CONSTITUTIONAL RIGHTS FOUNDATION

BILL OF RIGHTS IN ACTION

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WORLD HISTORY

Adam Smith and *The Wealth of Nations*

As the American Revolution began, a Scottish philosopher started his own economic revolution. In 1776, Adam Smith published *The Wealth of Nations*, probably the most influential book on market economics ever written.

Born in 1723, Adam Smith was the son of a customs official in Kirkcaldy, Scotland. At 14, he entered the University of Glasgow. After graduating, he attended Oxford in England and studied philosophy.

Scottish economist Adam Smith (1723–1790) wrote The Wealth of Nations, *one of the most important economics books ever written. (Library of Congress)*

Smith became a professor of philosophy at Glasgow in 1751. He actively took part in Glasgow debating societies and often argued for free trade.

In 1759, Smith published *The Theory of Moral Sentiments.* His book looked at human nature and ethics. At the beginning of the book, he stated that all people had the capacity to care about others. He pointed out that no matter how selfish a man might be,

> . . . there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it.

But Smith also believed that people often acted in their self-interest, especially in economic matters. He contended, however, that this was not bad. He concluded that self-seeking individuals were "led by an invisible hand" that caused them to unintentionally act in ways that still benefited society.

In 1763, Smith quit his professorship at Glasgow and tutored the stepson of Charles Townshend, who later became Britain's treasury minister in the years leading up to the American Revolution. Smith traveled to Paris with his student and met Voltaire and other philosophers involved in the French Enlightenment.

Smith also met the leading French economist, Francois Quesnay. Quesnay had devised a system called "Physiocracy," which he believed explained the source of national wealth. Quesnay took issue with the popular belief, known as mercantilism, that a nation's wealth was its hoard of

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Free Markets and Antitrust Law

This special expanded edition of *Bill of Rights in Action* looks at issues related to antitrust and the free market. The first article examines the ideas of Adam Smith, whose classic book *The Wealth of Nations* set forth the philosophy of free-market economics. The second article explores the era of trustbusting at the beginning of the 20th century and examines how three presidents of the period (Roosevelt, Taft, and Wilson) approached the problem of monopolies. The third article examines the development of modern antitrust law. The final article looks at media mergers and the recent controversy that erupted when the Federal Communications Commission tried to loosen it ownership rules for broadcast media.

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gold or silver. He believed a nation's wealth came from its farm produce, which circulated throughout the land, nourishing everyone. Quesnay's innovative idea prompted Smith to begin to write his own book on economics.

In 1766, Smith moved to London. He worked as a researcher for Charles Townshend, who was then in charge of Britain's finances. Townshend had to deal with the huge national debt that resulted from the Seven Years' War. This war enabled Britain to seize all of French North America. Townshend wanted the American colonists to help pay down the war debt through such measures as a tax on tea.

Smith researched Britain's credit and debt along with the history of colonization by ancient Rome. He also became acquainted with leading political figures such as Benjamin Franklin and Edmund Burke (an important British political writer and leader).

The following year, Smith returned home to Scotland to finish his book, a task that took him nine more years. During this period, he visited London several times and witnessed debates in Parliament on the growing American resistance to British rule.

Finally, in March 1776, Smith published *An Inquiry Into the Nature and Causes of the Wealth of Nations*. This massive work of almost 1,000 pages was based on his exhaustive research and personal observations. Smith attacked government intervention in the economy and provided a blueprint for free markets and free trade. These two principles eventually would become the hallmarks of modern capitalism.

A "Simple System of Natural Liberty"

When Adam Smith published his *Wealth of Nations* in 1776, Britain was just beginning to enter the Industrial Revolution. The first cotton-spinning factory had opened only a few years earlier. Increasingly, workers labored for pennies a day in factories and mines. Most employers believed that to get the poor classes to work, their wages had to be low, just enough to keep them from starving.

Smith began his book with a radical definition of "national wealth." He rejected the old mercantilist definition of acquiring gold and silver. Nor did he fully accept the Physiocrat view that wealth consisted solely of the produce of a nation's farms. Instead, Smith proposed that the wealth of a nation consisted of both farm output and manufactured goods along with the labor it took to produce them. To increase its wealth, Smith argued, a nation needed to expand its economic production. How could a nation do this? Smith thought the key was to encourage the division of labor.

Smith argued that workers could produce more if they specialized. He gave the example of a pin factory based on his real-life observations. One worker who did all the operations necessary to make a single pin, he said, could produce no more than 20 in one day. Ten workers could make 200 pins this way. If, however, the 10 workers each specialized in one or two of the pin-making operations—from drawing the wire to putting the finished pin on a paper card—they would work more efficiently. Smith estimated that these 10 workers could produce 4,800 pins per worker or 48,000 altogether in a day.

Smith argued that if all production could be specialized like the pin factory, workers could produce more of everything. Because humans naturally trade with one another, Smith reasoned, those involved in making one product will exchange it (or the wages they earn) for the goods produced by other workers. Thus, Smith concluded, "a great plenty diffuses itself through all the different ranks of the society."

Smith did not just present a theory about increasing production and the wealth of a nation. He worked out exactly how this would occur by describing what he called the "free market mechanism." (See box on page 4.)

Adam Smith described free markets as "an obvious and simple system of natural liberty." He did not favor the landowner, the factory owner, or the worker, but rather all of society. He saw, however, self-defeating forces at work, preventing the full operation of the free market and undermining the wealth of all nations.

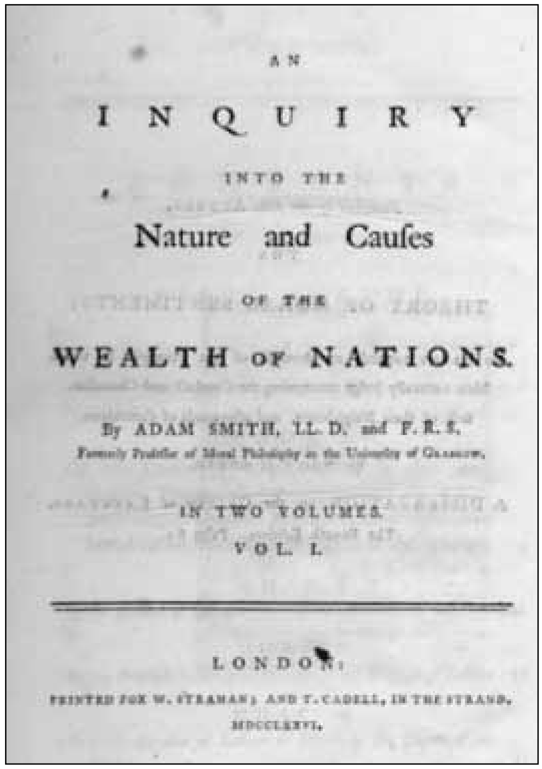
Smith's Attack on Mercantilism

In the 18th century, European nations practiced an economic system known as "mercantilism." Each nation's goal was to increase exports to its colonies and other nations, limit imports from them, and end up with a "favorable balance of trade." A nation that exported more than it imported demanded the difference in gold and silver.

The mercantilist nations believed that the more gold and silver they acquired, the more wealth they possessed. Smith believed that this economic policy was foolish and actually limited the potential for "real wealth," which he defined as "the annual produce of the land and labor of the society."

European mercantilism depended on a web of laws, subsidies, special economic privileges, and government-licensed monopolies designed to benefit specific manufacturers and merchants. This system, however, inflated prices, hindered economic growth, limited trade, and kept the masses of people impoverished. Smith argued that the free-market system along with free trade would produce true national wealth, benefiting all social classes, not just the privileged few.

In a major section of *The Wealth of Nations*, Smith attacked mercantilist trade practices. He insisted that what enriched European nations was not importing gold and silver, but opening up new free-trade markets in the world. This trade, he wrote, further stimulated the division of labor, expanded the production of trade goods, and increased "the real revenue and wealth" of all.


AN
INQUIRY
INTO THE
Nature and Caufes
OF THE
WEALTH OF NATIONS.
By ADAM SMITH, LL. D. and F. R. S.
Formerly Professor of Moral Philosophy in the University of Glasgow.
IN TWO VOLUMES.
VOL. I.
LONDON:
PRINTED FOR W. STRAHAN; AND T. CADELL, IN THE STRAND.
MDCCLXXVI.

First published in 1776, The Wealth of Nations *argued in favor of free markets. Highly popular and influential, the book has never gone out of print. (University of Leeds Library)*

sell goods like tea to the Americans.

According to Smith, these and hundreds of other restrictions benefited British special interests. But they slowed production and international trade, the sources of a nation's "real wealth." To Smith, the mercantilist system was self-defeating and resulted from "the monopolizing spirit of merchants and manufacturers." Their greed flowed from "an interest to deceive and even oppress the public."

Smith concluded that to achieve economic growth and social betterment, Britain should sweep away its network of government economic privileges and restrictions. Let the "free market mechanism" operate on its own without government intervention, Smith advised.

Smith criticized how the British Parliament had passed laws that crippled free trade and hindered the expansion of national wealth. These laws imposed high import duties, gave subsidies to favored companies, and granted monopolies to powerful special interests like the East India Company.

These laws harmed society by limiting competition and keeping prices high. Such measures, Smith wrote, were "extorted from our legislature" and "written in blood" since they served the interest of only a small class of privileged manufacturers and merchants.

Smith reserved his greatest criticism for the British colonial empire. He concluded it was "hurtful to the general interest of society." He focused especially on trade restrictions placed on the colonies in America.

Smith opposed mercantilist policies that required Americans to export certain products like fur pelts only to England. The Americans also had to ship their exports on British ships. Regulations prohibited transporting woolen products from one colony to another. Laws made it illegal for Americans to operate steel-making furnaces. Government-licensed monopolies like the East India Company held the exclusive right to

Adam Smith and the Role of Government

Adam Smith advocated a limited role for government. But he recognized significant areas where only it could act effectively.

Smith saw the first duty of government was to protect the nation from invasion. He argued that a permanent military force, rather than citizen militias, was necessary to defend any advanced society. Next, he supported an independent court system and administration of justice to control crime and protect property.

Smith favored "public works" to create and maintain an infrastructure to promote the free flow of commerce. These works included such things as roads, bridges, canals, harbors, and a postal system that profit-seeking individuals may not be able to efficiently build and operate.

Even in 1776, at the beginning stages of industrialization, Smith recognized that repetitive factory jobs dulled the minds of workers. He said they became "as stupid and ignorant as it is possible for a human being to become." Smith wanted all classes, even the poorest, to benefit from the free-market system. "No society can

(Continued on next page)

Adam Smith's "Free Market Mechanism"

The following is a simplified version of the economic system Adam Smith believed would emerge once governments ended their oppressive mercantilist policies.

1. A man builds a cloth-making factory, hires workers, and divides their labor into many specialized operations. The factory owner is motivated by self-interest, profit, maybe even greed.
2. Others, however, are also building factories to make and sell cloth. They all have to compete for the money of the buyers whose self-interest is to buy cloth at the best price.
3. Buyers bid up the price of the cloth when the supply of cloth is low and their demand for it is high. But when there is an oversupply, the buyers can pick and choose and refuse to purchase high-priced cloth. The factory owners then have to reduce their prices to attract more buyers. Economists call this the "law of supply and demand."
4. Additional innovative divisions of labor, maybe brought on by new machinery, motivate others to invest in more factories. But they must compete to hire more workers. The "law of supply and demand" applies here, too, and wages go up.
5. Higher wages lengthen the lives of workers and their children. The population grows, which increases the supply of workers. Wages then stop rising. But, soon another division of labor wave occurs, producing more economic growth and the need for even more workers. Wages go up again. The cycle repeats itself.
6. Families now can afford to buy (demand) more cloth and lots of other products. The factory owners make more profits. Everybody wins and society as a whole improves.
7. The cloth factory owner never intended to improve society; he just wanted to make money for himself. But his self-interest, as if "led by an invisible hand," resulted in the betterment of all. As Adam Smith put it, "By pursuing his own interest he frequently promotes that of the society more effectively than when he really intends to promote it."

surely be flourishing and happy," he wrote, when most of its people are "poor and miserable."

Thus, remarkably for the time, Smith advocated the education of all youth. He believed there was little difference in intelligence between the poor and the rich. Only the social conditions of the poor held them in ignorance, he concluded. He called for a "little school" in every district, supported by public taxes and small parent fees. "An instructed and intelligent people," Smith wrote, "are always more decent and orderly than an ignorant and stupid one."

Smith wrote that paying taxes was "a badge, not of slavery, but of liberty." By this, he meant that a taxpayer was an owner of property rather than the property of a master. Furthermore, Smith was an advocate of setting tax rates according to one's ability to pay. Taxpayers, he argued, should pay "in proportion to the revenue which they respectively enjoy under the protection of the state."

Smith believed in taxing property, profits, business transactions, and wages. But these taxes should be as low as possible to meet the public needs of the country. He also thought they should not be arbitrary, uncertain, or unclear in the law. Nor should they require home inspections that intruded into the private lives of individuals.

Smith criticized a large public debt, which, he observed, resulted mainly from wars. He believed that the mercantilists encouraged wars so that they could lend money at high interest to the government and exploit conquered lands. Smith viewed wars as "waste and extravagance," producing a "perpetual" public debt that diverted money away from investment in new enterprises and economic growth. Public debt, Smith concluded, "has gradually enfeebled every state which has adopted it."

Applying *The Wealth of Nations* to the World

Recognizing that the American colonists were victims of Britain's mercantile policies, Smith advised Parliament to let the American colonies peacefully go their own way. For the sake of maintaining a monopoly of trade, he argued, the colonies had cost the British people much more than they had gained. In the case of the Americans, Smith declared that denying "a great people" the freedom to pursue their own economic destiny was "a manifest violation of the most sacred rights of mankind." He urged Britain's rulers to awaken from their imaginary and wasteful "golden dream" of empire.

We know Adam Smith today as the father of *laissez faire* (“to leave alone”) economics. This is the idea that government should leave the economy alone and not interfere with the “natural course” of free markets and free trade. But he was mainly thinking about the government granting special economic privileges to powerful manufacturers and merchants. To Smith, these mercantile monopolists and their allies in Parliament were the great enemies of his “free market mechanism.”

In *The Wealth of Nations*, Smith only glimpsed the impact of the Industrial Revolution in Britain and later the United States. He did not foresee the development of huge corporate monopolies that suppressed competition without the need for government licenses. He did not imagine the brutal working and living conditions suffered by masses of men, women, and children. Thus, he never fully addressed the issue of whether government should intervene in the economy to prohibit such things as corporate monopolies and child labor.

Adam Smith did not write any other books. He died in 1790, well regarded by all who knew him. By this time, the British prime minister, William Pitt “The Younger,” was adopting Smith’s economic principles as government policy. Thus began the revolution of modern free-market capitalism that dominates world economics today.

For Discussion and Writing

1. Explain Adam Smith’s ideas about human self-interest and the “invisible hand.” Do you agree with him? Explain.
2. What did Adam Smith mean by the phrase “wealth of nations”?
3. Compare Adam Smith’s “free-market mechanism” with mercantilism.
4. What economic problems was Smith addressing in his day? What economic problems face modern society?

For Further Reading

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A C T I V I T Y

Adam Smith and Government Interventions in the Economy

1. Do you think Adam Smith would agree or disagree with the following government interventions in the economy today?
   - anti-monopoly laws
   - child-labor laws
   - minimum-wage laws
   - inheritance taxes
   - Social Security
   - North Atlantic Free Trade Association (NAFTA)
2. Form six small groups to each investigate one of the above interventions.
3. Use your textbook and school library resources to find out about the intervention you are investigating. Use quotes and other evidence from the article to decide what position Adam Smith would likely take on the intervention.
4. Each group should then report to the class its conclusion along with supporting evidence.

Please see page 23 for additional information.

Progressives and the Era of Trustbusting

Theodore Roosevelt is often given credit for launching the era of trustbusting, but he preferred government regulation of monopolies. His successor, William Howard Taft, wanted the courts to break up unlawful monopolies. Woodrow Wilson eventually adopted a combination of both approaches.

President Theodore Roosevelt believed that the best way to control monopolies was through government regulation. (Library of Congress)

In 1776, Adam Smith argued in *The Wealth of Nations* that free-market capitalism would bring prosperity for all by finding new ways for workers to divide their labor. The Industrial Revolution utilized machines and methods of mass production that magnified this division of labor. By the end of the 19th century, this resulted in an explosion of competitive businesses in the United States.

Adam Smith viewed wide-open competition as the driving force of the free-market system. Competition, however, sometimes resulted in price wars, wasteful duplication of production, and bankruptcies. Profit-minded business leaders discovered that the way around the instability of competition was to dominate the market by creating cartels and bigger industrial organizations.

"Captains of industry" like John D. Rockefeller and J.P. Morgan formed huge corporations owned by stockholders. The companies grew through two strategies—vertical integration and horizontal integration. In vertical integration, a company operates on more than one stage of production and distribution. For example, the Pabst Brewing Company owned breweries, saloons, and even forest lands for the wood to make beer barrels.

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In horizontal integration, a company expands by merging, usually by buying out rival firms. Between 1897 and 1901, more than 2,000 mergers took place in the United States. This horizontal integration reduced the number of competitive companies in an industry.

Defenders of "corporate bigness" claimed that the new super-corporations created jobs and efficiently produced and distributed goods and services at a lower cost. They further argued that property and contract rights permitted businesses to pursue their economic interests as they saw fit without government interference. This reflected the *laissez faire* (let business alone) idea of capitalism.

Others, however, attacked corporate abuses practiced by those they called "robber barons." The large corporations sometimes sold their products below cost until they drove competitors into bankruptcy or forced them to merge. Once a dominant firm eliminated most of its competition, it became a monopoly that could charge any price and pay any wage it wanted.

By 1880, John D. Rockefeller had merged about 100 independent oil refineries with his Standard Oil Company. He controlled about 90 percent of the U.S. oil business. (Oil was used to light kerosene lamps, utilized throughout the country.) In 1882, Rockefeller formed the Standard Oil Trust. He set up a board of trustees to take control of all the stock from his many vertically and horizontally connected companies.

The Progressives Demand Antitrust Laws

By forming the Standard Oil Trust, Rockefeller was trying to hide that Standard Oil was a monopoly. Soon corporate leaders in other industries such as railroads, cigarette making, and sugar refining organized their own trusts.

The trusts speeded up mergers and eliminated competition among their members. They also concentrated control of national wealth in the hands of a few millionaire families. As monopolies, the trusts often could dictate whatever prices and wages they wanted with little fear of competition.

Newspapers and magazines wrote stories raising questions about the trusts. As public criticism mounted during the 1880s, the American public called for government control over the powerful trusts. Reformers, called Progressives, demanded that states pass antitrust laws to make cartels and monopolistic practices illegal and to regulate railroad rates. These laws, however, were ineffective because most trusts operated across state lines. Only the federal government could regulate interstate commerce.

In 1887, Congress passed the federal Interstate Commerce Act. This law required interstate railroads to charge "reasonable and just" rates. But the Interstate Commerce Commission (ICC), which monitored the railroads, ended up with little authority to enforce its rulings.

In 1890, Congress passed the first federal antitrust law, the Sherman Act. It outlawed "every contract, combination in the form of trust or otherwise, or conspiracy in restraint of trade." The Sherman Act also made it a crime "to combine or conspire . . . to monopolize any part of the trade or commerce among the several states."

In the decade following passage of the Sherman Act, the generally pro-business presidents did little to enforce it. In fact, during this period, more mergers occurred and more trusts were formed than ever before.

In 1895, the U.S. Supreme Court ruled that the Sherman Act could regulate interstate sales and transportation. But the court said the act could not ban the merger of manufacturing assets that established monopolies, even by companies operating in interstate commerce. The court reasoned that manufacturing was not part of interstate commerce. In another case that year, the Supreme Court decided that the Sherman Act could bar union strikes that interfered with interstate commerce. Ironically, while Congress intended the Sherman Act to combat the big trusts, it was becoming a major weapon against organized labor.

TR: From "Trustbuster" to "Regulator"

Vice President Theodore Roosevelt became president in September 1901, following the assassination of President William McKinley. In his First Annual Message to Congress, Roosevelt expressed his admiration for the "strong and forceful men" who had "done great good" by building up the commerce of the nation. But he also observed that "there are real and grave evils" that needed to be corrected.

Roosevelt told Congress he opposed banning monopolies. Instead, he preferred that the federal government "assume power of supervision and regulation over all corporations doing an interstate business."

Despite his generally pro-business outlook, Roosevelt disliked the corruption and arrogance of the new class of super rich. In 1902, public demands for "trustbusting" (breaking up the monopolies) prompted him to file suit under the Sherman Act against the biggest railroad trust in the country.

In 1901, James J. Hill, E.H. Harriman, and J.P. Morgan had made a secret deal to combine their railroad stocks in a "holding company," another type of trust. Their new company, the Northern Securities Company, controlled all the major railroads in the Northwestern states.

News of Roosevelt's antitrust lawsuit shocked business leaders. J.P. Morgan went to the White House to meet with Roosevelt. "If we have done anything wrong," Morgan said, "send your man to my man and they can fix it up."

"That can't be done," Roosevelt replied. Morgan asked if Roosevelt was going to attack his steel trust and other interests. "Certainly not," the president said, "unless we find out that in any case they have done something that we regard as wrong."

Northern Securities lost in the lower courts and appealed to the Supreme Court, claiming that the Sherman Act violated the freedom to make contracts. In 1904 in a stunning opinion for the court, Justice John Marshall Harlan declared that "every combination" that eliminates interstate competition was illegal. The court included combinations of manufacturing companies and railroads. In separate opinions, however, a majority of justices indicated that they believed that the Sherman Act only banned unreasonable combinations.

The Supreme Court majority found that all monopolies tended to restrain trade and "to deprive the public of the advantages that flow from free competition." The court ordered the breakup of the Northern Securities Company into independent competitive railroads.

The voters returned Roosevelt to the White House in the election of 1904. Early the next year, Ida Tarbell and other Progressive journalists, whom Roosevelt later called "muckrakers," condemned secret railroad

(Continued on next page)

This 1904 political cartoon depicts Standard Oil as an octopus. Its tentacles wrap around the U.S. Capitol, a state house, and the oil, steel, and shipping industries. One tentacle stretches toward the White House. (Library of Congress)

rebates to Standard Oil and other big companies. The rebates had drawn controversy for years.

In December 1905, Roosevelt called on Congress to empower the Interstate Commerce Commission to ensure reasonable railroad rates for all. Congress responded with the Hepburn Act, which authorized the ICC to set maximum rail rates after finding that current ones were unreasonable. Thus, Roosevelt, the "trust-buster," tried to shift to his preferred role as federal "regulator."

Public pressure, however, forced Roosevelt to continue trustbusting. In 1905, he authorized a federal investigation of John D. Rockefeller's Standard Oil Trust. This trust then controlled about 80 percent of U.S. oil refining, which produced most of the nation's kerosene for lamps. The investigators uncovered secret rebates from railroads and concluded that Standard Oil held "monopolistic control . . . from the well of the producer to the door step of the consumer." Roosevelt's Justice Department filed an antitrust suit under the Sherman Act in 1906.

The following year, the federal government filed a Sherman antitrust suit against the American Tobacco Company. This trust controlled almost 90 percent of U.S. cigarette, snuff, chewing, and pipe tobacco sales. American Tobacco had bought out over 200 competitors, using such tactics as "fighting brands." These were cigarettes sold at below cost in order to bankrupt competitors.

Even so, by the end of his second term, Roosevelt remained convinced that federal regulation of big business was the best way to tame the trusts. Filing lawsuits against individual monopolies to break them up was a costly and slow slog through the courts, he believed. Besides, he thought that "good" monopolies benefited the public with efficient distribution of new products.

Taft, the Trustbuster

Roosevelt passed on the White House to fellow Republican William Howard Taft, who won the 1908 presidential election. Taft, a former prosecutor and judge, rejected Roosevelt's regulatory strategy and vigorously pursued trustbusting in the courts. In Taft's single term, the Justice Department almost doubled the number of antitrust lawsuits brought in Roosevelt's two terms. This angered both big business and Roosevelt.

In 1910, Taft's Justice Department filed suit against U.S. Steel. The corporation controlled half of all steel production and nearly 80 percent of iron-ore reserves in the country. In 1907, the corporation, the nation's largest industrial enterprise, had bought the competing Tennessee Coal, Iron, and Railroad Company, which further added to U.S. Steel's domination of the industry.

The Justice Department's suit claimed U.S. Steel was a "menace to the country and should be destroyed." The defendants included J.P. Morgan, John D. Rockefeller, and Andrew Carnegie.

Roosevelt, out of office but still active in politics, condemned the lawsuit. He said suing all trusts was "hopeless" and even if successful would "put the business of the country back into the middle of the 18th century."

The following year, the Supreme Court finally decided the Standard Oil and American Tobacco cases that Roosevelt had initiated. The justices found both companies were guilty of monopolization in violation of the Sherman Act. It ordered them broken into numerous independent firms.

The Supreme Court majority, however, also ruled that only "unreasonable" restraints of trade were illegal. For example, Standard Oil had been charged with such unreasonable practices as temporarily cutting prices to drive competitors out of business. Thus, the Supreme Court's "rule of reason" declared that monopolies alone did not violate the Sherman Act. Only when they behaved in unreasonable ways did they cross the line into illegality.

Monopolies and the Election of 1912

The controversy over what to do about monopolies erupted in the presidential election of 1912. Despite Taft's unpopularity among pro-business conservatives, the Republicans re-nominated him for president. He remained a trustbuster, sticking by his policy of strictly enforcing the Sherman Act by filing federal lawsuits to challenge monopolization.

Roosevelt wanted the Republican Party nomination. But when the Republicans chose Taft, Roosevelt's supporters formed the Progressive Party, which nominated him.

Roosevelt accepted monopolies as an inevitable part of a modern economy. He proposed, however, a federal commission to regulate them by inspecting their accounting books and setting maximum prices on their products. He also wanted to impose rules for hours, wages, and working conditions. Roosevelt declared that "the enslavement of the people by the great corporations . . . can only be held in check through the expansion of governmental power."

The Democratic candidate, Woodrow Wilson, at first criticized Roosevelt's idea of regulating monopolies. Nor did he favor Taft's strategy of trustbusting in the courts. Rather, Wilson wanted to eliminate monopolies by reviving vigorous competition through such measures as banking reform and tariff reduction.

Toward the end of the campaign, however, Wilson embraced the idea of a federal commission to stop monopolistic practices. Thus, he seemed to edge closer to Roosevelt's position.

The fourth major candidate in 1912 was Socialist Eugene V. Debs. Debs believed that large enterprises were inevitable. "The simple truth is, that competition in industrial life belongs to the past, and is practically outgrown. The time is approaching when it will be no longer possible." He did not favor using antitrust laws to break up large corporations. Instead, as a socialist, he supported worker and public ownership of large entities.

After Wilson won the election, he turned to Congress rather than the courts to deal with the monopoly problem. In 1914, Congress passed the Clayton Act, a new antitrust law that defined more clearly illegal business practices such as anti-competitive:

- price discrimination.
- corporate purchases of stock in competitive firms.
- simultaneous membership on the boards of directors of competing companies.
- sales of products on condition that the purchaser not deal with competitors.

The Clayton Act also sought to exempt peaceful union strikes from antitrust prosecution.

In other legislation, Congress created the Federal Trade Commission. Congress granted this regulatory agency the authority to investigate and issue "cease and desist" orders to businesses that violated the Clayton Act or the Federal Trade Commission Act's ban on "unfair methods of competition."

In 1920, the Supreme Court finally decided the U.S. Steel case begun in the Taft administration. The court ruled in favor of U.S. Steel. It found that U.S. Steel was not a monopoly and did not engage in illegal practices. The U.S. Steel decision confirmed that corporate behavior rather than just bigness determined whether a company violated the Sherman Act.

For Discussion and Writing

1. What is a monopoly? Why may it be harmful to a free-market economy?
2. Why did Roosevelt prefer government regulation of monopolies over trustbusting?
3. The Supreme Court decided that corporate behavior rather than mere bigness should determine if a monopoly is illegal. Do you agree? Why?

For Further Reading

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ACTIVITY

What Should the U.S. Do About Monopolies?

Imagine that leaders who lived during the era of trust-busting are available to discuss a modern antitrust case.

1. Divide into four groups. Assign each group one of the four leaders listed below.
2. Each group should:
   a. Discuss what its leader thinks about monopolies and antitrust.
   b. Read and discuss the Microsoft Case, below.
   c. Discuss what its leader would think about what should be done about corporations like Microsoft. Develop reasons and lines of argument.
   d. Choose one person to role play your leader in a panel discussion. Make a name tag for the leader.
3. Have the leaders meet in front of the class and discuss the question below.
4. After the debate, the class may want to vote on what they think is the best way to handle monopolies.

The Microsoft Case

The Microsoft Corporation is the world's most successful software company. Its stock is valued at hundreds of billions of dollars. Bill Gates, one of its founders, owns about 15 percent of Microsoft stock, making him the richest person in the world. Microsoft Windows software is the operating system for about 90 percent of the world's computers.

In the 1990s, the U.S. government complained about unfair practices of Microsoft. One of the practices was requiring computer manufacturers licensed to install Windows to include, or "bundle," its web browser, Internet Explorer, at no extra charge to the consumer. The government claimed that Microsoft's purpose was to drive Netscape Navigator out of the browser market. (Sales of market leader Navigator plummeted. Today Microsoft's Explorer is used by 95 percent of computer users.) Microsoft maintained that its sole purpose in bundling Explorer with Windows was to make it easier, more convenient, and less costly for consumers to use a computer. It also maintains that Explorer overtook Navigator because it is a far superior browser.

Question for the Panel to Discuss: **From what you know about monopolies and antitrust, what do you believe should be done about corporations like Microsoft?**

Leaders

1. **John D. Rockefeller:** Leave monopolies alone to efficiently produce and distribute products according to freedom of contract and the right of property.
2. **Theodore Roosevelt (or Woodrow Wilson):** Regulate the business practices, prices, and labor conditions of monopolies.
3. **William Howard Taft:** Break up all illegal monopolies by bringing lawsuits against them under the Sherman Act.
4. **Eugene V. Debs:** Monopolies are inevitable. They should be taken over by government and run in the public interest.

For use with the activity on pages 15–16.

Federal Trade Commission v. Staples and Office Depot

970 F. Supp.1066 (DDC 1997)

The federal judge granted an injunction to stop the merger, pending a full FTC hearing. The judge ruled that the FTC was likely to prove in the hearing that the effect of the proposed merger "may be substantially to lessen competition" in violation of Sec. 7 of the Clayton Act. He agreed with all the FTC arguments against the merger, especially the agency's all-important definition of the "product" as "consumable" office supplies. The judge also cited documents from the companies that even they considered only the superstore chains to be competitors in the office-supply business and not other types of retailers like Wal-Mart.

Because of this ruling, Staples and Office Depot abandoned their plan to merge.

The Development of Antitrust Enforcement

Since 1914, the Department of Justice and the Federal Trade Commission (FTC) have shared enforcement of the antitrust laws.

In 1906, the U.S. Justice Department had filed an antitrust lawsuit against John D. Rockefeller's Standard Oil Trust. This trust controlled about 80 percent of U.S. oil refining. The lawsuit and appeals took years. In 1911, the Supreme Court decided the case and ordered the trust broken up. In its decision, however, the court ruled that the Sherman Antitrust Act did not outlaw every restraint on trade. It banned only "unreasonable" restraints on trade, which left open the question of which business practices are illegal.

After Woodrow Wilson won the presidential election of 1912, he faced a dilemma about how to handle monopolies. He at first favored a new law that would define specific anti-competitive acts and declare them illegal.

But Wilson's close advisor, lawyer Louis Brandeis, favored a second approach. He argued that the possible anti-competitive acts were so numerous that no law could include all of them. Thus, such a law would have to be open-ended to allow for all the kinds of "unreasonable" monopolistic acts that were likely to occur. Brandeis (whom Wilson later appointed to the Supreme Court) called for an expert federal regulatory commission. This federal agency would have the power to investigate large corporations and to stop unfair business practices that harmed competition.

ECONOMICS

In 1914, Wilson adopted both approaches. The Clayton Act defined and prohibited specific anti-competitive practices such as price discrimination and anti-competitive mergers.

A companion act created the Federal Trade Commission. The FTC is an independent federal agency. The president nominates five commissioners for seven-year terms. The Senate confirms them. No more than three commissioners can be from the same political party.

Congress gave the FTC the power to order corporations to cease "unfair methods of competition." These methods included the anti-competitive practices defined in the Clayton Act and others that the FTC might later identify. Distrusting a "smug lot of experts" on the commission, Wilson insisted that FTC decisions be subject to court review.

Thus, Wilson and Congress designed the FTC to help the Justice Department enforce the Clayton and Sherman Acts. The FTC was supposed to catch problems before companies formed anti-competitive monopolies. It was also empowered to enforce the spirit of the Sherman Act so that violators could not escape on technicalities.

This 1913 political cartoon shows President Woodrow Wilson using antitrust legislation as part of his plan to get the economy moving.

Major Lawsuits

Since 1914, the Department of Justice and the Federal Trade Commission have shared enforcement of the antitrust laws. Only the Justice Department can prosecute criminal cases against corporate violators of these laws. But both the Justice Department and FTC can bring civil lawsuits against companies for collusion,

(Continued on next page)

monopolization, or mergers that may substantially reduce competition.

For corporations violating antitrust laws, the government could seek from courts remedies such as:

- breaking a corporation into two or more competing firms.
- prohibiting certain business conduct.
- imposing fines and imprisonment for corporate officers. (Only the Department of Justice can seek these criminal penalties.)

In 1920, the Supreme Court decided the U.S. Steel case, which had begun in 1910. This was the largest antitrust case filed by the Justice Department up to that time. The department sued U.S. Steel for violating the Sherman Antitrust Act. U.S. Steel controlled half of all steel production and nearly 80 percent of iron-ore reserves in the country. The Justice Department lost this case when it failed to show that U.S. Steel behaved in illegal ways (called "predatory conduct").

In later cases, the Supreme Court settled on a two-part test for illegal monopolistic behavior. First, a corporation had to possess "monopoly power," a large share of a product's market. Second, the corporation had to willfully create or maintain that "monopoly power" by engaging in unfair tactics against competitors or by merging with them.

The Justice Department and FTC continued filing anti-monopoly lawsuits against some of America's largest corporations, but with mixed results. The suit against International Business Machines, which in 1969 sold two-thirds of all the computers sold in the United States, dragged on in the courts for over a dozen years. Finally, the Justice Department dropped the case.

In 1974, the Justice Department filed a lawsuit against American Telephone and Telegraph (AT&T). AT&T was the largest corporation in the world. After nearly a decade, AT&T agreed to settle the case, giving the government most of what it sought. AT&T agreed to divide its telephone subsidiaries into independent companies.

The most recent major lawsuit brought by the Justice Department began in 1997 against Microsoft. Most states, which also have their own antitrust laws, joined as plaintiffs in this case. Microsoft's operating system software was installed on 95 percent of all personal computers. A federal trial court ruled that Microsoft was guilty of several forms of anti-competitive behavior aimed at stopping competing operating systems from being developed. An appeals court affirmed the decision on the main charge of illegal monopoly maintenance, but reversed other parts. In 2002, the government abandoned its attempt to split Microsoft into two or more companies. It agreed to a settlement that placed some restrictions on the conduct of the company.

Pre-Merger Notification

The FTC enforces the FTC, Clayton, and Sherman Antitrust Acts. The FTC often issues "cease and desist" orders (subject to court review) to stop unfair business practices. These practices include such things as conspiracies among competitors to agree on exclusive sales territories, which eliminate competition and tend to keep prices high.

Over the years, Congress has given additional responsibilities to the FTC. In 1938, Congress added protecting the consumer against "unfair or deceptive acts or practices." These practices include false advertising, consumer fraud, and, most recently, identity theft.

A 1976 law requires large companies seeking to merge to notify the FTC and Department of Justice in advance. The notice gives the government an opportunity to review and approve or disapprove the merger before it takes place. It is far easier to stop a proposed monopoly from forming than dismantle it once it exists.

The two government agencies decide between themselves which pre-merger cases to handle. If the companies hear nothing after 30 days, the merger is deemed approved. This happens in more than 95 percent of the cases. Most mergers are not between competitors and have little impact on competition.

The remaining 5 percent (or less) get a "Second Request," which requires more documents to be filed. The request is a red-flag warning to the companies. The government regulators are signaling that part of the proposed merger may violate antitrust laws.

The government reviews the documents and does complicated economic analyses. It particularly scrutinizes proposed mergers of directly competing firms ("horizontal mergers"). In markets with few competitors, horizontal mergers may significantly reduce competition.

Key Provisions of the Major Antitrust Laws

The Sherman Act (1890 as later amended)

Sec. l: Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce . . . is declared to be illegal.

Sec. 2: Every person who shall monopolize, or attempt to monopolize, or combine with any other person or persons, to monopolize any part of trade or commerce . . . shall be deemed guilty of a felony . . . .

Clayton Act (1914 as later amended)

Sec. 2: It shall be unlawful for any person engaged in commerce . . . to discriminate in price between different purchasers of commodities of like grade and quality . . . where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly . . . .

Sec. 3: It shall be unlawful for any person engaged in commerce . . . [to] fix a price . . . or rebate upon, such price, on the condition . . . [that] the purchaser thereof shall not use or deal in the goods . . . of a competitor . . . where the effect . . . may be to lessen competition or tend to create a monopoly in any line of commerce. [This is called "exclusive dealing."]

Sec. 7: No person engaged in commerce . . . shall acquire, directly or indirectly, the whole or any part of the stock or other share capital . . . or any part of the assets of another person engaged also in commerce . . . [where] the effect of such acquisition may be substantially to lessen competition, or tend to create a monopoly.

[This provision prohibits anti-competitive corporation mergers.]

Federal Trade Commission Act (1914 as later amended)

Sec. 5: Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are declared unlawful.

If the government decides that a merger would probably violate antitrust laws, it attempts to negotiate a voluntary agreement (known as a "consent decree"). Consent decrees often require merging companies to divest, or sell, parts of their business to competitors. Divesting reduces the likelihood that the merged company would acquire "monopoly power" (the power to raise prices, reduce output, or limit consumer choice without fear of competition).

If the companies refuse to agree to a consent decree, the government may seek an injunction (court order) to stop the merger, pending a hearing on the case. If the judge agrees to the injunction, the companies frequently give up their case since they are likely to lose.

If the merger battle continues, what happens next depends on whether the FTC or Justice Department is handling the case. The Justice Department goes directly to federal court. Instead of filing a court action, the FTC will sometimes conduct a hearing before an administrative judge. This judge may decide to allow the merger or bar it as a violation of the antitrust laws. Either side may appeal the judge's ruling to the full five-member FTC and then to a federal court.

Merger Guidelines

During the 1960s and '70s, the Justice Department and FTC pursued an aggressive anti-merger policy. They attempted to limit the growth of big corporations and of markets without many competitors. The courts, however, increasingly recognized that big businesses often were more efficient than smaller ones. "Efficiencies of scale" often enabled large corporations to reduce their costs and their prices to the consumer.

In 1968, the Justice Department produced its first set of horizontal-merger guidelines. The guidelines gave criteria for deciding whether to oppose a merger between competing firms. The FTC later adopted them for their own pre-merger reviews.

In 1982, the strongly pro-business Reagan administration introduced new merger guidelines. "Market share" (the percent of the production or sales of a

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merged company's product in a geographical area) mattered. But the new merger guidelines gave more weight to competitive effects of the merger, such as higher prices. Economic factors such as "efficiencies of scale" took a more prominent place in the new guidelines.

Since the Reagan era, the Justice Department and FTC have jointly revised the merger guidelines several times. The current guidelines still reflect the Reagan administration's emphasis on the positive economic effects that mergers may have on the economy.

Horizontal Merger Guidelines

1. **Market Definition and Concentration:** Will the merged company acquire significantly increased "market share" over the manufacture or sale of certain products or services in a geographical area? A high level of "concentration" (few competitors) may indicate that the merger would likely reduce competition, raise prices, and thus violate antitrust laws. For example, if two popular soda-pop companies merged and made 75 percent of all soda-pop sales in five Southern states, the new firm may be able to ignore its minor competitors and raise prices. A high level of concentration might also make it more likely that a conspiracy to coordinate activities will occur.

2. **Negative Competitive Effects:** Will the merger produce negative effects on competition? The government will investigate the likelihood that the merged company will be so dominant that competition significantly diminishes. In this situation, customers may have no choice but to pay higher prices. Also, if fewer competitors result, those that remain may more easily conspire among themselves to coordinate their sales territories and pricing.

3. **Barriers to Entry of New Firms:** Will the merger deter new competing firms from entering the product and geographical markets? If the merged company heavily dominates these markets through brand recognition, advertising, and number of retail outlets, potential competitors may likely conclude it is not worth setting up a new business. Thus, the merged company would face little future competition.

4. **Efficiencies:** Will those proposing the merger be able to show that "efficiencies" will benefit consumers? Companies wishing to merge may use this efficiency defense to argue that a merged company can use its combined assets to reduce costs, offer lower prices, develop new products, and provide better service than the companies could separately. Since a merger may decrease competition to some degree, a lack of efficiencies may mean both higher prices and few other benefits for consumers.

A New Era of Cooperation

The Justice Department in recent years has taken to trial only a few big antitrust lawsuits.

And the FTC has challenged only a handful of proposed mergers before administrative judges. The more usual approach has been to seek a preliminary injunction in federal court. Both the Justice Department and the FTC, however, have settled many other contested cases with consent decrees. These decrees have often permitted a merger on condition that one or both companies divest ownership in some corporate holdings to ensure a competitive market. This occurred in 2000 when the FTC approved the merger of the Exxon and Mobil oil companies. The FTC approved that merger on condition that the two companies sell hundreds of their gas stations along with other assets.

More important, today most companies understand government policies. They structure their mergers and other activities in ways that the Justice Department and FTC will not reject. In other cases where companies proceed with a likely anti-competitive merger, they know that a consent decree may be able to fix violations of the antitrust laws by eliminating any anti-competitive aspects.

For Discussion and Writing

1. Why are corporate mergers sometimes harmful to consumers? How can mergers sometimes benefit consumers?

2. How do the FTC and Justice Department differ in enforcing antitrust laws?

3. How did the early 20th century "trustbusters" differ from today's government regulators with regard to the growth of big corporations? Which approach do you agree with more? Why?

For Further Reading

"Guide to the Federal Trade Commission." *Federal Trade Commission*. March 2004. URL: www.ftc.gov/bcp/conline/pubs/general/guidetoftc.htm

Shenefield John H. *The Antitrust Laws: A Primer.* 4th Edition. Washington, D.C.: AEI Press. 2001.

A C T I V I T Y

Case Study: FTC v. Staples and Office Depot

Background

Staples and Office Depot own office-supply "superstores." They are the two largest office-supply chains in the country. They sell consumable products like paper, pens, and printer cartridges as well as computers, office furniture, and other business products. In September 1996, they developed a proposal to merge. Office Max was the only other "big box" office-supply chain (although many other retailers sold office supplies). The superstores had a record of substantially cutting the prices of office supplies to businesses and individuals.

Staples and Office Depot filed notice to the FTC of their intention to merge in October 1996. The FTC staff investigated the proposed merger to determine if the merged company would likely violate the antitrust laws.

The FTC decided to challenge this merger and sought a preliminary injunction to stop it, pending a full hearing before an administrative judge. Staples and Office Depot vigorously challenged the FTC decision before a federal judge who was considering whether to issue an injunction.

The Arguments

The main arguments for and against the merger are summarized below and are organized under the headings of the Merger Guidelines.

Market Definition and Concentration

Staples and Office Depot: The "product" in this case includes everything sold in the office-supply superstores. This includes not only consumables like paper and pens but also office furniture and many other types of items used by businesses. Many retail outlets other than the three chains sell office supplies. These outlets include stationery stores, mail-order companies, online businesses, drugstores, department stores, and discount stores like Wal-Mart. Someone can buy a legal pad at any of these places.

The FTC unfairly uses a narrow definition of our "product" as well as who our competitors are. Staples and Office Depot together sell only 5.5 percent of the office-supply products in the nation. Merging the two firms would not substantially increase concentration or lessen competition.

FTC: The "product" affecting competition in this case includes only the *consumable* office supplies that are the specialty of the superstore chains. Other items like office furniture are a sideline. On average, the superstores reserve 11,000 square feet of space for paper, pens, and other consumables contrasted with only 2,000 square feet in stores like Wal-Mart. Studies show that many customers, especially small businesses, prefer to purchase all their consumable office supplies at one place. They typically do not shop around for these items at drug stores or other retail outlets. In addition, ordering by mail or even online takes too much time for delivery in many cases. Thus, many office-supply customers compare only the prices offered by the superstores.

The prices of these items are up to 13 percent higher in cities where only one chain currently operates, even though stores like Wal-Mart are present. A merger of these two chains would result in the new firm controlling between 45 and 100 percent of consumable office-supply sales in over 40 cities. The lack of superstore competitors would result in a very high degree of concentration.

Negative Competitive Effects

Staples and Office Depot: While our prices may be currently higher in some cities than others, we can account for this by such factors as sales volume, shipping costs, wages, and rent. Our merged company will be committed to lowering prices as our companies have done in the past. Moreover, the merger will make the United States stronger in the global market.

FTC: Our studies show that office-supply prices are lowest in cities where all three superstore chains compete. Prices are higher in cities where two chains operate and are highest when only one chain is present. Eliminating one of the three office-supply chains will reduce competition in the consumable office-supply market. We estimate that the new merged company would be able to raise prices up to 10 percent in cities where Office Max does not compete because customers typically compare prices only among the existing three office-supply chains.

Barriers to Entry of New Firms

Staples and Office Depot: The office-supply market is expanding rapidly. New customers, many of whom work at home, are increasing. There is plenty of room for new office-supply businesses to enter the market. Moreover, the explosive growth of online businesses

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will be an increasingly large factor in expanding the office-supply industry.

FTC: Since they began in the 1980s, office-supply chains have dropped from over 20 to three. These three dominate the sales of consumable office supplies with their name recognition and numerous superstores, making it difficult for new firms to enter this market. Currently, no significant superstore competitors are preparing to enter the consumable office-supply market.

Efficiencies

Staples and Office Depot: We estimate that our merger will result in cost-saving efficiencies of $4 to $6.5 billion over the next five years. We intend to pass along more than 60 percent of these cost savings to our customers by lowering prices.

FTC: Historically, Staples has passed through only 15–17 percent of its cost savings to customers. Based on this record, if the merged company reduces its costs by 10 percent it will likely pass through only 0.5 percent of its savings to its customers. We also see no evidence that cost savings of the magnitude claimed by the two companies would in fact occur.

Directions for Activity

1. Read the case study above and write an answer to this question: **Should Staples and Office Depot be allowed to merge?**

   The main issue in this case is whether the effect of the proposed merger "may be substantially to lessen competition or tend to create a monopoly" in violation of antitrust laws. Back up your answer with the best arguments that persuade you as well as support from the Merger Guidelines, Key Provisions of the Antitrust Laws, and facts from the article.

2. Join with others who agree with your position, and participate in a debate on whether the Staples–Office Depot merger should be allowed to proceed. After the debate, take a class vote on the question.

* * * * *

See page 10 for the court's decision.

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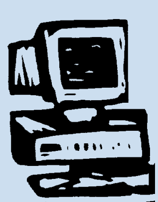

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About Constitutional Rights Foundation

Constitutional Rights Foundation is a non-profit, non-partisan educational organization committed to helping our nation's young people to become active citizens and to understand the rule of law, the legal process, and their constitutional heritage.

Established in 1962, CRF is guided by a dedicated board of directors drawn from the worlds of law, business, government, education, and the media.

CRF's program areas include the California State Mock Trial, History Day in California, youth internship programs, youth leadership and civic participation programs, youth conferences, teacher professional development, and publications and curriculum materials.

Media Mergers and the Public Interest

In addition to antitrust regulation, many media mergers and acquisitions are subject to regulations from the Federal Communications Commission. Are FCC rules on media ownership still necessary in today's world?

The Federal Communications Commission places restrictions media ownership, mergers, and acquisitions. (Eric Bechtold/iStock.com)

In 2003, the Federal Communications Commission relaxed its rules on ownership of media outlets. A storm of protest followed. That year Congress received more mail and phone calls on this issue than on any other—except the war in Iraq. Most of the response came from those who opposed the FCC rule changes.

The opposition brought together groups—liberal and conservative—who normally opposed one another. They argued that the rule changes would result in fewer companies owning more media outlets. They viewed increased concentration of media ownership as a threat to democracy. They argued that for democracy to flourish a great diversity of voices needs to be heard.

Congress responded by moving to overturn the new rules. In a compromise with the White House, Congress agreed to just slight changes in the rules. The opposition had stopped the new rules.

CURRENT ISSUES

Those supporting the new rules included big media companies and groups opposed to government regulation. They viewed the FCC rules as modest changes and, in fact, favor eliminating all FCC media ownership rules. They argue that today's media—radio, television, cable and satellite TV, satellite radio, newspapers, magazines, and the Internet—provide the consumer with the greatest diversity of voices in history. They believe that government regulations interfere with their right to free speech and also with the development of new technologies.

Should the FCC continue to issue rules on media ownership? Or should the FCC stop regulating the ownership of media?

The First Amendment

Any discussion of the media must consider the First Amendment to the U.S. Constitution. The First Amendment protects, among other things, freedom of speech and the press.

Freedom of speech and the press are important for many reasons. A free press plays a watchdog role on government, exposing misdeeds, mistakes, and mishaps that officials would like to keep quiet. It also ensures that citizens have access to all points of view and can make informed political decisions. "An enlightened citizenry," Thomas Jefferson once said, "is indispensable for the proper functioning of a republic."

By letting every idea be examined and questioned, freedom of expression doesn't just help the democratic process; it helps scientists, inventors, and ordinary people find the truth. Further, freedom of speech and the press serves as a "safety value," allowing people to vent their anger and frustration with government and lessening the likelihood that they will foment revolution or commit terrorist acts. Finally, freedom of expression helps people develop as individuals by allowing them to examine and express different thoughts and opinions. For all these reasons, freedom of speech and the press is one of the most basic rights of a free people.

The Federal Communications Commission

The First Amendment bans most government limitations on freedom of speech and the press. The emergence of radio in the 20th century, however, presented problems that Congress needed to deal with. The public owned the airwaves that radio broadcasters used, and thousands of broadcasters—stations, individuals, and the military—were clogging them. To bring order to

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broadcasting, Congress began licensing radio frequency airwaves in 1927.

Licensed radio networks, led by the National Broadcasting Company (NBC), used them at no charge in exchange for providing free broadcasting. NBC, soon followed by CBS and ABC, discovered that radio advertising made broadcasting over the public airwaves extremely profitable.

In 1934, Congress passed the Telecommunications Act. It set the course for government regulation of future commercial communication technologies like television.

The Telecommunications Act created the Federal Communications Commission. The president appoints and the Senate confirms five FCC commissioners, only three of whom may be from the same political party.

The FCC has the authority to grant and renew licenses for broadcasting over the public airwaves (still at no charge). Today, the primary responsibility of the FCC is to regulate over-the-air radio and TV broadcasting. It also regulates communications by telephone, cable, and satellite.

The 1934 law included a requirement that to renew their FCC licenses, broadcasters had to serve "the public interest, convenience, and necessity." Even today, however, there is little agreement over what this phrase means.

Radio and TV broadcasters typically argue that the "public interest" simply means programming that the public wants. In other words, what is popular to consumers (and profitable to advertisers). Others, however, insist that the "public interest" requires numerous independent broadcasting companies, diverse programming, attention to local issues, and lots of information and viewpoints for democratic debate.

Big Media

In the 1980s, President Ronald Reagan appointed new policymakers to the Justice Department, Federal Trade Commission, and FCC. They de-emphasized government regulation of media companies in favor of letting free-market competition do the regulating. This approach, largely continued under subsequent presidents, unleashed a wave of media mergers.

The media mergers over the last 25 years have been both "horizontal," combining similar competing firms, and "vertical," combining content production and distribution companies. This has resulted in a small number of huge conglomerates, now often called "big media."

In 2000, the largest-ever media merger took place. America Online (AOL) announced its intention to purchase Time Warner. AOL was the nation's dominant Internet service provider. Time Warner was a media powerhouse, owning magazines, video and high-speed Internet cable, cable TV channels, music labels, and TV and movie production companies.

AOL and Time Warner were not horizontal (direct) competitors, and the Department of Justice did not challenge the merger as an illegal monopoly. The Federal Trade Commission, responsible for guarding against anti-competitive practices, approved the AOL-Time Warner merger with conditions.

The FCC also had to approve the merger. Consumer groups and other critics noted that media companies distribute most of the ideas, news, and other information American citizens receive. They argued that the merged companies would have too much control over the nation's media content. They also argued that the media giant could stifle new technology. Nevertheless, a unanimous FCC approved the merger with conditions in January 2001.

AOL/Time Warner is now the largest of a handful of "big media" conglomerates. These are huge corporations, owning combinations of:

- Broadcast, cable, and satellite radio and TV.
- Production studios for movies and TV.
- Music labels.
- Internet services.
- Newspapers, magazines, and book publishing companies.

Today, big media companies own most TV networks, cable TV companies, radio networks, music labels, movie studios, magazines, and book publishers. (See box.) The big media conglomerates compete against one another. But they have many common economic and political interests and often cooperate in "joint ventures" by sharing ownership in some businesses.

Network Broadcasting

The country today is divided into 210 television broadcast markets. No company owns broadcast stations in all 210 television markets. That would violate FCC ownership rules. The major networks own and operate some broadcast stations, mainly in major cities. They contract with other independent local stations across the nation to carry the network's programming.

The Top Five Big Media Companies and Their Holdings		
Company	**Broadcast* & Cable TV**	**Other Media (sample holdings)**
AOL/Time Warner (now called just Time Warner)	Cable News Network (CNN) other cable channels	Warner Bros. Studios AOL (Internet service provider) Little, Brown (books) magazines
Viacom/CBS	CBS* CBS News* cable channels	Paramount Pictures Blockbuster Infinity Broadcasting (radio network) music labels
Disney	ABC* ABC News* cable channels	Walt Disney Pictures Walt Disney Records Walt Disney Publishing Internet sites
NBC Universal (owned by General Electric)	NBC* NBC News* cable channels	Universal Pictures Universal Production Studios Universal Studios DVD on-demand TV
News Corporation	Fox* Fox News other cable channels	Twentieth Century Fox DirecTV (satellite TV provider) Fox Sports Radio newspapers, books, & magazines

A network will give an affiliate station the exclusive right in its market area to air the network's programming for free. (In some cases, the network will even pay the affiliate station to air its programs.) In turn, the networks go to advertisers and sell commercial time based on their ability to air programs that will be viewed nationally. The more viewers a network has, the greater advertising revenue it will receive.

The affiliates usually broadcast the network's prime-time schedule, morning and late-night programs, week-day soap operas, and weekend sports events. Local stations also air their own programs—news and entertainment (most of the entertainment consists of reruns of network programming). Their revenue comes from commercial advertising. Although they are losing viewers, the stations are still highly profitable.

The FCC's Broadcast Ownership Rules

After Congress passed the 1934 Telecommunications Act, the Federal Communications Commission imposed conditions on those receiving licenses to broadcast (over-the-air) radio and TV stations. Early FCC regulators had decided if a company owned too many broadcast outlets along with newspapers, it would have too much control over information and entertainment. This, the regulators concluded, would be against the public interest.

Big media have always wanted to get rid of these rules, arguing that the rules hobble innovation and unjustly interfere with private free enterprise. In 1996, the major broadcasters successfully lobbied Congress to change some of the ownership rules.

Signed by President Bill Clinton, the 1996 Telecommunications Act amended the 1934 law. The new policy directs the FCC to "reduce regulation in order to secure lower prices and higher quality services . . . and encourage the rapid deployment of new telecommunications technologies."

The 1996 Telecommunications Act relaxed the limits, or cap, on the number of broadcast TV stations that

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companies could own. It stated that a single company could not own stations that broadcast to more than 35 percent of U.S. TV households. (This was up from a cap of 25 percent in the old FCC rule). It also lifted all caps on ownership of the number of radio stations one company could own. (It did, however, place limits on the number a company could own in the same geographical area.)

The law also lengthened the term of broadcasting licenses from three to eight years. In addition, it directed the FCC to review and revise the ownership rules every two years as market conditions warranted.

The 1996 law fueled more media mergers. Viacom merged with CBS. Clear Channel began buying many radio stations and now owns more than 1,200 radio stations nationwide.

Big media companies pressed for further easing of the FCC ownership rules. In 2001, President George W. Bush appointed Michael Powell chairman of the FCC. (He is the son of former Secretary of State Colin Powell.) The following year, a federal appeals court decided that unless the FCC could prove media ownership rules served the public interest, the intent of Congress was to abolish them. This decision along with persistent lobbying by big media prompted Powell to announce in 2003 new broadcast-ownership rules.

Three of Powell's proposed rule changes drew the most attention:

1. The FCC would end the rule that limited single companies to owning only one TV station in a local market area. Companies could own two TV stations in mid-sized markets and three in large ones. But only one of the stations in a market could be in the top four of audience viewing.
2. The broadcast reach of the total number of TV stations a single company owned would increase from 35 percent to 45 percent of U.S. TV households.
3. Certain combinations of radio, TV, and newspaper "cross-ownership" would be allowed in mid-sized markets. All limits to cross-ownership of broadcast media and newspapers would be eliminated in large markets.

Powell said the rule changes took into account the "explosion of new media outlets" and would promote diverse programming, local broadcasting, and a "vigorous competitive environment."

Firestorm at the FCC

As mentioned at the beginning of the article, FCC Chairman Powell's proposed changes in ownership rules ignited a firestorm of opposition from critics. They argued that any further weakening of media ownership rules would violate the public interest.

After a bitter conflict over Powell's refusal to hold nationwide public hearings on the proposed rules, the FCC finally approved them in June 2003. By this time, however, Congress had heard from the public and intervened.

In November, Congress and the White House reached a compromise on the most controversial new rule. The compromise put the broadcast cap on TV stations owned by any single company at 39 percent of U.S. TV households. (The new rule had proposed a 45-percent limit.) Viacom/CBS and News Corporation already owned stations that exceeded the 35 percent cap under the old rule.

In 2004, a federal appeals court blocked all the proposed rules because the FCC had acted arbitrarily and failed to allow adequate public comment. The court sent the rules back to the FCC for further review. Soon afterward, Michael Powell resigned from the FCC. In 2006, the FCC began reconsidering the broadcast ownership rules.

Arguments in Favor of the New FCC Rules

The big media companies and others opposed to government regulation contend that Congress never authorized the FCC to impose any ownership rules in the first place. They argue that the FCC could best serve the public interest by eliminating all ownership restrictions and letting the free market regulate the broadcast industry. They believe that existing antitrust rules, enforced by the Justice Department and Federal Trade Commission, would prevent anti-competitive practices. There is no need, they argue, for an additional layer of regulations on ownership from the FCC. As an interim measure, they favor the new FCC rule changes.

They point out that the ownership rules were imposed when only three networks (NBC, CBS, ABC) made up nearly 100 percent of all broadcasting in the United States. Now, most Americans have access to a wide diversity of broadcast, cable, satellite, and online outlets for news, information, and entertainment. Thus, they argue, the ownership rules are unnecessary in this new age of media abundance.

They contend that by owning more TV and radio stations, broadcast networks would be able to take advantage of economic efficiencies and stabilize the finances of the entire broadcasting industry, leading to better and diverse programming. They note that local broadcast TV stations are profitable today. But they claim that the stations are in danger of failing due to competition from cable and satellite TV, the high cost of news operations, and the expense of changing from analog to digital transmission by 2009. Merging with national media companies, they say, will provide these local outlets with the resources to better compete and serve their local communities. They conclude that rules restricting the "cross-ownership" of newspapers, broadcast TV, and radio intrude on the efficiency of the free-market system.

Arguments Against the New FCC Rules

Those against changing the broadcast ownership rules point out that the rules are questions of public policy. The public owns the airwaves, and they believe it is important to place conditions on those receiving free licenses to broadcast over the airwaves. They believe that loosening the ownership rules would unleash a new big media merger frenzy, resulting in further concentration of broadcast media ownership and control over what Americans see, hear, and read.

They point out what has happened to radio since Congress loosened the radio ownership rules in the 1996 Telecommunications Act. They note that there are now one-third fewer independent radio stations, with a handful of national radio networks like Clear Channel and Infinity Broadcasting controlling most of the music DJs play in local markets. The same thing, they argue, would happen to broadcast television, with big media control over local TV broadcasting.

They believe that eliminating FCC rules would decrease competition, squeezing out independent and innovative programming in favor of only what is profitable to advertisers. They argue that "cross-ownership" of radio, TV, and newspapers would reduce local competition and increase control by a few media owners over what news will be printed and broadcast in many cities. This, they contend, would be a dangerous trend in American democracy.

For Discussion and Writing

1. Why does the First Amendment protect freedom of speech and the press?
2. What is the purpose of the Federal Communications Commission?
3. What conditions do you think TV and radio broadcast stations should have to meet in order to renew their licenses? Why?

For Further Reading

Croteau, David and Hoynes, William. *The Business of Media, Corporate Media and the Public Interest*. 2nd ed. Thousand Oaks, Calif.: Pine Forge Press, 2006.

McChesney, Robert. *The Problem of the Media, U.S. Communication Politics in the Twenty-First Century.* New York: Monthly Review Press, 2004.

A C T I V I T Y

Senate Hearing: Do FCC Ownership Rules Serve the Public Interest?

1. Divide the class into four role groups:

   Federal Communications Commission agrees broadcast ownership rules serve the public interest, but need to be changed to reflect the modern media marketplace (the "Powell Rules").

   Consumers United agrees ownership rules serve a very important public interest and should not be changed.

   Broadcasters Association disagrees that ownership rules serve the public interest, so they should be entirely eliminated.

   Senate Commerce Committee will hold a hearing and then answer this question: **Do FCC Ownership Rules Serve the Public Interest?**

2. The first three role groups should research the article and prepare arguments to defend their position at a hearing on the question before the Senate Commerce Committee.
3. The Senate Commerce Committee members should research the article and prepare questions to ask each of the groups as they testify during the hearing. The committee may permit group members to respond to or challenge testimony during the hearing.
4. After the hearing, the Senate Commerce Committee members should publicly discuss the hearing question, try to persuade each other on an answer, and finally take a vote on it.

Standards Addressed

Adam Smith and *The Wealth of Nations*

National High School World History Standard 33: Understands the causes and consequences of the agricultural and industrial revolutions from 1700 to 1850. (6) Knows the strengths and weaknesses of Adam Smith's analysis of capitalism in *The Wealth of Nations* (e.g., his principle of the "Invisible Hand," the role of free enterprise, the profit motive, and competition; his "pin" story).

California History-Social Science Content Standard 12.1: Students understand common economic terms and concepts and economic reasoning. (5) Analyze the role of a market economy in establishing and preserving political and personal liberty (e.g., through the works of Adam Smith).

Progressives and the Era of Trustbusting

National High School U.S. History Standard 20: Understands how Progressives and others addressed problems of industrial capitalism, urbanization, and political corruption. (1) Understands the origins and impact of the Progressive movement (e.g., social origins of Progressives and how these contributed to the success and failure of the movement; Progressive reforms pertaining to big business, and worker's and consumers' rights; arguments of Progressive leaders).

California History-Social Science Content Standard 11.2: Students analyze the relationship among the rise of industrialization, large-scale rural-to-urban migration, and massive immigration from Southern and Eastern Europe. (5) Discuss corporate mergers that produced trusts and cartels and the economic and political policies of industrial leaders. (9) Understand the effect of political programs and activities of the Progressives (e.g., federal regulation of railroad transport, Children's Bureau, the Sixteenth Amendment, Theodore Roosevelt).

The Development of Antitrust Enforcement

National High School Economics Standard 4: Understands basic features of market structures and exchanges. (2) Knows that collusion among buyers or sellers reduces the level of competition in a market and is more difficult in markets with large numbers of buyers and sellers.

National High School U.S. History Standard 31: Understands economic, social, and cultural developments in the contemporary United States. (1) Understands how changes in the national and global economy have influenced the workplace.

California History-Social Science Content Standard 12.2: Students analyze the elements of America's market economy in a global setting. (3) Explain the roles of property rights, competition, and profit in a market economy. (5) Understand the process by which competition among buyers and sellers determines a market price. (6) Describe the effect of price controls on buyers and sellers. (7) Analyze how domestic and international competition in a market economy affects goods and services produced and the quality, quantity, and price of those products.

Media Mergers and the Public Interest

National High School U.S. History Standard 31: Understands economic, social, and cultural developments in the contemporary United States. (4) Understands various influences on American culture (e.g., . . . the influence of the media on contemporary American culture . . .).

National High School Media Standard 10: Understands the characteristics and components of the media. (11) Understands legal and ethical responsibilities involved in media use (e.g., censorship; copyright laws; FCC regulations; protection of the rights of authors and media owners; standards for quality programming; regulations for broadcast repeats; forms of media self-control; governmental, social, and cultural agencies that regulate media content and products).

National Civics Standard 19: Understands what is meant by "the public agenda," how it is set, and how it is influenced by public opinion and the media. (3) Understands the importance of freedom of the press to informed participation in the political system; and understands the influence of television, radio, the press, newsletters, and emerging means of electronic communication on American politics

California History-Social Science Content Standard 12.8: Students evaluate and take and defend positions on the influence of the media on American political life. (1) Discuss the meaning and importance of a free and responsible press. (2) Describe the roles of broadcast, print, and electronic media, including the Internet, as means of communication in American politics.

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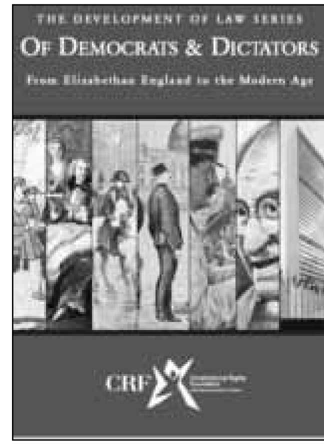

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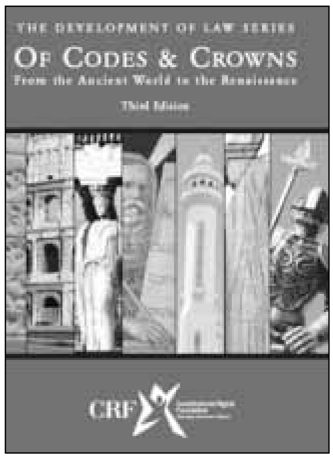

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