3. Competition and Cartels

The Preconditions for Competition Are the Same as the Preconditions for Cartels

To show the power of this general proposition, I will examine in greater detail two types of critical markets in which a strong political will could preserve the operation of competitive markets. These markets are agriculture and labor. In both cases, the question of competitive harm has played an enormous role in shaping the legal rules that govern them. In both cases, it is easy to envisage a competitive solution in which parties are able to buy and sell commodities and labor on whatever terms and conditions they see fit. In neither case do we have to worry about the need to create social infrastructure or to assemble complex networks through the wise use of government coercion. All that is needed is a willingness to allow prices to move in accordance with principles of supply and demand and to limit the use of monopoly power on either side of the market. This could be accomplished by a modest antitrust or competition policy that focuses on horizontal arrangements to limit quantity or to raise price. To be sure, the antitrust solution does not have an obvious libertarian pedigree, for it does not conform to the libertarian belief that the content of a contract is solely the business of the parties to it and not the concern of any third person. In contrast, a classical liberal will share Adam Smith's distaste for

monopoly and will distinguish sharply between monopoly and competition (see *The Wealth of Nations*, 1776). The classical liberal recognizes the social dislocations produced by the former condition, when prices are raised above marginal costs and fewer goods and services are produced than in a competitive system. This bad result can be achieved when a single firm produces all the goods and services in a particular market or when rival producers are able to organize themselves into a cartel, so that their production and pricing decisions replicate those of the single firm with monopoly power.

The social losses that flow from monopolies or cartels are capable of identification by economic theory, so that the central question is whether the tools that could be used to counter their effects are reliable enough to justify the costs of their imposition. In the traditional English system, these contracts to rig markets were not enforceable among the parties to them. The lack of state enforcement fostered a strong tendency to "cheat" among cartel members, which tended to bring prices back to competitive levels. After all, each member of the cartel would do very well if it chiseled a bit on price so long as all the other members kept to the higher price. But once any individual seller cuts his prices, the others would be sure to follow suit until the entire system fell under its own weight. The downward pressure would be further exacerbated if new firms were allowed to enter the market under the price umbrella that the cartel created. In essence, the minimalist strategy to deal with cartels is two-pronged. First, deny enforcement of any agreement among cartel members, and, second, allow new entry, so that the entire system will sooner or later fall under its own weight. The more aggressive critique of this position is that this low-key approach will allow cartels to operate, and perhaps even to thrive, for limited periods of time. Their gains could be prolonged, moreover, if the

rival firms merged, because a unified operation would no longer have to worry about cheating by any of its members. Thus, the more aggressive strategy imposes sanctions on cartels, both civil and criminal, and allows the state to block mergers that operate, as the expression goes, in restraint of trade.

For these purposes, I do not wish to take sides on whether the more aggressive arm of competition policy has borne fruit. Much depends on whether the enforcement of these competition laws turns out to be misguided, so that it punishes firms that aggressively compete for business on the ground that they are engaged in some unlawful form of "predation." Much also depends on whether the evidentiary rules that are used to isolate cartels and cooperative agreements are sensibly enforced. If they allow too much collusive behavior to slip through the net, then the system of antitrust regulation is not worth its cost. If these rules catch, by mistake, too much procompetitive behavior, then the edifice turns out to be counterproductive. Resolving these questions raises a host of hard trade-offs that I shall avoid, consistent with the theme of this lecture. What is striking, however, is how the development of agricultural and labor markets proceed from quite different assumptions.

The law in both countries has done a total flip-flop on the question of legality. Far from condemning cartels, it has worked overtime to prop them up precisely because it sees competitive harm as something to be feared, not welcomed. Starting from that position, the law helps cartels by systematically countering the two risks to which any collusive arrangement is subject: the inability to police the conduct of its own members against cheating and the inability to block the entrance of new firms that bring matters back to the competitive equilibrium. We may have some uneasiness about the

use of state power to enforce a competition policy directed against private collusive agreements, but whatever the doubts on that score, in principle, we have no reason to reverse the policy in so dramatic a fashion in the two key areas of agriculture and labor policy. My greater expertise on these areas is chiefly with the U.S. sources, but I shall refer to analogous British experiences to show that this dangerous tendency has truly international appeal, both historically and in the present day.

At this point, we have to ask why the forces within the agricultural and labor sectors were able to obtain that extraordinary dispensation from the state. Part of the explanation is technical. It is a sad but powerful truth that those markets that work best under perfect competition are also the ones that offer the greatest opportunities for cartelization. Fungible products are helpful for creating competitive markets. Once products are standardized, it is far easier to have a large number of buyers and sellers in the market because the standardization of products leads to an ease of comparison and substitution—the hallmarks of competitive markets. Thus, the ability to organize work in mass-production facilities creates opportunities for competitive labor markets as does the standardization of agricultural produce.

Unfortunately, the flip side of the proposition is every bit as potent. The standardization that allows for the emergence of competitive markets also paves the way for the formation of cartels, by both public and private means. So long as all sellers and workers are delivering the same product, it is easier for the cartel to coordinate prices and collateral terms. In contrast, in markets that feature highly individualized products, such as distinctive parcels of real estate, invariably there will be some jockeying over prices. The nonstandard nature of the good creates a spread between the maximum amount the

buyer will pay and the minimum amount the seller will expect. Accordingly, the parties will have to bargain out those differences. We need to live with friction in ordinary transactions even if we never learn to love it. Now, when you have perfectly standardized goods, all of this tends to disappear because of the ability to find a perfect substitute by going next door in a business district that specializes in the same kind of commodity. The full information that makes competition possible in standardized goods is exactly the same condition that makes collusion work. If every seller knows that the rival sellers are selling exactly the same good that he is and for exactly the same price, the gains to organizing this particular market to cut back production and raise prices (or wages) will make the privileged group better off and the rest of the world worse off. First, they have to pay for this elaborate scheme to the extent that it is subsidized by tax revenues; and second, they now have to pay a monopolistic price or wage that is higher than the competitive one. Additional complications will arise when price discrimination is available. But in our current reductionist frame of mind, it is best to put these to one side. The upshot is that we should see the greatest efforts at collusion in those markets that are most amenable to competitive solutions.

A moment's reflection, however, should show that these points are not sufficient to explain why the organizers of agricultural and labor markets were able to gain state support for their endeavors when ordinary manufacturers were subject to increased scrutiny of their behavior. So much turns on the intellectual climate of opinion in which the legislative and judicial deliberations take place. Any political body contains many members who do not have a large stake on either side of the question. These people are neither agricultural producers nor agricultural consumers; they are neither employers nor

workers, at least in the first instance. The ability to sway these neutral groups in argument often proves critical in gaining the necessary level of political support. The reason people on all sides of the political spectrum are to this day so concerned with forums like these, in which ideas are discussed and debated, is that they know that their political influence will only take them so far. If the public sentiment is strongly stacked against them, their options are limited. But if the political climate is congenial to their industry agenda, then their chances of political success correspondingly rise.

It is against this background that we can understand why appeals of farmers and workers could gain success while those of industrialists are turned aside because of, not in spite of, their greater wealth. Never underestimate the enhanced political sympathy when the underdog seeks to gain state power. Neither workers nor (individual) farmers are at the top of the income distribution, so they are perceived as having to struggle against greater powers on the other side of the market. In some cases, there may be a point here—for example, if railways are able to collude to raise the freight costs of shipping goods, some might argue in favor of creating a countervailing monopoly power for those that suffer.[1] However, in this situation the proper solution is to break up the initial collusion, not to create a rival monopoly that will be at loggerheads with the original one. But so long as people see the struggle between farmer and railways or capital and labor as a zero-sum game in which one side, by definition, wins what the other side loses, then it is easy to make the underdogs favorites in the game of life.

But once it is realized that this simplified view of the

1. The buying power of supermarkets might be a corresponding example relevant to the United Kingdom (Wood, this volume).

world omits some key concerns, then the persuasiveness of this maudlin plea should diminish. Successful cartelization by any group hurts not only their immediate purchasers but also all the others who, in turn, purchase from them, including ordinary consumers who may be more down on their luck than the individual cartel members. In addition, the entire process is never a simple transfer of wealth from one side to the other; instead, it is part of an elaborate process that results in the systematic destruction of wealth from at least three sources: the creation of an inferior market structure, the political costs needed to put that structure in place, and the nontrivial administrative costs to make sure that the program does not fall apart. At this point it does not make a difference whether the popular political forces are heard in Westminster, Brussels, or Washington. They all sing the same tune about the simple distributive consequences of cartel formation that overlooks the long-term consequences of these arrangements. One cannot rectify the problems arising from an undesired distribution of income or bargaining power by creating more cartels, such as those in agricultural and labor markets.