FREE FROM WHAT?

COMPETITION, REGULATION AND ANTITRUST DURING THE GILDED AGE

Nicola Giocoli[*]

University of Pisa

Introduction: the history of economic thought viewpoint

If asked to summarize in a single decision and a single doctrine the constitutional jurisprudence of the Gilded Age,[1] most American jurists would mention *Lochner v New York* and freedom of contract. *Lochner*[2] is one of the Supreme Court's most famous, and most reviled, decisions – the symbol of so-called *laissez faire constitutionalism*, when the Court substantively applied the due process clauses of the Constitution in order to strike down various state and federal laws that infringed constitutional rights to property and freedom of contract. The latter freedom was at the core of such jurisprudence, in that practically all the laws enjoined by the Court would have limited the contractual liberty of American citizens in the effort to further some public interest or social goals.[3]

The literature on *Lochner* and laissez faire constitutionalism is immense, but, for obvious reasons, it is entirely written from the viewpoint of legal or political history. The goal of this essay is to offer a different perspective from which to tackle the freedom of contract saga.

The history of economic thought is fairly well acquainted with freedom of contract too. The notion lay at the heart of one of the two interpretations of free competition offered by Adam Smith and the other classical economists. As the embodiment of classical competition, freedom of contract remained crucial for the next generations of economists, most notably the American scholars of the Gilded Age who faced the theoretical challenges raised by the huge transformation of the US economy. In fact, the classical economists' view of contractual freedom also played a central role in the heated legal and political controversies about competition and regulation that occurred between 1880 and 1910, following the dramatic increase in business size and concentration. In other words, it may be demonstrated that, when debating about the good and the bad of a free market system vis-à-vis government interference, American jurists and politicians were actually referring to the freedom of contract ideal developed by the Classics and still endorsed by most economists of the time.

[*] Email: nicola.giocoli@unipi.it .

[1] By the term Gilded Age it is usually meant the period of American history going from the 1870s to the outbreak of WWI, (with the last decade overlapping the so-called Progressive era).

[2] *Lochner v New York*, 198 U.S. 45 (1905).

[3] For example, at stake in *Lochner* was a law by the state of New York limiting the working hours of bakers for health and sanitary reasons.

My thesis is that, independently of the jurisprudential trajectory that, culminating in *Lochner*, led the Supreme Court to embrace freedom of contract,[4] we may conceive of the classical notion of freedom of contract – together with its classical alter ego, freedom to trade – as a red thread connecting the legal, political and economic discourse of the Gilded Age about free markets, the limits of competition and the desirability of regulation. The bottom line is that the history of economic thought may have a lot to say about the intellectual roots of so crucial an era of American constitutional law and socio-economic history. In view of the fact that, under several respects, we still live in the shadow of the legislation and jurisprudence about regulation and antitrust developed at the time, it may actually be argued that the freedom of contract *versus* freedom of trade dichotomy of the Gilded Age holds sway even today.

In view of this thesis, the structure of the essay is simple. In the first part (§§1-4), I present an overview of the classical notions of freedom of contract and freedom to trade, together with an analysis of the classical market mechanism and of classical monopoly theory. Then, in the second part, I show how the dialectic between two freedoms shaped the jurisprudential, political and, of course, economic debates about regulation (§§5-7) and the protection of competition (§§8-10). The Conclusion argues for the present-day relevance of these debates.

1. Two notions of free competition

The United States of the Gilded Age was allegedly the land of laissez faire. Yet, providing the popular expression "laissez faire" with precise analytical content is not so simple. The most immediate solution is to equate it with free competition and the absence of state intervention. Both notions are themselves far from obvious, though. To start with, what exactly does "free competition" mean? Free from what? How to assess when and if this "freedom" exists? This basic question admits of two answers.

According to the commonest interpretation, the yardstick of free competition is, quite literally, the existence of the freedom to compete, or *freedom to trade*. Under free competition, individuals should be free to pursue any kind of market activity without external interference or constraint, whatever its source. This interpretation is bound up with economic theory. A freely competitive market is depicted as an atomistic structure of diffused property, made up of prevalently small businesses, a universe of "small dealers and worthy men",[5] whose independence and possibility to compete is guaranteed by the market mechanism itself. Competition, both actual and potential, is the key economic force by which the market polices itself, warranting freedom to trade. Any market power is only temporary: whenever a business obtains, by either luck or merit, a supra-competitive profit, free entry brings profit back to the competitive level. No market position is in fact permanent or safe under freely competitive conditions; everything is fluid and subject to change under competitive pressure. Both free entry and

[4] On which see Giocoli forthcoming, Ch.5.
[5] To borrow Justice Peckham's dictum in *United States v Trans-Missouri Freight Association*, 166 U.S. 290 (1897), at 323.

market atomization highlight the *horizontal* character of competition: free competition is a market structure characterized by multiplicity and free entry of firms all placed at the same level of the production and marketing chain. The magic of free competition is that it guarantees everybody's freedom to trade while at the same time rewarding with temporary extra gains those smart enough to get them.

Competitive forces may stop functioning in two cases. The first is when the state disturbs their working by hindering actual or potential competition. The most general form of government interference is the creation of an artificial privilege or constraint – that is, an obstacle to the freedom to trade. In those cases some wealth exists that only certain individuals designated by government acts can gain and that, conversely, all other individuals are legally prevented from acquiring. The second hindrance to freedom to trade may arise from the market itself, whenever, contrary to the general principles of free competition, a business becomes so powerful that competition, both actual and potential, cannot effectively work against it anymore. Due to technological and organizational factors, this was an ever more frequent situation in the American economy of the Gilded Age.

Familiar as it is, the structural/horizontal characterization of free competition is not the only one. Another common view of free competition also focuses on the idea that individuals should be totally unconstrained in pursuing their economic activities, but emphasizes the *vertical* dimension of contract and exchange, rather than the horizontal ones of atomization and free entry. Competition is free, then, when the utmost *freedom of contract* is guaranteed.

By freedom of contract is meant the possibility for any individual to bargain about her own property rights without any hindrance or constraint. The notion stems directly from the legal protection of property rights, including the right to the value of property itself. Since value is determined in the market and materializes through exchange (viz., contractual activity), property is truly protected only when the individual is absolutely free to enter any kind of contract she deems proper to reap the value of her property. John Stuart Mill captured all this in the following definition: "The right of property includes then, the freedom of acquiring by contract. The right of each to what he has produced, implies a right to what has been produced by others, if obtained by their free consent; since the producers must either have given it from good will, or exchanged it for what they esteemed an equivalent, and to prevent them from doing so would be to infringe their right of property in the product of their own industry" (Mill 1909 [1848], II.2.3).

Buyer-and-seller bargaining involves agents placed at different levels of the supply-and-demand chain. Hence, depicting free competition as freedom of contract highlights the vertical character of competition. This, rather than the structural/horizontal dimension, was the image of competition classical economists – starting with Adam Smith – primarily emphasized. For them competition meant first and foremost the contrast of interests between buyers and sellers, each trying to get the most from the bargain. Indeed, the notion of free competition as full contractual liberty transcended economics and drew most of its attractiveness from higher values, such as the classical liberal goals of enhancing personal freedom and autonomy and ensuring complete control over the fruits of one's own labor. It was mainly because their political economy put at center stage these liberal values that classical economists granted so great an importance to vertical buyer/seller relations and, consequently, to the freedom-of-contract version of free competition.

For competition to be totally free, contractual liberty has to be absolute, under the only proviso of not violating someone else's contractual liberty. Thus, classical liberal economists and jurists admitted as the only exception to freedom of contract – and thus the only rationale for government interference –the Latin dictum *sic utere tuo ut alienum non laedas*. After the Civil War, this common law maxim would become the cornerstone of American police power jurisprudence.[6] For the rest, freedom of contract ought to reign undisturbed.

2. Freedoms on collision path

In the classical system the two freedoms, with their respective associated images of competition, could happily co-exist. While classical economists emphasized the vertical view of competition more than the horizontal one – indeed, they did not even conceive of a market structure in the modern sense of the word, this being a notion dating back no earlier than the 1920s – the bargaining between a buyer and a seller, typically both of small dimension, could cause no trouble to the atomistic structure of market. In any case, the equalizing action of market forces guaranteed that it did not. Thus, the most complete exercise of contractual freedom was consistent with the maintenance of freedom to trade.

But the germ of the eventual conflict between the two freedoms already existed. In a truly free system, contractual liberty should suffer no constraint even when its use may cause, or favor, the concentration of market power – that is to say, when it may violate freedom to trade by altering the market structure and limiting horizontal competition. By way of example, think of industrial combinations. Absolute freedom of contract entails that firms be free to form, or join, a cartel or any other combination – indeed, the law should *protect* their right to do so as a legitimate expression of their contractual liberty. Monopolistic positions may thus arise in the marketplace as spontaneous outcomes of bargaining freedom; moreover, they too are entitled to exemption from state interference. This particular way of exploiting freedom of contract is however in blatant violation of the other notion of free competition, namely, freedom to trade. It seems as if to defend the latter some limits need be put on the former. The conflict was bound to explode. Economists, jurists and politicians of the Gilded Age will struggle to reconcile the two freedoms – each, don't forget, based upon a specific economic notion of competition – in those all-too-frequent cases where they contradicted each other, namely, whenever market forces proved unable to dissolve monopolistic concentrations *against the prediction of classical economics* (see below).

---

[6] In Herbert Spencer's version the maxim read: "*Every man has freedom to do all that he wills, provided he infringes not the equal freedom of any other man*" (Spencer 1851, 103, original emphasis). Police power meant at the time the government's authority to protect public health, safety, morals and general welfare by appropriate laws. It was recognized that, in order to perform their task, these laws might even restrain individual rights of liberty, property and contract.

The dichotomy between freedom to trade and freedom to contract, and the related one between horizontal and vertical competition, also entail a different perspective about the limits of state intervention in the economy.[7] The vertical view sees the market as a mechanism to facilitate the exchanges among self-interested individuals; by doing so, the Classics guaranteed, the market also promotes the public good. Analytically speaking, buyer/seller bargaining brings market price to its normal, or natural level, eliminating both excess profits and unsatisfied wants. Exchange activity takes place within a framework of private property and contractual freedom, where the only role for government and the law is to protect property rights and remove any impediment to their unfettered circulation. It follows that free competition is not only synonymous with freedom of contract, but also with *freedom from government interference*. A public commitment to promoting individual economic liberty emerges as an essential component of this perspective: government must limit itself to safeguarding everyone's freedom to manage their own business.

The horizontal view of competition also underlines freedom from government interference. Yet, a major ingredient of this view is the notion of an atomistic market structure. Such a structure need be preserved, lest competition cease to work. As explained above, classical economists believed that, by default, any market power could only be short term because, in the absence of state privileges or constraints, supra-competitive profits would attract new firms into the market that would erode that power. Public intervention was not required and often counterproductive. Hence, with respect to government's role in the economy, both accounts of free competition, vertical and horizontal, led classical economists to the same laissez faire conclusion. This conclusion stemmed from specific analytical arguments, not (or not exclusively) from "political" or moral ones.

But when in the last quarter of the 19th century, under the push of impressive technological and organizational progress, markets started to show a robust tendency towards increasing concentration, many economists of industrialized countries realized that, contrary to classical predictions, market power could well be a spontaneous and permanent feature of economic life. In the presence of significant market power, the freedom to trade of other economic agents diminishes, possibly to nil; the atomistic market structure is altered; competition is no longer free. American economists were the first to understand that it was not just a matter of reconciling classical economics with the manifest tendency of real world markets towards increasing concentration. The bigger problem was that in some cases market power could evolve – actually, had evolved – into *economic* power. While market power only refers to the possibility of gaining supra-competitive profits, by economic power I mean power of a broader, more dangerous kind – power the sway of which extends beyond the boundaries of a single market and reaches the entire economy and, possibly, also the social, political and institutional spheres. This is a power that embodies the worst fears of the Founding Fathers (think of James Madison's "fear of faction"), namely, the specter of the economically powerful thwarting democracy and vanquishing the Republic – what, in a word, Gilded Age Americans used to denounce as plutocracy.

[7] See Peritz 1996, Ch.1; Page 2008; Giocoli 2014, Ch.2.

By the end of the 19th century, the freedom-to-trade, horizontal view of competition became synonymous with *freedom from market* (and, therefore, economic) *power*. The latter kind of freedom replaced freedom from government interference as the necessary safeguard of free competition. Indeed, public intervention was expressly invoked. Many late 19th-century economists understood that the market mechanism alone was unable to dissolve market power – indeed, it might even become the cradle that nurtured it. The only way to constrain, or eliminate market power (thereby preventing its transformation into economic power) was through deliberate government action, in the form of either an antitrust law or direct market regulation. A public commitment to economic equality, in the sense of the preservation of equivalent opportunities in the marketplace, became the intellectual cornerstone of this approach. Accordingly, its supporters were ready to accept various kinds of legislative and executive intervention to uphold it.

Once again, it is easy to see how the two commitments to liberty and equality were destined to clash. The two views of free competition as freedom of contract and freedom to trade that could find reconciliation in the small-business world envisaged by classical economists had morphed, by the end of the 19th century and in the wake of wholly different market conditions, into an almost irreconcilable opposition between freedom from government interference and freedom from market power. Pursuing the latter meant negating the former, and vice versa. The "free from what?" question was about to occupy center stage in economic as well as jurisprudential and political debates.

3. The classical competitive mechanism

The rest of this essay shows that, broadly speaking, American courts took a well-defined position in the controversy between the two freedoms. Scores of judges at all levels endorsed the freedom of contract perspective, with its commitment to individual liberty and hostility against state interference. Freedom of contract was the view that most properly fitted within the framework of the classical liberal Constitution as originally envisaged by the Founding Fathers. Given that it was also the feature of competition that classical economists most consistently remarked, in both their analytical theories and their political economy, contractual liberty emerged as the single most important thread connecting the American Constitution and the Gilded Age courts with Adam Smith and his heirs.[8]

For classical economists competition did not just represent a general organizing principle of social life. It also had a specific analytical function to perform in the classical model, namely, to bring market price to its normal, or natural level, via the elimination of both excess profits and unsatisfied wants.[9] Thus, classical economists

8 This is the main thesis of Giocoli forthcoming. On the classical liberal Constitution, see Epstein 2014.
9 See McNulty 1967, 396. The natural price, which Smith also called "the price of free competition" (*WN* I.7.27), was the reference point for the theorist as well as for market participants.

conceived of competition as the process overseeing the functioning of the price mechanism. Competition and the price mechanism were two sides of the same coin, viz., what made markets work.

Within the classical model, competitive actions consisted first and foremost in the *vertical* intercourse between buyers and sellers. The Smithian slogan "buy cheap or sell dear"[10] captured the vertical essence of market activity and, therefore, of competition itself. Analytically speaking, competition was a *behavior* – a process, not a state (Blaug 1997, 66). It meant the actions and reactions of buyers and sellers bargaining in the marketplace, not a specific market structure or equilibrium position. In order for the competitive mechanism to work, the only analytical requirement was that these buyers and sellers be endowed with the utmost freedom during their vertical intercourse, i.e., that they be free to act and react.

In a world of vertical relations, where each bargaining party tries to gain the most from every transaction, the power to set and modify prices is the main competitive weapon. The rivalry between buyers and sellers – viz., their effort to "buy cheap or sell dear" – suffices for the price mechanism to work. Under free competition, open and costless access to all exchange opportunities guarantees that no party may eventually exploit another. In his best-selling treatise, *Political Economy*, American economist Francis Walker thus captured the gist of classical competition: "Competition signifies the operation of individual self-interest among the buyers and sellers of any article in any market. It implies that each man is acting for himself solely, by himself solely, in exchange, to get the most he can from others, and to give the least he must himself" (Walker 1892, 91-2).

The analytical view of competition perfectly matched the classical economists' belief about the socially beneficial role of individual self-determination in directing the allocation of resources. A competitive agent was an agent free to act and react, i.e., to enter any contract she desired, unconstrained by either government or the law. Even when viewed from the theoretical, rather than political economic perspective, the essence of classical competition thus lay in the freedom of contract and, related to it, the freedom from government interference.

Unsurprisingly, the vertical dimension of competition found counterpart in the common law notions of contract and contracting parties: a contract was nothing but a juridical crystallization of buyer/seller bargaining activity. Legally speaking, the requirement of freedom translated into the necessity of guaranteeing the parties complete liberty to enter, exit or mold contractual relations. Thus, freedom of contract lay at the core of the common law, itself the main component of the institutional framework classical economists took as a datum.

Competition was not only vertical, though. Competition among sellers or among buyers was the other necessary component of the price mechanism. Thus, classical competition also consisted of a *horizontal* struggle between agents operating at the same level in the same market – say, two or more producers of the same good. As it turns out, the centrality of the vertical dimension also affected the classical analysis of this kind of competition.

[10] "The capital of a wholesale merchant, on the contrary, seems to have no fixed or necessary residence anywhere, but may wander about from place to place, according as it can either buy cheap or sell dear" (*WN* II.5.14).

Horizontally speaking, the essence of, say, sellers' competition was to undersell rivals and lead customers to patronize one's own product. As George Stigler (1957, 1) put it, classical competition was a "rivalry in a race" to win the purchasers' favor. Setting and cutting prices were again the main competitive weapons. The analytical task of horizontal competition in the classical model was to prevent either the seller or the buyer from exploiting their vertical counterparts by coercing them into lopsided exchanges. Competition guaranteed that whenever the seller increased the price, the buyer would always have the opportunity to quit the relation and buy at a lower price from another seller. The assumption was that in a freely competitive system – now to be read as a system of unfettered freedom to trade – such an alternative seller *always existed* or, at least, was always ready to enter a market where profitable opportunities arose. In short, that potential competition was always an active and powerful force.

More generally, we may say that in the classical world of perfect economic liberty the number of horizontally-competing agents was *indefinite*. Any buyer had always the option of abandoning a seller charging an "excessive" price and turning to a cheaper provider of the same good, because, given actual and potential competition, such a cheaper provider was always assumed to exist. The same held for any seller facing a buyer who bid too low. In order to prevent entry and preserve its vertical relations the original seller had to limit, or avoid, the price increase. Ditto for the original buyer. For classical economists competition was first and foremost a force depriving market participants of the power to influence the price. Freedom of entry, itself an embodiment of freedom to trade, was therefore the only structural feature classical economists invoked in their market analytics. Granted complete entry freedom, even a one-to-one buyer/seller relation would suffice for the price mechanism to work, i.e., push price to its natural level. Other structural assumptions, like those about the large number and small size of competitors, were basically redundant in such a setup.

In a market with complete free entry, horizontal competition was necessarily impersonal. It could never be targeted at a specific rival because no firm could ever undertake a competitive action – say, selling below cost (so-called cutthroat competition: see below) – with the deliberate goal of harming *that* rival. The latter would always have the possibility to sell to someone else and survive the attack. In the classical view, unfair trading practices were therefore vain, if targeted horizontally, or simply suicidal, if implemented vertically (by, say, coercing one's own customers). Hence, it was not just in an ethical sense that classical economists "[took] it for granted" that custom, i.e., fair trade, was "the only serious hindrance in the way of perfect competition" (where "perfect" should be read as "unbridled").[11] The upshot was remarkable, judicially speaking.

Courts were often called to assess the effects of competition over someone's property rights, like, say, the value of a business. For some judges, fair trade and obedience to custom carried with them a sort of "right to profit", i.e., a businessman's entitlement to a normal return on his own capital provided he behaved correctly in the marketplace – something that could be taken for granted under classical competition, since no misbehavior was possible in the form of coercion over customers or rivals. Others courts held on the contrary that no such

[11] So recited the entry "Competition and Custom" in Inglis Palgrave's influential *Dictionary of Political Economy* (Palgrave 1894, 377).

"right" existed, and that businessmen should always bear the consequences, however negative, of competition, conditional on the latter having been fairly and customary practiced – which again was always the case, by definition. Crucially, the analytical paradigm of classical competition underlay the courts' reasoning in both scenarios. The issue – which will be at the heart of Gilded Age controversies about regulation and antitrust – was therefore theoretical as much as moral.

4. Monopoly: special privilege or market outcome?

Competition was not just an analytical engine for classical economists, but also – in fact, chiefly – an institutional assumption. An implication of conceiving of competition in the latter sense is that there is no need to define it analytically – viz., in terms of economic categories – nor to explain how competition is endogenously generated within the model. Schumpeter claimed that classical economists were "so firmly […] convinced that the competitive case was the obvious thing, familiar to all, that they did not bother to analyze its logical content. In fact, the concept was usually not even defined. It just meant the absence of monopoly – which was considered as abnormal and was vigorously condemned, but was not properly defined either – and of public price fixing" (Schumpeter 1986 [1954], 545-6). As we explained in the previous section, this is not entirely correct, in that competition was indeed identified, albeit only indirectly, as freedom of contract. But even if we accept that classical competition "just meant the absence of monopoly", the question arises as to what happened when competition could not work – that is to say, when monopoly existed.

Monopoly as privilege

Classical economists substantially neglected the issue of monopoly. According to Stigler (1982, 1), they followed the Smithian tradition of paying "no attention to the formal theory of monopoly". The commonest explanation of this attitude underlines that, given the long-run orientation of their economics, their neglect of entry barriers, and the still limited role played in contemporary business affairs by sunk costs and technical progress, classical economists were bound to devote little attention to monopoly. Specific analytical factors play an important role in this account. In the classical model, monopoly was a short-term phenomenon that the forces of competition, if left free to operate without external interference, would quickly eliminate. The ubiquitous presence of potential competition, coupled with complete free entry, ensured that any supra-competitive profit would immediately attract new capital that, in turn, would bring profit back to its natural level. Here lay the gist of the *profit equalization theorem*, one of the core analytical principles of classical economics.

For Smith and his heirs, perfect resource mobility and entry freedom drove market prices to their natural level by equalizing the total advantages of alternative employments of labor and capital. Smith had claimed in the *Wealth of Nations* (*WN*) that an individual would invest in a resource, be it capital, land or labor, so as to earn the highest possible return on it. It followed that all uses of the resource should yield an equal rate of return (adjusted for the relative riskiness of each enterprise), lest reallocation of the resource to alternative uses result. Stigler (1976, 1201) called this argument the "most substantive proposition in all of economics".[12]

Epitomized by the profit equalization theorem, the Smithian characterization of competition would be neither "amplified [nor] challenged in any significant respect for the next three-quarters of a century by any important member of the English school" of classical economics (Stigler 1982, 3). By way of example, in 1825 Ramsey McCulloch declared: "The inextinguishable passion for gain– the *auri sacra fames* – will always induce capitalists to employ their stocks in those branches of industry which yield, all things considered, the *highest rate of profit* […] But the rate of profit in different employments has a natural tendency to equality; and it can never, when monopolies do not interpose, continue either permanently higher or lower in one than in the rest" (McCulloch 1825, 163, original emphasis). Three decades later, Nassau Senior could still write that the operation of competition "can be supposed to be perfect only if we suppose that there are no disturbing causes, that capital and labour can be at once transferred, and without loss, from one employment to another, and that every producer has full information of the profit to be derived from every mode of production" (Senior 1854, 102).

The theorem's implication for monopoly theory was clear. Smith, like many of his predecessors and all of his heirs, "intensely disliked monopoly in all its forms" (Viner 1960, 65), but at the same time thought permanent (private) monopoly impossible. This because classical economists extended to every industry and trade Smith's argument that "the size of the task, the number of persons involved, and their dispersion over space, made the establishment of an enduring monopoly a practical impossibility" (ibid.). Easy and rapid entry of newcomers would always automatically discipline any firm, or group of firms, that attempted to charge monopoly prices In short, free competition – actual and potential – made persistent monopoly unfeasible.

This thesis, which we may call the *non-persistence argument*, itself enjoyed persistence in the economic literature. Indeed, it long outlasted classical economics proper. Faith in potential competition remained strong in many of the early neoclassical authors. The best economic mind of the Gilded Age, John Bates Clark, famously established potential competition as the most fundamental feature of the market mechanism – a sort of magic wand capable of dispelling any supra-competitive profit. "The competitor who is not now in the field, but who will enter it at once if prices are unduly raised, is the protector of the purchasing public against extortion", he proclaimed. "The competition that is now latent, but is ready to spring into activity if very high prices are exacted, is even now efficient in preventing high prices" (Clark 1900, 407). As it turns out, the non-persistence argument (along with several other classical doctrines) was alive and kicking long after the "official", textbook-style ending of the classical era around 1870.

[12] For the theorem to work further conditions on knowledge and time are necessary: "The entrepreneur (or other agents) must know what returns are obtainable in various fields, […] and he must be given time to make his presence felt in these fields" (Stigler 1982, 3). While rarely stating them explicitly, classical economists held these conditions also to be true.

Never a spontaneous outcome of the market mechanism, permanent monopoly could only be an artificial result of external interference with that very mechanism. Such interference, the Classics believed, could take many forms, but all of them could be subsumed under the single heading of *special privilege*. The latter term indicated any kind of legislation aimed at allocating resources in a way that denied equality of opportunity to all individuals, usually by constraining their freedom of contract. In other words, monopoly meant market power achieved through the only means that escaped the leveling effect of market forces, viz., government action arbitrarily obstructing competition. It followed that monopoly was first and foremost a political, rather than theoretical problem, and that, accordingly, competition as freedom to trade (that is, absence of market power) received less attention in the classical system than competition as freedom of contract (that is, absence of government interference). Granted the latter, the former always subsisted and, what mattered more, could always police itself (because in a free market no monopolistic position could arise or survive). This explains why, as Stigler noted, these economists devoted little energy to the analysis of an issue, market power, which was regarded as at most temporary and, in any case, fully within the sway of competitive forces.

Monopoly as market outcome

After the Civil War the structure of the American economy witnessed a dramatic change, pushed by an enormous acceleration in capital accumulation. Between 1869 and 1889 the average American factory doubled in size, capital invested per manufacturing worker almost trebled and total factory productivity grew at an exponential rate. Industry also introduced powerful new technologies. The outcome was impressive. Measured by per capita growth of income, tangible wealth, amount of savings, and investment funds, the 1880s was the decade that enjoyed the most rapid growth in US history to date.[13]

The rise of big business was the *leitmotif* of Gilded Age socio-economic discourse – and the toughest theoretical challenge for US economists. Big business pushed to center stage the relation between firm size and competition. Size meant scale economies and increasing returns, in themselves positive phenomena, but which led to even greater concentration. The latter could take the form of either monopolization or various types of combination, like cartels, trusts, mergers, etc. The flip side of this revolution were more extreme competitive conditions and a greater fragility of financial and managerial structures, the evolution of which lagged behind that of capital and technology. Unable to sustain the competitive pressure of big firms, small businesses in several industries had to shutdown and exit the market. Moreover, the American economy became exposed to sudden financial downturns, like the Panics of 1873 and 1893. The consequences from the socio-political point of view were as dramatic as those of the productivity boom. While the latter had long-term positive effects on aggregate welfare, the high costs associated with the now rapid obsolescence, if not sudden annihilation of human and physical capital generated substantial hardship and widespread complaints.

[13] For this information, see Sklar 1988, 44; Jensen 1993, 834; Perelman 2006, 70-71.

American economists found themselves in the difficult situation of having to reconcile their classical view of competition with the multiple effects of rising business concentration. In the classical model, free competition meant either freedom to trade or freedom of contract. Yet, under the new industrial conditions of big business and huge fixed costs, the outcome of such freedoms was no longer a fluid and atomistic market structure of the kind envisaged by classical economists. Now laissez faire generated a clustering and persistence of economic power. The market mechanism, if left free to work, no longer guaranteed its beneficial effects in terms of power dispersion and, consequently, widespread justice and prosperity. On the contrary, leaving businesses free to compete in the presence of massive fixed costs led to ever more concentration.

Shockingly, American economists were discovering that market power could well be the natural product of competitive markets and that, under certain conditions, the inevitable outcome of free competition was monopoly, i.e., the demise of competition itself. This new awareness meant that what jurists called privilege, and economists monopoly, now had another source beyond state grants. What was worse, it was an endogenous source, the roots of which lay in the market mechanism itself.

Most US economists thus realized that a whole rethinking of the classical notion of competition was called for. A significant share of them – those gathered in the so-called “new school”[14] – became persuaded that in the new industrial landscape laissez faire favored the consolidation of market and economic power, as well as the rising inequality of wealth and greater instability of the markets themselves. Eventually, these economists argued, the utmost liberty to compete played *against* individual freedom. Far from promoting social welfare and personal autonomy, laissez faire hampered them (McCann 2012, 223). In fact, competition itself could have disastrous consequences.

5. Ruinous competition and freedom from contract

Already the leading pre-war form of big business, railroads occupied center stage in the transformation of the American economy. Investments in the railway industry were huge: they surpassed aggregate investment in manufacturing for every decade between 1850 and 1890, while the book value of railroad capital exceeded aggregate capital for the entire industrial sector until the early 20th century. Railroads also provided the most significant example of the difficult reconciliation between the classical, idyllic view of socially beneficial competition and the reality of ruthless market rivalry, anti-competitive combinations and sudden financial collapses. The cheapest possible transportation could only be achieved by those railroads capable of fully

[14] This was the name of the group of young economists who founded the American Economic Association in 1885 in open opposition to classical economics. Fine 1956, Ch.7, is still a good introduction to the “new school”. For more modern accounts, see Yonay 1998, Chs.2-3, and Bernstein 2001, Ch.1.

exploiting their massive scale economies, but, as several authors recognized, this entailed a tendency to monopoly in the industry that was incompatible with classical competition.

Yale economist Arthur Hadley earned international fame for applying in his 1885 book *Railroad Transportation* the lessons of the railroad industry to the economy in general. Hadley observed that in the presence of significant sunk costs the classical idea that capital could be easily withdrawn from unprofitable uses and re-invested in more profitable ones was meaningless. This was obviously the case with railroads. But in the economic environment of the Gilded Age ever more industries looked like railroads, i.e., they were characterized by "a large permanent investment, which can be used for one narrowly defined purpose, and for no other. The capital, once invested, must remain. It is worth little for any other purpose" (Hadley 1885, 40).

Beyond the slow readjustment of bad investments, two further problems affected those industries. The adoption of new technologies and sheer scale effects combined to lower the production cost below current market price, generating supra-competitive profits and attracting new capital. As a consequence, industries characterized by huge fixed investments and increasing returns frequently experienced situations of excess capacity and overproduction. Yet, contrary to what classical economists maintained, capital in those industries was hardly fluid: as a matter of fact, it was very difficult to withdraw or redirect it. Hence, overproduction was a semi-permanent phenomenon in heavily-capitalized sectors of the economy.

A big debate arose among American economists about the nature and permanence of the overproduction caused by irreversible investments in fixed capital – what Herbert Hovenkamp has called "the great fixed-cost controversy" (Hovenkamp 1991, 311). Some scholars remained faithful to the classical thesis that, thanks to the working of competition, general gluts or enduring resource misallocations were impossible. Others, including Hadley, believed that the presence of enormous sunk costs undermined the classical mechanism: given the conditions of modern capitalism, overproduction emerged as an endogenous and chronic tendency of the market.

Economists in the latter group also shared a second, even more serious concern. Speaking of the railroads' experience, but again only in order to instance a more general problem, Hadley noted: "In order to attract new capital into the business, [railway] rates must be high enough to pay not merely operating expenses, but fixed charges on both old and new capital. But, when capital is once invested, it can afford to make rates hardly above the level of operating expenses rather than lose a given piece of business" (Hadley 1886, 223). In modern terms: the price capable of attracting new investment in industries characterized by massive sunk costs must be above average *total* cost, but this is always higher – often much higher – than the price forcing existing firms to withdraw old investment, namely, a price below average *variable* cost. In Hadley's smart synthesis: "the rate at which it pays [for capital] to come in is very much higher than the rate at which it pays to go out" (ibid.).

The situation turned problematic in view of the downward pressure on price that was unavoidable in any sector affected by persistent overproduction. The loss to be suffered (in terms of lost capital) by stopping production and exiting the market was so large that firms preferred to fight until the end and keep producing as long as price exceeded average variable cost, and maybe even below that. Such a low price would eventually drive those firms into bankruptcy. Again contrary to classical economics, in these industries the free entry mechanism stabilized neither the price nor the return on investment around their normal levels. In fact, no "normal" limit to competition existed in the presence of large sunk costs. Forced to compete by cutting prices, firms were inevitably destined to collapse. Competition was simply ruinous.

Several American economists shared Hadley's opinion, claiming that competition was indeed destructive in industries with huge fixed costs. Cornell economist Jeremiah Jenks was exemplary in this regard. As he wrote: "competition will eventuate, not in the elimination of some few while the majority are still making profits, but rather in a depression of the entire business, so that only the very few most skilful or best situated will be making any profit at all, while the others still struggling along may be losing money for a long period before they finally yield. Indeed, the result may well be that for a considerable length of time all will be running at a loss" (Jenks 1900, 19). These industries, Jenks and Hadley concluded, naturally gravitated away from competitive conditions. Competition often led to the survival of only one firm, i.e., to monopoly, and thus to the end of competition itself.

Monopoly could be either the spontaneous outcome of ruinous competition or possibly the deliberate goal of so-called *cutthroat competition*. The latter was a strategy addressed to preserving a firm's invested capital by waging a price war: drastic price cuts were undertaken, aimed at forcing competitors to leave the market; once it remained the lone producer, the firm was capable of exploiting its plant fully again. Clark (1886, 120) so described the strategy's outcome: "Easy and tolerant competition is the antithesis of monopoly; the cut-throat process is the father of it".

A third alternative existed, *combination*, which could take various forms (from loose deals to tight cartels to complex governance structures), but the essence of which always lay in an agreement between producers to act as a joint monopoly and set "fair" prices, i.e., non-competitive prices capable of guaranteeing an adequate return on capital to all participants. Such an artificial, rather than natural limit to competition, was an appealing alternative, free as it was of the wasteful consequences of ruinous or cutthroat competition. Yet, it remained that in all three cases a significant reduction in the number of actual competitors or, frequently, a fully fledged monopoly would follow.

American economists could not escape the recognition that, far from being just the product of government interference in the marketplace, as the Classics believed, monopoly seemed ubiquitous in the new industrial era. It could emerge as the natural outcome in an industry characterized by enormous fixed costs, or as the end result of a ferocious competitive struggle, or as the smooth escape from competition itself, in the form of a trust, a cartel or a merger. "New school" leader Richard Ely felt it legitimate to conclude that competition in the presence of large fixed costs was self-destructive and *inevitably* led to monopoly (Ely 1888, 121). In a similar vein, Jenks proclaimed: "Under a system of free competition industrial efficiency tends toward monopoly. The business genius whose industrial efficiency is greatest tends to overcome his rivals, and to take over a continually increasing proportion of the business, until he becomes a monopolist" (Jenks 1912, 349). Unlike the classical model, monopoly had therefore another possible source beyond state interference, a source dependent on the strict logic of competition paired with the concrete existence of giant fixed costs – a feature the Classics had no experience with. As it turned out, privilege was not only state-granted, but could have a pure economic origin. It could, in short, be *economic* privilege. Worse, this second source entailed that monopoly was not only possible, but practically inevitable.

Given the mayhem caused by destructive or cutthroat competition in the context of heavily-capitalized businesses, many economists were not hostile to what looked like the least harmful solution. Neoclassical champion Irving Fisher argued that combination was a legitimate form of self-defense for a firm's investment: "The rise of trusts, pools, and rate agreements is largely due to the necessity of protection from competition, precisely analogous to the protection given by patents and copyrights" (Fisher 1997 [1912], 331). Even Clark recognized the private and social attractiveness of combinations.[15] As to Hadley, he took a fairly positive view of railroad combination, or pooling, which he saw as a market-based solution to the industry's peculiar problems – a solution, that is to say, preserving a role for market forces and voluntary contractual behavior with no outside coercion by the law (Hadley 1885, 76-7). Railroad pooling looked to him as the only way the stability of so crucial an industry could be reconciled with the true core of classical economic freedom, namely, freedom of contract and freedom from government coercion. The latter could thus survive and preserve the gist of free competition, classically understood, even when competition as freedom to trade had to give way, for objective industrial reasons, to concerted behavior.

Starting from the 1870s destructive competition began to appear regularly as a courtroom defense raised by firms accused of having formed unlawful cartels or combinations.[16] Lawyers, as well as economists, argued that competition – or, more specifically, a low price – could be such a bad thing that firms could invoke their right to protect themselves against it. The novelty was not so much in the legal argument itself – the "ruinous competition" defense had been raised long before by participants to various contracts in restraint of trade, usually paired with appeals to custom and fairness. The new feature was that now the argument had found legitimization in economic analysis.

Beyond theoretical and judicial issues, the further dilemma arose as to what policy-makers should do with ruinous competition and inevitable monopoly. Fighting the new form of economic privilege meant interfering with the market mechanism, but letting it go undisturbed meant favoring the eventual demise of that very mechanism. Even worse, any business endowed with economic privilege – viz., monopoly power – had also the ability to interfere, one way or another, with other businesses' freedom to trade and contract. This power to interfere was all the more significant when it stemmed from the contractual activity of a powerful firm or group of firms. Even those jurists and economists who identified laissez faire with freedom of contract, rather than with

[15] See e.g. Clark 1887, 55 and 57.
[16] See Hovenkamp 1991, 313. On the illegality of cartels and combinations, see below.

freedom to trade, had to recognize that, in a world of rising concentration and business power, a central issue was how to guarantee freedom *from* contract.

By the latter expression is meant the opportunity for every market participant to pursue her economic activity – her freedom to trade and compete – without being coerced, either vertically or horizontally, by other firms' activity, which often takes the shape of formal or informal contracts.[17] Think, for example, of a firm whose freedom to trade is affected by its rivals' market power – more specifically, by the contractual restraints they can enforce. The typical case is that of a cartel, that is, a "contract" among some firms with the goal of restraining competition and, therefore, the freedom to trade of all non-participants: customers, competitors and suppliers alike. Classical economists believed that no such restraint could survive the competitive pressure brought by free entry and full resource mobility. Alas, no such equilibrating market forces were available in industries impaired by ruinous competition and inevitable monopoly. State intervention could thus be invoked in such cases to preserve a firm's freedom to trade and, with it, the possibility of competition itself to survive. Remarkably, the plea did not exclusively, or did not necessarily, come from anti-business quarters. Even conservative supporters of freedom of contract might advocate government action for the simple reason that the constraints imposed by a powerful business affected not only a firm's freedom to trade but also, more directly, its freedom of contract (think for instance of the limitations suffered by a cartel's supplier).

By the last decade of the 19th century, *freedom from contract* became a catchword for everyone demanding that some checks be placed upon unbridled competition. For many of those who appealed to it, it was synonymous with freedom to trade and compete. For others, it was a way to recall the importance of protecting the universal right of freedom of contract against any undue interference. For all, it meant urging government action to guarantee the persistence of competitive conditions in the new industrial landscape. The coercion of the law was invoked to block those particular business contracts or practices that could be used by powerful firms or groups to encroach someone else's economic freedom. Little surprise, then, that from these ranks emerged the voices in favor, first, of state and federal regulation; then, of a federal antitrust statute; and, finally, of the latter's strictest enforcement.

6. The regulatory dilemma

Stephen Siegel explained long ago how the Gilded Age controversies about the power and limit of regulation stemmed from the transformation of the US economy from one based on small-scale, decentralized, individual businesses to one where large-scale, concentrated, corporate enterprises prevailed (Siegel 1984, 188). This

[17] Note that in modern economic jargon one would talk rather of freedom from market power (see above). In the absence of a recognized measure of market power (which will only emerge in the 1930s: see Giocoli 2012), late 19th-century scholars referred to such power's closest proxy, namely, the contracts in restraint of trade that only a powerful firm (or group of firms) could enforce.

revolution altered the traditional "property v. privilege" dichotomy that characterized American law. Property used to denote only those valuables the acquisition of which was open to everybody, typically through work and saving. In this sense property stood in contrast to privilege, which was identified with "those assets that only specially designated individuals could acquire, characteristically through special governmental act" (ibid., 190). Privilege endangered equality, harmony, freedom, and the overall economic and political liberty that property established. In particular, it corrupted government, directing it from the pursuit of the general good to that of individual self-interest.

The conventional reading was seriously questioned by the post-Civil War advent of large-scale business – a phenomenon that, as we just explained, took place thanks to, rather than despite, market forces. Now economic privilege – viz., monopoly – did not necessarily stem from government intervention. New economic conditions allowed the achievement of market dominance through private contracts rather than governmental grants. The dilemma arose as to what to do in the face of the free play of market forces. To many observers, especially outside the economics profession, the laissez faire recipe appeared counter-productive; in a shocking reversal, government regulation was now invoked by powerless individuals as a curb against rising monopoly power. Aware of the multiple and complex sides of the regulatory dilemma, American jurists endeavored to handle it by redefining no less than the substance of constitutional law. Their privileged response, Siegel argued, was *to constitutionalize the free market* (ibid., 260). In this respect, *Lochner* was only one instance of a broader trend.

As the most important American industry in terms of employees, capitalization and social influence, railroads were of course *the* issue as far as regulation was concerned. No surprise, then, that the first comprehensive regulatory measure passed by Congress, the 1887 Interstate Commerce Act, was designed to regulate the railroad industry. Indeed, by the time of its enactment, states had already been regulating railroads for the previous half century and courts had been called to adjudicate law several times in regulatory conflicts between the states, the railroads and other parties with an interest in railway services.

Alas, railroad regulation was no easy task. During the Gilded Age the problem had at least two facets: how should the railroads be regulated and who, between the states or the federal government, should regulate them? The latter side was as delicate as the former – possibly more so, in that it touched the constitutionally sensitive issue of the division of power between Washington and the states. The stakes were so high, both economically and constitutionally, that the jurisprudential answers given to both sides of the railroad regulation problem would eventually shape all other areas of regulatory activity in the US.

Admitting regulatory power over rates meant granting legislatures full control over the value of property. No surprise, then, that even when everybody recognized the legitimacy of such power, as in the case of railroads and other privileged businesses, many jurists still balked at the idea of placing vast amounts of private wealth, accumulated in the nation's most significant enterprises, at the mercy of state legislators. Still, for almost a decade the ruling precedent on regulatory matters was *Munn v. Illinois* (94 US 113, 1877). In sanctioning regulation of a business (grain elevators) that enjoyed no special privilege, Chief Justice Morrison Waite had expressly rejected the counsel's argument that the value of property – viz., its profitability – should receive the same degree of constitutional protection as its title and possession. The regulatory power of the legislature, Waite's opinion held, was complete and exclusive, so much so that courts had no right to question the reasonableness of regulated rates. Protection against abuses of the regulatory power by the legislature, he famously concluded, was to be found in "the polls, not [the] courts" (*Munn*, at 134).

As Siegel explains (ibid., 210), *Munn* was clearly anachronistic. By the late 19th century, non-landed wealth had achieved a significance it could not have held in the early decades of the Republic, when the main form of property was land and the constitutional protection over title and possession sufficed to guarantee individual freedom from external interference. In modern economies, largely based upon immaterial wealth, value had to be recognized as an essential element of the constitutional conception of property. The Supreme Court recognized the problem and reneged on this side of *Munn*.

In the so-called *Railroad Commission Cases* (1886), Waite himself made a first move in this direction. "It is not to be inferred", he averred, "that this power of limitation or regulation is itself without limit. *This power to regulate is not a power to destroy, and limitation is not the equivalent of confiscation.* Under pretense of regulating fares and freights, the state cannot require a railroad corporation to carry persons or property without reward; neither can it do that which in law amounts to a taking of private property for public use without *just compensation* or without due process of law".[18] Three years later and in another railroad rate regulation case, the Court finally ruled that the Constitution mandated judicial review of the "reasonableness" of regulated rates. Justice Samuel Blatchford declared in *Chicago, Milwaukee & St. Paul Railway*: "The question of the reasonableness of a rate of charge for transportation by a railroad company, involving as it does the element of reasonableness both as regards the company and as regards the public, is eminently a question for judicial investigation, requiring due process of law for its determination".[19]

The 1890 decision marked a turning point in American constitutional jurisprudence on regulatory matters. In a complete overturn of *Munn*, the Court now recognized that rate regulation was *not* beyond judicial review: the Constitution both allowed legislative control of the charges of privileged enterprises and required courts to substantially protect from spoliation the private wealth invested in them. The new doctrine did not just affect the (copious) case law on railroad rates. At the price of expanding the boundaries of judicial discretion, it established the reasonableness scrutiny over all applications of regulatory and, more broadly, police power. Needless to say, economic theory had a lot to say about how such scrutiny should be made.

[18] *Stone v. Farmers' Loan & Trust Co.*, 116 U.S. 307 (1886), at 331, emphasis added. See Smalley 1906, 27-8.
[19] *Chicago, Milwaukee & St. Paul Railway Co. v. Minnesota*, 134 U.S. 418 (1890), at 458. See Smalley 1906, 32-8.

7. What is "reasonable" regulation?

The difficulty implicit in the reasonableness standard was apparent. No test existed that clearly bounded the limits of "reasonable" regulation. Although the constitutional notion of property now included its value, it was hard to pin down what "value" meant. Guaranteeing the absolute intangibility of value would effectively bar all rate regulation. But a wholly discretionary analysis of the relationship between regulated rates and declared public policy ends would not do either, because it would give too much leeway to judicial opinion vis-à-vis legislative motives. Identifying a fact-based, non-discretionary notion of value that could determine, both theoretically and practically, the boundary separating regulation from confiscation: this was the tough challenge facing American courts. The answer they found in classical economics.

Brewer's test and its critics

In a series of cases in the late 1880s and early 1890s,[20] Justice David Brewer proposed a clever solution based on the notion of "just compensation", itself drawn from the standard constitutional doctrine of takings and eminent domain. His analysis took private, not public ownership as the natural starting point; as a consequence, any regulation was fundamentally confiscatory. That government should not take property without "just compensation" was a settled constitutional principle and the first substantive right from which stemmed all others (including contractual freedom). Brewer's idea was to extend this doctrine to prevent rate regulation from "work[ing] a practical destruction to rights of property" (*Reagan*, at 410) – including shareholders' property in the regulated business. He argued that the anti-takings doctrine necessarily protected shareholders against rates set so low by regulation that they did not cover operating expenses and other compulsory payments, like the service of debt. This was a smart way to distinguish permissible from impermissible rate regulations because it envisaged a clear, fact-based test as a direct offspring of traditional eminent domain doctrine. The boundary of confiscation was objectively determined by the total of operating expenses plus necessary charges: a rate that failed to cover this amount entailed an unconstitutional taking of shareholders' property.

Brewer's test had three remarkable features. First, and on jurisprudential grounds most significantly, it shifted the rate regulation problem from the police power to the takings doctrine, that is to say, from being a public welfare concern to being a property rights issue. The move thus placed the problem firmly within the realm of classical liberalism and classical political economy.

Second, the test referred constitutional protection of the "just compensation" value of property to an array of observable economic values, like operating costs and interest expenditures. This marked the definitive recognition of the constitutional protection of property as a mutable economic value, rather than as a static

[20] Among which, *Chicago & North Western Railway v. Dey*, 35 F. 866 (C.C.S.D. Iowa 1888); *Ames v. Union Pacific Railway*, 64 F. 165 (C.C.D. Neb. 1894); *Reagan v. Farmers' Loan & Trust Co.*, 154 U.S. 362 (1894). For more details on these cases and Brewer's role, see Smalley 1906, esp. Chs. II-III-IV; Siegel 1984, 215-20.

vested right. The test, note well, achieved that result by simply enlarging the category of what constituted property – once again, an affirmation of classical economic theory.

Third, the protection offered by the test did *not* cover profits in the form of shareholders' dividends. Brewer apparently believed that a difference existed between bonds and shares. In the case of privileged businesses that, like railroads or public utilities, owed their existence to government permission, shareholders were only entitled to their ownership rights, not to any pre-established profit. The extent of dividends was a discretionary policy issue, involving the legislator's estimation of what profit would attract capital in the industry. Bonds, on the contrary, were purely a matter of property. They were "a creature of the common law, a form of wealth and investment available to all as a matter of right" (Siegel 1984, 218). The contract clause of the Constitution ensured protection from state interference to all kinds of contracts, including those between a company and its bondholders.

Brewer's test attracted criticism from all camps. Classical liberals attacked the idea that the return on capital could be a matter of discretionary policy. Markets, rather than legislators, determined profit as much as interest. Reasonable regulated prices should therefore include at least a market return on capital, lest capitals shun the regulated industry and fly elsewhere.

This criticism did not especially trouble Brewer. His test could easily encompass the notion that, as California's highest court put it, "no distinction can be made between those who construct the works with their own money and those who do so with money borrowed from others".[21] The takings clause could well entitle both to the competitive rate of return existing at the time of their investment. The final version of Brewer's test thus set the boundary between regulation and confiscation at the level of operating expenses plus a competitive rate of return on all invested capital, evaluated at *historical cost*.[22] Once again, all ingredients in the calculation were objectively quantifiable by a court. Moreover, in order to avoid easy abuses or sanctioning waste and mismanagement, expenditures could only be included in the calculation conditionally on their having been "prudentially incurred" – hence the name *prudent investment rule* that came to identify the test.

Progressive critics had much to complain about it. The main drawback was that the conditions of the late 19th-century American economy made the test excessively favorable to regulated industries, first of all railways. The reason was the dramatic fall in railroad construction costs since the 1870s.[23] Deflation made the historical cost of investment a high hurdle for regulators to overcome in order to satisfy the prudent investment rule. The bottom line was that regulated rates could not be significantly lower than current (viz., monopoly) ones. A different benchmark was needed if regulation were to bite, as progressive jurists desired. Brewer himself gave them an opening.

[21] *San Diego Water Co. v. City of San Diego*, 118 Cal. 556 (1897), at 570.
[22] What is today called rate-of-return, or cost-plus regulation. See Viscusi et al. 2005, 429-36.
[23] The general price index fell from a high of 129 in 1864 to a low of 71 in 1894. As to single materials, the wholesale price of pig iron fell by about two-thirds and refined petroleum by over 90 percent. The production cost of steel rails dropped by 88 percent between the early 1870s and the late 1880s; that of aluminum by 96 percent in the same period. See Perelman 2006, 71.

From present value to reproduction cost

Writing for the Supreme Court in an 1893 takings case, and called to determine the exact value of just compensation for condemned property, Brewer proclaimed the following criterion: "The value of property, generally speaking, is determined by its productiveness – the profits which its use brings to the owner. Various elements enter into this matter of value. […] The value […] is not determined by the mere cost of construction, but more by what the completed structure brings in the way of earnings to its owner".[24] This was nothing but the modern idea that the value of a business is equal to the *present value* of its future net earnings. Given the depressing effect on future monetary flows exercised by the deflation, progressive jurists were quick to propose present value as an alternative, more favorable benchmark than historical cost for assessing the reasonableness of regulated rates.

Yet, present value was itself an ambiguous concept when applied to regulatory issues. What did present value mean, exactly? If it meant the value of an *unregulated* business, which by definition included its ability to gain supra-competitive profits, the whole purpose of regulation would have been defeated. Neither could it mean its *regulated* value, that is, the value resulting from employing regulated rates in the calculation of future earnings. In such a case the constitutional protection of shareholders would have been clearly infringed by basing the permissible rates on the rates already set by legislators. Seemingly, only one solution existed.

The proper present value of a business could be no other than the value set by the *competitive market*. In other words, rate regulation was confiscatory only when it reduced the overall return of the regulated business below that obtainable from an investment of comparable size and risk made in a competitive environment. Needless to say, using competitive markets as a benchmark for "just compensation" rested upon the solid foundations of classical political economy. Both conservative and progressive jurists could invoke Adam Smith's authority of to defend the choice as philosophically, as much as economically, grounded. How could anyone accuse a court of having exercised excessive discretionary power if its decision had been guided by the inspiring light of classical competition? Courts did not miss the opportunity to avail themselves of an inflow of external authoritativeness in so controversial an issue.

Under the doctrine of competitive present value, the judicial task was to determine what the value of a railroad or public utility would have been if operated in a competitive environment. That would again have been a hard task, were it not for the help coming from business and engineering valuation techniques. The notion of *reproduction cost* provided the answer. While the notion had been theorized by antebellum economist Henry Carey,[25] it is very likely that late 19th-century courts borrowed the idea of reproduction, or replacement cost from more mundane sources. For example, the 1886 volume of the *Transactions of the American Society of Mechanical Engineers* included a paper, by a New Jersey engineer named Oberlin Smith, about "Inventory

[24] *Monongahela Navigation Co. v. United States*, 148 U.S. 312 (1893), at 328.
[25] See Carey 1837-1840, vol.1, 9-12.

evaluation of machinery plant". Smith discusses the evaluation techniques a business should apply in cost accounting, the problem being to ascertain "the true value of property kept account of" (Smith 1886, 433). The only correct answer, he declares, is reproduction cost: "The grand principle which lies at the root of correct evaluation, and which should govern the appraiser throughout all his work, is, that any article is worth not what it *did cost*, but *what it would cost to replace it to-day*" (ibid., 436, original emphasis).

In a sort of mutually enforcing feedback, the notion of replacement cost owes a lot to the history of regulation itself. For instance, the concept was employed as far back as the 1840s in controversies raised against the British Railway Commission about the evaluation of capital improvements (Pollins 1956, 353). Accounting historian Germain Boer confirms that the earliest arguments about replacement cost in the US had no theoretical foundation or origin, but stemmed from rate cases involving public utilities and heard before regulatory agencies: "It was in the hearings before these commissions that replacement cost first received prominence in America" (Boer 1966, 92). In short, railroad regulators used reproduction cost because engineers and accountants did; engineers and accountants in turn used it because some regulators had.

By the last two decades of the 19th-century, engineers, accountants and even a few regulators had agreed that the present value of a business was equivalent to the funds a potential buyer of the whole business would have to expend to construct anew that specific enterprise, i.e., to the business's reproduction cost. This technique rested on the more or less implicit assumption that in a free market buyers always had the option of building, rather than buying, and should bear the full consequences of their own choice. Once again, the reference to free – that is, competitive – markets proved crucial in the technique's success (Siegel 1984, 222). Under the reproduction cost approach, a businessman in a regulated industry would reap the fruits, positive or negative, of his own ability: if he had built his enterprise at less than its current reproduction cost, even regulated rates would guarantee him an extra profit; by contrast, if he had spent too much, he would suffer from his bad choices. This was exactly what would happen in the unregulated market, given that the reproduction cost always identified the exact value of his business.

The Smyth *rule*

Calculating the reproduction cost of a railroad or public utility was no easy task either, but still no harder than determining the historic cost, as required by the prudent investment rule. Moreover, it was again a matter of factual inquiry rather than mere judicial opinion. This catered to the courts' need to avoid excessive discretion. In 1898 a unanimous Supreme Court established the reproduction cost rule in the landmark *Smyth v. Ames* case. Despite mounting criticism (especially after WWI), and a considerable degree of ambiguity in the Court's own wording, the rule would remain valid for the next forty years, helping judges at all levels to separate rate regulation from confiscation.[26]

[26] *Smyth v. Ames*, 169 U.S. 466 (1898). The decision will be formally overruled only in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

The case involved Nebraska's 1893 railroad rate legislation. With an opinion written by Justice John Harlan, the Court found the regulation unconstitutional: when set too low to permit the railroads a reasonable return, regulated rates amounted to an unconstitutional taking of private property. In the key passage of his opinion, Harlan wrote: "the basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway under legislative sanction must be the *fair value* of the property being used by it for the convenience of the public. And in order to ascertain that value, the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stock, *the present as compared with the original cost of construction*, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses are all matters for consideration, and are to be given such weight as may be just and right in each case. […] What the company is entitled to ask is a *fair return* upon the value of that which it employs for the public convenience" (*Smyth*, at 546-7, emphasis added).

These words were subjected to careful scrutiny over the following four decades.[27] Taken literally, they merely offered a list of evaluation criteria that eschewed any commitment to a specific determination of the vague concepts of "fair return" and "fair value". So Harlan's statement has been considered ambiguous at best and useless at worst. According to Siegel, though, this was not how most contemporary courts and commentators understood it. At the time it was widely recognized that the Court had endorsed the reproduction cost approach to rate regulation. Indeed, all subsequent decisions on rate regulations took it for granted that the "fair return" to which a regulated company was entitled was the competitive dividend, and that the "fair value" upon which that return had to be calculated was the present reproduction value of the company's assets, as required by the reproduction cost method, and not their original cost, as required by Brewer's test.

One year later, in *San Diego Land & Town*, Harlan himself clarified the Court's endorsement of reproduction cost, calling for a "fair return upon the reasonable value of the property at the time it is being used for the public" as the measure of just compensation, while rejecting the appellant's request based on the original cost.[28] Even more significantly, the next rate regulation cases – where the Court consistently applied the new method – were all decided unanimously.[29] In 1903 Justice Oliver W. Holmes quoted Harlan's words from *San Diego Land & Town* to proclaim that "[i]t no longer is open to dispute that under the constitution" evaluation for regulatory reasons should be based on reproduction cost. "That is decided", Holmes wrote, "and is decided as against the contention that you are to take the actual cost of the plant, annual depreciation, etc., and to allow a fair profit on that footing over the above expenses".[30]

[27] Given that the "fair return on fair value" mantra underlies all forms of cost-plus regulation, one may legitimately argue that the debate raised by *Smyth* still continues today.
[28] *San Diego Land & Town Co. v. City of National City*, 174 U.S. 739 (1899), at 757.
[29] On these cases, see Whitten 1912, 26-8; Siegel 1984, 226-8.
[30] *San Diego Land & Town Co. v. Jasper*, 189 U. S. 439 (1903), 442.

As we said, the logical underpinnings of the reproduction cost principle resided in the notion of competitive markets. Fairness (of values and returns) was expressly translated in terms of the outcomes of classical competition. *Smyth* thus constitutionalized competitive values and returns as the fair yardsticks for measuring property and for protecting it against unconstitutional takings (Siegel 1984, 231-2). Classical competition gave substantive content to all those vague ethical or political attributes – justice, reasonableness, fairness – a regulated rate should satisfy. Indeed, its outcomes were themselves just, reasonable and fair. Under competitive conditions, the public would pay no more for a product or service than what would grant a competitive return to a freely entering rival – viz., the equilibrium rate of profit. The Court recognized that this was also the amount the Constitution should guarantee to railroad and utility shareholders. Competitive market returns, and only such, represented the *justified* profits that even privileged businesses like railroads and utilities were entitled to gain. Judicial determination of reasonable rates thus suffered no arbitrariness: competition, not the judge's idiosyncratic will, drew the constitutional boundary between regulation and confiscation. Courts should just establish by factual analysis what the competitive return on the present market value of a given enterprise would be and compare it with that implied by the regulated rates.

Remarkably, the kind of competition the unanimous Court had in mind in *Smyth* and later decisions was still the classical one. As classical economists envisaged, competition was the dynamic process leveling the profit rate and canceling monopolistic rents unsupported by legal privilege. Competitive markets were simply those where this process worked unhampered. Proof of their effective functioning rested in the tendency itself to the equalization of returns – the analytical core of classical economics. Even more significantly, the Court's jurisprudence on rate regulation did *not* constitutionalize the *neo*classical notion of competition as a market structure made up of small enterprises devoid of market power. This should be kept in mind when, in the next sections, we examine the so-called competition principle the same Court allegedly established, in the same years and amid heated controversy, in its early antitrust jurisprudence.

In sum, by 1898 the Court had fully and unanimously endorsed the strong connection between competition and property that lay at the core of classical political economy. The former provided no less than the measure of the latter, because free markets were the one and the only place where the value of property was determined. This free market value was, according to the Court, also the value protected by the American Constitution. One could not separate competition and property without violating the Constitution – and classical economic principles, too.

The *Smyth* doctrine had momentous consequences that went beyond rate regulation. At the turn of the century, American judges agreed that "the constitutional notion of property included its free market value" (Siegel 1984, 260). First settled in the railroad regulation context, the idea was soon generalized. All citizens were entitled, like railroads, to the free market value of their property. Even the central doctrine of Gilded Age jurisprudence, freedom of contract, emerged as a corollary of the constitutional protection of the competitive value of property. Free market value is nothing but *exchange* value; the latter, in turn, depends upon the possibility of trading property with the utmost liberty. Hence, freedom of contract may be constructed as a necessary implication of the Court's interpretation of the "just compensation" principle of rate regulation in terms of the reproduction cost rule – that is to say, of the ironclad connection between classical competition and the constitutional protection of property rights.

8. Contracts in restraint of trade and American law

This section sketches the principles followed by American courts when administering the common law of contracts in restraints of trade (CRTs henceforth), large parts of which had been developed by their English counterparts. The key insight is that, at least until the Sherman Act, a common pattern existed in the way judges administered the law of CRTs – which also encompassed combinations – in pursuit of antitrust goals. In particular, a steady shift of emphasis from freedom to trade to freedom of contract characterized Anglo-American jurisprudence.[31]

The common law of CRTs involves two contrary principles. The dichotomy – which mirrors that between the two freedoms – explains why in the last three centuries there has never been a monolithic attitude towards these contracts. Arguments over the distinction between good and bad restraints have been a perennial feature of common law scholarship and jurisprudence.

On the one hand, the common law may uphold a CRT in the name of contractual liberty. To own property means the right to freely dispose of property by contract; this freedom covers property in all its forms, including intangible property such as goodwill or trademarks, and the law should not interfere with the way a free and grown-up individual exercises her right. On the other hand, the common law may invalidate a CRT in the name of freedom to trade. The latter expression may mean either a given individual's liberty to exercise her own commerce or profession or a generic reference to everyone else's opportunity to enter a given trade. In the first, more traditional sense, CRTs are indicted at common law because they deprive an individual of the means to earn her livelihood. In the second meaning, which has gained increasing relevance in England since the 18th century, the law condemns CRTs because they deprive the public of the advantages of competition. We find in this conflict the germs of what would later become the key dilemma of antitrust enforcement, namely, the divergence between competition as freedom from market power and competition as freedom to contract, i.e., the liberty to exercise one's own property rights.

Writing for the Supreme Court in *Oregon Steam*, Justice Joseph Bradley formulated in 1873 what became the American legal orthodoxy on CRTs. "There are two principal grounds on which the doctrine is founded that a contract in restraint of trade is void as against public policy", Bradley averred. "One is the injury to the public by being deprived of the restricted party's industry; the other is the injury to the party himself by being precluded

[31] For a more detailed analysis, see Giocoli 2014, Ch.2, from which this section draws.

from pursuing this occupation and thus being prevented from supporting himself and his family. It is evident that both these evils occur when the contract is general not to pursue one's trade at all, or not to pursue it in the entire realm or country. The country suffers the loss in both cases, and the party is deprived of his occupation or is obliged to expatriate himself in order to follow it. A contract that is open to such grave objection is clearly against public policy. But if neither of these evils ensues and if the contract is founded on a valid consideration and a reasonable ground of benefit to the other party, it is free from objection and may be enforced".[32]

The Court believed that contracts restraining the freedom to trade were harmful both because they deprived an individual of his occupation and because they deprived society of that individual's activity. General CRTs suffered from both evils and were therefore void. But, the Court conceded, reasonable contracts did exist that could well be enforced, despite their restraining effect. This was especially true in the case of contracts pertaining to corporate life and activities. *Oregon Steam* thus provides a useful benchmark for understanding how, before the Sherman Act, American competition policy consisted of a combination of corporate law and the common law of CRTs.[33]

Once again, it is easy to realize the extent to which the classical view of competition shaped Bradley's doctrine. Classical competition emphasized contractual liberty and freedom from coercion, while giving no importance to a competitive market structure in the modern sense of the word. So, for instance, a voluntary price-fixing agreement could never be "anticompetitive", in the classical sense, if nobody's freedom to act was artificially restrained. This explains why for the good part of the 19th century American law did not proscribe cartels and mergers. Price-fixing agreements could at most be unenforceable at common law, but they were not illegal, nor actionable by outsiders.

That the common law of CRTs did not aim at preserving, or establishing, a competitive market structure (neither in the US nor, for that matter, in Britain) was also clear from the way courts enforced it. Consistently with the classical model, American courts treated those CRTs that actually destroyed competitors exactly like those that did not. The key distinction lay elsewhere, namely, in the separation, of English origin, between general and partial restraints – the former being, under American common law, those covering an entire state. Given this distinction, and consistently with Bradley's doctrine, many CRTs were viewed unfavorably by US judges, broadly speaking.

Hostility to CRTs went hand-in-hand with a relaxed attitude about cartels.[34] Within the classical model, the simple price-fixing conspiracy, with no exclusionary practices directed at nonparticipants, was not particularly offensive. Classical economists posited that monopoly prices could never persist unless artificial restraints prevented new competition. Apart from law-created obstacles, restraints to entry could take the form of either a contract, where the restricted business was a voluntary participant, or a combination, which was by definition

[32] *Oregon Steam Navigation Co. v. Winsor*, 87 U.S. 64 (1873), at 68. The doctrine mirrored the analogous principles affirmed in English common law since the early 18th century.
[33] See Hovenkamp 1989, 1029.
[34] See Hovenkamp 1989, 1036-7.

directed at restraining other nonparticipant businesses. A mere agreement among sellers to fix prices was therefore of little concern, provided that neither the law nor the price-fixers prevented other firms from entering the market. If cartel members sought to charge monopoly prices, new competition would immediately frustrate their attempt.

Accordingly, the few common law cases that did condemn cartel agreements were founded on the defendants' efforts to exclude, or coerce, outsiders. The latter, note well, never included customers. That buyers be required to pay a higher price was considered no coercion at all, because in the classical model patrons were always free to walk away and purchase elsewhere. In the revealing words of a late 19th-century New York jurist, the principle was that "the public is deprived of no legal right, unless some individual is deprived of a legal right; […] What is this so-called right of 'the public', as to freedom of competition? Who is there, that has the legal right – that two sellers of merchandise shall compete?" (Stickney 1897, 157).

Starting from these benchmark doctrines, American law gradually accommodated a more pro-business and pro-freedom-of-contract approach to CRTs. Fewer and fewer contracts were deemed unlawful at common law. Even general restraints, or contracts unlimited as to time and place, became reasonable in the eyes of Gilded Age courts. It was for instance recognized that those CRTs that just embodied simple noncompetition agreements accompanying the sale of a business were of no public concern in a competitive market. So, for instance, in an 1887 case the New York Court of Appeals concluded that a simple covenant not to compete could not create a monopoly and, therefore, had to be sanctioned; this in view of the fact that "the business is open to all others, and there is little danger that the public will suffer harm from lack of persons to engage in a profitable industry". Fifteen years later, after the Sherman Act had been enacted and, above all, the jurisprudential transition towards a more lenient approach to CRTs had been completed, the same court was even more explicit: "Contracts between parties, which have for their object the removal of a rival and competitor in a business, are not to be regarded as contracts in restraint of trade. They do not close the field of competition, except to the particular party to be affected".[35]

By the late 19th century, the blending of the common law of CRTs with traditional corporate law – which e.g. included the possibility of enjoining corporate misbehaviors as *ultra vires* (viz., beyond chartered powers) – provided states with a set of powerful instruments to combat the proliferation of collective business agreements and the tremendous rise of industrial concentration. Before 1890 more than a dozen states had already included antimonopoly provisions in their constitutions or enacted their own antitrust legislation, often as an integral part of state corporation law. Violations were punished with the withdrawal of corporate charters or every other special privilege.[36] Some states had even foreran the Sherman Act by bringing action against some of the biggest national trusts, like those of sugar and oil. The states won all these litigations, leading to either annulment of defendants' franchises and privileges or to forced severance of trust connections.

[35] *Diamond Match Co. v. Roeber*, 106 N.Y. 473 (1887), at 483; *Wood v. Whitehead Bros*, 59 N.Y. 545 (1901), at 551.
[36] On pre-Sherman Act antitrust activity at state level, see May 1987, esp. 499-501.

When combined with the common law of CRTs, state corporation law was considered as a powerful shield against the threatening economic transformations of the time. This view was shared by learned scholars and public opinion alike.[37] Legal treatises and surveys focused prominently on state statutes and decisions, giving them at least equal, and in some cases considerably more attention than federal developments. For its part, the public followed state antitrust cases with great interest, stimulated by their intriguing mix of economic, political, and moral dimensions. The trust problem was actually headline news, with newspapers featuring coverage of law enforcement activity and litigation developments in the various states.

This was the environment in which most of the congressmen debating the Sherman Act expressed their confidence in state authority and the common law. Their main concern was how to strengthen what states were already doing. Hence, in voting for the new statute, they manifested a desire to merely supplement, and not hold back, state antitrust activity and the work of state courts. The Sherman Act simply aimed to sustain the antitrust efforts by the states by means of a federal statutory rendition of the principles underlying the common law.

9. Senatorial competition

The common law of CRTs was the main reference for the framers of the Sherman Act. The Act's wording, with the use of common law terms like "restraint of trade" and "attempt to monopolize", is self-explanatory in this regard. However, the common law roots of the 1890 statute do not tell the whole story of its enactment, nor suffice to answer the most basic question arising in the courts called to enforce it, namely, whether the Act embodied or superseded the common law.[38] Should the offenses identified in the Act, namely, contracts, combinations and conspiracies in restraint of trade (as to section 1) and monopolizing attempts (as to section 2), be given the traditional common law explanation, or did the new statute redefine them in a substantive sense?

Congress turned to the trust problem in 1888. The electoral platforms of both major political parties contained statements indicating opposition to industrial monopolies. Accordingly, in the first session of the 50th Congress the House of Representatives instructed its Committee on Manufactures to conduct a study of the combination movement. Initial attitudes were in favor of federal intervention because states seemingly lacked sufficient powers to check the growth of business concentration (McCurdy 1979, 323). However, by the time the House Judiciary Committee was ready to report out a bill, a score of successful cases had established the states' formal competence, and effective control, on the issue. This circumstance would be crucial in the process leading to the statute's approval.

Congressional debates on the Sherman Act once again validate our dichotomic characterization of free competition. Records show that both views, freedom of contract and freedom to trade, were openly on the table.

[37] See May 1987, 504; Freyer 1992, 50-52.
[38] On the importance of this question, see Sklar 1988, 105.

The eventual outcome was an Act that featured elements of both. By adopting the common law language, it endorsed the freedom of contract approach that, inspired by classical political economy, had come to dominate the late 19th-century common law of CRTs (as always, the term included combinations). But the Act also contained elements of the alternative approach, that is, of the idea that only court interventions could restore the proper working of competition in the face of excessive market power. In particular, by making violations actionable by either third parties or the government and by establishing civil and criminal sanctions against violations, the Act marked a sea-change with regard to traditional common law, procedurally speaking.

The dichotomy between freedom of contract and freedom to trade thus provides a useful guide in interpreting the events leading to the statute's approval.[39] As is fairly well known, the enacted version of the Sherman Act was *not* authored by Ohio Senator John Sherman, but mainly by Vermont Senator and prominent corporate lawyer, George Edmunds, chairman of the Senate Judiciary Committee.[40] It is not simply that the statute should more properly be called the "Edmunds Act". The real point is that the difference between Sherman's various proposals and Edmunds's final version exactly matches that separating the two views of competition.

Sherman's original bill, titled "A Bill to declare unlawful trusts and combinations in restraint of trade and production", had been drafted on the assumption that the states were "unable to deal with the great evil that now threatens us", the rise of industrial concentration. The Ohio Republican warned his colleagues against the trust-builders' ability to evade the jurisdiction of state courts. It was up to Congress, therefore, to employ federal powers to dissolve combinations "extend[ing] to two or more States", while state officials should continue to police the charters of those active within a single jurisdiction. No doubt existed as to Congress's constitutional power in the field because the effect of trusts was to "restrain commerce, turn it from its natural courses, [and] increase the price of articles". All these activities, Sherman suggested, negatively affected interstate trade in the same way as a bridge obstructs interstate navigation or a state tax impedes the free circulation of goods – two realms where Congress's power was undisputed.[41]

Clearly, Sherman had in mind a model of antitrust involving a direct control over market structures by federal and state governments. Much as a government could decide whether and where to build a bridge, so it should be allowed to determine the extent of competition in a given market. And exactly like unobstructed navigation, or tax-free commerce, so free competition should be the default mode of operation. Accordingly, all of his proposals – he made three of them, between August 1888 and March 1890 – contained (a version of) the following statement: "That all arrangements, contracts, agreements, trusts, or combinations between persons or corporations made with a view, or which tend to *prevent full and free competition* in the production, manufacture, or sale of articles of domestic growth or production, […] and all arrangements, contracts, agreements, trusts, or combinations between persons or corporations designed, or which tend, to *advance the*

[39] The whole debate is reproduced, with just a few lacunae, in *Bills and Debates in Congress Relating to Trusts, 1888-1902*, from which all the following quotations are drawn.
[40] For a more detailed reconstruction of the episode, see Letwin 1965, 93-5; McCurdy 1979, 325-6.
[41] See Sherman, *Bills and Debates*, 105.

cost to the consumer of any of such articles, are hereby declared to be against public policy, unlawful, and void" (*Bill and Debates*, 8, emphasis added).[42] Regardless of Sherman's own political goals, this wording placed his bill firmly within the freedom to trade rhetoric. Both the notions of "full and free competition" and that of consumers paying the cost of anti-competitive behavior could find no place in the late 19th-century common law approach to CRTs. They were, on the contrary, consistent with a characterization of antitrust as committed to defend competition from market and, possibly, also economic power.

The enacted version of the statute would contain no such wording, including no mention at all of the term "competition". Senator Edmunds would draft it explicitly in the then-standard common law language of contracts, combinations and conspiracies in restraint of trade and of monopolizing attempts. This phrasing validates Justice Holmes's dictum that "the [Sherman] act says nothing about competition".[43] Were it not for its revolutionary procedural provisions, the Act could be plainly interpreted according to the common law (and, eventually, constitutional) language of property rights and freedom of contract typical of English and American courts of the time.

The congressional debate triggered by Sherman's proposals illustrates the division between the two camps. The bill met a less-than-friendly reception in the Senate. Doubts arose about both the constitutionality and the necessity of so sweeping a reform. Several senators contended that Sherman's equation of the trusts' impact on interstate trade with other kinds of interference, like obstruction to navigation and state tax barriers, was legally unfounded, given the Supreme Court's consolidated distinction between transportation and manufacturing. Others asserted that, far from being helpless, states had recently demonstrated their legal capacity to handle structural problems caused by giant combinations. But the most interesting aspect of the debate turned on the two views of competition. A few glimpses will suffice.[44]

Sherman and other supporters of the original bill emphasized two negative consequences of combinations: harm to industrial liberty and harm to consumers. The former threat struck at the traditional, republican image of a country of "small dealers and worthy men", viz., of a fluid and atomistic economy of small businesses, none of which were endowed with significant market power. The latter struck at the possibility of consumers escaping from high prices by turning to alternative producers. Taken together, these two harms led to an even more dangerous threat against American society. Evoking Thomas Jefferson's republican ideal, Sherman emphasized how an economically independent citizenry was the cornerstone of representative government. Competitive equality in the marketplace was therefore crucial to preserve not only economic, but also political liberty and, ultimately, democracy itself. Failure to answer the citizens' demand for congressional action against the combination ogre would risk opening the door to "the socialist, the communist, and the nihilist" (Sherman, *Bills and Debates*, 101).

[42] Further details on Sherman's bills can be found in Letwin 1965, 87-91, and Sklar 1988, 107-9.
[43] *Northern Securities Co. v. United States*, 193 US 197 (1904), at 403.
[44] For a more complete analysis, see Letwin 1965, 85-99; Sklar 1988, 105-17; Peritz 1996, 14 ff.

Remarkably, the opposing camp was not manned by naïve believers in the power of laissez faire to automatically destroy monopoly. Most of those against Sherman's proposal actually believed – like "the younger economists of the country who have studied the question thoroughly" (von Halle 1896, 117) – that "full and free" competition could be even more dangerous than combination and that private agreements could often mitigate the effects of destructive competition. They subscribed to the anti-classical view of "new school" economists, who held that business concentration and monopoly were the inevitable products of competition in a modern economy and that such a natural, evolutionary outcome could not, and should not, be hindered by the government or the law.

Many senators thus believed that, by preserving the most complete freedom of contract, the law could actually favor the birth of private agreements and combinations as a safeguard against the most destructive effects of competition. Like many economists of the time, they too thought that industrial liberty was not synonymous with unrestrained competition – that "unrestrained competition is not free competition", as Rudolph Peritz (1996, 16) put it. Competition could only be termed "free" when market participants could exercise their most complete contractual freedom, including the freedom to voluntarily restrain one's own market opportunities. The law should aim at preserving that freedom by proscribing only those contracts and practices that curtailed it – viz., that coerced an individual into adopting a behavior he would not voluntarily choose. But this was precisely the message of the late 19th-century common law of CRTs, itself inspired by classical political economy.

Freedom of contract, that quintessential feature of classical political economy and the pillar of Gilded Age jurisprudence, also provided the rationale for those who rejected any outright condemnation of business concentration and were ready to consider it as a natural, possibly beneficial evolution of market forces. So even a "new school" economist could see no contradiction in adopting classical principles, including the desirability of the utmost contractual liberty, while believing that new technological conditions had made the classical competitive order simply impossible. At the same time, it was perfectly possible to endorse freedom of contract as a constitutional principle, a common law doctrine and a milestone of classical political economy, while belonging to the opposing camp of those who believed the economic and political threats raised by business concentration outweighed its alleged benefits.

The extent of the common ground established by classical notions is revealed by what both camps of the Senate debate extolled as a key benefit of the market system, namely, the guarantee of a "fair price". The true yardstick for assessing the desirability of a given price, every senator agreed that fairness meant not only that consumers ought not to be exploited by trusts, but also – indeed, *especially* – that "every man in business" ought not to be deprived of his "legal and moral right" to a "fair profit".[45] None denied that businessmen were entitled, as anyone else, to a fair price embodying the "just" reward for their honest work, where "just" was intended in the legal, and classical sense of respecting the property rights on the fruits of one's own labor. "The true theory on these matters", Senator Platt proclaimed, "is that prices should be just and reasonable and fair, that prices, no

[45] Connecticut Senator Orville Platt used these words while debating the final version of Sherman's proposal: see *Bills and Debates*, 297.

matter who is the producer or what the article, should be such as will render a fair return to all persons engaged in its production, a fair profit on capital, on labor, and on everything else that enters into its production" (Platt, *Bills and Debates*, 295).

Both sides of the debate would endorse these words. But only one side would assent to the rest of Platt's statement. The two factions split again when it came to determining what the law and the government could do to guarantee the actual fairness of market prices. Sherman and his allies believed that a fair price could only be achieved when conditions of "full and free competition" prevailed in the marketplace. Hence, the law should strike at combinations like, say, price-fixing cartels, which generated an unjustly high reward for their members at the customers' expense. The opposing view emphasized, as did also many economists of the time, the losses caused by ruinous competition, and saw combinations, including cartels, as voluntary contracts aimed at establishing fair prices and fair profits. The law should not prohibit these combinations, unless they undertook practices imposing unfair conditions upon someone else.[46]

Platt belonged to the latter camp. Unsurprisingly, he attacked "the theory of [Sherman's] bill" for entailing that "no matter how much the price may have been depressed, no matter how losing the business may be, the parties engaged in it must have no understanding between themselves by which they will come together and say that they will obtain a fair and fairly remunerative price for the article which they produce. That is wicked, the bill says" (ibid., 295-6). For those on Platt's side, no law should interfere with a businessman's effort to defend his right to a fair profit. This was the logical consequence of considering that "right" as part of his property, i.e., itself a property right. As such, it should be in the owner's full and free disposal. And as such, many courts would conclude, it was constitutionally protected and no federal statute should violate it.

The blending of contractual freedom with the property rhetoric made Platt's the winning position, and not only with respect to "fair price". Most congressmen saw in the combined action of state corporate law and common law an adequate weaponry to protect the American economy from both dangers – unrestrained combination *and* unrestrained competition. Accordingly, they relegated the Sherman Act to a supporting role. The phrasing of the first two sections in Edmunds's enacted version mirrored this view. The motion to commit the bill to the Judiciary Committee thus turned out to be the decisive event in the statute's legislative history: the Committee's recourse to familiar common law wording for defining statutory liabilities bears witness to its "reaction against the original bill's explicit and unmediated imposition of 'full and free competition' as the only natural and legitimate form of commerce" (Peritz 1996, 20).

In the end, the main outcome of the Senate debate over Sherman's proposal was to establish the constitutional *limitation* of any federal action against corporations and industrial concentrations. The Senate concluded that Congress "lacked the authority to vest federal officials with a roving license to 'bust' state-chartered corporations" (McCurdy 1979, 326). Still, in the debate about the final draft, no Senator attempted to specify

[46] For example, a conspiracy to boycott a rival who refused to join the cartel should be declared unlawful because it coerced the rival's freedom and caused him unfair losses.

exactly what the federal authorities' role should be in fighting the trusts. Presenting the Committee's work, Edmunds simply explained that the bill incorporated traditional common law categories and that Congress ought to leave courts free to determine the categories' concrete applicability on a case-by-case basis (Edmunds, *Bills and Debates*, 315). An unexceptional piece of legislation, in short, which senators could safely vote into law.

A few additional details only were provided in the discussion about the ambiguous notion of "monopolizing". CRTs necessarily involved an agreement between two or more parties, but the Judiciary Committee had added a provision extending section 1's prohibitions to target the restraints to trade caused by a single individual or firm. The problem with section 2 was the word "monopolize", which had no immediate correspondence in the common law. Edmunds was aware of the vagueness of the new provision, which could be read as a prohibition of all loosely-defined monopolies, and so as a radical attack against any big business endowed with significant market power. Hence, he tried to reassure perplexed senators that section 2 dealt with just another form of restraint of trade and would never be applied against any individual who had conquered a whole business by his own "superior skill and intelligence". The Committee, Edmund insisted, had read "monopoly" as a technical term at common law, meaning "the sole engrossing to a man's self by means which prevent other men from engaging in fair competition with him". In this reading, even "monopolizing" fell within the common law boundaries of "coercion", viewed as limitation of someone else's freedom. It followed that no market position, no matter how large, could ever be called a monopoly if gained by "superior skill and intelligence".[47]

Thus reassured, an almost unanimous Senate voted the bill as proposed by the Committee, with a new title: "A Bill to protect trade and commerce against unlawful restraints and monopolies". As a courtesy to Senator Sherman, the Act retained his name, although its substantive content had entirely changed.[48] Unsurprisingly, most American economists did not welcome the new statute. Critical voices were hardly homogenous, though, in that they focused on different aspects of the trust problem. Three main positions emerged.

As we know, "new school" economists believed that scale effects, better management and massive investments increased productive efficiency so much that even full-blown monopolies could further social welfare. A few admitted just one proviso for the beneficial effect of size, namely, that the magic wand of potential competition be allowed to work properly. These economists viewed the Sherman Act as at best a misguided attempt that, in the hands of theoretically untrained courts, could obstruct the natural evolution of markets towards the inevitable augmented concentration. Combination should be encouraged, not thwarted, as the most virtuous way to cope with the inevitability of monopoly.[49]

---

[47] For the lively exchange involving Edmunds and other senators on this specific issue, see *Bills and Debates*, 322-4. It was the very last point debated by the Senate before the final vote.

[48] And notwithstanding Sherman's own complaint that the final version was "totally ineffective in dealing with combinations and trusts. All corporations can ride through or over it without fear of punishment or detection". So he declared to the *New York Times*: see Letwin 1965, 94.

[49] That in its early years the Sherman Act was enforced almost exclusively as an anti-cartel, rather than anti-trust statute and that, as a consequence, American firms were pushed towards tighter forms of concentration (the slogan being: "merge, don't collude") was therefore an outcome these economists could welcome.

A second group remained faithful to the classical view of competition. These traditional economists singled out contractual liberty and freedom from state interference as the key requirements for the competitive process. Faith in the power of the invisible hand led them to accept whatever outcome the spontaneous play of market forces might produce. Judicial intervention was only justified when someone's freedom had been coerced, but in general no grounds existed for interfering with voluntary contracts. Even this group thus concluded that no real need existed for an antitrust statute if not, as we explained, as a way to federalize the established common law of CRTs. Any use of the new act beyond this narrow boundary would represent an illegitimate interference with economic freedom.

The rhetoric of "small dealers and worthy men", which had played so big a part during senatorial debates, became the slogan for a third group. Populist commentators praised in principle the outcomes of the free play of market forces, but unlike members of the other two groups, they ascribed economic evils to the abandonment of old-style "fair" competition among roughly equal agents. In the new industrial era the spread of monopoly power had disrupted the natural and socially beneficial harmony of free markets. Crucially, these populist writers – most of whom were not professional economists – believed that it was size itself, rather than any specific practice, that should be blamed for the disruption. Concern for this undesirable outcome went beyond economic effects. American democracy itself was said to be threatened by the rising plutocracy and trustification.

While this group could invoke no solid theoretical argument in support of its diagnosis, its policy recipe was clear. It was up to the federal government to restore the markets' natural harmony by fighting, and possibly dissolving, big business. A rigorous antitrust law was instrumental to this task. Not surprisingly, the populists were the only declared supporters of Senator Sherman's original proposals. Though the enacted version of the statute did not fully satisfy their expectations, American courts soon offered them some grounds for hope.

10. The classical political economy of early antitrust jurisprudence

The so-called formative era of US antitrust law conventionally spans about 25 years, from 1890 to 1914. This is the most intensively studied period in the history of American competition policy. The reason is simple: the courts of this formative era, first among them the Supreme Court, handed down a series of landmark decisions the doctrines of which would shape antitrust law for several decades and, in a few instances, even survive into the new millennium. Some of these decisions are almost legendary, if only because they involved the biggest names in American capitalism – J.P. Morgan in the *Northern Securities* case, J.D. Rockefeller in *Standard Oil*, or J.B. Duke in *American Tobacco*. These cases dominated the news of the day. Presidential elections were won and lost in their shadow. A mythical aura surrounds the Justices who left their mark in this case law.

It is impossible to investigate this extraordinary period in a few pages.[50] My goal is therefore merely to pinpoint the key turning points of the Supreme Court's jurisprudence, with a view to understanding how events of the period were shaped by the "freedom to trade v. freedom of contract" dichotomy. To this aim, the customary division of the formative era into three phases – the common law phase, the literalist phase and the rule of reason phase – is quite convenient. Each phase saw the Supreme Court's majority entertain a different attitude towards the Sherman Act. Each attitude was, in turn, the outcome of the conflict within the Court between the two freedoms.

The Justices split in two factions, usually labeled Literalists and Rule-of-Reasonists. In broad terms, the former endorsed the idea that the goal of antitrust should be freedom from market power, as epitomized by Senator Sherman's image of "full and free competition" among roughly equal businesses. The latter viewed the principle of contractual freedom as the guiding light for antitrust enforcement and believed that reasonable CRTs could often be the best method of guaranteeing fairness of price and profit instead of destructive competition.

It's all in common law

The landmark case in the first phase is *In re Greene*, an 1892 decision about the whisky trust by Ohio Circuit judge, and future Supreme Court Justice, Howell Jackson.[51] The key doctrine established by Jackson vindicated Senator Edmunds's interpretation of "monopolizing". Jackson declared that "a business might be a monopoly in fact, yet not a monopoly at law, if it had become the sole producer of a commodity without having done anything illegal to achieve or retain its control" (Letwin 1965, 147). His decision was even more important because of the way he reached the conclusion that the trust had done nothing illegal "to achieve or retain" its dominant position.

Jackson argued that no trust could violate the Sherman Act by its mere existence. A monopoly at common law consisted of two necessary elements: an exclusive right enjoyed by the monopolist and some restrictions imposed on other agents' rights or liberty in order to prevent them from infringing that privilege (*In re Greene*, at 115). The plaintiff, the US Department of Justice, had failed under both respects. First, the whisky trust had no exclusive control of the market: competitors, actual or potential, did exist. Moreover, the indictment contained no allegation that the trust had undertaken any particular action to curtail its competitors' business freedom (ibid., at 116-18). In case a restraint did exist, it should be evaluated according to the common law test of reasonableness. In particular, Jackson pointed at the version of the test developed by the British House of Lords in a recent cartel case:[52] a restraint would be unreasonable only if it were "more injurious to the public than is required to afford a fair protection to the party in whose favor it is secured" (at 118). The choice of a British common law precedent was crucial because it impressed a well-defined stamp upon the first phase of the

[50] Good general references are Letwin 1965, Chs.5-6-7; Sklar 1988, Ch.3; Freyer 1992, Ch.4; and Peritz 1996, Ch.1.
[51] *In re Greene*, 52 F. 104 (C.C.S.D. Ohio, 1892).
[52] *Mogul Steamship Co v. McGregor, Gow & Co and others*, All ER Rep 263 (1891-94), at 280. See Giocoli 2014, Ch.2.

formative era. Enforcing the Sherman Act meant applying the ongoing common law of CRTs – in other words, it meant defending the freedom of contract as well as the intangibility of property rights.

Classical competition was for Jackson the rationale for constructing the law – in this case, the Sherman Act – as a statute addressed to protecting contractual freedom and property rights. Nothing prevented the whisky trust's competitors from offering larger rebates to their dealers. Actual and potential competitors would always be around, ready to steal business from the trust if it ever charged excessive prices. A trust having no exclusive control of the market or doing nothing wrongful to exclude its rivals could never be guilty of monopolizing.

If Jackson's decision captured the gist of the conventional economists' viewpoint, "new school" ideas found their counterpart in the first two trials in the *Trans-Missouri Freight Association* (*TMFA*) case.[53] Both the district court and the Court of Appeals for the Eighth Circuit affirmed the lawfulness of an agreement to fix uniform rates and terms of freight carriage entered by a number of railroad companies for the purpose of avoiding destructive competition. Both courts agreed that the Sherman Act should follow the common law and that the latter did not aim at preserving competition as such. As if he were rebuking Senator Sherman himself, the trial judge wrote: "the public is not entitled to free and unrestricted competition, but what it is entitled to is fair and healthy competition". A restraint eliminating excessive competition and setting reasonable prices ought to be reasonable. In fact, not only should it be lawful, it would actually be beneficial to society.

Casting doubts on the unlimited merits of competition may once again seem miles away from the classical logic. The distance gets shorter, however, if the Act is read with the lenses of common law, and in particular of its guiding light, contractual freedom. Liberty of contract policed competition in both cases: according to Judge Jackson, freedom of contract, if unrestrained by the trust's unlawful practices, would guarantee competition via free entry and the "rivalry in service" towards customers; according to the *TMFA* lower courts, freedom of contract included the freedom to voluntary enter a combination to preserve "fair and healthy" competition.

Free competition, literally

The Supreme Court's 5-to-4 decision to reverse the lower courts' acquittals in *TMFA* marked the transition between the first and the second phase of the formative era.[54] The 1897 verdict was shocking. Writing for the Court, Justice Rufus Peckham – the future author of the *Lochner* opinion – declared that with the Sherman Act the Congress aimed at *canceling and replacing* the common law of CRTs, especially the distinction between reasonable and unreasonable restraints. Moreover, the decision contained the earliest formulation by the Supreme Court of what we may call the *competition principle*, that is, the idea that the only "fair" prices are competitive prices.

[53] *United States v. Trans-Missouri Freight Association*, 53 F. 440 (C.C.D. Kansas 1892), *affirmed* 58 F. 58 (8th Circuit, 1893). See Letwin 1965, 152-4.
[54] *United States v. Trans-Missouri Freight Association*, 166 US 290 (1897). For a thorough analysis of this case, see Giocoli forthcoming, Ch.10.

Peckham's main thesis was based on a simple, literal reading of the Act. "By the simple use of the term 'contract in restraint of trade'", he wrote, "all contracts of that nature, whether valid or otherwise, would be included, and not alone that kind of contract which was invalid and unenforceable as being in unreasonable restraint of trade" (*TMFA*, at 328). It followed that, for instance, all price-fixing agreements violated the Act, regardless of the reasonableness of the established prices. But Peckham went beyond that. He deemed it impossible to determine whether any agreed price be reasonable. Only competitive prices were reasonable: "Competition, free and unrestricted, is the general rule which governs all the ordinary business pursuits and transactions of life" (ibid., at 337).

This statement about the absolute merits of "free and unrestricted competition" vindicated, after almost a decade, Sherman's original bill. Absent from the Act's final text, the competition principle found its earliest formulation in *TMFA* and has accompanied US antitrust law to the present day. Beyond faith in competition, the principle also expressed the literalist majority's dread of the socio-political consequences of an excessive concentration of economic power. Like Sherman and his faction, Peckham viewed rivalry among roughly equal firms of relatively small size as the bedrock of individual liberty. Powerful combinations in restraint of trade could drive out of business "the small dealers and worthy men whose lives have been spent therein", turning each of them from "an independent businessman, the head of his establishment, small though it might be, into a mere servant or agent of a corporation" (at 323-4). Only "free and unrestrained competition" could effectively rein in economic power. Still, it is important to underline that the competition principle has lived a life of its own in antitrust law: even when divested of Peckham's socio-political reading, the principle has found support in the *neoclassical* image of a competitive market structure.

The principle also helped dismiss the habitual ruinous competition defense used by the railroads' counsel. Peckham countered that different opinions existed as to the ultimate effects of combination, even in the railroad industry. It was therefore impossible to determine whether the prices fixed by the combination were reasonable (at 338-9). But, he added, this was precisely the reason Congress had *not* distinguished between reasonable and unreasonable restrains. The Act should be read literally, that is, as a statute directed against *all* CRTs.

TMFA is also important for Justice Edward White's dissenting opinion, which contained the first statement of the doctrine later known as the "rule of reason". The problem, as White saw it, was the permanent industrial warfare that would inevitably follow from a system of "free and unrestrained competition". Worse, Peckham's approach, if truly taken *literally*, would construe the Sherman Act as prohibiting almost every trade, because most trades involving the sale of property have some restraining conditions attached to them. The result would be paradoxical: "The plain intention of the law was to protect the liberty of contract and the freedom of trade", White wrote. "Will this intention not be frustrated by a construction which, if it does not destroy at least gravely impairs, both the liberty of the individual to contract and the freedom of trade?". The solution lay in the rule of reason, viewed as the best safeguard of the common law standard of "utmost liberty of contracting" at (355).

By 1897 the conflict between the two visions of antitrust that had animated the Senate debate had reignited at the highest judicial level. One view had prevailed, but the Court's 5-to-4 split testified how precarious the new equilibrium might be. Peckham himself recognized this: in a series of later decisions, though never reneging his *TMFA* opinion, he nevertheless endeavored to soothe its most irking implications.[55]

Enter the rule of reason

Flash forward fourteen years. The rule of reason was introduced into antitrust law in 1911, with the *Standard Oil* decision.[56] The case was a big deal, because it involved the emblem of all trusts, Rockefeller's mammoth petroleum business. At the same time, it was a difficult case, because, despite the massive trial record the Justices were presented with, the decision turned on a single, thorny issue: could a trust like Standard Oil ever be lawful under the Sherman Act? Or, even more bluntly, could trusts themselves be lawful as a form of organizing corporate affairs?

The Department of Justice prepared the case with great care. Sensing the difficulty of winning the verdict, it alleged that Standard Oil had violated not only the Act's section 1, but also section 2. Ample evidence justified invoking the latter provision. Defendants had engaged in several practices aimed at securing a substantial portion of the interstate petroleum market, practices such as taking preferential rebates from shippers, employing commercial spies, or setting cutthroat prices. These conducts would satisfy, so the government argued, the *In re Greene* doctrine that "monopolizing" meant forcibly excluding competitors. Even the defendants actually conceded that Standard Oil had used these practices. The crux of the matter was whether they represented illegal monopolization, i.e., an unlawful way to get control of a large share of the market.

Circuit judges had argued that unlawfulness followed from the very fact that, by forming the trusts, the defendants had joined in a combination in restraint of trade. This was per se illegal under section 1, as established by *TMFA*. This interpretation, which entailed that *every* trust was per se unlawful, was rejected by the *Standard Oil* Court, with a decision authored by the new Chief Justice White.

Two issues were at stake. The first was whether trusts as big as Standard Oil should be declared per se illegal. The second was whether in that specific case the defendants had violated the Sherman Act. White managed to keep them separate: the lawfulness of trusts ought to be decided case by case, by applying the rule of reason; yet, in this specific case, Standard Oil deserved dissolution. The trick of splitting the issues, while at the same time avoiding marking too large a distance from previous antitrust jurisprudence,[57] consisted of "imagining the trust problem as a question of individual conduct rather than an instance of combination". By so doing, "the Court could reconcile competition policy as articulated in the cartel cases with common-law private property rights and with the constitutionalized liberty of contract" (Peritz 1996, 50).

[55] On these decisions, see Letwin 1965, 178-81, and Giocoli forthcoming, Ch.10.
[56] *Standard Oil Co. of New Jersey v. United States*, 221 US 1 (1911).
[57] White was very successful at reconciling the opposing factions. The decision was almost unanimous, with only Justice Harlan concurring in the verdict but dissenting from the opinion.

In practical terms, White's rule of reason stood for the implicit proposition that there were good trusts and bad trusts, and that the former could be perfectly lawful monopolies even under the Sherman Act. The point was, as always, that competition was not necessarily beneficial. Competition could well be destructive; hence, combinations could be reasonable. Trusts could be good if and when they avoided ruinous competition. Remarkably, White rejected the principle of "free and unrestrained" competition without invoking anymore a businessman's right to fair price or fair profit. The Constitution protected freedom of contract and individual property rights against government interference, while the common law guaranteed that neither trusts nor monopolies could be illegal just because of their existence or size, but only "because of their restriction upon individual freedom of contract and their injury to the public" (*Standard Oil*, at 54).

In an illuminating passage White revealed the classical inspiration behind his argument. The Sherman Act, he wrote, "indicates a consciousness that the freedom of the individual right to contract, when not unduly or improperly exercised, was the most efficient means for the prevention of monopoly, since the operation of the centrifugal and centripetal forces resulting from the right to freely contract was *the means by which monopoly would be inevitably prevented* if no extraneous or sovereign power imposed it and no right to make unlawful contracts having a monopolistic tendency were permitted" (ibid., at 62, emphasis added). A classical economist could not have said it better. Freedom of contract, undisturbed by government interference, was the key liberty fostering competition and its beneficial effects, including the dissolution of monopolies.

The 1911 decision against Standard Oil, and the analogous one against the American Tobacco trust,[58] were epoch making. Under White's rule of reason, freedom of contract and the protection of property rights became the guiding light of antitrust enforcement until the New Deal. While the competition principle remained formally valid, it would not drive the Court's case law. First and foremost, contractual freedom and property rights had to be protected against government intrusions into private agreements. As in the first phase of the formative era, the Court was back with a property right language, though now devoid of any reference to the fairness of profits and prices. The rule of reason aimed at affirming freedom of contract, while prohibiting only unreasonable exercises of that freedom. The goal was to *broaden* contractual freedom, rather than limiting it.

White's construction of the rule of reason also contained the rationale for condemning Standard Oil and, a few days later, American Tobacco. Liberty of contract was never absolute. The common law set its limit in respect of anyone else's contractual freedom – viz., the *sic utere tuo* doctrine. A trust was unreasonable when and if it engaged in conduct that unduly restricted rivals' possibility to compete. It was precisely the infringement of other market participants' liberty that doomed the two giant trusts.

The Court argued that contractual freedom could be exercised in an "unnatural" way, by making use of acts or agreements of an "unusual and wrongful character" (*American Tobacco*, at 181), such as predatory pricing, boycotting or cartelization. Hence, the problem was never the trust itself. Reasonable restraints of trade, like the good trusts, did not violate the Sherman Act, no matter how general or how powerful. Unlawfulness only

[58] *United States v. American Tobacco Co.*, 221 U.S. 106 (1911).

emerged when the trust "abused" its contractual freedom to curb other market participants' freedom. In the classical view of competition, this behavior would represent an obstacle to the natural working of the competitive process, and so warrant condemnation. Standard Oil and American Tobacco had done exactly that. By acting badly against their competitors, they had trespassed the common law boundaries of reasonableness, i.e., they had unreasonably restrained trade.

That with only one exception the rest of the Justices undersigned White's *Standard Oil* opinion is noteworthy. The ample majority signaled a substantial agreement with respect to the illegality of the trust's practices. It also indicated that the Justices did not view White's opinion as a radical change with respect to previous jurisprudence. White took care to clarify that, following *TMFA*, cartels would remain per se unlawful even under the rule of reason. A few unilateral practices that everybody deemed unreasonably exclusionary (most famously, predatory pricing) became per se illegal too. For the rest, free competition should still be policed in the name of (classical) freedom of contract, rather than (neoclassical) freedom from market power.

Conclusion: the shadow of old debates

The paradox of *Standard Oil* is well-known. A verdict that had actually condemned the mother-of-all-trusts was read by many contemporary observers[59] as establishing a very lenient approach towards big business. This eventually pushed Congress to approve new antitrust legislation. Even more significantly for our aims, it led a prominent economist to rethink his views about competition and actively campaign for legislative reform.

One of this essay's goals was to show how the classical dichotomy between the two freedoms did not just shape the Gilded Age discourse about regulation and antitrust, but also the way these themes are handled today. Under several respects, we still live in the shadow of these old debates. For final evidence about such present-day relevance, let us consider the economic rationale underlying two further pieces of US antitrust legislation that are still with us, one hundred years after their enactment.

The intellectual source behind the 1914 Clayton and the FTC Acts was John Bates Clark. While this is, again, fairly well-known,[60] what is seldom recognized is that the great American economist formulated the proposals that would eventually be incorporated in the two statutes only after a profound reconsideration of the "freedom to trade v. freedom of contract" dichotomy. A comparison of the two editions of *The Control of Trusts* – the first, published in 1901, written by Bates Clark alone; the second, which appeared in 1912, co-authored with his son John Maurice – is enlightening.

The declared intent of both editions was to influence the public debate about trusts and other combinations. The policy advocated by Clark in 1901 was very simple, and very classical: rely upon the power of actual and,

[59] And not only mere observers. Stock indexes *rose* after the decision, signaling business satisfaction.
[60] See e.g. Fiorito 2012a.

above all, potential competition and do whatever is needed to help market forces exercise their restraining action on trusts. In his words: "It is the policy that relies wholly on competition as the regulator of prices and wages and as the general protector of the interests of the pubic. It welcomes centralization, but aims to destroy monopoly, and to do this by keeping the field open to all independent producers who may choose to enter it" (Clark 1901, v). Clearly, at this time he still believed in the self-regulative ability of freely competitive markets.

However, Clark was also aware that actual and potential competition could fail in the presence of exclusionary practices undertaken by big firms and combinations against independent rivals. Blocking the efficiency-based selection operated by market forces paved the way for external intervention: "When economy in production no longer saves [the independent competitors], it is time for the state to intervene; and it needs to do this, if it would carry out the very end for which it was originally established, — *the protection of property itself, by the suppression of refined forms of robbery*" (ibid., 65, emphasis added). The italicized words clarify that intervention should not aim at directly protecting consumers or social welfare. At stake was a specific *right*, viz., the independent competitors' right to thrive from their market efforts without suffering undue interference from bigger rivals. The classical premise still held that if agents enjoyed the utmost freedom to carry on their business, then the whole society would inevitably prosper – producers, workers and consumers alike. At the same time, no ideal image of a specific market structure – like, say, neoclassical perfect competition – influenced Clark's reasoning. Exclusionary practices operated by big businesses simply robbed some firms of their fair chance to win a hard-earned market prize. Safeguarding this chance – and, more generally, the competitive process, actual and potential – was a legal matter of defending a well-defined, though abstract, property right. Those practices should therefore be expressly outlawed.

No new antitrust statute was required, though, but just a list of proscribed practices as identified by the common law. Clark still believed in 1901 that the latter would provide the ultimate weapon. "Statutes are not our sole reliance", he wrote, "the most efficient action that has thus far been taken in curbing the power of trusts has been taken under the common law" (ibid., 69). In short, both pillars of Clark's 1901 view of antitrust policy were thoroughly classical, namely, potential competition and the common law. Courts should just recognize, and protect, the role of potential competition.

More than a decade later, and now writing with his son John Maurice, Clark would abandon the optimism of the first edition and invoke a wider program of antitrust reform. Benefiting from the experience of another decade of antitrust enforcement, the 1912 edition contained a mature assessment of the pros and cons of alternative proposals. The authors' blueprint for regulating competition via the proscription of a specific list of business behaviors and the break-up of excessive concentrations of economic power marks the 1912 work as a very modern contribution to antitrust policy, ahead of its times in several respects. Yet, the volume was also a child of its time, its publication owing much to the *Standard Oil* decision and ensuing paradox.

The Clarks' disillusion with respect to the actual power of potential competition was now strong and, absent explicit legislative intervention, definitive. Pessimism seeped already in the Preface: "When the first edition of this work was issued, so called potential competition had shown its power to control prices". Unfortunately, combinations had "soon discovered their own power to crush audacious rivals when they appeared. In a number of ways, which are now well known and are discussed in this volume, they could club a competitor whenever he should show himself in an active way. They so often did this that their evident power to do it had its effect in advance, and deterred competitors from appearing. The potentiality of unfair attacks by the trust tended to destroy the potentiality of competition" (Clark & Clark 1914 [1912], vi-vii). And later in the book: "The real difficulty s that the influence of this latent competition cannot be trusted as it could in earlier days. […] the possible competitor does not become an actual one as promptly as he should. The trouble is that he has not a fair chance for his life when he appears on the scene. He is in danger of being crushed by the trust, and that too, not in any natural way, but by certain entirely abnormal things that the trust is able to do" (ibid., 27). As it turns out, by 1912 the Clarks had abandoned the common law and classical ideal that what they called the "honest race for cheapness" (ibid., 28) could represent the only kind of horizontal competition between rival firms.

Still, the wand of potential competition had not entirely lost its magic, if only the curse inhibiting it could be removed: "If the great company could not do these things, the competitor would be comparatively safe, and in many departments of industry he would appear promptly whenever profits should become high enough to make his presence desirable" (ibid., 27). Much of the 1912 book was dedicated to explaining the nature of the curse and to devising a counter-spell that would restore the power of the magic wand.

The abracadabra was congressional intervention, in the form of a new statute. The statute should declare per se illegal a list of exclusionary practices (such as price discrimination, selective discounts and predatory pricing), regardless of the nature of the firm undertaking them or of their eventual outcome: "The situation demands that such acts be made illegal in themselves, whether or not they have been carried so far as to result in monopoly" (ibid., 100).[61] In other words, a business's behavior – its contractual freedom, that is to say – should be statutory constrained. The shift towards a freedom *from* contract perspective was a sea-change with respect to Bates Clark's previous views, which only admitted the auxiliary role of common law courts, and a significant breach in the classical edifice.

The vagaries of legislative process notwithstanding, the gist of the Clarks' proposal would feature in the Clayton Act.[62] Yet, their blueprint for reform contained a second horn, complementary to the list of proscribed practices. Fearing troubles with courtroom enforcement, they advocated an administrative, rather than judicial, approach. Accordingly, Congress should create a new administrative body, an "Interstate Commerce Commission" as they called it (ibid., 117-18). Guided by economic experts, the Commission would take most regulatory power away from courts; in particular, it would guarantee a prompt reaction against any newly invented form of exclusionary practice.

[61] Anticipating the legislative difficulty of providing an exhaustive list of undesirable practices, the Clarks also proposed that the new law should contain a broader, and quite modern, definition of exclusionary behavior: "'unfair competition' comes to mean, virtually, any practice whose natural result is to make survival depend on other qualities than industrial efficiency" (Clark & Clark 1912, 103).
[62] For the details, see Fiorito 2012b.

Both horns of the Clarks' proposal would find application in the 1914 statutes. From the viewpoint of the history of economic thought, this was a remarkable achievement. Contrary to what had happened with the Sherman Act, this time the impact on the legislative process of economists' reflections on the two meanings of free competition, and on how to reconcile them under the new industrial conditions, was direct and explicit. One century later, a big part of the antitrust enterprise is still driven by the outcomes of those very reflections.

References

Bernstein, M. A. (2001). *A Perilous Progress. Economists and Public Purpose in Twentieth-Century America*. Princeton: Princeton University Press.

Blaug, M. 1997. "Competition as an End-state and Competition as a Process". In *Not Only an Economist: Recent Essays by Mark Blaug* (pp. 66-86). Cheltenham: Edward Elgar.

Boer, G. (1966). "Replacement Cost: A Historical Look". *The Accounting Review, 41*(1), 92-97.

Carey, H. C. (1837-1840). *Principles of Political Economy.* Philadelphia: Carey, Lea & Blanchard.

Clark, J. B. (1900). "The Necessity of Suppressing Monopolies While Retaining Trusts". In *Chicago Confererence on Trusts* (pp. 404-409). Chicago: Civic Federation of Chicago.

Clark, J. B. (1887). "The Limits of Competition". *Political Science Quarterly* 2 (1): 45-61.

Clark, J. B. (1901). *The Control of Trusts*. New York: Macmillan.

Clark, J. B., and Clark J. M. 1914 [1912]. *The Control of Trusts. Rewritten and Enlarged*. New York: Macmillan.

Ely, R. T. (1888). *Problems of To-Day. A Discussion of Protective Tariffs, Taxation, and Monopolies.* New York: Thomas Y. Crowell & Co.

Epstein, R. A. (2014). *The Classical Liberal Constitution. The Uncertain Quest for Limited Government.* Cambridge Mass.: Harvard University Press.

Fine, S. (1956). *Laissez Faire and the General-Welfare State. A Study of Conflict in American Thought, 1865-1901.* Ann Arbor: University of Michigan Press.

Fiorito, L. (2012a). "When Economics Faces the Economy: John Bates Clark and the 1914 Antitrust Legislation". *Review of Political Economy* 25 (1): 139-163.

Fiorito, L. (2012b). "The Influence of American Economists on the Clayton and Federal Trade Commission Acts". *Research in the History of Economic Thought and Methodology*, 30: 1-58.

Fisher, I. 1997 [1912]. *Elementary Principles of Economics*. In *The Works of Irving Fisher*, edited by W. J. Barber, Vol. 5. London: Pickering & Chatto.

Freyer, T. A. (1992). *Regulating Big Business. Antitrust in Great Britain and America 1880-1990.* Cambridge, UK: Cambridge University Press.

Giocoli N. (2014). *Predatory Pricing in Antitrust Law and Economics. A Historical Perspect*ive, Routledge, London & New York, 2014

Giocoli N. (forthcoming). *A Smithian Constitution. The Classical Political Economy of the* Lochner *Era*. Oxford: OUP.

Giocoli, N. (1912). “Who Invented the Lerner Index?”. *Review of Industrial Organization*, *41*(3), 181-191.

Hadley, A. T. (1885). *Railroad Transportation. Its History and Its Laws*. New York: Putnam’s Sons.

Hadley, A. T. (1886). “How Far Have Modern Improvements in Production and Transportation Changed the Principle That Men Should Be Left Free to Make Their Own Bargains? I”. *Science, 7*(161), 221-225.

Hovenkamp, H. (1989). “The Sherman Act and the Classical Theory of Competition”. *Iowa Law Review, 74*, 1019-1065.

Hovenkamp, H. (1991). *Enterprise and American Law, 1836-1937.* Cambridge, Mass.: Harvard University Press.

Jenks, J. W. (1900). *The Trust Problem.* New York: McLure, Phillips & Co.

Jenks, J. W. (1912). “Economic Aspect of the Recent Decisions of the United States Supreme Court on Trusts”. *Journal of Political Economy, 20*(4), 346-357.

Jensen, M. C. (1993). “The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems”. *Journal of Finance, Papers and Proceedings*, *48*(3), 831-880.

Letwin, W. (1965). *Law and Economic Policy in America: The Evolution of the Sherman Antitrust Act.* Chicago: University of Chicago Press.

May, J. (1987). “Antitrust Practice and Procedure in the Formative Era: The Constitutional and Conceptual Reach of State Antitrust Law, 1880-1918”. *University of Pennsylvania Law Review, 135*(3), 495-593.

McCann, Ch. R. Jr. (2012). *Order and Control in American Socio-Economic Thought. Social Scientists and Progressive Era Reform*. London: Routledge.

McCulloch, J. R. (1825). *The Principles of Political Economy: with a Sketch of the Rise and Progress of the Science.* Edinburgh: William and Charles Tait.

McCurdy, C. W. (1979). “The Knight Sugar Decision of 1895 and the Modernization of American Corporation Law, 1869-1903”. *Business History Review, 53*(3), 304-342.

McNulty, P. J. (1967). “A Note on the History of Perfect Competition”. *Journal of Political Economy, 75*(4), 395-399.

Mill, J. S. (1909 [1848]), *Principles of Political Economy with some of their Applications to Social Philosophy* (7th ed.). London: Longmans, Green and Co.

Page, W. H. (2008). “The Ideological Origins and Evolution of U.S. Antitrust Law.” *Issues In Competition Law and Policy* (ABA Section of Antitrust Law), 1: 1-17.

Palgrave, R. H. Inglis, ed. 1894. *Dictionary of Political Economy*. Vol. I. London: Macmillan.

Perelman, M. (2006). *Railroading Economics. The Creation of the Free Market Mythology.* New York: Monthly Review Press.

Peritz, R. J. R. (1996). *Competition Policy in America. History, Rhetoric, Law*. Oxford: Oxford University Press.

Pollins, H. (1956). “Aspects of Railway Accounting Before 1868”. In A. C. Littleton, & B. S. Yamey (Eds.), *Studies in the History of Accounting* (pp. 332-355). Homewood, Ill.: Richard D. Irwin.

Schumpeter, J. A. (1986 [1954]). *History of Economic Analysis.* London: Routledge.

Senior, N. W. (1854). *Political Economy* (3rd ed.). London: Richard Griffin and Co.

Siegel, S. A. (1984). “Understanding the *Lochner* Era: Lessons from the Controversy over Railroad and Utility Rate Regulation”. *Virginia Law Review, 70*(2), 187-263.

Sklar, M. J. (1988). *The Corporate Reconstruction of American Capitalism, 1890-1916. The Market, the Law, and Politics*. Cambridge, UK: Cambridge University Press.

Smalley, H. S. (1906). “Railroad Rate Control in Its Legal Aspects: A Study of the Effect of Judicial Decisions Upon Public Regulation of Railroad Rates”. *Publications of the American Economic Association, 3rd Series, 7*(2), 4-147.

Smith, A. (1904 [1776]). *An Inquiry into the Nature and Causes of the Wealth of Nations* (5th ed., E. Cannan, ed.). London: Methuen & Co.

Smith, O. (1886). “Inventory Evaluation of Machinery Plant”. In *Transactions of the American Society of Mechanical Engineers* (Vol.VII, pp. 433-439). New York: American Society of Mechanical Engineers.

Spencer, H. (1851). *Social Statics; or, The Conditions essential to Happiness specified, and the First of them Developed*. London: John Chapman.

Stickney, A. (1897). *State Control of Trade and Commerce by National or State Authority.* New York: Baker.

Stigler, G. J. (1957). “Perfect Competition, Historically Contemplated”. *Journal of Political Economy* 65 (1): 1-17.

Stigler, G. J. (1976). “The Successes and Failures of Professor Smith”. *Journal of Political Economy, 84*(6), 1199-1213.

Stigler, G. J. (1982). “The Economists and the Problem of Monopoly”. *American Economic Review, 72*(2), 1-11.

Viner, J. (1960). “The Intellectual History of Laissez Faire”. *Journal of Law and Economics, 3*(October), 45-69.

Viscusi, W. K., Harrington, J. E. Jr., & Vernon, J. M. (2005). *Economics of Regulation and Antitrust.* Cambrdige, Mass.: MIT Press.

von Halle, E. (1896). *Trusts or Industrial Combinations and Coalitions in the United States.* New York: MacMillan.

Walker, F. A. (1892). *Political Economy, Third Edition*. London: Macmillan.

Whitten, R. H. (1912). *Valuation of Public Service Corporations.* New York: Banks Law Publishing.

Yonay, Y. P. (1998). *The Struggle over the Soul of Economics. Institutional and Neoclassical Economists in America between the Wars*. Princeton, NJ: Princeton University Press