The Relationship Between Competition Policy and Industrial Policy: The Historical Experience of the United States

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Thank you Mr. Chairman, and I'd like to thank UNCTAD for inviting me to speak today. Before I begin today, I should note that my comments have not been reviewed by anyone in my agency or the United States Government, and are very much my own views.

Let me lay out the following situation, which may sound familiar to you. A major financial institution has failed. The existing regulatory structure has proven inadequate to solve the problem. Public confidence in the financial system is falling, and the system itself is in danger of collapse. A major financial firm finds itself in trouble, largely because of the imminent failure of an industrial firm it controls. But at the last moment, the dominant competitor of the industrial firm steps forward and offers to buy it, which will in turn save the financial firm.

There is only one obstacle: the threat of enforcement of the competition law against the bailout, which could result in the creation of a monopoly. But the would-be rescuers reply, "but this is an emergency. Let the economists have their fun with competition laws and fancy ideas like market power when times are good, but now jobs are on the line, and competition law is a luxury we cannot afford. We must subordinate the interest of competition law to the greater interest in protecting jobs."

If this sounds familiar, it should. I am, of course, referring to the American financial panic of 1907, only 17 years after our first antitrust law was passed.[2] The dominant industrial firm was United States Steel, which was controlled by the industrialist J.P. Morgan. A major investment house was about to fail, and it held stock in a failing coal company. Morgan's solution was for U.S. Steel to buy the coal company, which would in turn save the investment house (as well, perhaps, as strengthening U.S. Steel's own position given its own interests in the coal business). Morgan sent his men to meet with Theodore Roosevelt, who was President of the United States at the time, bypassing the Department of Justice, which at the time was the sole enforcer of the antitrust law.[3] They

[1] The views expressed herein are my own, and do not necessarily represent the views of the Federal Trade Commission or any individual Commissioner. These remarks were inspired by, and draws heavily from *Antitrust and the United States Financial Crisis of '07*, an article by Marc Winerman, Attorney Advisor to FTC Commissioner William E. Kovacic, Originally published in the December 2008, edition of The Antitrust Source, an online publication of the Section of Antitrust Law of the American Bar Association, *available at* http://www.abanet.org/antitrust/at-source/08/12/Dec08-FullSource12-22f.pdf.
[2] Sherman Antitrust Act, 15 U.S.C. §§1-2.
[3] The Federal Trade Commission would not be created until 1914.

persuaded Roosevelt that the greater industrial policy goal of saving the financial system justified the merger, and Roosevelt personally approved the deal.[4]

So what happened? It turns out that the failing coal company in fact produced a type of coal that was especially well-suited to a new technology that was coming on line – and U.S. Steel now controlled it. As there had been no investigation, this fact did not come out. A few years later, the Justice Department under the next President tried to challenge the deal as part of a broader challenge to U.S. Steel. When the case reached the Supreme Court some years later, the Court rebuffed the challenge, partly on the grounds that President Roosevelt had approved it.[5] Because of our common law system, that precedent may have made it harder to challenge mergers, and this may have contributed to the wave of concentration that took place in the 1920s.[6]

The lesson for us should have been clear. As Deputy Assistant Attorney General Carl Shapiro recently said, "Keeping markets competitive is no less important during times of economic hardship than during normal times."[7] I liken the situation to highway speed limits. While it is important to drive safely on a beautiful today like today, it is even more important to follow the safety laws when it's icy, dark and raining, because that's when the bad things are most likely to happen.

Did we learn our lesson? Let's move the clock forward to the next economic crisis, the Great Depression of 1929. In 1933, another President Roosevelt (Franklin) took office and tried to stem the crisis. Some things seemed to help, like enacting securities regulation. But he also persuaded the Congress to pass the National Industrial Recovery Act. This law essentially legalized cartels and suspended enforcement of our antitrust law. It authorized firms to establish "industrial codes" that were subject to nominal government review and were enforceable by the government. What did industries do with this new authority? They did exactly what you might expect: they established cartels that restrained price and constrained output, all justified in the name of preventing "disruptive" and "wasteful" competition. The very language of commerce changed – discounters were called "chiselers," a pejorative term in English.

What was the effect? I'll quote Christina Romer, one of Carl Shapiro's colleagues at Berkeley and now Chairman of the President's Council of Economic Advisors: "The more important effect of the NIRA was to diminish the responsiveness of price changes to the deviation of output from the trend. . . . It prevented the economy's self-correction mechanism from working. Thus, the NIRA can be best thought of as a force holding

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[4] It is highly unusual for the President to become personally involved with the direct enforcement of the antitrust laws, which is normally left to the Department of Justice and Federal Trade Commission.
[5] United States v. United States Steel Corp., 251 U.S. 417, 446–47 (1920).
[6] William E. Kovacic, Failed Expectations: The Troubled Past and Uncertain Future of the Sherman Act as a Tool for Deconcentration, 74 IOWA L. REV. 1105, 1112, 1115–16 (1989).
[7] Carl Shapiro, Deputy Assistant Attorney General for Economics, U.S. Department of Justice, "Competition Policy in Distressed Industries," Remarks Prepared for Delivery to American Bar Association Antitrust Symposium (May 13, 2009), *available at* http://www.usdoj.gov/atr/public/speeches/245857.htm.

back recovery."[8] One academic found that output was depressed by 10% due to the NIRA.[9] In the end, the NIRA made the depression longer and more severe than it would otherwise.

Ultimately, the United States Supreme Court declared the NIRA unconstitutional in 1935. By then, Roosevelt had realized that it had been a bad idea. He changed course and appointed strong antitrust enforcers, who began to resume enforcement of the antitrust laws.

The climate that led to the passage of NIRA, which favored protecting firms from competition, had other effects that were not as easy to eliminate. I'll give you two examples.

The airline industry, which was in its adolescence if not still in infancy, had originally been dependent on airmail subsidies to survive. By the 1930s, new technology had led the industry to the point where airlines could begin to make a profit carrying passengers. And indeed, some innovative new carriers began to move into the market to compete with the holders of the airmail contracts, such as one that began hourly service between New York and Washington. At the request of the airline industry, which claimed to need protection from harmful competition, Congress enacted a pervasive regulatory scheme in 1938 that regulated entry, price, and routes. Airlines could compete on the basis of food service and schedules, but very little else.

At the same time, as our highway system was becoming better, trucking emerged as a viable competitor to the railroads. The railroad industry had long been regulated by the Interstate Commerce Commission, at first to protect the interest of farmers, shippers, and passengers. Eventually, it seemed to be more concerned with protecting the railroads themselves. At the behest of the railroads, the ICC was charged with regulating the trucking industry. Routes were fixed, so that if a trucking route held a route from New York to Florida and another from Florida to Chicago, it could only haul freight from New York to Chicago via Florida. Manufacturers and sellers began setting up their own trucking operations, but their trucks had to return home empty. Rates were also fixed. The system was grossly inefficient, and since transportation is a major component of the price of many goods, the costs were often paid by the consumer.

While the Depression ended with World War II, these regulatory schemes persisted right through until the 1980s, by which time the "infant" airline industry was flying 747s. Eventually both industries were deregulated. Costs came down and innovative new entrants came into the market.[10] The lessons we learned were these: first, a regulatory response intended to respond to a short-term economic crisis can take decades to undo,

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[8] Christina Romer, "Why Did Prices Rise During the 1930s?" *Journal of Economic History*, 59(1), 167-199, p. 197, quoted in Shapiro, *supra* note 7.

[9] Jason Taylor, "The Output Effects of Government Sponsored Cartels During the New Deal," *Journal of Industrial Economics,* 50, 1-10 (2002).

[10] Robert Crandall and Jerome Ellig, Economic Deregulation and Customer Choice, 34-47.

and second, insulating our firms from competition made the inefficient and ill-prepared to cope with foreign competition, let alone more efficient domestic competitors.[11]

You may think that I am attacking the idea of regulation. This is not the case, as regulation certainly has its place. In air transportation, for example, nobody argues with the idea of regulating safety. But regulation can go too far when it is employed only to exclude competition, which is typically justified in the interest of promoting "stability," "competitiveness," or other industrial policy goals. The trick, of course, is to find the balance by weighing the cost of regulation against the benefits.

Why is this hard? It's hard because economic crisis creates an opportunity for those who would exclude competition to claim that the emergency situation justifies brushing aside sound competition principles with only the slightest glance, as Theodore Roosevelt did in 1907, and as Congress did in the 1930s when it regulated the airline and trucking industries.

I won't speak to the question of whether regulation was, as some suggest, to blame for the present crisis, as I'm not an expert in financial markets. The important point is that the legitimate purpose of regulation must be carefully balanced with its impact on the functioning of competitive markets. We must recognize that those who would exclude competition will be quick to propose regulation that benefits them at the expense of consumers and will try to justify it on the basis of economic crisis without taking the trouble to measure the true costs and benefits.

So moving the clock forward again to 2009, we have another economic crisis. Have we learned our lesson this time? In our recent election, neither candidate called for setting aside our antitrust laws. Indeed, President Obama has appointed committed antitrust enforcers to head both of our antitrust agencies. However, calls for the application of industrial policy are likely to persist, and we will have to be vigilant in the years to come. Our experience has been that these calls must be met with well reasoned argument in favor of competition. While regulation may well be appropriate where the benefits of regulation exceed the costs, that does not justify casting aside what we have learned about the benefits of competition.

[11] See Michael Porter, The Competitive Advantage of Nations (1998) 662-65.