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The Neal Report and the Crisis in Antitrust

Herbert J. Hovenkamp
University of Pennsylvania Law School

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The Neal Report[1] was secretly commissioned by President Lyndon Johnson in late 1967. The President asked Phil C. Neal, Dean of the University of Chicago Law School, to lead a group of distinguished lawyers and economists in reporting on the state of competition in American industry and recommend reforms of the antitrust laws. President Johnson requested the Report by June 30, 1968, about four months prior to the election, and its release was intended to be part of the LBJ re-election strategy. However, Johnson's political standing was severely damaged by the unpopular war in Vietnam, and in March, 1968, he announced that he would not run for reelection. The authors finished the Report nevertheless, and it was submitted to President Johnson in July, 1968, and released to the public early in 1969.[2]

The authors of the Report included six law professors who were teachers and scholars of antitrust,[3] three economists,[4] and three practicing antitrust attorneys.[5] The entire project took only seven months to complete, involved no new research, and contains virtually no citation. Yet it proposed expansive antitrust reforms, including most centrally a "Concentrated Industries Act" which gave the Attorney General a mandate to "search out" oligopolies[6] and order divestitures to the point that no firm would end up with a market share exceeding 12%. In addition the Report recommended a much more aggressive merger provision that essentially would have

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* Ben V. & Dorothy Willie Professor of Law, University of Iowa.

[1] Report of the White House Task Force on Antitrust Policy (May 27, 1969), originally published at 115 Cong. Rec. 11, 13890.

[2] See Stephen Calkins, Antitrust Modernization: Looking Backwards, Symposium, The Antitrust Enterprise: Principle and Execution, 31 J.Corp.L. 421 (2006).

[3] Phil C. Neal (chair, and Dean of the Univ. of Chicago Law School); Willam F. Baxter (Stanford Law School); Robert H. Bork (Yale Law); Carl H. Fulda (University of Texas Law School); William K. Jones (Columbia University Law School); James A. Rahl (Northwestern University Law School).

[4] Paul W. MacAvoy (MIT) James W. McKie (Vanderbilt), and Lee E. Preston (Univ. of California, Berkeley).

[5] Dennis G. Lyons (Arnold & Porter), George D. Reycraft (Cadwalader, Wickersham & Taft); Richard E. Sherwood (O'Melveny and Myers).

[6] Defined as *CR4>70* – that is, using the four firm concentration ratio, the sums of the market shares of the four largest firms in the industry exceeded 70%.

condemned mergers in any large industry where the four firm concentration ratio (CR4) exceeded 50% and one of the firms involved in the merger exceeded a market share of 10%. It is worth noting that such a market could have an HHI as low as 650 or so, well under the 1000 HHI that the government's Merger Guidelines currently in force regard as "unconcentrated," and in which mergers have a virtual safe harbor. In addition, the Report recommended several amendments to the Robinson-Patman price discrimination statute, many of which were designed to weaken it. Finally, the Report recommended patent reform that went not to the quality and quantity of issued patents but rather to licensing and use. The principal recommendations were a requirement that all patent licenses be registered, and that if a patent is licensed to one licensee it must be licensed to all other prospective licensees on nondiscriminatory terms. Finally, the Report recommended that a repository of economic data concerned mainly with industry structure and profits be collected and disseminated.

A couple of historical footnotes: *first*, Robert H. Bork wrote a stinging dissent from the Report's recommendations and firmly aligned himself with the Chicago School critique.[7] William F. Baxter kept silent but would very largely repudiate the report later as he learned more about economics.[8] *Second*, all of the recommendations in the Neal Report were ignored, in part because the change in Administration from Johnson to Nixon killed any political momentum for massive antitrust reform. Indeed, very early in his Presidency Nixon appointed a second, competing Commission, this one chaired by George J. Stigler, another prominent member of the University of Chicago faculty except in the economics department, as well as several of his colleagues.[9] The Stigler Report was never officially released,[10] but it leaked out in May, 1969.[11] The Stigler

[7] Separate Statement of Robert H. Bork 2 Antitrust L. & Econ. 53 (Winter 1968).

[8]See Richard Schmalensee, Bill Baxter in the Antitrust Arena: an Economist's Appreciation, 51 Stan.L.Rev. 1317, 1319 (1999).

[9]The members were George J. Stigler (University of Chicago, chair), Ward S. Bowman, Jr. (Yale, law and economics), Ronald H. Coase (Univ. of Chicago, economics), Roger S. Cramton (University of Michigan Law School), Kenneth W. Dam (University of Chicago Law School), Raymond H. Mulford (President, Owens-Illinois, Inc.), Richard A. Posner (Univ. of Chicago Law School) , Peter O. Steiner (Univ. of Michigan law and economics), and Alexander L. Stott (vice president , AT&T).

[10] It was subsequently published, however, at 115 Cong. Rec. 12, 15933-15942 (June 16, 1969); and reprinted in 2 Antitrust Law and Economics Review 13 (No. 3, Spring, 1969). The editors of that journal did not disguise the fact that they sided with the Neal Report and largely rejected the recommendations of the Stigler Report.

Report disagreed with the industrial concentration warnings in the Neal Report, largely rejected the correlation between market concentration, profits, and anticompetitive results that the Neal Report purported to find, and made several technical recommendations for revision of the antitrust laws. At least in the short term, its recommendations faired no better than those contained in the Neal Report.

Reading the Neal Report today is a trip to another world. But in fact it represented the received orthodoxy of its day. The tragedy of the Neal Report is that the model it represented was just on the verge of complete, catastrophic replacement. The views expressed there reflected the culmination of thirty years of industrial organization thinking that we today identify as the "structure-conduct-performance" (S-C-P) paradigm.[12] Indeed, the publication of the Neal Report played no small part in instigating a massive reaction among younger academics that eventually cast the S-C-P paradigm onto the dung heap of defunct economic doctrines.

The S-C-P paradigm was one of the most elegant and certainly the most tested model of industrial economics up to its time. Indeed, its greatest perceived virtues were its simplicity and its robustness. The theory represented the high point of structuralism in industrial organization economics, resting on the proposition that certain market structures were highly concentrated and experienced high barriers to entry, making certain types of conduct inevitable. Under the very strong Cournot assumptions of the day oligopolists simply could not avoid setting prices above costs and continuously and excessively differentiating the products. The result was high short-run profits, excessive investment in product differentiation and advertising, reluctance to cut price in order to grow market share, and general stagnation. The theory appeared to be verified by numerous studies showing positive correlations between industrial concentration and profits – the more concentrated the industry the higher its price-cost margins.[13] By

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[11] See Louis M. Kohlmeier, Study of Conglomerates for Nixon Urges No Antitrust Suits to Block Their Mergers, Wall St. J., May 23, 1969. This article was published two days after the Neal Report was released. See Calkins, note __ at 433.

[12] See E. S. Mason, Economic Concentration and the Monopoly Problem (Cambridge, Mass.: Harvard Univ. Press, 1964).

[13] See Leonard Weiss, "The Concentration-Profit Relationship and Antitrust," *Industrial Concentration: The New Learning*, Harvey J. Goldschmid, H. Michael Mann, and J. Fred Weston, eds., Little Brown & Co. (1974) (summarizing numerous pre-1970s studies). See also Joe S. Bain, Relation of Profit Rate to Industry Concentration: American Manufacturing, 1936–1940, 65 Q.J.Econ. 293 (1951). Other important work includes H. M. Mann, Seller Concentration, Barriers to Entry, and Rates of Return in Thirty Industries, 1950–1960, 48 Rev. Econ. & Stat. 296 (1966).

contrast, the relationship between *conduct* and poor performance was thought to be virtually impossible to quantify.

Under the principle of excluded middle, if the structure dictated the conduct and the conduct dictated the performance, then conduct dropped out as an interesting subject of study. Thus the S-C-P paradigm led directly to the conclusion that structure and not conduct is what antitrust policy should be about. Thus the Neal Report could state that:

> Effective antitrust laws must bring about both competitive behavior and competitive industry structure. In the long run, competitive structure is the more important since it creates conditions conducive to competitive behavior.[14]

This emphasis on structure and de-emphasis of conduct also motivated Donald F. Turner's proposal in the early 1960s that firms in oligopolistic industries should be broken up because price competition in such markets could not be expected to emerge.[15] The editors of the *Antitrust Law and Economics Review*, who were deeply sympathetic to the Neal Report and hostile toward the Stigler Report, introduced their publication of the latter with a proposed set of "Guidelines" for the antitrust enforcement agencies. The Guidelines were entitled "A Structure-Conduct-Performance Questionnaire," and consisted of queries about the size of markets, the level of concentration, the amount of product differentiation, and the height of entry barriers. A few conduct questions were tacked on to the end.[16]

Today we can find much to criticize and even mock in the Neal Report. But it was largely faithful to the dominant industrial economics and law of its day. Its recommendations were built on some of the best theory coming out of an economic model that was just in the process of ending its period of domination. The tragedy of the Neal Report is that, while it was highly sensitive to where the intellectual winds were blowing from, it paid too little attention to where they were going.

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[14] Neal Report, note __ at ____.

[15] Donald F. Turner, *The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusals to Deal*, 75 HARV.L.REV. 655 (1962). These recommendations appeared earlier in more truncated form in C. Kaysen & D. Turner, Antitrust Policy 110-119, 266-272 (1959). Turner went on to be head of the Antitrust Division from 1965-1968, in the years leading up to the Neal Report.

[16] See "Appendix: A Structure-Conduct-Performance Questionnaire," 2 Antitrust Law and Economics Review 8 (#2, Spring, 1969).

Initially the S-C-P paradigm had offered a robust solution to problems that had festered within competition theory ever since the rise of marginalist economics in the late nineteenth century. [17] Prior to the Great Depression industrial economists had been unable to solve a problem that Alfred Marshall had observed already in his *Principles of Economics* in 1890: in the presence of fixed costs competition tends to drive prices down to marginal cost without enough left over to cover fixed costs, leading to "ruinous" competition.[18] During an era when technological progress was greatly increasing the proportion of fixed costs in production, this theory seemed to explain why so many economists opposed the antitrust laws and tended to favor collusion facilitating cooperative ventures such as trade associations.[19] The prevailing models assumed fungible products and "representative" firms – i.e., firms that were all more-or-less the same in significant characteristics.

Edward Chamberlin's *Theory of Monopolistic Competition* largely solved the equilibrium problem in 1933,[20] but did so by abandoning the Marshallian notion that firms in multifirm markets pursued relentless price competition. Instead, they competed by differentiating their products. Further, this differentiation was "excessive," in the sense that it was driven by pursuit of mini-monopolies rather than by consumer interest in an optimal variety of products at competitive prices. While the Marshallian story denigrated antitrust, Chamberlin's theory seemed to call for a great deal of it. Indeed, this change in dominant models explains why the Roosevelt Administration so abruptly shifted its policy from virtual abandonment of antitrust and encouragement of collusion to one of aggressively enforcing the antitrust laws.

But that left open the question how the antitrust laws should be applied. While Marshall tended to see firms as similar, the Chamberlin story was one of extreme diversity in both strategy and behavior. The one unifying element was structure, a result

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[17] See Herbert Hovenkamp, The Neoclassical Crisis in U.S. Competition Policy, 1890-1955 (Iowa Legal Studies research paper, July, 2008, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1156927).

[18] Alfred Marshall, Principles of Economics (1890). See D.H. Robertson, Piero Sraffa and G.F.S. Shove, Increasing Returns and the Representative Firm 50, reprinted in John Cunningham Wood, Alfred Marshall: Critical Assessments (London: Taylor and Francis, 1993).

[19] On the impact of the fixed cost controvery in antitrust policy prior to the 1930s, see Herbert Hovenkamp, Enterprise and American Law, 1836-1937 at 308-322 (Cambridge, Ma.: Harvard Univ. Press, 2001).

[20] Edward Chamberlin, The Theory of Monopolistic Competition (Cambridge, Ma.: Harvard Univ. Press, 1933). On the theory's profound impact on Marshallian equilibrium theory, see Mark Blaug, Economic Theory in Retrospect 375 (5th ed. 1996).

of the fact that Chamberlin's theory also imported Cournot-style structural analysis into formal industrial organization analysis to a much greater extent than before. The defining characteristic of Cournot models at this time was formulas that related the markup of price over cost to two principal variables: the number of firms in the market and their size disparities.

Monopolistic competition largely solved the fixed cost problem and made equilibrium possible. Chamberlin's equilibrium would always be suboptimal, however, with prices above marginal cost, continuous excess capacity, and excessive investment in product differentiation. In 1940 John Maurice Clark published his pathbreaking essay on "Workable Competition," which argued that antitrust policy should not trouble itself with the pursuit of perfect competition.[21] Rather, it should be satisfied with a set of compromises. Clark's genius lay in his observations that market imperfections have a way of cancelling each other out – for example, product differentiation made perfectly competitive equilibria impossible, but it also made collusion much more difficult to maintain. The interesting cases for Clark were the middles ones that fell between the monopolistic and the highly competitive, where policy making could have its most important role.

A few years later Joe Bain, the most prominent industrial organization economist prior to the rise of the Chicago School, exalted the strong link between market structure and the workability of competition. In the process Bain laid the foundation for an antitrust policy whose principal goal was to ensure that industry did not become excessively concentrated, but would maintain just enough firms to ensure that price competition remained a part of business strategy and that product differentiation did not become excessive.[22] For Bain, one of the most important problems was high concentration accompanied by high barriers to entry. Chamberlin's basic model of monopolistic competition and product differentiation had assumed that entry was easy. Competition seemed to be more workable, with prices driven to total costs, when entry

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[21] John Maurice Clark, Toward a Concept of Workable Competition, 30 Am. Econ. Rev. 243 (1940).

[22] Joe S. Bain, *Workable Competition in Oligopoly: Theoretical Considerations and Some Empirical Evidence*, 40 AM.ECON.REV. 35 (papers and proceeding) (1950). Id. at 38-39):

> Whatever the degree of association within oligopolies between competitive behavior and results, it seems quite likely that such behavior may be in turn either influenced or determined by certain characteristics of the underlying market structure. If so, a demonstrated association between market structure and results would establish the more fundamental determinants of workability of competition (and, also, determinants more easily influenced by conventional public policy measures).

was easy. But high concentration accompanied by high entry barriers led to the worst of both worlds – namely, excessive product differentiation and excessive profits. [23] To the extent the theory offered a set of ideas that were useful for policy purposes, they were ideas about structure. In his market dominating book on *Industrial Organization*, which was published in 1959, Bain concluded that conduct was too heterogenous and too difficult to evaluate. The verifiable conditions for workable competition could be stated only by reference to industry structure. "We eschew," he wrote, "any general attempt to state an operational criterion of the conduct conditions of workable competition, and adhere in the main to a suggestion only of structural conditions." [24]

Bain's work and that of his Harvard teacher Edward S. Mason have come to be identified with the "Harvard School" of industrial organization and the S-C-P Paradigm.[25] The theory was unquestionably dominant among the industrial economist and policy making gentry in the 1960s, including most of those in Neal's group. But when Neal and his colleagues began penning their *Report* it was already well on its way to crumbling. Chicago School writers had already exploded the leverage theory of tying[26] and provided competitively benign explanations for resale price maintenance.[27] Stigler had written a formative article arguing that the strict Cournot assumptions about oligopoly should be relaxed, that the number of firms was only one of many factors that indicated whether a market was prone to noncompetitive pricing, and that there was much more room for competition in highly concentrated markets than previously thought.[28] The Bainian definition of entry barriers was in dispute.[29] Richard Posner, a member of the competing Stigler task force, had written an answer to Turner's argument for structural solutions to the oligopoly problem, relying heavily on Stigler's competing

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[23] Joe S. Bain, Barriers to New Competition: their Character and Consequences in Manufacturing Industries (Cambridge, Ma.: Harvard Univ. Press, 1956).

[24] Joe S. Bain, Industrial Organization 427 (New York: Wiley, 1959).

[25] Although Bain was educated at Harvard he spent nearly his entire academic career (1939-1975) at the University of California, Berkeley economics department.

[26] Ward Bowman, Tying Arrangements and the Leverage Problem, 67 Yale L.J. 19 (1957).

[27] Lester G. Telser, Why Should Manufacturers Want Fair Trade?, 3 J.L. & Econ. 86 (1960).

[28] George J. Stigler, A Theory of Oligopoly, 72 J.Pol.Econ. 45 (1964).

[29] George J. Stigler, The Organization of Industry 67 (1968).

theory of oligopoly.[30] A broad based attack was being launched against the proposition that one could infer monopoly power from high accounting profits.[31] Finally, Robert H. Bork, a dissenting member of the Neal Commission, and Ward Bowman, who was on the Stigler Commission, had already published their influential "The Crisis in Antitrust."[32]

One could continue with this list,[33] which makes it easy to criticize the S-C-P paradigm as structuralism run amok, to see it as preoccupied with making firms smaller and as completely insensitive economies of scale or scope. There is even a tendency to see it as anti-consumer, aided in no small part by some of the characterizations in Bork's and Bowman's famous *Crisis* essay.[34]

But the Neal Report was clearly not anti-consumer on its own terms. In fact, it concluded that "consumer welfare is … in the forefront of antitrust policy."[35] The

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[30]Richard A. Posner, Oligopoly and the Antitrust Laws: A Suggested Approach, 21 Stan.L.Rev. 1562 (1969). See also R. Posner, Oligopolistic Pricing Suits, the Sherman Act, and Economic Welfare, 28 Stan.L.Rev. 903 (1976) (recapping the debate).

[31] The literature is summarized in Franklin M. Fisher and John J. McGowan, On the Misuse of Accounting Rates of Return to Infer Monopoly Profits, 73 Am.Econ. Rev. 82 (Mar. 1983). See also Harold Demsetz, Industry Structure, Market Rivalry, and Public Policy, 16 J.L. & Econ. 351 (1971); and Harold Demsetz, "Two Systems of Belief About Monopoly" 164 In Harvey J. Goldschmid, H. Michael Mann, and J. Fred Weston, eds., *Industrial Concentration: The New Learning (*Boston: Little, Brown, 1974).

[32] Bork and Bowman, The Crisis in Antitrust, Fortune Dec. 1963; and 65 Col.L.Rev. 363 (1965).

[33] For differing perspectives, see Richard A. Posner, The Chicago School of Antitrust Analysis, 127 Univ. of Pennsylvania L. Rev. 925 (1979); Leonard W. Weiss, The Structure-Conduct-Performance Paradigm and Antitrust, 127 U. Pa. L. Rev. 1104, 1105 (1979).

[34] Bork and Bowman, *Crisis in Antitrust*, 65 Col.L.Rev. at 364 (1965):

> Long-standing contradictions at the root of antitrust doctrine have today brought it to a crisis of policy. From its *inception* with the passage of the Sherman Act in 1890, antitrust has vacillated between the policy of preserving competition and the policy of preserving competitors from their more energetic and efficient rivals. It is the rapid acceleration of the latter "protectionist" trends in antitrust that has brought on the present crisis. Anti-free-market forces now have the upper hand and are steadily broadening and consolidating their victory. The continued acceptance and expansion of their doctrine, which today constitutes antitrust's growing edge, threaten within the foreseeable future to destroy the antitrust laws as guarantors of a competitive economy

[35]Neal Report, note __ at ___.

difference between the milieu that came to an end just about the time the Neal Report was published – indeed, in part because of it – was not that the older regime was unconcerned about consumer welfare while the successor regime was. Rather, it lay in the set of economic premises upon which the theories were built. Nothing in the Neal Report favored the protection of small business for its own sake at the expense of consumers, and the authors specifically mentioned high prices as one of the evils produced by high concentration.[36] The whole premise of the Bainian analysis of entry barriers as factors that deter entry even while profits are high, or the use of accounting data to infer a relationship between concentration and high profits, was that high prices were in fact the evil to be addressed. The questions pertained to the set of economic assumption that would get the job done. To that end, the turning point marked by the Neal Report and the reaction to it was at least as much a change in prevailing economic theory as in antitrust policy.

[36] Id. at ____