inflated rates of return because you don't face any competition.

Stasio: It's important to note that accepting industries where we find natural monopolies, it's nearly impossible for one company to gain complete control of a market without the help of government.

Kratinaker: For example, supposed everybody…all the automobile manufacturers in America got together and merged into one firm and then started to restrict output and raise prices. Well, they'd be an effective monopoly only if somebody else didn't start up another automobile company seeing that there are these profits to be made or only if we didn't start having massive amounts of automobiles shipped in from Japan or Europe. Um, keeping people out of the American market either from building firms here or from supplying or from exporting goods from abroad usually requires active governmental protection.

Stasio: Also bear in mind that while government may allow a monopoly to do business, the approval isn't always permanent. A monopoly may lose its protected status when technological changes make competition feasible.

Goeken: If I came up with this idea to put this microwave from Chicago to St. Louis, not to compete with AT&T but to uh, expand our two-way uh, radio business, find more customers. So uh, we filed an application with the uh, FCC and uh, oh, what in a few weeks AT&T, Illinois Bell, Southwestern Bell, General Telephone Electronics, and Western Union all filed petitions to deny our applications.

Stasio: That's Jack Goeken, one of the founders of MCI Corporation. Goeken soon learned why the phone company objected to his application. If permitted, it would break Bell's monopoly on long distance communication. Henry Geller was General Counsel for the Federal Communications Commission.

Geller: What you had was a revolution in how telecommunications went about its business of switching and of communicating between points and the revolution, the computer, the microwave, the satellite, were really available to everybody. It wasn't like stringing a wire, and that made possible the competition.

Stasio: MCI was successful and Ma Bell's monopoly over long distance communication was over. The growth of MCI and other long distance carriers seems to prove the theory that monopolies will be tolerated only as long as they clearly serve the best interest to the general public. There is an argument for encouraging the spread of monopolies generally across the economy. Proponents suggest that there are long-term benefits to consumers that outweigh the short-term costs brought on by restricted supply.

Kratinaker: Real growth in the American economy comes in any economy comes from innovation, real innovation, breath-taking innovation like the automobile. No more horse and buggy. Let's go to automobiles. Or like the airplane. Forget covered wagons, we're

flying to California. That's a very big deal. It's not such a big deal to get the price of watchbands down from a dollar to ninety-eight cents, as competition will do. The argument is that a monopolist has the luxury, the resources, and the time to invest money in fundamental research and development that a competitive firm may not have time for and eventually that any kind of harm that's done to consumers is a short-term harm. Meanwhile what you're hoping for is that that firm with a monopoly on horse and buggies may have the luxury and the wherewithal to invent the Model T.

Stasio: Let's look back now at some of the ways monopolies gain control over their markets and how governments deal with them. A monopoly is a market with a single seller. Once a business has control of the market it will tend to restrict supply to keep prices high. Near the turn of the century some businessmen took advantage of economies of scale and general economic growth in the United States and built trusts, which gained almost complete control of their markets. Complaints that Trusts charged unfair prices began with farmers and quickly spread throughout the population. The government responded by passing the Sherman Anti-Trust Act in 1890. The Sherman Act merely reinforced the common law principles against restraint of trade. Few Trusts were prosecuted under the Sherman Act in the year shortly after its passage. In Nineteen Fourteen, Congress passed the Clayton Anti-Trust Act, which specified practices which were illegal. The Federal Trade Commission Act also passed in Nineteen Fourteen, set up the Federal Trade Commission with authority to regulate business competition. There are two ways to view anti-trust policy. One is to at the firm's behavior to determine whether its actions hurt consumers. This is called the market performance approach. The other method is to use the firm's position in the market as the sole basis to make a ruling.

This is called the market structure approach. A monopoly can occur because of patents, control of inputs and government action. Economies of scale also assist in developing a monopoly. If a firm can lower costs by serving an entire market, it's called a natural monopoly. For such a market it may not be desirable to maintain competition and the public may insist on a government-regulated monopoly. Public utilities are examples of natural monopolies. They're usually regulated by a public agency, which decides the output and the rates a utility may charge. The regulatory agency allows the monopoly a fair rate of return on its investment based on total costs and demand. Regulated monopolies are often criticized for the rates they charge. Some critics say regulatory agencies give in too easily to the businesses they oversee. Some question whether the cost of regulating a monopoly is worth the benefits. Finally, since regulated monopolies are guaranteed a profit, critics charge that there is little incentive for cost efficiency. While monopolies tend to restrict supply and charge higher prices then if they were in a more competitive environment, there is an argument that monopolists may use their higher profits and freedom from concerns of competition to invest in basis research that could lead to dramatic innovation.

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Stasio: You've been listening to Economics U$A, one of a series of programs on micro and macro economic principles. Our guest has been Doctor Thomas Kratinaker, Law Professor at Georgetown University. The song "Rally Around the Grange" was performed by members of the Hutchinson Family Singers of Minneapolis, Minnesota. Economics U$A has been produced by the Educational Film Center in Annandale, Virginia. I'm Frank Stasio.

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