

**Evaluating Antitrust After One Hundred Years  
Honors Research Paper**

**University of Oregon  
May 31, 1991**

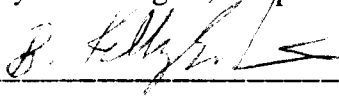
**Dawn M. Whalin**

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## Introduction

1990 was the 100 year anniversary of the Sherman Act and the beginning of Antitrust law. The original acts still remain, though over the years Congress has made amendments and the Supreme Court has made many interpretations. These have had a huge impact on business practices and created many divergent schools of thought with differing opinions on what should be done with antitrust. Today it is critical that we look at its consequences on competition and efficiency and decide if it has been successful in boosting the economy of the U.S., in order to guide its future.

Here are the main provisions of the acts:

### Sherman Act of 1890

Section 1. "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states or with foreign nations, is hereby deemed to be illegal . . ."

Section 2. "Every person who shall monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several states, or with foreign nations, shall be deemed guilty of a misdemeanor . . ."

Section 7, "Any person who shall be injured in his business or property by any other person or corporation by reason of anything forbidden or declared to be unlawful by this act, may sue . . . and shall recover three fold the damages by him sustained, and the costs of suit, including a reasonable attorney's fee."

The Clayton Act of 1914: Basically declared illegal these specified types of restrictive or monopolistic practices.

Section 2. Price discrimination.

Section 3. Exclusive dealing and tying contracts.

Section 7. Acquisitions of competing companies.

Section 8. Interlocking directorates.

Federal Trade Commission Act of 1914

Section 5. "Unfair methods of competition in commerce and unfair or deceptive acts or practices in commerce are hereby declared illegal."

Robinson-Patman Act of 1936: To amend Clayton section 2. This act focused attention on the buyer who fixed prices with the supplier in order to get advantages against the small trader.

Celler- Kefauver Act of 1936: To amend Clayton section 7. This act was meant to close a loophole that allowed mergers by purchases of assets. It also made explicit that the Clayton Act covered all mergers: horizontal and vertical.

These are the laws that businesses in the United States are supposed to abide by. Sometimes it is felt that someone has broken the law and gone too far towards harming the competition. When this occurs private parties or the government can bring a lawsuit against the party in question. The court decides guilt in two ways. First of all the law may be *per se* illegal. This means that all that must be shown is that the defendant did the behavior in question. It doesn't matter whether there were extenuating circumstances, or whether the act promoted competition. If it happened, then the firm committed a crime and will be charged. The rule of reason process is more flexible. It looks at the facts of the case, intent and consequences. It is a more enlightened view because there are really very few acts that are always wrong or harmful.

In this paper, I will attempt to give some different ways of looking at the acts antitrust makes illegal, specifically in vertical restraints. While it is true that these can be anticompetitive, they aren't always. And unfortunately many of them are *per se* illegal. I believe the courts should look more at specific efficiencies and inefficiencies caused by each action. Luckily this is beginning to occur as more economists get involved with antitrust decisions.

Of course, antitrust policy can not be determined from economic policy alone, and I'm not suggesting that it should be. Antitrust has many more intentions than creating efficiencies. But efficiency is important and economic theory can add a specific process for dealing with antitrust to alleviate some of the inconsistencies. I should acknowledge that economic policy contains many unrealistic assumptions. It tends to look at a static situation, it holds variables constant that would be changing in the real world, and finally, it almost magically comes up with a single first best solution. These are problems that must be dealt with. Economics over all is helpful and as one author of antitrust said, "whether lawyers like it or not, economics is here to stay."(14 p 116)

Not only is economics here to stay, but antitrust is too. There are cycles in which antitrust becomes more and less popular, or more and less influential. And at times cases are decided incorrectly and may cause more harm than good. Or there may be antitrust cases that should never have been brought to court, therefore wasting money and time. Yet overall, antitrust laws offer society hope for a strong, productive economy that will bring to the U.S. an increasing standard of living. So people continue to support antitrust despite its

problems. With increasing knowledge of consequences and efficiencies antitrust law should improve and become even better suited to support the economy.



## Original Intent of Antitrust

In order to understand antitrust and to critique its progress and appropriateness in today's business environment, we need to study its beginnings. In 1890 when Senator Sherman and the 21st congress passed the first act of United States Antitrust legislation, they had certain goals and intentions for the future. It is impossible for us, in 1991, to determine exactly what they were but we can make our best educated guess. As is true with any interpretation, not everyone has come to the same conclusions.

I would like to first look at the name "antitrust." Anti is defined as opposite or opposing. A trust is "a combination of firms or corporations for the purpose of reducing competition and controlling prices throughout a business or industry."<sup>(8)</sup> So very simply, congress was concerned with breaking apart trusts. But why? In the years following the Civil War, the United States experienced a huge growth of pools, monopolies and trusts. There were sugar, whiskey, caster oil, slate-pencil, and envelope trusts, to name a few.<sup>(12)</sup> The public began to see economic power as a growing concern. Our country was founded on democratic ideals of equality and freedom. Trusts seemed to be challenging these basic rights. This caused a fear and intense dislike of trusts, by most people, whether they understood trusts or not. The widely held opinion that trusts were bad prompted law makers to take action, and hence oppose these numerous trusts.

By 1890 twelve states had already passed antitrust laws.<sup>(12)</sup> Senator Sherman was merely summing up public opinion when he said, "If Congress failed to address the problem, there would 'be a

trust for every production and a master to fix the price for every necessity of life."(1 p 27) The Sherman Act passed in the Senate with a vote of 52 for and 1 against, obviously the time was right to take action.

Some logical goals of antitrust follow from this response to the public's fear and dislike of trusts. One is to please the constituents and calm their fears. Antitrust was really the result of a strong populist movement. Another goal was to protect competition. And another was to keep economic power out of the hands of a few elite, making sure that it stayed spread among the people.

Before going into more detail on these, and other goals, we should look back at the intellect and academic knowledge available to the lawmakers. We tend to judge past occurrences without taking into account their time frame. In the late 19th century economic theory was very different from how we know it today. Keynes was only seven years old in 1890 and the Chicago School was unheard of. The economists of the time were just beginning to deal with marginal value theories, not efficiencies of business structures and practices. In fact some people assert that the field of micro-economics grew from a desire to study antitrust laws and their consequences.(14) Rather than antitrust being the product of a well thought out efficiency maximizing economic model.

Yet some economists today, such as Bork, argue that efficiency was the number one goal that congress had in mind. This is probably a much too easy and simple conclusion. Lawmakers had many concerns, which they discussed before writing the final drafts of the acts. They talked about the high product prices charged by trusts

and the low input prices paid by suppliers.(12) If they had known about economic theory, they would perhaps have said these differences cause profits and restrictions of output, resulting in a dead weight welfare loss. So, implicitly, they were concerned with getting rid of market inefficiencies thereby protecting consumers.

Free competition was also a major concern of the Sherman Act. Basically sections 1 and 2 explicitly declare any acts that might restrain or limit trade to the most powerful companies to be illegal. Adam Smith had shown that a competitive market system would naturally regulate itself and keep economic power at safe levels. As the people saw that the market system was not maintaining its competitiveness, they realized that rules or laws were needed to keep industries acting competitively. The basic nature of a competitive system is to innovate and reach for abnormal profits. The system needs profit incentives to grow and improve society. Yet the more successful or profitable companies are, the less competitive the system may become. So Congress established antitrust in order to preserve the competitive market, which would in turn be a natural regulator of economic power.

They also discussed issues dealing with the rights of laborers. Congress was concerned with the danger of riots in reaction to the trusts and with allowing the workers to combine and form unions in order to battle the trusts.(12) In fact many senators wanted to grant exemptions from antitrust for the unions. This goal could potentially conflict with the desires for free competition and efficiencies. Traditionally unions have fought for wage increases, which could cause costs to increase and output to be restricted. Perhaps Congress

was more interested in fairness and a decent standard of living than always achieving what we now know of as the perfectly competitive price and output.

Senator Edmunds at one point said, "Although for the time being the sugar trust has perhaps reduced the price of sugar, and the oil trust has certainly reduced the price of oil immensely, that does not alter the wrong principle of any trust."(12 p 346) Essentially he is saying that low prices which may benefit consumers and perhaps increase efficiencies in the short-run , are not good if they come about as the result of a trust. This suggests that Congress had a fundamental concern with industries having excessive power, even if that power had good consequences. This makes clear the apparent confusion of the Congress and how they established many conflicting goals.

One of the first antitrust cases was *Chicago Gas Light and Coke Co. v. The People's Gas Light and Coke Co.* , 1890.(12) In this case the city where the companies sold their services had been divided into two exclusive territories. Essentially, they created their own monopolies. The court said that this dividing arrangement was unenforceable because companies involved in public service could not legally make this type of deal. The court did not say it was illegal because it was a restraint of trade. They did not look at the possible merits such as increased customer service or a reduction in fixed capital such as duplicate pipelines for gas to reach all areas of the city. It was a very simple decision based on power; the court did not like the control the trusts and other large companies had, so they were trying to take their ability to control away.

As I mentioned earlier, antitrust could be viewed as a set of rules to maintain a competitive market system to solve the economic power problem. Adams and Brock in an article on the Sherman Act call antitrust "a social blueprint for controlling power."(1 p 29) They say that economic power is used in an arbitrary and unaccountable way to run economic affairs; therefore it is an irresponsible and unstable base for the economy. Economic power has many consequences that lawmakers were trying to control by passing antitrust laws.

Economic power has ramifications in many areas of society, making it a formidable challenge for antitrust. Even though many of its consequences were not as evident as they are today, the Congress wisely saw its potential to cause problems and made a good attempt to stop it. Economic power is really the root of economic inefficiency. It allows firms to artificially raise prices and stabilize them at these levels. This can cause severe problems to the macroeconomy, especially when firms keep prices high during recessions. Large corporations have the ability to manipulate the government to provide regulation, grant them monopolies, or pass tax laws that are more lenient to big business. Therefore they can increase their own economic power and drive the smaller companies out of the market. Economic power can also bring about private planning power. Influential firms can dictate the allocation of society's resources and arrange the economic landscape.(1) A good recent example of this is a case with GM. GM bought out the efficient urban rail transit systems in Los Angeles and put them out of business in order to sell more cars.(1) This drastically changed the commuting system and

the amount of pollution in the air increased. In effect they took over the job of an urban planner without any concern for society's well being. All they cared about was using their economic power to increase their profits and power. So even if the 21st Congress didn't understand the full extent of economic power, they did see it as a problem and one of their original intents was to curb it.

One reason legislative intent may be difficult to discover is that the legislators themselves were confused about the appropriate goals. Senator Sherman said "I admit it is difficult to define in legal language the precise line between lawful and unlawful combinations. This must be left for the courts to determine in each particular case."(12 p 354) They were merely attempting to set up some guidelines for the court. Robin Carey developed a reasonable list of possible guidelines that Congress had in mind.(12 p 356-357) The first is that the competitive market should be made of many competitors. The second is that the operation of the market should not crush out all the small competitors. Also Congress seemed to intend that monopoly by a small business over a small market that was gained completely by superior skill and intelligence should not be considered illegal. Mergers, trusts and any other combinations should be illegal if they create an economic entity of excess size and power. So far it is evident that Carey sees protecting competition and maintaining the small competitor as a fundamental goal. Actions contrary to this should be deemed illegal.

Carey also notes some political goals. Congress did not want workers and farmers to be prohibited from forming groups. They needed to be able to protect themselves from large corporations.

Also large corporations shouldn't be allowed to exert political power. In addition Congress wanted to prevent exclusionary practices that threatened competition. The last goal Carey suggests is that all predatory pricing should be forbidden. I feel that Carey has done an accurate job of assessing what Congress intended.

Of course there are other views on original intent. Robert Bork believes that the sole goal was to increase allocative efficiency without harming productive efficiency and keeping consumer welfare at the same level. He calls this goal consumer welfare, but it's more aptly called a goal of economic efficiency.<sup>(17)</sup> He acknowledged the ambiguousness of the antitrust laws in his book The Antitrust Paradox and makes a very interesting suggestion:

"It would have been best, . . . , if the courts first confronted with the Clayton Act and later the Robinson-Patman Act had said something along these lines: We can discern no way in which tying arrangements, exclusive dealing contracts, vertical mergers price differences, and the like injure competition or lead to monopoly. We certainly are unable to estimate the likelihood of such results in their incipiency. For these reasons, and since the statutes in question leave the ultimate economic judgment to us, we hold that with the sole exception of horizontal mergers, the practices mentioned in the statutes never injure competition and hence are not illegal under the laws as written . . . Congress may think our judgment wrong, or it may have other reasons to outlaw certain of the practices involved. Should it enact a law describing what is to be outlawed with

some particularity, or enunciating criteria that we are capable of applying, we will of course enforce the law."(9 p 410)

Interestingly, he seems to be saying Congress was not clear in its intentions. Therefore the courts had to make their own decisions without clear guidelines. He sees this as the main reason antitrust laws have had problems and many times have allowed for inefficiencies and condemned efficient situations. From this it doesn't necessarily follow that Congress had one specific intent in mind. If they had, I tend to think their laws would have been very clear and concise with little room left for questions. Instead I believe, as do the majority of other economists, that Congress had many intentions for antitrust laws and due to their many goals and their possible conflicts, antitrust laws could not be written out as specifically as Bork suggests they should have been.



## The Antitrust Intent of Today

Even though it seems that Congress' original intent was quite complex and covered a wide variety of problems, today's intent seems to be focused mostly on efficiency and protection of a competitive environment. Some people believe this change has come about from the Reagan Administration's policies. Others feel that work in the law field, and industrial organization economics is influencing the case law, and changing the direction of antitrust. It really appears to be a mixture of both. Reagan appointed many judges and his Chicago School view of the economy most certainly had an impact on new policy, and how government agencies dealt with antitrust problems. These affected case law, as well as the new academic findings. Case law and rate of enforcement, in turn are the bases for seeing how antitrust is moving.

In the 1980's there was a general decline in antitrust enforcement. This is shown in the judges' case rulings and in statements by antitrust authorities. One judicial judgment dealt with vertical integration. In *Copperweld Corp. v. Independence Tube Corp.*, it was decided that any conspiracies between the parent company and its fully owned subsidiary are not actionable.(21) Thereby giving them the right to fix prices, or deal exclusively with each other. In the past this was sometimes seen as an illegal restraint of trade. Also in *Monsanto Co. v. Spray-Rite Service Corp.*, (1984) the court made it much harder to prove resale price maintenance. They ruled that a "supplier's cut-off of a price-cutting distributor is insufficient evidence of conspiracy to maintain resale

prices."(21 p 789) Thus making it much harder to prove resale price maintenance and indirectly lowering the number of RPM cases that will be brought to court. In fact, in the last eight years the Antitrust Department has not had any vertical price fixing cases, despite the fact that the Consumer Goods Pricing Act of 1976 made RPM *per se* illegal.(20) These cases represent the movement towards a more lenient antitrust system, based on efficiency.

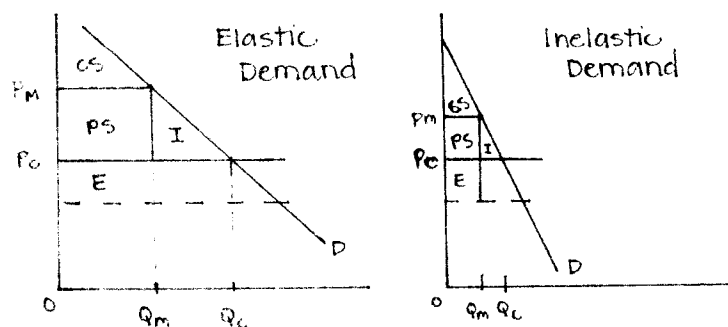
Within the government's antitrust division, the attitudes of the 1980's were much less restrictive and more geared towards efficiency. In 1981, William Smith, the attorney general, said that "promotion of competition" was the policy of the Department of Justice. He also pointed out that "bigness in business does not necessarily mean badness" and that "efficient firms should not be hobbled under the guise of antitrust enforcement."(25 p 994) The assistant attorney general, William Baxter said "although not always . . . corporate size would seem to be symptom of efficiency and success" and the "sole goal of antitrust is economic efficiency."(25 p 994) The movement is also evident in the 1984 merger guidelines which say that the Department will assume the "primary benefit . . . is their efficiency-enhancing potential which can increase the competitiveness of firms and result in lower prices . . . As a consequence, in the majority of cases, the Guidelines will allow firms to achieve available efficiencies through mergers without interference from the Department."(25 p 996) But this is a much more extreme view than the courts have taken. Even though much of the case law points towards efficiency as becoming increasingly important, the court still asserts that there are other factors. They

want to look at the original intent of the Sherman Act, therefore they maintain that an act that increases efficiency can still be *per se* illegal.(25 p 997)

One of the main reason's for this shift in antitrust is a desire for a clear and predictable policy. In the past court decisions have contradicted each other, making it hard to decide new cases by looking at precedence. Also it is hard for corporations to follow rules and for the Department of Justice to enforce them if they aren't concise. Luckily, the field of economics has grown and prospered since 1890. A possible antitrust violation can be analyzed in a somewhat simple and predictable way. If we can estimate demand, supply, and cost functions we can analyze the surplus changes and the dead weight welfare loss created or changed to surplus. As one assistant professor of law, Robert Lande points out, it is simple to just measure and compare triangles and rectangles.(17)

Lande asserts that by graphing the demand functions we can determine areas of E and I. In this example of inelastic demand, the merger should be allowed since  $E > I$ , therefore total surplus increases.

E = efficiency gained  
 I = inefficiency  
 PS = producer surplus  
 CS = consumer surplus



These changes in antitrust thought have manifested themselves in two views: the Harvard School and the Chicago School. The Harvard School view likes a laissez-faire economic system, but also wants government to intervene if certain business practices have an

adverse effect on the market structure and performance.(5) They are also believers in the idea that Congress had a variety of goals when establishing antitrust, though they focus their attention on behavior that creates barriers to entry. Two examples they give are: high expenditures on advertising and product differentiation. To prove their point they cite studies which give evidence that relates profits to certain market structures and that shows antitrust law has significantly increased competition. Therefore they support antitrust and want to continue to use it to break down harmful barriers to competition.

On the other hand, the Chicago School wants to dismantle antitrust. They feel that the mainstream is not using the basic tools of economic theory. If they were, Chicago School feels they would see the inefficiencies in their theory. A big difference is found in their definitions of entry barriers. Stigler says an entry barrier is "any cost of production that must be borne by potential entrants but is not incurred by firms already in the industry."(5 p 144) So expenditures on promotion or advertising are not barriers to entry. They are just part of competition and are actually evidence of a superior product or an efficiency, according to the Chicago view. This view, as I've mentioned before, is the initiator of the single antitrust goal of efficiency. The two schools of thought contain some major differences; but both are represented in today's interpretation of the intention of antitrust. Despite their differences they do show a movement towards efficiency and economic analysis overall, even if they don't agree. Chicago has a more extreme case against antitrust, whereas the Harvard view is much more conservative.

## Vertical Restraints and Antitrust Law

Aside from the theories about antitrust intents and what intent should be, cases are continuing to be brought to court and judges are making decisions. These decisions create case law which is at times efficient and at other times inefficient. Either way it is informative to look at the actual antitrust cases and make a judgment. Antitrust law has dealt with many problems found in business practices since 1890. Through time as industry has evolved some practices have become more prevalent and antitrust cases reflect these changes. One important area in today's market is exclusionary practices. This includes any action taken in an effort to force rivals out of the market. Under this heading, I would specifically like to look at vertical restraints: tying, vertical mergers, and resale price maintenance. These are all ways in which a firm vertically integrates possible illegal behavior into their structure and behavior. These actions can be interpreted to be anticompetitive and are therefore under the jurisdiction of antitrust law.

### Tying Arrangements

Tying arrangements are generally taken to be *per se* illegal in U.S. courts. Tying exists when the seller of a good makes the consumer buy another good (the tied good) in order to purchase the good they originally wanted (the tying good). The consumer cannot simply buy the one desired good. Typically this has been seen as discriminatory and as causing an inefficiency. The producer is using the market power they have in the tying good market and extending it into other markets. By doing so they not only harm the consumer, but also competition. Other producers of the tied good lose the

market of consumers that are forced to buy the product from the firm with monopoly power. In most cases, this monopoly power has come from a patent, so the power in the tying market is legal.

Basically the leverage theory of tying sums up the whole problem. It says "If the producer of product X has a monopoly, then by tying product Y to the sale of X, the monopolist can gain a monopoly in product Y. Other producers of product Y are excluded from selling to purchasers of X. Therefore, the seller of X transfers his monopoly power in the tying product to the tied product."(7 p 229)

The test to determine *per se* illegality is fairly simple. First the court determines whether the firm has economic power in the market for the tying good. If they do, the next step is to determine if they possess substantial commerce in the tied good's market. If both of these can be shown, then the firm has committed a *per se* violation of the antitrust laws.(23 p 109) These criteria have some basic problems. Some economists argue that market power is often wrongly assessed by the courts.(24) Legal patents, copyrights, or a distinct product don't indicate harmful market power. Also the courts often look at large dollar amounts of sales of the tied good to show market share or a tendency to monopolize rather than looking at concentration ratios or influence on the market as a whole.

Unfortunately this type of test fails to note the differences in motives and consequences found in the variety of possible tying arrangements. There are basically five different situations in which tying arrangements can be used.(10a) The first case is that of goods used together in fixed proportions. For example, right and left shoes or nuts and bolts. In these cases the price of the combination is the

only one of interest since the products are only useful together. If the monopolist has power over bolts, and the nut market is perfectly competitive, they can't increase the price of the tied nuts and increase profits. Consumers look at the package deal and will demand less, therefore causing total revenue to decrease. Therefore in this case tying does not yield any more monopoly power.

The second case is when the tied good is used as a counting or metering device. There are two reasons that a firm will decide to meter. The first is in order to price discriminate. At times a firm will have a patent over an industrial machine. In order to maximize their profits they will want to charge more to the customer who will use it more and less to the customer who will use it less. These consumers will have different value determinations of the product and the producer would like to charge them each the maximum they are willing to pay. This is very hard to do since firms can lie about how much they value the good, or the lower use firm can buy from the supplier and then sell it to the high use firm at some median price, making both of the consumers better off. But since this is a patented good, the firm is legally entitled to the monopoly profits. Therefore they can maximize profit by selling the good at cost and then selling the necessary input as a tied good at a price to achieve monopoly profits. An example is a fax machine. The machine could be sold or leased at cost to all consumers, but the necessary paper could be sold at a monopoly price. Therefore the consumers will separate themselves into different use markets and the producer can maximize profits in each one.

The second reason is to measure actual wear and tear on the product and charge appropriately. The producer will behave the same as before. Either way, they aren't effectively gaining any more monopoly power than they would have had. They are perhaps gaining market share in the tied good that they wouldn't necessarily have had. And this may act to exclude competitors from joining the tied good market. At the same time they are acting more efficiently and charging consumers by their reservation prices. They need to realize their monopoly profits for the patented good and tying may be the only way to do it. If firms never received their profits on these types of goods, research and development expenditures would possibly decrease and society would then see some inefficiency.

Technological interdependence is the third tying rationale. In this situation the firm is concerned about their own reputation and the success of their product. An example is a patented tabulating machine. The machine may only work effectively with a high quality card. The card may not be patented so anyone can produce and sell them. If a consumer uses the lower quality card, the tabulating machine will be inaccurate. This makes the producer of the machine seem to be at fault or could even damage the machine. By tying the proper cards to the tabulator the seller is merely trying to increase efficiencies by making sure the machine works correctly. Tying in this case is not being used to gain monopoly power.

Next comes the case where there are economies of joint production and scale. The classic example is shoes and shoelaces. You can only purchase shoes with laces, though you can purchase additional laces separately. We need them together and few people



would argue that selling them together is actually an extension of monopoly power. In fact it probably helps the consumer because they may cost less together than separately. The producer can save money by shipping them together and by not having to package each separately. These cost savings are then passed on to the consumer, with few complaints.

Finally comes the case where two complementary goods are tied together. With complements, the price of one affects demand for the other, so it is preferable to the producer to get the optimal combination to maximize profit. By determining price and quantity of the tying good, the price and quantity of the tied good are determined, therefore leverage is present. This is the only case where tying is an extension of monopoly power. In addition this type of arrangement causes no extra efficiencies. This is the only type of tying which should possibly be *per se* illegal.

An important tying case which has been cited in almost every following tying case is *International Salt Company, Inc, v. United States* (1947).(7c) In this case the producer had patents on two machines which use salt. One injected salt tablets into canned products and the other dissolved rock salt into a brine, to be used in various industrial processes. They were tying their salt to the lease of these patented products. There were some rather interesting conditions. International Salt said that the contracts contained clauses which allowed the lessee to buy salt from another producer, if they could do so at a lower price. They also claimed that their salt had a higher sodium chloride content and was therefore better to use in their machines. The Supreme Court ruled that this behavior was a

constraint on competition and in direct violation with the Sherman Act; therefore *per se* illegal.

Using the more modern economic analysis outlined above, this behavior would be legal. International Salt was not spreading their monopoly power. They were not gaining monopoly profits on the salt. In fact, they were selling at a very competitive cost, below or equal to their rivals. Also I doubt that this tying arrangement gave them a monopoly size share of the salt market. These were just two possible uses of salt within a huge market. They had no power over any other part of the market. They argued that they were merely protecting their product from lower quality salt, thereby reducing maintenance costs and maintaining the reputation and quality of their patented product. It seems that this arrangement, decreased costs and increased efficiencies without creating any new monopoly power.

Another case worth considering is *Siegel et al. v. Chicken Delight, Inc. et al.* (1971).(7e) Chicken Delight was a fast food franchise that let people use its trademark and start a franchise only if they would buy the cookers, food mixes, and packaging from them. Chicken Delight made its profits by charging monopoly prices for these tied goods rather than from royalties. The court decided that this was a restraint of competition and *per se* illegal. Chicken Delight argued that this was essentially the same as charging a royalty fee, yet better because it allowed them to control the quality and consistency of their franchises. They said that their trademark was not separate from their packages, mixes and equipment. The Supreme Court said evidence of their market power was in their

strong trademark and the fact that they were able to enforce these tie-ins. The decision of *per se* illegality was affirmed, even after appeal.

Today, with a more Chicago based theory this case might have gone much differently. This decision almost seems ludicrous. It seems very reasonable that the franchise had to buy Chicken Delight's products. We have grown to accept that all fast food restaurants operate in a like manner. Every McDonalds is exactly the same, and we wouldn't have it any other way. From a more economic view, we could note that a trademark is not evidence of market power that can cause leverage. A trademark would mean that the firm had market power against potential rivals because it would be able to blockade entry. But it wouldn't necessarily give the firm power over the franchise. In addition this is really just a case of a tied good being used as a sort of metering device. Instead of charging a flat fee, the high volume franchises would pay more because they purchased more. This is really more efficient since price is being based on costs. It is evident that they were protecting goodwill and assuring a standardized product to their consumers. Also since Chicken Delight was producing goods for all it's franchises, they were most likely achieving some economies of scale. Transaction costs could be kept to a minimum, since the franchise was able to purchase all necessary goods from one supplier. Perhaps this behavior does cut out some competitors, but in an economic analysis the benefits must exceed the costs, otherwise it wouldn't be done.

My analysis of these cases is more lenient than the actual judgment. This is due mainly to a shift towards using efficiencies as the criteria for legality and a new understanding of leverage theory. Most economists today believe that this trend of deciding tying arrangement cases is a good one. Unfortunately, the case law which continues to be used as precedence conflicts with these ideas. Relevant cases need to be brought to court so that case law can be changed. This is also a continuing problem in the other areas of vertical restraints.

### Vertical Integration

A vertical merger is another exclusionary practice that the antitrust laws are trying to control. A vertical merger is the linking of two levels in the production process that would normally have a buyer-seller relationship. Traditionally, it's believed that this will allow monopolies to spread their power into other markets and decrease competition. Vertical mergers will also foreclose on competing firms, further hurting the market. The courts generally use a rule of reason approach to assess the illegality of vertical mergers. They look to see if mergers may substantially lessen competition. Congress did acknowledge that certain mergers can benefit competition. This is more insightful, but still has problems. Many vertical mergers allow for efficiencies and a cut back in costs which benefit producers and consumers alike. Unfortunately the court has not looked at vertical integration in the same way an economist would, thereby failing to always provide efficient, predictable rulings. In *United States v. Griffith* (1948), the court said "the use of monopoly power, however lawfully acquired, to foreclose

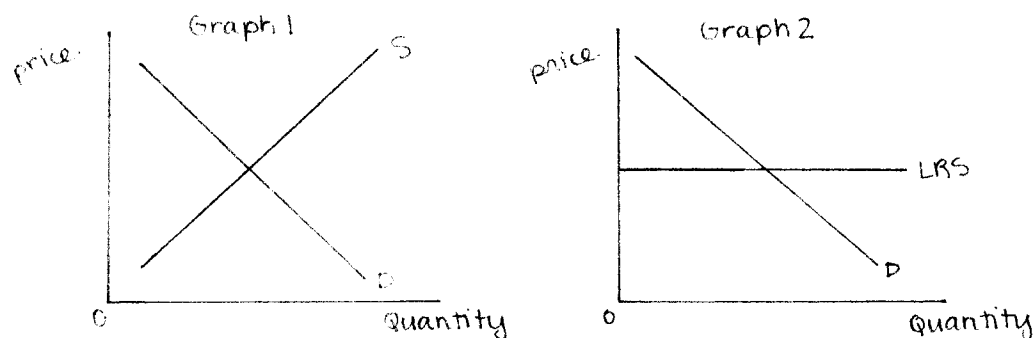
competition, to gain a competitive advantage, or to destroy a competitor is unlawful."(24 p 305) So even if the court says they use rule of reason to judge these cases, the precedence is effectively discouraging vertical mergers even if they are economically beneficial.

In some situations vertical integration is plausible for the firm and socially desirable.(10d) This has been known for quite some time. In 1937 Coase developed a theory of the firm which outlines reasons why vertical integration will occur.(13) Basically there is an information failure in the market so that the price mechanism and the invisible hand do not necessarily allocate resources properly. Instead an entrepreneur is needed to organize resources. Market transactions have a cost due to the information failure which can successfully be reduced by vertical integration. Detailed contracts are less important within a cooperating firm, there isn't a need to discover relevant prices, and normally there is no sales tax on transactions within a firm. All of these effectively reduce marketing and organizing costs, therefore causing efficiencies. Coase and others with theories of the firm(2) may actually argue that vertical integration is a natural way to correct a market failure, not cause one.

Sometimes there are interdependencies in the technological process. This is when the design or raw materials used in one stage of production have a large affect on costs in another. Or the reputation of the final product may depend on the quality of the inputs. In these cases the firm has a vested interest in vertically merging in order to protect their image and market share, to

maximize profit. It is also a great way to insure that you will always get the necessary inputs in the right quantity and at the right time to meet demand. All of these cases develop efficiencies and help to better serve society.

In some situations the producer may have some monopoly power and wish to vertically merge.(10d) These cases are a little tougher to analyze. They may or may not be creating an efficiency. In some cases firms are able to use their existing power to participate in anticompetitive practices. One case is where there is no opportunity for substitution of inputs. If a monopoly exists at one level of production and at an input level there exists an imperfect market (where price exceeds marginal cost), then by merging with the inputting firm, the monopolist can gain more monopoly profits, by saving on costs. This can be seen in this simple example:



A non integrated firm perceives the supply schedule in graph 1. If you are buying from a firm with market power, as quantity demanded of the input increases, price will increase and the firm will experience increasing marginal costs(MC). If a vertical merger were to occur, the firm would no longer pay the inputting firms profit. It would perceive constant MC, as in graph 2. Therefore a firm can integrate, quantity produced will increase and prices will be less

than before the merger, since the firm is now perceiving constant MC for that input.

The harmful practices occur when inputs are substitutable. The monopolist will choose to integrate downward and force companies to only purchase their inputs. This harms other suppliers of the input. If this firm is the only buyer of the input, the monopolist can effectively foreclose the market to all the other suppliers. Another case where the monopolist can cause harm is when the firms they sell to have different elasticities of demand. In order to price discriminate the monopolist can merge with the firms with more elastic demand, and sell to them at a lower price while selling to firms with inelastic demand at a higher price. This insures that the firm with elastic demand won't resell to the other firms, since they are now a subsidiary. This enables the monopolist to gain power and to price discriminate where they were previously unable to.

These last two situations involve the monopolist gaining power by vertically merging and should be illegal. A third harmful situation involves the large scale company caused by vertical integration. At times it is not feasible to enter the market and compete with a large firm at just one of their vertical levels. For example, if an entrant wants to produce a new soft drink but doesn't want to produce all the ingredients and do all the distribution themselves their transaction costs may be much higher per bottle than Coca Cola's who does all of this. Also it may deter entry and therefore competition, if the only way a firm can compete is to enter the market at the same scale as the monopolist. This may be the

case if a monopolist controls all the channels. As in my soda example, if all the distributors were owned by Coke, the entrant would have to enter at a large enough scale to get their product in to the market. It is much more costly to enter a vertically integrated market, so it will occur less often. Firms may also be able to practice predatory pricing. They can use profits at one level to subsidize another level that is charging at a price lower than marginal cost. Also it is easier for the large firm to hide these types of anticompetitive practices within their financial accounts. A final way vertically integrated firms can act anticompetitively is through price squeezing. If a monopolist provides inputs to many firms they can sell to themselves at cost and to competitors at a monopoly price. Then the monopolist's final price will be based on lower costs, so they can under price competitors and squeeze them from the market.

*Brown Shoe Company, Inc. v. United States* (1962)(7a) has been a very influential case on decisions of merger legality. It involves elements of horizontal and vertical mergers, but I will just deal with the vertical elements. In this case Brown was a large manufacturer of shoes, supplying 4% of the nation's footwear in 1955. Kinney was mainly a shoe retailer. They controlled 1.2% of national retail shoe sales and .5% of production. Before the merger, Kinney didn't sell any of Brown's shoes, afterwards 7.9% of their shoes were supplied by them. The court felt some efficiencies would be gained, but overall competition would be hurt. The trend in this industry was moving towards greater concentrations and this merger was viewed as one of the main causes of this undesirable trend.



Looking at this case in light of my previous comments on vertical mergers, we can see some possible efficiencies. Transaction costs would decrease since there would be no bargaining or negotiating between Brown and Kinney. Brown would be assured a buyer and Kinney assured a supplier, thereby decreasing inventory risk. Brown could control the reputation of their shoes more efficiently, since they are now acting as a retailer. When a company has some market power they may be able to extend it and foreclose rivals from the market. In this case even though Brown was one of the largest shoe manufacturers, it only had 4% of the market. And after acquiring Kinney they only supplied 7.9% of their shoes. It does not seem that they were wielding any substantial monopoly power in an effort to foreclose competitors from the shoe market. Furthermore, the benefits of merging must exceed Brown's costs, for an economic view would determine that they wouldn't merge otherwise. Therefore it is highly probable that there is an efficiency gain from this vertical merger and highly questionable as to whether it is actually harming competition.

A second antitrust case involving vertical integration is *Ford Motor Company v. United States* (1972).<sup>(7b)</sup> Ford, GM, and Chrysler accounted for 90% of the automobile market. All cars need spark plugs and in 1960, there were three manufacturers, one of which was Autolite. Ford successfully acquired Autolite's only spark plug plant, so that it could become a part of the profitable replacement spark plug market. Apparently spark plugs are replaced about five times in a car's life. The common practice among mechanics is to replace them with the brand already in the car. Therefore the brand

used most in original production will realize a greater market share. After Ford acquired Autolite, its main competitor, Champion, experienced a significant market share decline from 50% in 1960 to 33% in 1966. It was found by the court that this vertical merger substantially lessened competition. One reason is that previously Ford was a potential entrant in the spark plug market and therefore acted as a deterrent to the exercise of market power. Secondly, by acquiring Autolite, Ford was erecting a barrier to entry. The court ruled that "a merger is not saved from illegality under (Clayton Act) sec. 7 because . . . it may be deemed beneficial."(7b) Ford said that this acquisition made Autolite a more formidable competitor in the market. Also Autolite opened a new spark plug factory which by 1964 had 1.6% of the domestic market. Therefore Ford contends that this vertical integration fully enhanced competition.

This case is very different from the Brown Shoe case. Ford did have a major share of the market and definitely possessed monopoly power. By acquiring a spark plug manufacturer they were foreclosing from the other competitors a major part of the market: Ford cars. In Brown Shoe there was not a full foreclosure of the Kinney retail market. In addition Ford wasn't really achieving any cost savings by acquiring Autolite. The spark plug companies were already selling to car manufacturers at below cost in order to gain market share in the oligopoly market of replacement spark plugs. What Ford cited as increased competition was miniscule compared to the existing companies. If they had entered the spark plug market by internal growth, rather than acquisition they could have enhanced competition. In this case the actual act of vertically merging was the

problem. I believe the court was correct in their decision, Ford was using its monopoly power to create monopoly power in another market. The efficiencies created are debatable, but the harm to competition seems very real.

Vertical integration is prohibited in many areas of the antitrust law. It is true that sometimes vertical mergers can foreclose markets, raise prices and harm competition. Yet they also decrease transaction costs, pass on cost savings to consumers and allow producers to insure quality products. The goals of antitrust include increasing efficiencies, protecting competition and the more political goal of pleasing the people. Vertical mergers in many cases achieve exactly these goals. The courts need to be more careful in their analysis and perhaps ease their stance. Economic analysis is hard to do in many cases, but the efficiencies gained make it worthwhile to apply it here.

#### Resale Price Maintenance

Resale price maintenance, or RPM, is the last vertical restraint I wish to discuss. RPM is when manufacturers set a uniform price or a minimum or maximum price level that retailers must charge. It is basically done to keep retailers from discounting brand name products which the manufacturer wants to keep a certain image, or level of service associated with. Currently this sort of behavior is *per se* illegal. Yet, as I mentioned earlier, the Antitrust Department has not had a single price fixing case in eight years. The Reagan administration took a more Chicago view of exclusionary practices. Bork, a strong Chicago school economist, recommends, "The law should abandon its concern with such beneficial practices as . . . all

vertical and conglomerate mergers, vertical price maintenance, . . . , tying arrangements . . . and the like."(9) Obviously, the views on antitrust laws dealing with RPM vary greatly. Some economists think these laws are very helpful and should be enforced, others want them abolished. Just as with any other business practice, RPM has its good and bad effects on efficiency and competition.

Resale price maintenance has had a very interesting history. Vertical price agreements can't work unless the manufacturer can make a contract with all the retailers who sell their product, and enforce it. This was recognized and in 1931 California passed the first State Fair Trade law. This law exempted RPM agreements from the state's antitrust laws. Then in 1933, California passed a "nonsigners" clause, which enabled manufacturers to enforce a RPM agreement with one retailer, onto all other retailers of their brand. On the federal level, in 1937 the Miller-Tydings Act exempted interstate RPM agreements from the Sherman Act. The conditions for exemption were that the goods needed to be name brands and the state law had to allow RPM. The law also allowed manufacturers to refuse to deal with retailers and wholesalers who didn't follow the pricing guidelines. Case law has varied depending on the degree of exclusion and severity with which manufacturers tried to enforce these price agreements. It seems the law was fairly lenient until 1976 when RPM became *per se* illegal.

Resale price maintenance agreements can be procompetitive.(11) They are usually used on brand name goods, which have a lot of advertising and promotion costs associated with them. If the consumer benefits from this type of information, then

they are worthwhile and should be supplied. The problem is that they may not be unless a price floor is set. Without a fixed price discounters can choose to sell at a lower price and free-ride off of the advertising paid for by other retailers. The discounters will tend to get a lot of the actual purchases. This hurts consumers because full price retailers won't be able to afford promotion. There are also many complex goods which require a lot of explanation on use or added services. It would be possible without RPM for consumers to go to full service retailers for information and then purchase the good from a discounter. There would be a free-riding problem, and eventually the services would not be offered. Information is a critical assumption in the competitive market model, and in cases like this, RPM enables it to be supplied. It also hurts the small full price, full service businesses that can't compete with the big discounters. Therefore small competitors can be saved by RPM.

Quality can also be assured to the customer by vertical price restraints. Many goods and brands have certain images that can be undermined if they are sold at discount outlets. Polo shirts, gucci bags and rolls royces may lose their appeal if everyone could afford them. Status goods may depend on RPM agreements to maintain their market demand. Also with these agreements the manufacturer can choose their retail outlets and insure that there is an efficient number. This does decrease intrabrand competition, which is competition among retailers of the same brand. But it increases interbrand, or competition between different brands. Some economists believe that interbrand competition is really what the antitrust laws were trying to preserve. These nontangible goods and

processes are of value to the consumer and in some cases we need a way to charge for them to create a market in order for them to continue to exist.

On the other hand, RPM agreements can be used for anticompetitive purposes also. By allowing them, we are effectively creating a government sponsored cartel. From the consumer's point of view, a manufacturer practicing price fixing and a cartel doing it have essentially the same consequences. Either way price and quantity are not set by the competitive market. There are strong theories of the competitive market setting its own prices, which say that those prices will necessarily be efficient. If we allow RPM agreements it is more than likely that the prices will not be set in such a way that marginal social benefit equals marginal social cost. Therefore there will be a misallocation of resources and a loss to society.

Pricing agreements can also be used to monitor or police cartel arrangements. If a cartel of manufacturers or dealers exists, this would be an easy, legal way for the members to check up on each other. They would also be provided with a legal ground on which to punish the nonconforming member. It is pretty much accepted that cartels are anticompetitive. Therefore if RPM can help them to be more successful at a lower transaction cost, it is almost encouraging firms to cartelize.

RPM raises price to a uniform level for all retailers. This may cause an increased level of profit in the industry, which would act as an incentive to entry. In this type of situation, manufacturers would keep prices high and compete with quality or services offered. They

will incur large advertising and service costs in their competition. This type of competition can lead to too much variety offered or too many services.(10c) Society does not need this duplication, and can actually be hurt by it and by the nonprice competition that RPM agreements may stimulate.

One important issue to realize when looking at any vertical relationship in business is that the buyer and seller are dependent on each other.(19) As with any relationship there will be an exercise of power. Sometimes this is ignored in the laws and by judges deciding cases. This power relationship is assumed not to exist and if it does, then it is assumed that there is a market imperfection present. Modern marketing often uses a push type of strategy in which each successive link in the product channel pushes the next to get the product sold. In this relationship, power is important, it helps the channel to flow. When courts are analyzing RPM and other vertical constraints they need to recognize that these power relationships exist and are an important part of the marketing process.

The case law concerning vertical price fixing, is inconsistent. In *United States V. Colgate & Company* (1919) (7f), Colgate was accused of violating the Sherman Act. They were setting retail prices and refusing to do business with retailers who wouldn't follow them. They sent out detailed letters describing prices to be charged, they conducted investigations, and published lists of retailers who had not followed the pricing guidelines. The court ruled that this was perfectly legal. No contracts were involved, Colgate was merely practicing their right to choose with whom they wanted to do

business. They were not creating a monopoly, or forcing retailers to behave in a certain way. They were setting up guidelines and allowing retailers to decide for themselves what they wished to do. As long as the supplier announced their policy in advance and no contracts were made, RPM was perfectly legal.

The Chicago school would probably applaud this ruling, which is known as the Colgate doctrine. It allows firms to behave as they wish without interference from the law. The important topic here is whether or not a written agreement is really important or not. The consumers are most likely affected by the price setting in the same way regardless of how it's achieved. The court is allowing Colgate to maintain above normal profits and discriminate among retailers. Unfortunately the court's opinion does not include a discussion of reasons as to why Colgate was doing this. They don't give a defense argument. I can't see any real efficiency gained by Colgate. They don't sell goods which require a high level of service, and price image probably doesn't influence demand for their product. This type of behavior, with or without an actual contract most likely harms competition and decreases efficiency and perhaps should have been declared illegal.

While at times the court is excessively lenient with RPM, it can also be more harsh. In *Kiefer-Stewart Company v. Joseph E. Seagram & Sons*, (7d), the Supreme Court decided that any activity to fix prices, even if they are being fixed by a price ceiling, is *per se* illegal. Seagram was refusing to sell to Indiana wholesalers unless they would resell the liquor at prices below the maximum level Seagram set. The Kiefer-Stewart company wouldn't follow this so



they were unable to get their needed supply of liquor from Seagram. Other suppliers also abided by the price ceiling, although it is unknown whether they were colluding with Seagram or acting independently. Either way, Kiefer-Stewart couldn't get any alcohol which injured their ability to compete in the market. The Supreme Court disagreed with the court of appeals, who said a price ceiling would enhance not restrain competition. They also said that the suppliers don't have to be explicitly colluding to violate the Sherman Act. Just the fact that the defendants had price ceilings and wouldn't sell to Keifer-Stewart makes them guilty.

In this case, the judicial system acted consistently with antitrust case law. They used precedence from *U.S. v. Socony-Vacuum Oil Co*, which states "under the Sherman Act a combination formed for the purpose and with the effect of raising, depressing, fixing, pegging, stabilizing the price of a commodity in interstate or foreign commerce is illegal *per se*." (7d) This shows that they are looking at behavior economically. The court of appeals had naively decided that a maximum price level that can be charged is necessarily good for competition. It is really more important to compare price and marginal cost. Seagrams may have been requiring low prices in order to gain market share, or force firms out of the market who couldn't compete. On the other hand this behavior could have been procompetitive. Perhaps retailers had artificially bid up prices way above marginal cost and Seagrams wanted to bring them down. Maybe they were trying to create an image of good quality and lower prices. They could actually stimulate demand and increase competition. Or maybe the

wholesalers had some market power which enabled them to affect the price level and Seagrams was merely trying to take away their power base. In these scenarios Seagram was actually acting procompetitively. While it is good that the Supreme Court recognizes that all ways in which price level can be set can cause problems, they need to look further. RPM agreements can actually create efficiencies and benefit competition and should be judged on a more individual basis.

## Conclusion

Now that you have read about the beginnings of antitrust, it's original intentions, and an efficiency based analysis of some major antitrust cases, it's time to look towards the future. Antitrust law has been around 100 years, will it be around 100 more? Some say yes, others no. Most experts seem to feel that antitrust needs some changes, the question is more over the extent of these changes. The Chicago School argues for repeal, whereas others argue for reform.

An economics professor, D.T. Armentano, believes that it is time to repeal antitrust legislation.<sup>(3)</sup> He bases his case on five problems that he sees in the current antitrust system. First of all, the enforcement of antitrust laws is based on a static economic theory of equilibrium. He says that the business world is dynamic and uncertain. Our market conditions are constantly changing with new knowledge and preferences. He feels that it doesn't make sense to judge all efficiency standards against some static equilibrium which is nonexistent. Secondly, he notes that the barriers to entry which antitrust makes illegal usually represent economies of scale, technological advances or good will. These are actually efficiencies which benefit consumers and should be ignored by antitrust laws.

Armentano notes that in the actual case history of antitrust, cases have been decided against competitive businesses. He believes that if antitrust is used against successful firms, the consumer and efficiency are harmed. If it's used against unsuccessful firms, we are spending money to fix a firm that the market will take care of by itself eventually. In addition, he doubts that regulators are truly able to discover and evaluate true social costs and benefits

accurately. Therefore what they enforce may not be optimal and the market could do it better. Finally he says antitrust laws violate the natural property rights of owners to decide for themselves what to do with their own property. The economists who advocate repeal, believe that antitrust costs society much more than it benefits society. Dewey (14) points out that no one has ever done a cost benefit analysis on antitrust, perhaps now is the time.

Others feel that antitrust is worthwhile and that its overall performance increased efficiencies and benefitted the consumer. Although competition seems to be doing well, it still needs nurturing.(19) There are some suggestions for improvement that could make antitrust more successful. Treble damages in antitrust cases, have been questioned for quite some time. They provide incentive for people to bring antitrust cases against violators, but sometimes it's too much. Cases have been brought that had little to do with important violations and plaintiffs have won. Not only does this waste the courts time but it also scares firms. Firms may stick to safe, static behavior rather than attempt to compete or grow. This hurts society's economic development and actually inhibits the competitive process.

Jury trials in antitrust cases are another area where reform could be beneficial. By eliminating juries, cases would be shorter, less costly and the rulings would be more consistent. Most juries don't have adequate knowledge of antitrust law or economic theory. They are unable to decide cases in a way that will always benefit society. They have also added to the contradictions in antitrust case

law. These are two legitimate, realistic reforms that could benefit antitrust in the future.

The three areas where the Supreme Court has yet to conform to Chicago School theory are: merger law, tying agreements, and RPM. I showed how these can actually increase efficiencies in more situations than they cause inefficiencies. As the Supreme Court moves more towards a standard of efficiency (which they are already doing, due largely to the Reagan administration and an increasing understanding and acceptance of economic theory), changes in these areas are likely to occur.

One can also argue that antitrust has become increasingly important after the period of deregulation in the 1970's and 1980's.(11) Industries such as airlines and banks that were exempt from antitrust, aren't any more. Therefore the future of antitrust lies in dealing with these changes and ensuring that these industries remain competitive.

Earlier, I discussed the movement of antitrust towards a goal of allocative efficiency, as advocated by Bork. Some economists feel that in the future antitrust's goal will move to a "price to consumers" or "wealth transfer" standard.(17) Certain business practices contain no inefficiencies but they do redistribute income. The standard will no longer be based on evaluating total surplus and dead weight welfare loss created. In the future antitrust may look more closely at the movements from consumer surplus to producer surplus.

Overall antitrust has done its job of preserving competition. It has been a learning process for everyone involved. It seems that antitrust, though some speak loudly for repeal, will remain and

slowly be reformed and adapted into a coherent body of law. Right now economic models are too abstract and the public is still too afraid of market concentration and the possibility of eliminating small firms from the competition(20) for Congress to seriously contemplate removing from the United States all of antitrust law.

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