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Costly Exercises in Futility: Breaking Up Firms to Increase Competition

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Executive Summary

U.S. antitrust policy began in earnest almost 100 years ago with attempts to create competition by breaking up dominant firms, such as Standard Oil and American Tobacco, into a number of smaller, competing companies. In later years, the government would succeed in requiring divestitures in the shoe machinery, motion picture, network television, and telecommunications industries. There is no evidence that any of these extreme measures, other than the AT&T divestiture, had salutary effects, and even the AT&T divestiture could have been avoided if the Federal Communications Commission had adopted a simple rule of requiring equal access to AT&T's local facilities for all long distance carriers. Now, some telecommunications industry participants are advocating further "structural separation" of the country's large local telecommunications carriers because they believe that a new divestiture would contribute to greater local competition. Given the history of earlier government-mandated break-ups, this proposal is not only unlikely to succeed, but it is likely to impede network investment at a time when major network innovations are occurring.

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1. Introduction

It has been almost a century since Ida Tarbell assailed John D. Rockefeller in her famous *The History of the Standard Oil Company*, providing much of the political pressure on the federal government to bring a landmark antitrust suit against Standard Oil in 1906. The government succeeded and obtained a court decree under the Sherman Act that required the dissolution of Standard Oil in 1911. Soon thereafter, the government also succeeded in breaking up the American Tobacco Trust in another major antitrust victory, but after that the trustbusters eased off in trying to break up monopolies. The large movie companies were forced to split off their theaters by the Supreme Court's 1948 *Paramount* decision, and in 1982 AT&T settled an antitrust suit by agreeing to divest itself of its local telephone companies. But recently the drumbeat for using antitrust to restructure industries has resurfaced.

The current target for those who would encourage government-mandated restructuring is the high-technology sector, particularly telecommunications. For four years, the government pursued a major Section 2 Sherman Act case against Microsoft, and various commentators offered their views on how the company should be split up, divided, or dissected. These proposals have been rejected by the Justice Department and the courts. Now, given the recent failures of large numbers of new entrants into telecommunications, the restructuring proponents have shifted their focus to the telecom survivors, particularly the "Baby Bells" who were split off from AT&T in 1984, insisting that these companies should submit to "structural separation" or outright divestiture.

With 100 years of years of history in the use of U.S. antitrust laws to restructure various firms or industries to draw upon, one might expect the proponents of such a policy to cite the successes of the past in support of their new initiatives. But these advocates rarely cite this history for an important reason: there is little evidence that the past forays into restructuring through antitrust have worked. Indeed, a careful reading of the evidence suggests that most such exercises were either misguided or futile. Given that the cost of engaging in such disruptive activities is likely to be very large in the short run, we should be very sure that the likely longterm consumer benefits are sufficient to offset these costs. Unfortunately, with 100 years of evidence to look at, the proponents simply look the other way and hope to seize on the political mood of the moment. As we shall see this political mood seems to lurch back and forth every thirty years or so.

2. The "Thirty Year" Wars

There is little dispute that open, competitive markets are important for ensuring that the U.S. economy exploits its full potential to provide goods and services to consumers. We now know, for example, that the elimination of government-erected barriers to entry in the airline, railroad, trucking, oil, natural gas, and telecommunications industries have provided enormous benefits to consumers. If private firms in these or in other industries use anti-competitive practices or attempt to fix prices, they are subject to legal action under the U.S. antitrust laws. Moreover, the antitrust laws may be used to block anticompetitive mergers.

The antitrust laws can also be used much more widely to attempt to impose on an industry a structure that market forces have not generated. For example, a court decree can require that a large firm convicted of "monopolizing" under the Sherman Act be broken into many component parts. In addition, there have been occasional proposals to "strengthen" the antitrust laws or even to override them entirely to allow for even greater government intervention in the structure of industries. About 30 years after the government first charged *Standard Oil* with monopolization, the Roosevelt Administration concluded that markets were *too* competitive in the midst of the Great Depression, thereby placing too much downward pressure on prices and industry profits. As a result, it proposed and Congress passed the National Industrial Recovery Act which would have allowed the federal government to cartelize industries in much the same the manner as Rockefeller and American Tobacco had tried 30 years earlier. Fortunately, the Supreme Court found this exercise in government cartelization to be unconstitutional.

After World War II, many industries, such as steel, automobiles, petroleum, and industrial machinery, seemed to become permanent oligopolies dominated by a Big Three or a set of Big Sisters and impervious to competitive entry. A committee of economists and lawyers assembled by President Johnson's Justice Department in the mid-1960s under the leadership of University of Chicago Law School Dean Phil Neal recommended that legislation be passed to amend the antitrust laws so that these dominant oligopolies could be broken up. The goal this time -- slightly more than 30 years after the National Industrial Recovery Act -- was to generate *more* competition through widespread, systematic restructuring of American industry, *i.e.,* by breaking up the industrial giants. A Concentrated Industries Act was drafted, but the legislation died in Congress.

For the next thirty years, the U.S. economy shifted away from traditional manufacturing to high technology, but U.S. industries also became much more competitive. The stable oligopolies that the Neal Commission had wrongly identified withered away or collapsed under the pressure of imports and new entry. Even the large, conglomerate firms that had been built out of the 1960s merger wave soon found that they were too large and diverse to compete. Industrial concentration fell steadily, and the share of U.S. assets controlled by the largest 50, 100, or 500 industrial firms fell dramatically. No one worries today about concentration in the steel, oil, or automobile industries, because these industries are no longer dominated by a stable group of industrial giants. These industries are, for the most part, highly competitive.

Instead, 30 years after the drafting of the Concentrated Industries Act, 60 years after the government proposed to cartelize all industry, and 90 years after the trustbusters broke up Standard Oil and American Tobacco, the war has shifted again – this time to high tech. The incredible pace of technological change in information technology and communications has created some large winners and a trail of losers. In 1969, the same year that the Neal Commission announced that it wanted to break up concentrated industries, the Johnson Administration brought a major antitrust case against IBM for monopolizing computers. By 1982, IBM's dominant position in the industry had been substantially reduced by the new minicomputers and by the introduction of the personal computer. The Justice Department dropped the case against IBM and pursued other agendas. At this time, the personal computer was just beginning to spread across the world, and IBM was unprepared for the battle. To gird itself for the struggle against the upstart, Apple Computer, it licensed Bill Gates and his young associates to develop an operating system. They succeeded beyond anyone's wildest dreams, driving Microsoft to such a prominent position in about 15 years as to invite the scrutiny of the antitrust authorities who were in despair because of a lack of good targets in the increasingly competitive U.S. economy.

The Microsoft case is now winding its way to a conclusion that does not include government-ordered restructuring. As a result, advocates of government-mandated industrial restructuring have their gaze fastened intently on telecommunications.

3. <u>Has Antitrust Restructuring Worked?</u>

Although the winds of antitrust have blown alternately hot and cold, there have been several cases that have resulted in the breaking up of companies judged to have violated the antitrust laws. In addition to *Standard Oil*, *American Tobacco, Paramount,* and *AT&T*, United Shoe Machinery was broken up by court order in 1969, IBM had to divest some punch-card production capacity in 1955, and the three national television networks were forced to sell their (syndicated) program distribution operations in 1972. In only one of these cases, *AT&T,* is there any evidence that this restructuring increased competition, but even in this case divestiture was unnecessary.

For example, the break up of Standard Oil into 38 separate companies had no measurable effect on oil prices, oil output, or even the price of Standard Oil stock. The reason seems clear: the government's case was brought after John D. Rockefeller had already begun to lose market share to new oil companies in the middle of the country, the Gulf-coast states, and the West. Monopolies generally erode over time in the wake of competitive entry; Standard Oil's monopoly power could not withstand the entry of companies like Gulf Oil, Pure Oil, and Sun Oil. The government did not have to break up Standard Oil to get a competitive market structure.

American Tobacco is somewhat different. Whatever American Tobacco's monopoly power, the break up of the Tobacco Trust into separate companies appears to have had little effect on cigarette prices because a three-firm oligopoly emerged after the dissolution. If anything, breaking up the Trust led to more spending on advertising, but little change in industry price-cost margins, hardly a pro-consumer result.

When all of the country's major motion-picture companies were judged to have monopolized the distribution of feature films through essentially a collusive set of arrangements in 1948, they were required to spin off their theaters. This proved to be serendipitous for the companies because immediately thereafter a new medium – television – devastated motion picture theaters, reducing annual attendance by three-fourths. Ironically, theater admission prices rose after the divestitures and motion-picture companies grabbed a larger share of the dwindling box office revenues from the hapless companies that owned the theaters. Once again, the evidence is hardly consistent with consumer gains from antitrust intervention.

The government's pursuit of United Shoe Machinery (USM), the largest supplier of shoe manufacturing equipment in the period before and immediately after World War II, was nothing if not persistent. USM was first charged with a violation of the Sherman Act in 1911, but USM prevailed in court. The government made another run at USM under the Clayton Act in 1915 and won, forcing the company to modify its leasing practices. A third case was brought under the Sherman Act, charging USM with monopolizing shoe machinery through a variety of leasing policies and the tying of supplies and service to its machines. The government won this case and asked for divestiture of certain of USM's assets to create new competitors. The judge demurred. Instead, in 1954, he imposed a decree that required USM to offer machines for sale as well as for lease, to modify its leasing practices, and to end its tying arrangements. Ten years later, hearings were held to determine if the decree had worked. After a lengthy appeals process, the judge was forced to order divestiture of some of USM's assets in 1969, just as the U.S. shoe industry was beginning a calamitous decline. USM was soon sold to another company, but there is no evidence that its dismemberment increased competition in shoe machinery. Give the shift of shoe production abroad, the market for such equipment became global. USM's share of U.S. sales had become irrelevant.

In 1952, IBM was charged with monopolizing tabulating machines and tabulating cards. The case was settled in 1956 through a limited sale of some presses that produced the tabulating cards. In 1962, the company had to divest itself of more card-production capacity, but by this time computers were replacing tabulating machines. The demand for tabulating cards was declining sharply, and IBM was shifting its attention to the production of computers. By 1969, the government would file another case against IBM for monopolizing computers which, in turn, was dropped in 1982 because the business machine market had changed again – this time towards personal computers. The attempt to restructure IBM was too little and far too late.

The final case that deserves mention is the one example that proponents of antitrust restructuring can (and do) claim as a success. In 1974, the government charged AT&T with monopolization. Eight years later AT&T and the government settled the case with a consent decree that required AT&T to spin off its local telephone operating companies. The theory behind this divestiture was that competition in long distance and customer equipment would be enhanced if the local "bottleneck" companies were independent of AT&T and therefore had no incentive to block their customers' access to competitors of AT&T in the long-distance or terminal equipment businesses. The theory was correct as far as it went, and competition in these latter two markets surely blossomed after the break-up of AT&T in 1984. What is often neglected in such a facile observation, however, is that telecommunications was and is a government-regulated industry. Equal access to AT&T's local customers could have been mandated by the local regulators and/or the Federal Communications Commission (FCC). Such access is required in Canada, France, Germany, and Italy, for example, and all were able to achieve a substantial degree of competition in long distance and equipment without breaking up their phone companies. Indeed, in just five years, Canada was able to achieve as much as the U.S. accomplished in 20 years after first allowing competition in long distance.

4. Boom, Bust, and Divide: Government and Telecommunications

The United States began to open its telecom markets, particularly long distance, in the 1970's, but the FCC was not persuaded that unfettered competition was a good idea. As a result, it did not allow entrants to offer ordinary long distance services to business and residential customers. Nevertheless, an entrepreneurial company, MCI, figured out how to evade the FCC's strictures and began to offer dial-up long distance services to business customers in 1974. Given the FCC's opposition to MCI's activities, it was hardly surprising that AT&T tried to deny MCI access to its local circuits, which were essential to MCI's operations. Without access to AT&T's circuits, MCI could not possibly complete most of its calls.

Lacking a sympathetic audience at the regulatory commission, MCI pressed its case for access to AT&T customers at the Justice Department and in various courts. In 1974, the Justice Department brought a Sherman Act suit against AT&T, a case that was settled eight years later with the break-up of the company. For the next 14 years, enormous resources were spent on legal proceedings before U.S. District Court Judge Greene, in whose courtroom the case had been tried. Because of the complexity of telecommunications technology and the rapid evolution of that technology, there were endless arguments before Judge Greene over what constituted permissible activities on the part of the divested Bell operating companies. Was the separation of "local" and "long distance" to include Internet services (which had not yet begun when the decree was entered) as well as traditional telephony? Given that divested Bell companies could not engage in manufacturing, could they provide the research, engineering, and design for new products needed to offer new services? What distinguished an "information service" from a telecommunications service?

Finally, these wasteful and endless arguments placed pressure on the Congress to end the 1984 AT&T decree, but the Bell companies had to agree to a new set of regulations designed to facilitate the opening of their local markets to competition. The 1996 Telecommunications Act opened all telecommunications markets to competition and required the local telephone companies, including the Bell companies, to lease necessary facilities on a piecemeal basis to new entrants on a cost basis to be determined by the regulators. This process, in turn, has created enormous controversy because the FCC has opined that virtually everything owned by the local companies has to be leased to entrants at "forward-looking" long-run incremental cost.

Since 1996, a large number of entrants have rushed into local telecommunications markets across the country with a variety of business plans, leasing plans, and technologies. It is safe to say that none had any idea what might work because such widespread entry had never been tried before by anyone. At least fifty new local telephone companies offered public stock between 1996 and 2000; scores of other also entered various local markets, often simply as resellers of Bell company services. At one time, the public companies had stock market valuations that totaled more than $100 billion, roughly the market capitalization of the Big Three U.S. motor vehicle companies. Between 1998 and 2000,the price of wireless (cellular) stocks increased by 500 percent and the stock prices of the long distance companies trebled. This boom could not last.

Many other firms entered telecommunications or expanded their activities in the sector after 1996. Global Crossing began to build a global fiber-optics network and later acquired a smaller U.S. local telephone company, Frontier. Qwest, a recent entrant into long distance services, invested heavily in a national fiber optics network and bought one of the local Bell companies, U.S. West. Metromedia Fiber and Williams Communications invested heavily in fiber-optics capacity around the country. WorldCom, the fourth largest long distance company, bought a large number of companies, including MCI, with its soaring stock. AT&T used its high-priced equity to buy two of three largest cable television companies in the country.

Most of these investments and acquisitions occurred during a period of soaring technology, telecommunications, and "dot.com" stock prices. None of the aggressive telecommunications companies could possibly know which strategies would succeed in a competitive, vertically-fragmented telecom market that was being driven by a completely new phenomenon, namely, the Internet. Many, perhaps most, were bound to fail. Indeed, virtually all of the new local entrants have encountered severe difficulties and most have filed for bankruptcy, regardless of whether they leased facilities from the Bell companies, built their own networks, or resold Bell-company local services. There is no obvious successful entry strategy in these local markets, perhaps because most of the entrants simply mimic the incumbent companies' services. It is not even clear that a purely *local telephone* entry strategy can work. An entrant may have to offer a bundle of long-distance services, video services, and high-speed "broadband" services because of the large marketing costs required to induce subscribers to abandon the incumbents' services.

Nor have the past few years been kind to the aggressive long distance companies and the regional fiber-optic carriers. WorldCom and Global Crossing have failed, and Qwest and Sprint's long distance operations have a zero stock-market value. Eighteen years after divestiture, only AT&T appears to have a chance of survival as an independent long-distance company. The experiment with separate local and long distance companies begun with the 1984 AT&T divestiture now appears a failure. No other country has attempted to divide its national telephone company into separate, independent "local" and "long distance" companies. (Japan has required its large carrier, NTT, to divide *internally* along these lines.) As the U.S. experiment looks more and more like a failure in the restructuring of an industry, few countries will be induced to imitate us.

Despite the obvious difficulties faced by virtually *all* of the new entrants into the U.S. telecom sector, regardless of their strategies, some would have us believe that breaking up the survivors, the Bell companies, is the only way to assure that competition emerges, particularly for new services. The failing recent local entrants, in particular, blame the Bell companies for their difficulties with various allegations of slow responses to the demand for service connections and high prices for leasing facilities or providing various services. However, may of these companies have failed despite having succeeded in leasing hundreds of thousands of Bell lines or in obtaining Bell services for resale. Others, such as AT&T, have failed to develop their own assets – in AT&T's case, the cable television systems that they had acquired from TCI and Media One – into viable local telephone service networks. Nor have any of these new entrants been able to thrive by simply offering the new high-speed services, such as DSL, to their customers.

Despite any evidence that Bell-company actions have been responsible for the widespread collapse of a myriad of new and old telecom operators, there has been pressure in various state regulatory agencies to require the "structural separation" of the Bell companies so that their wholesaling activities would be separated from retail activities. The Bells would then have their own retail divisions that lease facilities from their own wholesale divisions. Alternatively, some would split the companies into completely independent wholesale companies and retail operations. How such a separation would work is not clear. The likelihood of new legal and regulatory struggles of the variety staged in Judge Greene's court is obvious as telecommunications technology evolves. When would a retail company be permitted to invest in its own network assets? How could the wholesale company invest in new technologies without disadvantaging some of the retail companies that are its customers?

The U.S. was not alone in suffering a telecom meltdown. Failing companies in Europe are blaming the erstwhile incumbent monopolists, such as France Telecom and Deutsche Telecom, for their inability to find a successful entry strategy. Many of these failing companies were also mounting a political campaign to require structural separation of the large incumbent companies. However, in July 2002, the British regulator rejected a plea for structural separation of British Telecom. Moreover, the stark decline in the stock prices of the other European operators, has made any discussion of "breaking them up" seem rather silly.

There is no reason to believe that breaking up modern incumbent telephone carriers will increase competition in telecommunications, but it surely could reduce the incentive for these companies to invest in new technologies. As technologies and services change in this dynamic sector of the economy, it is essential that the investment and sales functions be coordinated. Breaking carriers into separate wholesale and retail companies breaks this connection between investment and marketing new services.

5. <u>How Will Telecom Competition Develop?</u>

Unfortunately, no one knows how telecommunications will evolve over the next ten or twenty years. In the face of enormous uncertainty, the last thing the government should do is to launch upon a plan to break up firms in order to create a competitive telecom sector. Rather, it should simply sit back and let telephone companies, cable companies, wireless carriers, and even satellite carriers deploy facilities, develop new technologies, and battle for customers.

Indeed, through sharply-declining rates, the wireless, or "cellular," carriers are taking traffic away from traditional telephone companies at an astounding rate. The long distance companies are finding that their customer minutes are declining at double-digit annual rates despite the fact that they offer service at 5 cents per minute or less. In addition, the number of traditional telephone lines is no longer growing as younger subscribers rely solely on wireless and others dump their second lines when they subscribe to the new broadband services. And now competition from cable television companies offering telephone service over the Internet is about to begin in earnest.

Telecommunications networks require large amounts of capital. They must be designed to deliver specific services to specific locations. Today's traditional copper-wire telephone network cannot deliver high-speed Internet services to dispersed households without enormous investments in fiber optics, remote switching centers, multiplexing equipment, new packet switches, and customer modems. These facilities will not be built if carriers have to fear being broken up or being required to lease the facilities at low forward-looking costs. Risky investments in new technologies require some probability of large returns to offset the considerable probability of negative returns if they do not turn out as anticipated. This is true for telephone companies, cable television companies, and wireless companies alike. Fortunately, the latter two are generally free of the deadly grasp of regulation in the United States.

If we want meaningful competition and investment in the rapidly-expanding array of new technologies, we should let all carriers -- cable companies, telephone companies, and wireless carriers -- compete against one another without fear of regulatory expropriation. There is even the possibility that the satellite companies and electric utilities may also join the fray. Given that most U.S. households already have a choice among six wireless carriers, a cable television company, and one incumbent local telephone company in a dynamic communications marketplace, there is surely enough rivalry to assure that new technologies are deployed and that prices are not very far above the incremental cost of service. To try to break up some of the incumbents into wholesale and retail divisions to permit small-scale entry at the retail level by various resellers would add little to new services and technologies, but it could surely reduce investment by the incumbents.

In fact, we have little alternative but to let the market work without attempting to use antitrust, regulation, or new legislation to divide or subdivide existing players. In a rapidly-changing marketplace, any attempt to divine the ideal market structure of carriers will very soon begin to look foolish, much as the 1984 AT&T divestiture or the 1992 exercise in cable television rate regulation looks today. When you do not know where you are going, it is very dangerous to draw up a map of the best route to get there.