4. Agricultural Markets, Protectionism, and Cartels

A Right to Farm?

I think that this general analysis is borne out by a closer look at the agricultural and labor markets. Let me start with the American agricultural market in an effort to see how it learned to deal with the uncertainties introduced by fierce competition in a setting where technical progress tended to increase output and, therefore, to reduce prices. Individual farmers knew they could not alter that outcome by individual actions, for the laws of competition mete out harsh penalties on sellers who do not meet the competitive price. Raise prices and you lose your customer base; lower prices and you lose your profits. No wonder *everyone* wants public dispensation from competition. Indeed, in agriculture, if it is allowed to run without state intervention, then rising productivity should lead to an exit of farmers from the market. This exit is welcomed from a social perspective because it releases valuable resources for other more valued uses, but it is clearly not welcomed from the perspective of individual farmers.

Yet one of the great political successes of the agricultural movement is that it sought to insulate its members from the uncertainties of price fluctuations by appealing to the so-called parity principle, by which farmers sought to maintain prices at the constant high levels, relative to other goods, that they were able to fetch in the bumper years between 1910 and

1914. There is no question that fixed prices make life easier for farmers, but they make it far more difficult for everyone else who has to bear the full brunt of any fluctuation in supply and demand. The government has to use taxpayers' money to enter the market to soak up the excess demand, or it must find a way to reduce the level of production so as to maintain the prices at the desired level. Clearly strong subsidies and restrictions are needed to meet this unwarranted goal.

How is it, then, that any group is able to insulate itself from world uncertainties when that form of protection increases the uncertainty for everyone else? Part of the solution is rhetorical, with a strong appeal to positive rights. Thus, when Franklin Roosevelt introduced his second bill of rights on economic matters in his 1944 State of the Union address, the constant theme of "the right to farm" was very prominent on his list and helped pave the way for the post–World War II dominance by the farm lobby on agricultural policy. But what is meant by "a right to farm"? As an analytical matter, every assertion of a right should give rise to an instant query as to its correlative duty. Here, the claim of a right to farm has to be set against two different kinds of correlative duties with vastly different implications. The first of the duties is that if somebody has the right to farm, nobody can block that person's entry or exit from the business. Hence, any farmers can offer produce for sale at whatever price to whomever they see fit, so long as they can find a willing buyer. So, the right to farm reduces to a particular application of the more general right to go into any lawful occupation; entry and pricing decisions are left to the individual alone. Deals, however, require a willing buyer. If that were all that was involved, then the agricultural lobby would simply be working fiercely for free competition and open markets. Who could complain?

Of course, that proposition is not what they mean when farmers claim the right to farm. What they mean is that once they enter a particular occupation, they have a right to remain in that occupation, no matter what the conditions or what changes in demand or supply take place. At this point, the government's position or obligation is to make sure that any farmer can persevere as a farmer so long as he desires to remain in the trade. Major steps are taken to insulate farmers from the powerful economic forces that engulf everyone else.

Agriculture as an Easy Case

The system, however, requires not only rhetoric but also specific economic measures to sustain it. Here, in effect, we find an inversion of the three central principles that organize economic markets: restraint of trade is now allowed, entry of new firms is blocked, and massive subsidies are used to prop up the overall arrangement. Easy questions, big errors. Here is a thumbnail sketch of how it all works.

One way to raise prices is to enter into contracts in restraint of trade. In principle, every single contract between two rival sellers could be treated as a restraint of trade, for it reduces the number of sellers from 1000 to 999. But the key point here is not to deny that some small restraint in trade has happened, for indeed it has. It is important to stress the smallness of that effect, for given this change in market structure, none of the remaining 999 firms obtains any real market power to set price or curtail output. Indeed, even this small change in market structure is likely to prove a nonevent if a new firm takes up where an old one left off. Contracts in restraint of trade only start to bite when the level of collusion is high enough for the few independent pricing decisions to allow sellers to raise market prices. But the formation of a firm has a second effect that is much more powerful. It allows for division of labor and a specialization of effort within the firm that makes this new operation a much more formidable competitor than the sole trader who has none of these advantages. The point here, moreover, neatly generalizes because the system becomes better if everyone forms more efficient firms, at least until the concentration becomes so high that the balance of advantage shifts. The gains from specialization are not likely to continue as firms become ever larger, but the risk of monopolization grows. Therefore, we have to adopt some rule of reason that sets the "horizontal" transaction against a backdrop of general economic theory from which we could conclude that 100 strong and efficient firms will do better than a marketplace of 1000 underdeveloped ones. The world is full of trade-offs, even on questions of merger.

Much of this learning has to crystallize around the phrase "contract in restraint of trade," which will cover the giant trust but not the two-man firm. In the United States, the Sherman Act of 1890 marked the first federal effort to place a generalized prohibition on private efforts to monopolize various markets, and its reach was extended by the Clayton Act of 1914, which was passed under the "progressive" influences in the early days of the Wilson administration. Here, it is instructive to set out the Act's terms for two reasons. First, it illustrates the close connection between labor and agricultural markets in the regulatory framework. Second, it shows the dangerous inversion of classical liberal principles, not because there is error on a hard question but because it gets the easy questions wrong in principle. Here is the text of Section 6 of the Clayton Act:

> The labor of a human being is not a commodity or article of commerce. Nothing contained in the antitrust laws shall be construed to forbid the existence and operation of labor, agricultural, or horticultural organizations, instituted for

> the purposes of mutual help, and not having capital stock or conducted for profit, or forbid or restrain individual members of such organizations from lawfully carrying out the legitimate objects thereof; nor shall such organizations, or the members thereof, be held or construed to be illegal combinations or conspiracies in restraint of trade, under the antitrust laws.

This passage is rich in rhetorical power and symbolism. On the first point, the initial sentence only refers to "the labor of a human being"—to which we shall return—because even the most ardent defender of cartels could not claim that agricultural produce did not count as a commodity or an article of commerce. But the consequences are the same nonetheless. Both labor and agricultural organizations are, in so many terms, exempted from the class of contracts in restraint of trade that run afoul of the antitrust laws. The powerful differences among types of contracts prove to be of critical importance, as this provision remains in force to this very day. Indeed, the same spirit that informs this section of the Clayton Act also influences the interpretation of the general Sherman Act prohibition against cartels and other contracts in restraint of trade. Where various groups who are not protected by the Clayton Act have worked to obtain the assistance of state governments in organizing cartels for their produce sales, the question is whether this activity is caught by the Sherman Act. At the height of the New Deal, the answer to this question was "no," in the important 1943 case of *Parker v. Brown*. This case held that the decision of California to organize a raisin cartel for sales to citizens mainly in other states was immunized from antitrust scrutiny because the Sherman Act was, in the first instance, only directed toward private cartels.

The *Parker* decision is remarkable for two reasons. First, the system in question misses the critical point that state-sponsored cartels are more dangerous than private ones precisely because the state enforcement reduces the (desirable) possibility of cheating by its members. Second, in this case, the brunt of the high prices was borne by individuals and firms that lived or operated in other states. This was a case in which California was able to export misery elsewhere, just as the general blessing of export cartels in the United States under the Webb-Pomereine Act also places smaller amounts of domestic gain ahead of larger amounts of foreign dislocation. The political economy point could not be clearer: today, the question of whether cartels are good or bad should be determined on a case-by-case basis. Yet no reason is offered as to why some cartels should flourish and others not. The strong classical liberal tradition may have doubts about breaking up voluntary cartels for fear its efforts could misfire, but this should offer no consolation to those who wish to prop them up with state power, as is done here. In any event, it is clear that in agricultural markets, American domestic policy sweeps aside any principled objection to state-sponsored cartels.

The next question is whether this strategy will succeed. The basic answer is that an exemption from competition law, without more, would be most imperfect. There are two reasons for this. First, other firms could still enter the market under the umbrella that the cartel's price list broadcasts to the rest of the world. Given sufficient numbers, new entrants would bid down prices to the competitive level. Second, individual members could expand their output in ways that could escape detection, although this is less of a threat, obviously, when public funds are used to monitor the behavior of cartel members. The next inversion of classical liberal principle, therefore, is that the incumbents must be able to choke off new entry and to make sure that the individual farmers still in business do not expand their production in ways that drive down the price. There are a number of techniques that help achieve this situation: acreage restrictions, for example, could limit the number of acres that individual farmers could place under cultivation. Or bumper crops could be purchased by government officials, again with the view of restricting the supply that reaches the market. The agricultural marketing order thus becomes the tool of choice to restrain supply.

Within the American context, however, this task was not easily done before and during the New Deal because of the constitutional impediments that arguably stood in the way of any administrative system of production restraints. The original design gave the U.S. government only limited powers, the most expansive of which was the so-called commerce power, which provided that Congress has the power "to regulate commerce with foreign nations, among the several states, and with the Indian tribes" (U.S. Constitution, Art. I, §8). The traditional view of that power was that it allowed Congress to regulate the shipment of goods and people across state lines, but it did not allow for the regulation of agriculture or manufacture, all of which took place within the individual states. The grant of the commerce power was intended chiefly to make sure that Congress could neutralize the barriers to commerce that individual states might wish to create in order to protect their own manufacturers and farmers from out-of-state competition. But the language of the clause was not perfectly congruent with that end, because the affirmative power to regulate commerce could be turned to restrictive ends, as frequently happened with the protective tariffs that were passed under the aegis of the foreign commerce power.

On this score, one of the unanticipated developments in constitutional doctrine involved the judicial creation of the *dormant*, or *negative*, commerce clause, which said that the case for a national common market was so strong that states could not frustrate its operations in the absence of clear authorization from Congress. No state can stop your transports or your telephone wires from running across their boundary line. The upshot was that the Supreme Court took it upon itself to police the actions of the various states. Ironically, the doctrinal pedigree of the dormant commerce clause was far from secure, for an explicit grant of power to Congress does not automatically translate into an implicit limitation on the power of the states. But if we put those interpretive issues to one side, for the most part, the U.S. Supreme Court has done a decent, indeed near admirable, job in keeping the lines of commerce clear while allowing the states, on clear and convincing evidence, to limit the importation of goods when they could establish a paramount local interest in health and safety, narrowly defined. The point here is that because the Court has shown a deep and consistent commitment to competition across state boundaries, it has worked hard to see that the needed accommodations have been made, and it has refused to defer to clever ruses that advance the cause of protectionism under such dubious banners as the ostensible indirect health and safety benefits from price stabilization. Much of the engine of U.S. economic growth can be traced to this one heroic judicial innovation, for Congress has, on most occasions, been slow to overturn state legislation that the Supreme Court has struck down. The federal system works when Congress is silent, and the synthesis that has been created under the dormant commerce clause is an appropriate model for the program of the World Trade Organization or the European Union today.

Changes in the Attitude of Congress in the 1930s

The dormant commerce clause, however, is not the dominant part of the American story. Rather, the key developments of the modern welfare state involve the radical expansion of the affirmative commerce power. The basic decisions to cast aside the traditional limitations on congressional power came just after the court-packing crisis of 1937, when the Supreme Court switched course and held that Congress could regulate agriculture and manufacturing, to the extent that the industries had, as they always do, an indirect economic effect on the national economy. Once the floodgates were open, Congress responded in predictable fashion, and the dislocations of the 1930s were largely attributable to two catastrophic mistakes. The first was the Smoot-Hawley tariff, a form of protectionism, which, as noted, fell squarely within the scope of the foreign commerce power. Regrettably, it was designed to allow for the creation of a tariff wall around the United States. The second was the steep deflation that increased the real debt of farmers and others by an unanticipated manipulation of the currency. In turn, it led to massive foreclosures and other dislocations, many of which preceded Franklin Roosevelt's rise to the presidency in 1933.

But little effort was made to attack these two causes of economic woe directly. Rather, in connection with agriculture, the effort was focused on creating a nationwide cartel for agricultural produce, which did nothing to address the underlying structural difficulties but only exacerbated the whole situation by adding a third set of mistaken programs to the witch's brew. The cartelization effort could not be achieved by the individual states acting on their own, for the importation of produce across state lines effectively undermined local efforts to rig the market. Nor could cartelization be accomplished by the national government under the restricted view of the commerce power, because in-state sales and home consumption of farm goods could undercut the restrictive effects of any national order. But at this point, the U.S. Supreme Court had lost its basic faith in markets and, thus, could see no reason to restrict the power of Congress in an integrated national economy to attack these local sales and consumptions. As the marketing orders from the U.S. Department of Agriculture went out, the Court, in rapid succession, first sustained the power of the federal government to regulate in-state sales of milk, which were undertaken in competition with milk marketed on an interstate basis (*U.S. v. Wrightwood*); next, in what has to be regarded as a tour de force of constitutional interpretation, the court held that Congress could regulate the feeding of grain to one's own cows under the commerce power even when there was no commercial transaction, state or interstate, at all (*Wickard v. Filburn*). In a weird sense, its logic was unassailable: any leak in the restrictive wall would undercut the overall power of the cartel, so the power of Congress to move had to follow the threats, even if these activities were as "local" as one could imagine. And local consumption of grains could consume as much, I am told, as 20 or 25 percent of local production. There is little exaggeration to say that the expansion of federal power in the United States, as far as agriculture is concerned, was to make the world safe for cartels.

In the pre–New Deal era, the judicial resistance to state-sponsored cartels was manifest in yet another doctrine with clear English origins. To backtrack for a moment, the basic English position was that the owner of property could normally charge what the market would bear, where the clear implication was that competition by rival sellers would place an effective check on price. But at the same time, the English courts, following the lead of Sir Matthew Hale, took the position that the state could regulate the prices in those industries that were "affected with the public interest." Those firms that had, either by virtue of government grant or natural advantage, a monopoly position were the prime targets of this prohibition. Hale's position was relied on extensively in the 1810 English decision in *Allnut v. Inglis*, where it was held that the operator of a Crown custom house, in which goods were stored for shipment overseas free of customs duties, could only charge a reasonable rate; otherwise, the increment in price could largely nullify the tax break that had been supplied by the Crown. *Allnut* made its way into American constitutional law in the post–Civil War period, where it was used in far more complex settings to allow the state to limit the rate of return that could be charged by the natural monopolies in the network industries that emerged in the last third of the nineteenth century. Once again, there are many difficult questions on the permissible forms of state regulation: after all, if rates are set too high, then the monopoly can prosper, but if they are set too low, then the individual owners of the venture would not be able to recover a reasonable rate of return on their investments.

Subsidies, Tariffs, and Protection

As befits the temper of this lecture, I shall not stop to explain the ins and outs of the American doctrine. Instead, I shall turn again to the easy cases gone wrong. Somewhat oversimplified, the basic position of pre–New Deal American constitutionalism was that the states and national government had substantial power to combat the dangers of monopoly, but none to regulate the prices and rates that could be charged in competitive markets. This made good economic sense. Any effort to reduce the rates of competitive firms would, in effect, drive them into bankruptcy or confiscate their wealth. Any effort to increase their prices and rates would cartelize a competitive industry. The public loses either way if it is forced to spend resources on regulation in order to obtain an inferior outcome. But this sensible constitutional synthesis gave way in 1934 in *Nebbia v. New York* when the Supreme Court, on matters of rate regulation, showed the same degree of agnosticism toward this doctrine that it was to show shortly thereafter toward the commerce clause. It is no surprise that the transformation in doctrine was done with an eye to allowing the state of New York to make it a crime to sell milk to consumers at less than nine cents per quart. A doctrine that had been designed to curb the power of monopolies and cartels was now reinvented to permit the state to strengthen their hand. It is again critical to realize just how much of American constitutional doctrine has been driven to make the world safe for cartels.

I have less to say about the third part of the inversion. As a matter of basic principle, the appropriate cases for subsidy are limited to those activities that generate some kind of public (or nonexcludable) benefit for the community at large. Otherwise, subsidies, in their own way, distort competitive markets as much as restrictions on output do. The individuals who bear only some portion of the cost of production will continue to produce goods until their private marginal cost equals their private return. That private decision will, however, yield systematic overproduction of goods, because the additional public moneys spent do not generate social gains of equal value. The net effect is too many goods for too high a social price. The situation gets worse in the long run, as the firms that do not make an orderly exit before the subsidy is supplied continue to press for its expansion long after it has been put in place. I wish I could report that there were a series of American constitutional doctrines that sought to limit the ability of the state and national governments to supply subsidies to what should otherwise be competitive industries, but the sad truth is that, as the constant wrangling in the World Trade Organization shows, it is a lot harder to define a subsidy than it is to define a restraint of trade and harder to regulate subsidies, even when they amount to direct subventions for the production of particular goods. For example, can we determine objectively whether providing good roads in agricultural areas is a subsidy to agricultural products? The constitutional history inside the United States is therefore much like the toleration of subsidies encountered elsewhere. Political forces turn out to be regnant, and all too often they interact with tariffs and the domestic situation to produce a most ungodly situation.

I have no deep knowledge of the British or the European Union tradition, but I have no doubt that the forces that have proved so powerful within the American context have manifested themselves on the other side of the Atlantic. There is, of course, no tradition of judicial review that might have placed brakes on legislative power, but the fundamentals are the same. The only way the cartels can operate is by the restriction of entry, which means high tariff walls and powerful systems of national allocation. And any group that is powerful enough to organize protection can usually gain some direct or indirect subsidy. It takes only a peek at the current newspapers to realize that this free trade issue will not go away, whether it is manifested through debates over genetically modified foods in the European Union or the U.S. steel tariff, mercifully lifted by the president only after it allowed economic wounds to fester for the better part of two years. It is a testament to the defect of our political institutions that positions that have so little to commend them intellectually are able to gain such political mileage.

Why, one might ask, do we see this regrettable set of results? I do not believe it stems from any conceptual inability to perceive the dangers of protectionism in the abstract. The case against mercantilism and protection is one of the great achievements of Adam Smith's *Wealth of Nations*, which does not grow dim from repetition. But even if we put aside the emotional appeals made by discrete and identifiable groups that lose from competition, there is still another reason for the regrettable persistence of restraints in international trade: it is the problem of the second best. We can all agree that if all nations were to lift all trade barriers, all would benefit from the result. But what if the local faction of farmers in one nation or bloc captures the levers of power, and a similar phenomenon takes place elsewhere, perhaps dominated by the steel industry or owners of intellectual property? Here the issue of path dependence becomes paramount. Each side will demand liberalization from the other before it is prepared to take the first step of its own. The interconnections between intellectual property and agriculture have been apparent in the international arena since the World Trade Organization Doha round of talks, and the recent shipwreck in Cancún shows just how difficult these struggles are.

Unilateral Reform Would Bring Big Gains

But even so, there should be a clear course of action: declare unilateral surrender. The use of agricultural subsidies and trade barriers causes huge domestic dislocations. The United States, for example, would be far better off in its own economic well-being if it scrapped these program tomorrow, even if the rest of the world were determined to keep them in place. We could get the benefit of more goods and services in the United States, including those that are foolishly subsidized by foreign governments. We win, no matter what the rest of the world does. In this regard, it is useful to recall the great contribution of David Ricardo, who pointed out that the nation that imposes tariffs on imports hurts itself in the export market even if it invites no retaliation from abroad. The simple but ingenious point is that the relative value of the two currencies will not remain the same once the tariff is imposed. The shrinking demand for goods from abroad reduces the demand for the currency in which those goods are sold. The local currency thus becomes more expensive relative to the foreign currency, which acts as a price barrier to export. That cost is effectively avoided by a unilateral policy on free trade.

In looking at the wreckage of U.S., EU, and world politics in agriculture, it is important to ask just how much protectionism matters. In one sense, it matters less than meets the eye. Determining what goods are made available is a function not only of the political organization that surrounds their sale, but also of the cost of production and the quality of the goods so produced. The raw products are only part of the overall price, and the incredible improvements in efficiency have driven down world prices so that the self-interested cartelist will find it in its interest to lower prices to maximize profits. The numbers here are huge: an egg costs about 5 percent of what it did 100 years ago because of the ceaseless innovation at every stage of production, much of which takes place in ways that the agricultural cartel cannot identify, let alone reach. But before we rejoice in our good fortune, note that the gains from technology are not spread uniformly around the world, and in some contexts they do little to offset the advantages of climate and cheap labor found in less-developed parts of the world. What has caused minor dislocations in advanced nations could wreak devastation in backward economies that can only expand if they gain access to developed markets. Then again, this is one consistent cost of regulation. Democracy works on a territorial principle, such that those who do not vote do not really count, even if they suffer. What for us are small issues, are for others matters of life and death.