THE ECONOMICS OF BASING POINT PRICING

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Basing point pricing, adopted by steel producers some fifty years ago and since by many other industries, has been a subject of vigorous controversy among lawyers and economists for a quarter of a century. The clash of views has raised temperatures to the point of incandescence and has eventually shed some light on an intricate and significant problem. In the light, all economists have not seen the problem alike, but they have lined up on opposite sides of an issue, the general nature of which is fairly clear. That issue is whether basing-point pricing results from independent decision-making by business rivals, each anxious to maximize his earnings, or from conspiracy. A parallel issue is: what should be done about it? The second issue has forced students to look at the economic consequences of basing point pricing as well as its causes. Moreover, as the controversy has sharpened the issues, it has also narrowed the differences. Thus it has made for intellectual progress.

I

CONSPIRACY V. SPONTANEOUS EVOLUTION

The late Frank A. Fetter, Vernon Mund, and Fritz Machlup have been the most articulate "members" of what may be called the "conspiracy school."¹ John Maurice Clark has been by all odds the most articulate proponent of what may be called the doctrine of "spontaneous evolution." He has found strong allies in Melvin G. de Chazeau, Theodore Yntema, and Arthur Smithies.²

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¹ Cf. FRANK A. FETTER, *THE MASQUERADE OF MONOPOLY* (1931); *The New Plea for Basing-Point Monopoly*, 45 J. POL. ECON. 577 (1937); *Exit Basing Point Pricing*, 38 AM. ECON. REV. 815 (1948); VERNON MUND, *OPEN MARKETS*, esp. 165 ff. (1948); *Monopolistic Competition and Public Price Policy*, 32 AM. ECON. REV. 727 (1942); *Application of Economic Analysis to Antitrust Law Policy*, PROCEEDINGS TWENTIETH ANNUAL CONFERENCE OF THE PACIFIC COAST ECONOMIC ASS'N 75 (Dec. 1941); *The "Freight Allowed" Method of Price Quotation*, 54 Q. J. ECON. 232 (1940); FRITZ MACHLUP, *THE BASING-POINT SYSTEM* (1949).

² Clark, *Basing Point Methods of Price Quoting*, 4 CAN. J. ECON. AND POL. SCI. 477 (1938); *Imperfect Competition Theory and Basing-Point Problems*, 33 AM. ECON. REV. 283 (1943); *The Law and Economics of Basing Points: Appraisal and Proposals*, 39 AM. ECON. REV. 430 (1949); *Machlup on the Basing-Point System*, 63 Q. J. ECON. 315 (1949). I MELVIN G. DE CHAZEAU, CARROL R. DAUGHERTY, AND SAMUEL S. STRATTON, *THE ECONOMICS OF THE IRON AND STEEL INDUSTRY* 533-578, esp. 537 (1937). De Chazeau concludes that although in the beginning rivals cooperated in establishing and maintaining the basing point system, the underlying technological characteristics of the steel industry, plus the formation of the United States Steel Corporation in 1901, "made it certain that a basing-point system of prices would be adopted for rolled products." *Id.* at 537. He also states that "agreement is not a necessary condition of uniform pricing under oligopoly." II *id.* at 631.

Each of these two groups has a logical theoretical basis for its position. The conspiracy school—particularly Fetter and Mund—relies largely on the logic of competitive pricing; the spontaneous evolutionary school, on the logic of oligopolistic pricing.³ Neither group rejects wholly the logic of the other; they differ in applying it to somewhat obscure industrial facts.

A. The Logic of the "Conspiracy School"

The conspiracy school contends that the systematic practice by business rivals of quoting delivered prices at any destination equal to the lowest combined base price and freight charge to that destination is itself evidence of conspiracy and should be prohibited by law. The implied remedy is mandatory f.o.b. pricing.⁴ As stated above this conclusion is based on the logic of competitive pricing. According to this logic as expounded by Mund, no seller of a standardized product will accept less from any buyer than he can get from any other buyer; no buyer will pay to any seller more than he need pay any other seller. The rivalry of sellers, each trying to get as much as he can for what he sells, and the rivalry of buyers, each anxious to pay as little as possible for what he buys, will force all sellers to sell to all buyers at the same price in the same market. The "principle of indifference" prevents discrimination. Delivered prices will consist of the f.o.b. price plus freight to the delivery point. They will differ solely by differences in transportation costs. In competitive markets there may be several production centers which compete for business on the margin of their normal market areas. Relative production costs and transportation rates will determine the boundaries of the competing markets. These may shift from time to time in response to changes in the conditions of supply and demand. But as Mund puts it, "The prices in two different market places . . . do not differ, except temporarily, by more than transportation costs and handling charges, for competing traders will ship goods and level off the price differential."⁵ According to Mund, four conditions are essential to this kind of pricing: (1) freedom of competition in trading; (2) freedom of entry; (3) a willingness by producers to compete; and (4) a market demand that warrants more than

See also United States Steel Corporation, TNEC Papers (1940), in three volumes, especially Volume III, *THE BASING-POINT METHOD*. Volume I, *ECONOMIC AND RELATED STUDIES*, states in a foreword: "The work of an economic nature was under the direction of Professor Theodore O. Yntema of the University of Chicago. He also acted as a consultant on the economic issues considered in the study of the Basing Point Method." The analysis of Volume I, *ECONOMIC AND RELATED STUDIES*, lends support to the de Chazeau thesis. Smithies, *Aspects of the Basing-Point System*, 32 *AM. ECON. REV.* 705 (1942).

³ Clark makes it clear that he uses theory as an analytical tool. "In the last analysis the conclusive thing is not any theory as such, but an understanding interpretation of the forces actually at work in basing-point industries. In this process theories can help or mislead, according to how they are used; but they cannot be relied on for ready-made answers." *Imperfect Competition Theory and Basing-Point Problems*, 33 *AM. ECON. REV.* 283, 285 (1943).

⁴ Although Fetter, Mund, and Machlup all apparently accept this remedy, they do not use precisely the same arguments in justifying it. In citing any one of these, I do not imply that any other occupies precisely the same position. In my judgment Machlup's is the more sophisticated logic and it is not inconsistent with the logic of imperfect competition, of which it indeed takes account.

⁵ Mund, *Prices Under Competition and Monopoly: Some Concrete Examples*, 48 *Q. J. ECON.* 288, 299 (1934).

one producer. Mund illustrates his conception of competitive pricing by a study of the pricing of lettuce, potatoes, apples, beans, and furs in the Puget Sound area. He found that for any one of these products bought in this market all buyers, remote or nearby, paid the same f.o.b. price at any time. Because distant buyers had to pay higher transportation charges, they paid higher delivered prices. As Mund puts it, "A seller with competition . . . is effectively precluded from practicing discrimination; that is, from making a difference in prices without a corresponding difference in quality, service or conditions in the terms of sale; or from not making a difference in prices for a difference in the service rendered."⁶

From his analysis of competitive pricing in produce markets he concludes that whenever sellers discriminate among buyers, they are monopolists. Where monopoly power grows out of location, as for example, an isolated cement plant, the monopolist sells at high prices in his "protected" territory and cuts prices to distant buyers (by absorbing freight) "to the extent that the plant desires the business or that it wishes to forestall or eliminate competition."⁷ But monopolies through collusion (open or tacit) are more prevalent than single-seller monopolies, and the basing point system is a common device for strengthening such collusion. The different mill nets that sellers realize under it, being discriminatory, are evidence of monopoly.

Mund made his study of competitive pricing before the recent theory of imperfect competition had made its imprint on the thinking of economists. More recently he has taken account of the theory of oligopolistic pricing.⁸ He recognizes that fewness of sellers makes collusion easier, and that small sellers through fear or avarice may choose to follow a price leader in a market where there is a dominating seller. At one point he concedes that, "Assuming strict rational behavior, identical output and trade interests, a demand that is highly inelastic, and few sellers with entry of others improbable, it is conceivable that each seller might hesitate to reduce his price for fear his rivals would follow suit." He believes such assumptions are highly unrealistic, however, and that if sellers act independently in markets in which "no one person [is] so dominant as to be able to threaten or ignore the price independence of another," competitive pricing will result. He concludes that even where only two evenly matched sellers supply a market, if they do not conspire, prices will be competitive—that is, equal to total unit cost in the long run, marginal cost in the short. In brief, to Mund, discrimination means monopoly; monopoly in markets of more than one seller means collusion; collusion means monopoly profits—that is, prices above marginal cost in the short run, with a tendency to exceed total unit cost in the long run. As he expresses it, "When sellers are few in number . . . the frequently found desire to form rings and combinations is most easily effected. The power which brings, and holds, a few rivals together is simply the cohesive

⁶ *Id.* at 299.

⁷ *Id.* at 301.

⁸ Mund, *Monopolistic Competition Theory and Public Price Policy*, 32 AM. ECON. REV. 727, 728-730 (1942).

power of private plunder." Elsewhere he raises the question, "When *can* a concern or industry discriminate in price?" And he answers it: "It is a generally accepted economic principle that systematic price discrimination can occur only with monopoly. Thus the 'inherent' and 'structural' elements which, it is said, make possible price discrimination, can logically do so only *after* producers have secured monopoly by agreement upon a pricing formula."⁹

While Mund nowhere states his position on policy toward basing point pricing, his reasoning seems to be: (1) conspiracy is a prerequisite to the basing point system; (2) conspiracy is illegal; (3) therefore basing point pricing is illegal; and (4) it should be prohibited. Machlup and Fetter reach similar conclusions.¹⁰

B. The Logic of the Doctrine of Spontaneous Evolution

Chamberlin, primarily a theorist, gave a powerful weapon to policy-makers.¹¹ Unfortunately it has proven a double-edged sword, wielded lustily both by those who favor and those who fear Big Business. Opponents of Big Business have argued that since oligopolists behave like monopolists and since oligopoly is inevitable, the government must regulate business in the public interest.¹² Proponents have used the Chamberlinian doctrine as a defense in antitrust proceedings.¹³ The essence of the Chamberlinian doctrine of oligopoly is that if only a few well-informed sellers control the sale of any standardized product and each behaves rationally, trying to maximize his earnings, he must take account of the total effect—direct and indirect—of his decisions. Recognizing that his rivals will meet his lower price if he cuts them, an oligopolist refuses to cut.¹⁴ Chamberlin is not quite so precise on how oligopolists will react to price increases, but he implies that, through a series of moves, they will settle on a uniform price that will maximize the profits of each.¹⁵ And he concludes that "the equilibrium result is the same as though there were a monopolistic agreement between them."¹⁶

⁹ Mund, *The Application of Economic Analysis to Antitrust Law Policy*, PROCEEDINGS TWENTIETH ANNUAL CONFERENCE OF THE PACIFIC COAST ECONOMIC ASS'N 80 (1942).

¹⁰ MACHLUP, *THE BASING-POINT SYSTEM* 250-251 (1949); Fetter, *Exit Basing Point Pricing*, 38 AM. ECON. REV. 815-827 (1948).

¹¹ EDWARD CHAMBERLIN, *THE THEORY OF MONOPOLISTIC COMPETITION*, esp. c. 3 (1932).

¹² ARTHUR ROBERT BURNS, *THE DECLINE OF COMPETITION* 40 ff., 526, esp. 529, 589-590 (1936).

¹³ See, for example, Brief of Respondents-Petitioners, Vol. I, Appendix A, *Aetna Portland Cement Co. v. Federal Trade Comm'n*, 157 F. 2d 533 (C. C. A. 7th 1946); *Federal Trade Comm'n v. Cement Institute*, 333 U. S. 683 (1948) *passim*, and *United States v. American Tobacco Co.*, 328 U. S. 781 (1946).

¹⁴ As Chamberlin puts it: "Since the result of a cut by anyone is inevitably to decrease his own profits, no one will cut. . . ." CHAMBERLIN, *op. cit. supra* note 11, at 48.

¹⁵ He says: "When a move by one seller evidently forces the other to make a counter-move, he is very stupidly refusing to look further than his nose if he proceeds on the assumption that it will not." *Id.* at 46.

¹⁶ *Id.* at 48. Chamberlin recognizes that uncertainty as to how any seller will react may force prices below the monopoly level. Paul Sweezy has argued that oligopolists will follow price cuts, but may not follow price advances. This creates a "kink" in the demand curve confronting an oligopolist and makes for stable prices somewhat below the monopoly level. See Sweezy, *Demand Under Conditions of Oligopoly*, 47 J. POL. ECON. 568 (1939).

This is the theoretical basis for the doctrine that basing-point pricing is a spontaneous evolution. Clark was among the first to expound basing point pricing in terms of oligopoly.¹⁷ He regards basing point pricing as a form of imperfect competition that arises in industries in which some form of imperfect competition is inevitable. Industries using it have four characteristics or "predisposing conditions." (1) They produce a standardized product; (2) they produce from isolated plants or clusters of plants scattered throughout the country, each plant or group of plants having a local market within which the local firms have a comparative freight advantage (a monopoly of location); (3) freight charges on the product are high in relation to value; but not high enough to dissuade sellers from reaching out for additional business, even if to do so they must accept a lower mill price (that is, absorb freight) on the additional business; and (4) operating costs per unit of output are constant over a wide range of output up to the absolute limits of capacity—that is to say, short term marginal costs are constant and consistently below total unit cost. For cement, of which Clark made a detailed study as consultant to defendants in the Federal Trade Commission proceedings, marginal costs are about half of total average costs—long run supply price including a moderate return on investment. Other characteristics of industries in which basing point pricing has become a matter of public policy—characteristics that Clark does not specifically enumerate but neither does he ignore—include (1) a large fixed investment in specialized plant and equipment; (2) below capacity operation over long periods; (3) an inelastic demand at prices for an output less than that of the industry's capacity; and (4) only a few sellers within any particular market.

These are the characteristics which lead firms to price on what Clark calls the "oligopoly principle."¹⁸ A seller of a standardized product knows that he can get no more for his product than any other seller, and that if he reduces his prices his rivals will cut theirs. Thus he may gain little or no business from his rivals by cutting prices. Where demand is inelastic, price cutting is doubly unattractive because not only will all rivals meet the cut, but also increased sales will bring lower gross revenue to all sellers. At the lower price each will do a lower dollar volume of business. Where marginal costs are well below total unit cost, competition which reduced prices to marginal costs would mean bankruptcy.¹⁹ With capital facilities fixed and specialized, below-cost selling might continue for a long time without establishing equilibrium in the industry. Hence sellers who take account of the total influence of their decisions on the market will not try to get business by reducing prices. Nevertheless, in times of slack demand they are under great pressure to increase sales. They try to do so not by cutting prices on all

¹⁷ Clark, *Basing Point Methods of Price Quoting*, 4 CAN. J. ECON. AND POL. SCI. 477 (1938).

¹⁸ Clark, *Imperfect Competition Theory and Basing-Point Problems*, 33 AM. ECON. REV. 283, 288 ff. (1943).

¹⁹ *Ibid.* Clark says: "If they did go to marginal cost, the industry in general would go bankrupt, being unable to cover operating expenses, let alone any return on investment." I believe this statement is inaccurate, or if accurate, unclear. I should think that a firm's marginal costs, if constant throughout the range of normal operating rates, would be its per unit operating expenses.

sales, but by matching the delivered prices of their rivals in areas where they are at a freight disadvantage. To overcome this freight disadvantage, they absorb freight and take a lower mill-net price. It pays to reach out for business as long as the difference between the delivered price and the freight charge exceeds marginal cost. Any price above marginal cost helps to meet overhead expenses. Self-interest will lead a seller to accept the base price of his rival when selling in territory freight-wise nearer to his rival than to his own mill.²⁰

II

HOW THE SCHOOLS DIFFER

The two schools, as represented by Clark and Mund, obviously differ in two respects. Mund believes that businessmen conspire to use the basing point system to obtain monopoly prices. Clark believes that, acting independently, businessmen adopt the basing point system to avoid ruinous competition. He argues that while the basing point system tends to prevent prices from falling to strictly competitive levels—marginal costs—it does not insure monopoly earnings.²¹ Either “chiseling” or self-restraint will lead to prices that in the long run yield only a reasonable return on investment.²²

Despite the clash between them, neither Clark nor Mund is wholly wrong. Clark is on solid ground in contending that basing point prices are generally below a monopoly level and in recognizing the usefulness of the theory of oligopoly as an analytical tool. Mund is on solid ground in contending that basing point pricing has generally been a part of a broader program of concerted action to restrain competition. Clark, concerned primarily with developing a theoretical explanation

²⁰ Why fear of invasion of his “natural” market area by his rivals, who will resort to counter freight absorption sales with ultimate reduction in earnings for everyone, will not deter any seller from initiating such invasions is not entirely clear. If demand were distributed equally over the total market for the product and if plants were equidistant and of optimum size, the theoretical solution would be one of local monopoly with neither price cutting nor freight absorption. Clark, however, states: “The possibility that an extension of A’s freight-absorbing sales in B’s territory will provoke an equal extension of freight-absorbing sales by B in A’s territory is far less traceable or certain; and sellers are not in fact much deterred by this prospect. Each knows that, if he stopped absorbing freight, that would have little or no effect in causing others to stop making freight-absorbing sales in his area, unless demand were pressing against productive capacity.” *Id.* at 290. This is the reverse of Clark’s reasoning in explaining why sellers will not openly cut prices. If, as Stigler avers, basing point pricing results primarily from geographic instability in demand and involves an ebb and flow of sales in response to shifting centers of demand, with little or no cross-hauling, the inconsistency disappears. Stigler, *A Theory of Uniform Delivered Prices*, 39 AM. ECON. REV. 1143 (1949). The implications of Stigler’s theory to the contrary notwithstanding, cross-hauling with freight absorption has been a continuous phenomenon in steel and cement at any rate—with a tendency to diminish in boom times and increase in depression.

²¹ See Clark, *The Law and Economics of Basing Points: Appraisal and Proposals*, 39 AM. ECON. REV. 430, 440-441 (1949).

²² Clark, *Basing Point Methods of Price Quoting*, 4 CAN. J. ECON. AND POL. SCI. 477, 481-482 (1938): “The actual base price policy of producers appears to be a form of compromise . . . which, under reasonably normal conditions of demand, may be expected to yield what they conceive as a fair return.” This does not mean of course that prices are at the socially desirable level.

of basing point pricing, has ignored the arrangements that have helped to keep prices above a competitive level (*i.e.*, above marginal costs).²³

A. The Cement Case

The Federal Trade Commission found that cement manufacturers had conspired to use the basing point system and the Supreme Court has upheld the finding.²⁴ For purposes of economic analysis, however, the facts—which the evolutionary school have ignored—may be more important than the law. Space permits only a summary of the facts. They are fragmentary but not meaningless. They disclose a long and persistent record of concerted action among cement producers to limit competition. The general attitude of producers is reflected in the oft-quoted statement by John Treanor, formerly president of the Riverside Cement Company and trustee of the Cement Institute:²⁵

²³ Clark would be on sounder ground if he argued that in industries of the sort about which he is theorizing, businessmen will collaborate to prevent competition from injuring them, and that collaboration may eventually develop a set of practices and a code of ethics to which they will continue to subscribe long after their initial understanding. This would bring Clark pretty close to Mund.

Only in Clark's two most recent discussions does he recognize that concerted action has anything to do with basing point pricing. See *The Law and Economics of Basing Points: Appraisal and Proposals*, 39 AM. ECON. REV. 430 (1949), and *Machlup On the Basing-Point System*, 63 Q. J. ECON. 315, esp. 317 (1949).

Clark now implies, without specifically saying so, that conspiracy may play a considerable role. But he implies also that the *making of prices* (that is, the actual setting of base prices) as distinct from the *method of pricing* merely reflects independent decisions by oligopolists. According to this view, oligopolists determine base prices after taking account of the indirect as well as the direct effects of their decisions. If this is correct, it means that conspiracy on pricing methods makes it possible for oligopolists to exert the influence on prices that according to Chamberlin they will exert if they behave rationally; that is, conspiracy enables them to act according to the oligopoly principle. See *The Law and Economics of Basing Points*, *supra*, esp. 439.

Corwin Edwards, an able exponent of basing point theory and practice, falls between the two schools. See his *Basing Point Decisions and Business Practices*, 38 AM. ECON. REV. 828-842 (1948); *Doing Business Under the Present Law About Delivered Prices*, speech before the Philadelphia Chamber of Commerce, January 25, 1949; *Trends in the Enforcement of the Antimonopoly Laws*, speech before the American Business Law Institute, New York City, December 28, 1949; *The Effect of Concentration of Economic Power*, speech before the Institute of Economics and Finance, Occidental College, Los Angeles, January 28, 1950. He recognizes that conspiracy frequently accompanies basing point pricing but he rejects mandatory f.o.b. pricing as a remedy, and he makes some nice distinctions that neither the Mund-Fetter nor Clark group makes. Apart from problems of price discrimination, as to which he does not think the basing point system raises problems different from those raised elsewhere, he regards the main issue as whether or not basing point pricing results only from conspiracy or whether it may originate in independent action. He thinks that rigorous competition, independent oligopolistic pricing, and conspiracy might all lead to identical delivered pricing at any point (but he thinks markets are so imperfect that price identities under competition are likely to be recurrent rather than continuous). But he thinks that price behavior will differ under the three circumstances. Under competition any rival may initiate a change and price changes are likely to occur frequently. Under non-collusive oligopoly any seller may initiate a price change—for fear a rival will if he doesn't, even though he knows his rival will follow—but price changes will be made more reluctantly and less frequently than under competition. Under a conspiratorial basing point system—the essence of which is an allocation of the right to take the lead in price changes—the same mills will always initiate changes and, because they know others will never lead but will always follow, prices are apt to be higher and more stable than under either competition or non-collusive oligopolistic pricing.

²⁴ Federal Trade Comm'n v. Cement Institute, 333 U. S. 683 (1948).

²⁵ Letter of May 17, 1934, from John Treanor to B. H. Rader, Chairman of the Code Authority for the Cement Industry, Respondent's Brief, p. 127, *Aetna Portland Cement Co. v. Federal Trade Comm'n*, 157 F. 2d 533 (C. C. A. 7th 1946).

Do you think any of the arguments for the basing-point system which we have thus far advanced will arouse anything but derision in and out of government? I have read them all recently. Some of them are very clever and ingenious. They amount to this however: that we price that way in order to discourage monopolistic practices and to preserve free competition, etc. This is sheer bunk and hypocrisy. The truth is of course—and there can be no serious, respectable discussion of our case unless this is acknowledged—that ours is an industry above all others that cannot stand free competition, that must systematically restrain competition or be ruined.

Mr. Treanor recognized that the systematic restraint of competition required concerted action. He denied the "spontaneous evolutionary" doctrine in stating that cooperation cannot always "be left to the mutual spontaneous adoption of considerate policies on the part of each and every competitor. . . . The practical need for argument, persuasion, conferences, exchange of assurances, soon appears." He laments that by "gradual steps even the most righteous upholder of the laws, finding himself in a competitive industry, may also find himself drawn into the realm of law evasion, or even of downright law violation in the form of deliberate price fixing."²⁶

Concerted action to restrict competition in the cement industry began early in this century and continued, though with interruptions, at least until the Federal Trade Commission instituted its proceedings in July, 1937. Concerted action, although not always formal, expressed itself through the following organizations or instruments: (1) Association of American Portland Cement Manufacturers, 1902-1916; (2) Association of Licensed Cement Manufacturers, 1907-1911; (3) Portland Cement Association, 1916-1919; (4) Cement Manufacturers Protective Association, 1916-1922; (5) Cement Institute, 1929-1937; (6) N.R.A. Code Authority, 1933-1935; (7) "Compendium of Established Terms and Marketing Methods," 1935-1937.²⁷

Some of these agencies operated only in particular geographic areas; others operated nationally; some were encouraged or even authorized by the government; others ran afoul of the law; some operated a short time, others a long time. But whether national or regional, legal or illegal, long- or short-lived, each and all at one time or another sponsored joint action to restrict competition in the sale of cement. They led to understandings—specific or tacit—covering basing point pricing; the use of freight books showing freight rates or "common freight factors" from production centers to all delivery points; restrictions in the use of trucks for delivering cement; standardization of cement; diversion of shipments; standardization of trade practices; and the exchange of trade statistics.²⁸ These understand-

²⁶ Brief in Support of Complaint, Vol. II, p. 261, The Cement Institute, Docket No. 3167, 37 F. T. C. 87 (1943).

²⁷ The dates indicate either the life span of the organization or the period during which producers cooperated to limit competition. I have arbitrarily assumed that concerted action stopped when the Federal Trade Commission instituted proceedings against the Cement Institute in July, 1937. Actually the Institute was still in existence when the circuit court handed down its decision in *Actna Portland Cement Co. v. Federal Trade Comm'n*, 157 F. 2d 533 (C. C. A. 7th 1946).

²⁸ See *The Cement Institute*, 37 F. T. C. 87, 143-161 (1943); *United States v. Cement Mfrs' Protective Ass'n*, 294 Fed. 390 (S. D. N. Y. 1923), *generally*, and see for *freight factors*: *The Cement Insti-*

ings facilitated if they did not insure the quotation of identical prices by all sellers of cement at any point of delivery. They also contributed to an *esprit de corps*, a code of ethics, which made the non-conformist a "chiseler," held in about the same esteem by his associates as a labor "scab" by the union. They tended to convert basing point pricing from a method of quoting prices into a system for stabilizing them. They apparently offer a more adequate explanation of the initiation and operation of basing point pricing in cement than economic theory alone has provided.

B. Collaboration in Steel Pricing

The record of concerted action in the steel industry is as notorious as that of cement, although perhaps less well authenticated. But whatever its legal status, concerted action has helped greatly to insure the use of basing point pricing as a device for restricting competition in the sale of steel. As with cement, so with steel, the record of concerted action in pricing dates back a half-century. It includes pooling arrangements; trade meetings; the famous Gary dinners; Pittsburgh Plus;²⁹ an N.R.A. Code of Fair Competition administered by the American Iron and Steel Institute, providing specifically for basing point pricing, designating the basing points, and fining those who violated the Code's provisions;³⁰ collaboration in establishing base prices;³¹ compilation of freight-rate books showing freight from production centers to delivery points;³² prescription of arbitrary rates because of the

tute, *supra*, at 143, 162 ff., United States v. Cement Mfrs' Protective Ass'n, *supra*; *trucking*: Petitioner's Brief, Appendix A, Vol. III, pp. 1401-1694, 1834, 1851-1860, 2112, Aetna Portland Cement Co. v. Federal Trade Comm'n, 157 F. 2d 533 (C. C. A. 7th 1946), Commission's Brief, pp. 130-161, Aetna Portland Cement Co. v. Federal Trade Comm'n, *supra*, The Cement Institute, *supra*, at 191-195; *diversion*: The Cement Institute, *supra*, at 199; *exchange of trade statistics*: United States v. Cement Mfrs' Protective Ass'n, *supra*, at 391; Petitioner's Brief, Appendix A, Vol. I, pp. 557 ff.; Aetna Portland Cement Co. v. Federal Trade Comm'n, *supra*, *id.*, Vol. IV, pp. 2560, 2597-2598; *identical prices basing-point system*: Petitioner's Brief, Appendix A, Vol. I, pp. 135-136, Aetna Portland Cement Co. v. Federal Trade Comm'n, *supra*; United States v. Cement Mfrs' Protective Ass'n, *supra*, at 395.

²⁹ See United States v. United States Steel Corporation, 251 U. S. 417 (1920). Concerning Pittsburgh Plus, Judge Gary stated:

"It was deemed necessary for the orderly conduct of the business to have *one basing price* . . . so that every user of steel all over the country bought and used his steel on a certain basis, knowing in advance that everyone else who bought steel had to pay exactly as he did, *with the addition of the increased freight depending upon where he wanted to use the steel.*" United States Steel Corporation, 8 F. T. C. 1, 33 (1924).

³⁰ I NRA, CODES OF FAIR COMPETITION, *passim*, esp. 189, 198 (1933). Cf. also FTC, REPORT TO THE PRESIDENT IN RESPONSE TO EXECUTIVE ORDER OF MAY 30, 1934, WITH RESPECT TO THE BASING POINT SYSTEM IN THE STEEL INDUSTRY (1935); FTC, REPORT ON THE STEEL CODE TO THE PRESIDENT OF THE SENATE PURSUANT TO SENATE RESOLUTION No. 166 5-8 (1934).

³¹ FTC, REPORT TO THE PRESIDENT, *op. cit. supra*, note 30; FTC, REPORT ON THE STEEL CODE, *op. cit. supra*, note 30.

³² Benjamin F. Fairless, Chairman of the Board, United States Steel Corporation, testified before the TNEC that:

"The American Iron and Steel Institute has a traffic committee composed of traffic managers of 10 different steel companies. This committee supervises the institute's Freight Rate Book . . . and the responsibility of keeping these sections up to date is assigned to different members of the committee. When corrections are necessary—and by necessary I mean when rate changes take place—these committee members have the changes made on supplementary sections or pages, sending these sections or pages to the institute for distribution to holders of the rate book." *Hearings before the TNEC*, pt. 27, 76th Cong., 3d Sess. 14222-14223 (1940).

See also letter presented in Commission's Brief, pp. 171-172, quoted in FRITZ MACHLUP, THE BASING-POINT SYSTEM 128 n. (1949).

diversity of switching charges;³³ collaboration in determining the price of "extras";³⁴ and ratification of a resolution on the death of NIRA to maintain the standards of fair competition as set forth in the Code.³⁵

As with cement, so with steel, the government at times has encouraged, even required, concerted action to limit competition. As with cement, so with steel, collaborative action has been an educational process designed to insure uniform and predictable behavior by rival sellers under the leadership of the United States Steel Corporation.³⁶ Industry members have tried to educate themselves and each other to behave as economists have argued that informed, intelligent oligopolists will behave. But education has not been enough, and when the going has gotten rough "chiselers," even when faced with formal machinery designed to prevent it, have upset a precarious equilibrium at prices above competitive levels.

C. Freight Equalization in Selling Bottle Caps

Crown bottle caps consist of cork discs enclosed in metal shells. Bottling industries use them to close bottles. Their manufacture and sale does not conform exactly to Clark's specifications of industries that fall naturally into a basing point pricing pattern, but it comes close to doing so. It *may* differ in that crown bottle caps are light and freight charges are a relatively unimportant part of delivered costs.³⁷ But caps are standardized and a small difference in price will shift business from one supplier to another. Demand for bottle caps is derived from the demand for the bottled beverages whose containers they cap and is therefore highly inelastic. The price of the cap is such a small part of the price of the bottled beverage that a large percentage drop in the price of caps would probably bring no increase in their use. Their production is highly mechanized, and operation below plant capacity probably results in constant marginal costs substantially below total unit costs throughout the normal range of operations. Price competition during periods of slack demand, therefore, is apt to be "ruinous," *i.e.*, it is likely to drive prices

³³ Exhibit No. 2206, *Hearings before the TNEC*, pt. 27, 76th Cong., 3d Sess. 14435 (1940). Also, Wooden and White, *An Analysis of the Basing Point System of Delivered Prices as Presented by the United States Steel Corporation in Exhibits Nos. 1410 and 1418*, in *THE BASING POINT PROBLEM* 94 (TNEC Monograph 42, 1941).

³⁴ Cf. testimony of Benjamin F. Fairless, in *Hearings before the TNEC*, pt. 19, 76th Cong., 2d Sess. 10560 (1940).

³⁵ Mr. James Brackets of the United States Steel Corporation wrote the Executive Secretary of the Temporary National Economic Committee on December 18, 1939, that so far as he knew the 1935 policy had not been modified. See *Hearings before the TNEC*, pt. 27, 76th Cong., 3d Sess. 14232 ff. (1940); see also, Wooden and White, *supra* note 33.

³⁶ Eugene G. Grace, President of the Bethlehem Steel Co., and of the Bethlehem Steel Corporation, on November 9, 1939 testified before the Temporary National Economic Committee that "... one of the principal factors which we have in that process of reaching decisions as to what we will do sales-wise as a rule has been the announcement of the Steel Corporation from time to time periodically as to what their prices are to be." *Hearings before the TNEC*, pt. 19, 76th Cong., 2d Sess. 10586 (1940). He also stated that during the 1938 depression, when competition had forced actual steel prices below quoted prices, he "... was very glad ... of the opportunity to follow the Corporation's lead in the publishing of new base prices, which they did. I was glad to see that take place. I thought then it was constructive and a good thing to do." *Id.* at 10592.

³⁷ This is a question of fact about which I am not sure. Data are not available to answer it.

well below total unit costs. And finally, a few sellers dominate the business. Crown Cork & Seal has about 50 per cent of the market. With six others, it controls 85 per cent.

Here then is an industry where the likelihood of pricing in accordance with the "oligopoly principle" is great. On purely theoretical grounds producers might be expected to refrain from active price competition without resorting to conspiracy. Moreover conspiracy is easy to conceal, and an order forbidding it hard to enforce.

How in fact have manufacturers priced bottle caps? Have they conspired in doing so? Both the Commission and the circuit court have answered these questions.³⁸ They found that since 1921 manufacturers have quoted prices for bottle caps f.o.b. their plants. All have equalized delivered prices at any delivery point at any time, absorbing freight when necessary to do so. Although sometimes referred to as "universal freight equalization," this method of selling works like basing point pricing with every production center a basing point. From 1938 to 1948 all producers sold bottle caps at identical and unchanging prices.³⁹ All sellers also used identical schedules of discounts, additions, and differentials. Since all buyers at any delivery point were always quoted the same delivered price regardless of from whom they bought, they apparently could not influence prices by turning from one seller to another. Without proof of any express agreement to charge uniform base prices, the Commission found "that the respondents have in fact entered into . . . and carried out an understanding, agreement, combination or conspiracy . . . to restrain and suppress competition in the sale of their products."⁴⁰ What was the circumstantial evidence to support the finding? In 1925 the leading manufacturers of bottle caps organized themselves into a trade association. Shortly thereafter, through the efforts of the association, all members standardized their bottle caps even to colored decorations. At an early meeting of the association, members discussed ways of insuring that all would charge the same delivered price for their standardized product. They decided that the best way to do this was to incorporate a schedule of deductions, additions, and differentials into a standard form of contract. The members, however, never formally adopted a standard contract. In truth, they have since used no contract form but have quoted prices informally by correspondence or through oral negotiation. In 1933, Crown Cork & Seal licensed most other manufacturers to use its patents and the licensees agreed not to sell caps for less than Crown Cork & Seal did. To aid them in complying with the arrangement, Crown Cork & Seal supplied each licensee with its price list. Moreover, it adjusted a patent lawsuit with one of its rivals by an exchange of licenses and, although neither litigant used the other's patents, each thereafter exchanged price lists. Crown Cork & Seal continued to furnish its rivals with its price list until shortly before the Commission began its proceedings against the

³⁸ *Bond Crown & Cork Co. v. Federal Trade Comm'n*, 176 F. 2d 974 (C. C. A. 4th 1949).

³⁹ Before this period price changes were infrequent, and with minor variations all sellers charged the same price.

⁴⁰ *Bond Crown & Cork Co. v. Federal Trade Comm'n*, 176 F. 2d 974, 977 (C. C. A. 4th 1949).

industry in 1941. As previously stated, all sellers for more than a decade charged precisely the same delivered price to any designated point.

The Commission concluded from all these circumstances that "an understanding or agreement under which the respondents acted and still act in concert may be inferred."⁴¹ In supporting the Commission's findings the circuit court, quoting from *Fort Howard Paper Co. v. Federal Trade Commission*,⁴² said: "The essential combination or conspiracy may be found in a course of dealings or other circumstances as well as in any exchange of words."

In view of all the circumstances of this case, a wayfaring economist, making an excursion into a legal maze, may perhaps be justified in concluding that the Commission's and the court's findings make sense.

In other industries using basing point pricing, against which the Commission has proceeded, the evidence of conspiracy has been even more specific and more convincing.⁴³

D. The Glucose Cases

In only two cases where the Commission has condemned basing-point pricing has conspiracy not been charged and proven. These are the so-called glucose cases. In these cases the Commission proceeded under the price-discrimination prohibitions of the Robinson-Patman Act. The essential facts in the *Corn Products Refining Company* case follow.⁴⁴ The Corn Products Refining Company made glucose in two plants—one at Chicago, the other in Kansas City. It quoted prices for any delivery point, whether the sale was from Chicago or Kansas City, at the Chicago base price plus rail freight from Chicago. As a result, on sales to buyers from its Kansas City plant, when located freightwise nearer Kansas City than to Chicago, the company charged a so-called "phantom-freight." On sales from its Kansas City plant to buyers freightwise nearer Chicago than Kansas City it absorbed freight. Thus its mill-nets (corresponding to an f.o.b. price at Kansas City) varied with the location of the buyers. Buyers close to the Kansas City plant frequently paid more for glucose than more remote buyers. The Commission found that such price discrimination injured competition among candy manufacturers, some of whom had been forced to relocate at or near Chicago in order to survive. The Commission held that such price discrimination violated the Robinson-Patman Act and forbade it. A similar principle was involved in the *Staley* case.⁴⁵ In both cases,

⁴¹ *Id.* at 976.

⁴² 156 F. 2d 899, 905 (C. C. A. 7th 1946).

⁴³ *United States Steel Corporation*, 8 F. T. C. 1 (1924); *Corn Products Refining Co. v. Federal Trade Comm'n*, 324 U. S. 726 (1945); *Federal Trade Comm'n v. A. E. Staley Mfg. Co.*, 324 U. S. 746 (1945); *Federal Trade Comm'n v. The Cement Institute*, 333 U. S. 683 (1948); *Triangle Conduit and Cable Co. v. Federal Trade Comm'n*, 168 F. 2d 175 (C. C. A. 7th 1948), *aff'd per curiam sub nom. Clayton Mark & Co. v. Federal Trade Comm'n*, 336 U. S. 956 (1949); *United States Maltsters Ass'n v. Federal Trade Comm'n*, 152 F. 2d 161 (C. C. A. 7th 1945); *Fort Howard Paper Co. v. Federal Trade Comm'n*, 156 F. 2d 899 (C. C. A. 7th 1946); *Milk and Ice Cream Can Institute v. Federal Trade Comm'n*, 152 F. 2d 478 (C. C. A. 7th 1946).

⁴⁴ *Corn Products Refining Co. v. Federal Trade Comm'n*, 324 U. S. 726 (1945).

⁴⁵ *Federal Trade Comm'n v. A. E. Staley Mfg. Co.*, 324 U. S. 746 (1945).

basing point pricing injured competition among the buyers of glucose. While these cases did not involve a charge of conspiracy, the history of the glucose industry reveals a long record of concerted action to eliminate price competition⁴⁶ and, had it chosen, the Commission might have proceeded in the glucose cases under Section 5 of the Federal Trade Commission Act.

Certainly such facts as are available regarding concerted action by business rivals using basing-point pricing lends little support to the doctrine of spontaneous evolution. Even where sellers are few, and a rational consideration for the total consequences of their decisions would be expected to lead to pricing on the "oligopoly principle" without any collusion, they have in fact found concerted action essential to restrain price competition.

III

ECONOMIC CONSEQUENCES OF BASING POINT PRICING

The economic consequences of basing-point pricing are as important to sound public policy toward it as are the factors that have brought it about. The acceptability of any "competitive" arrangement depends on whether or not other arrangements would work better. There are three practical alternatives: (1) mandatory f.o.b. pricing; (2) basing point pricing maintained through concerted action—overt or tacit; and (3) non-conspiratorial pricing with sellers free to sell as they wish, even to absorbing freight, subject only to rules laid down by Congress designed to preserve competition.

For three reasons this study rejects mandatory f.o.b. pricing. In the first place, as long as the organization and control of those industries practicing basing point pricing is undisturbed, and as long as industries are as free as they have been to act concertedly rather than independently on prices and production policies, mandatory f.o.b. pricing will not necessarily make competition more effective than it has been in basing point industries. Businessmen can agree on marketing areas as well as on pricing policies. Unless restrained from doing so, they might work out understandings, more or less tacit, about where each will sell and at what prices. Price leadership might be as effective under f.o.b. pricing as under basing point pricing. Oligopolistic behavior (that is the tendency for rivals to take account of the indirect as well as the direct consequences of their decisions) can be supple-

⁴⁶ See MYRON WATKINS, *INDUSTRIAL COMBINATIONS AND PUBLIC POLICY*, c. X (1927); FTC, *Corn Products Refining Co.*, Docket No. 5502, Complaint, June 20, 1947; Docket No. 927, November, 1922; *United States v. Corn Derivatives Institute*, consent decree, 1932; Complaint, Docket No. 3633, October, 1938; Complaints, Docket Nos. 3798, 3799, 3800, 3801, 3802, 3803, 3804, 3805, June, 1939; Cease and Desist Order, Docket No. 3798, September 26, 1940; also Cease and Desist Orders Nos. 3802, Nov. 2, 1940, 3804, December 11, 1940, 3805, March 15, 1941, 3801, April 3, 1941, 3800, March 17, 1942, and 3803, June 10, 1942. For the court rulings, see *Corn Products Refining Co. v. Federal Trade Comm'n*, 144 F. 2d 211 (C. C. A. 7th 1944); *A. E. Staley Mfg. Co. v. Federal Trade Comm'n*, 144 F. 2d 221 (C. C. A. 7th 1944); *Corn Products Refining Co. v. Federal Trade Comm'n*, 324 U. S. 726 (1945); *Federal Trade Comm'n v. A. E. Staley Mfg. Co.*, 324 U. S. 746 (1945). Also see Motion to Dismiss Complaint, *Corn Products Refining Co.*, before the Federal Trade Comm'n, Docket No. 5502, September, 1948.

mented by concerted action to curb competition under either mandatory f.o.b. selling or basing point pricing.⁴⁷ In the second place, if mandatory f.o.b. pricing should not be accompanied by tacit agreements, marketing areas, and the like, it might seriously disturb the pattern of plant location that has developed under basing point pricing, encouraging plant expansion in new areas and forcing sharp devaluation of plant and equipment in areas of surplus capacity. In the long run this would be economical, but its immediate effects might be disturbing, particularly if and when business activity generally declines.⁴⁸ In the third place, to tell businessmen that they must price their products f.o.b. when in their individual judgment freight absorption might prevent bankruptcy or enhance their profits, seems inconsistent with the function of the *entrepreneur* in a competitive society. Positive state interference of this sort is apt to lead to the government's assuming further responsibility in the guidance of individual enterprise. Eventually the government may so encroach on individual liberty in business matters that it has no alternative but to take over industry.

Let us consider then alternatives (2) and (3). Non-conspiratorial pricing with individual firms free to sell with the right to absorb freight if they want to as long as they do not violate rules laid down by Congress to preserve competition, apparently has two advantages over conspiratorial basing point pricing. (1) Except at the height of a business boom when capacity is fully utilized, it would make for lower prices and it would probably make for more flexible prices at all times. (2) It would tend to insure a more economical use of resources.

A. Basing Point System Makes for Higher Prices

A characteristic of the major industries which have relied on basing point pricing along with a lot of complementary paraphernalia to restrain competition is that they have operated below full capacity over long periods. This is true of the cement and steel industries, both of which operated well below capacity throughout the period between the two world wars. The object of concerted action has been to keep cost-price margins high—that is, higher than they would have been in the

⁴⁷ There is an important distinction between the above argument and that of Clark. See Clark, *Basing Point Methods of Price Quoting*, 4 CAN. J. ECON. AND POL. SCI. 477 (1938). Clark thinks that if businessmen are required to sell f.o.b. they may for a brief period engage in ruinous competition, after which they will discover some other arrangement that will more adequately protect their interest. The above argument does not imply that businessmen should not be prevented from conspiring in one way merely because they *might* find some other way to conspire. The problem is to find a way to prevent conspiracy, not a way to enforce f.o.b. selling.

If Stigler is correct in his theory that geographic fluctuation in demand is the main force behind basing point pricing arrangements, it would be difficult for rivals to work out acceptable agreements on market areas. I think it would be difficult even though I do not accept fully Stigler's theory, but I do not think it would be impossible.

⁴⁸ The argument that mandatory f.o.b. pricing should not be required merely because it may correct a pattern of location which has arisen as a result of arbitrary pricing of another sort is not of itself compelling. But the third alternative offers a better way of doing the same job. There are other reasons for rejecting mandatory f.o.b. pricing. See Kaysen, *Basing Point Pricing and Public Policy*, 63 Q. J. ECON. 289 (1949), who develops a convincing argument that f.o.b. pricing is unlikely to make prices more flexible or lower than basing point pricing.

absence of concerted action. To do this, both industries formulated specific trade practices and encouraged self-discipline through a code of business ethics designed to reinforce the "natural" tendency of an oligopolist to take account of his rivals' probable reactions in formulating his own business policies. While this did not always prevent "chiseling" and at times not even an erosion of the price structure, the very fact that business leaders persisted in it over long periods indicates that it paid off. Businessmen do not surrender their individual discretion on pricing and production policies for the fun of it. They have tried to advance their individual interests by promoting the interest of their group.

In oligopolistic markets any seller, of course, may be reluctant to cut prices because he fears that his rivals will promptly meet the cut. When sellers are acting independently, this fear may not prevent some producer, because of the urgency of his needs or the temporary advantage he hopes to gain, from initiating a price cut which others may be forced to follow.

But oligopolists acting independently may be equally reluctant to raise prices, except in periods of capacity operation, for fear their rivals will not follow. The basing point system removes this fear. Where faithfully followed, basing point pricing enables any base mill to raise prices with the knowledge that other mills will not sell for less in the area where its base price governs. At most the price increase will have broadened the area within which other base prices govern and the area within which the other mills can profitably absorb freight. If other base mills follow the price increase, the initiator need suffer no loss of business to rivals. In technical language, basing point pricing may be a means of eliminating the "kink" in the demand curve facing an oligopolist.⁴⁹

This helps to explain why cement producers raised base prices of cement in the second half of 1932 and the first half of 1933 despite a drastic decline in demand. That the steel industry's pricing methods have kept steel prices abnormally high is suggested by the slight response that changes in the percentage of capacity at which the industry has operated have brought in the price of steel. With the industry operating at 98 per cent of its steel ingot capacity in 1942, average delivered prices actually paid for hot rolled sheets were 101 per cent of published delivered prices; for cold sheets, 101 per cent; for hot rolled strips, 100 per cent; for plates, 102 per cent; and for structural shapes, 101 per cent. Three years earlier, in the second quarter of 1939, with the industry operating at only 51 per cent of its steel ingot capacity, and published prices substantially the same, on the average an 8 per cent concession from published delivered prices was made for hot rolled sheets; a 5 per cent concession for cold rolled sheets; an 8 per cent concession for hot rolled strips; and only a 3 per cent concession each for plates and for structural shapes.⁵⁰

⁴⁹ See Sweezy, *Demand Under Conditions of Oligopoly*, 47 J. POL. ECON. 568 (1939).

⁵⁰ Fazar and Bean, *Labor Department Examines Consumers' Prices of Steel Products*, 157 IRON AGE 118-145 (April 25, 1946); and Kaysen, *supra* note 48, at 298.

Steel prices were so high in 1938, a year of depression, that the Steel Corporation could break even while operating at from 40-45 per cent of capacity.⁵¹

B. Basing Point System Makes for Higher Costs

But not only does systematic and concerted basing point pricing make for higher margins than would prevail without it, it also tends to keep costs high. Two factors contribute to this. In the first place, when price competition is eliminated in the sale of a standardized product, business rivals must rely largely on sales effort to obtain business. Since salesmen may perform other functions besides trying to get orders—as for example, the actual taking of orders, giving advice on specifications and on the adaptability of a product for a particular use, etc.—not all expense for salesmen represents an added cost. However, when the new manager of the Bay City, Michigan plant of the Aetna Portland Cement Company abandoned price cutting in 1936, following a protest from its trade rivals to the president of Aetna and the firing of its old manager, and began to sell “according to the ethics of the industry,” he had to increase his sales force “in the process of getting business on a new basis.”⁵²

Even oligopolists who are free to sell as they see fit, if they quit acting in concert and make their own decisions, are likely to be forced to rely more on price than on sales effort to get business. At times, however, they no doubt will reach out for business by absorbing freight in preference to cutting their f.o.b. price which would ordinarily govern the bulk of their sales. When they do, they may prefer to meet their rivals' delivered price rather than to cut below it. They are therefore likely to use some salesmen to get business, but getting sales through freight absorption is a game two can play. Since freight absorption means lowered mill nets, if they do not conspire to prevent it, rival sellers are likely to be driven, whether they like it or not, to rely more on price to get business than they would under concerted basing point pricing. It seems reasonable to conclude that non-conspiratorial pricing will reduce selling costs somewhat.

But increased reliance on price to get business will tend to lower costs in another way. Business firms will be forced to cut costs or go into bankruptcy. Basing point pricing through concerted action permits high cost producers to live and weakens the incentive of both high and low-cost producers to reduce costs. A price leader committed to the philosophy of live-and-let-live is apt to be more concerned with keeping his investments intact through price controls and his followers in line than in placing himself in a position to bankrupt them by cutting prices. Expenditures for group activities—compilation of freight rate books, joint determination of the costs of “extras in steel,” joint advertising to increase the use of the

⁵¹ See UNITED STATES STEEL CORPORATION, TNEC PAPERS, Vol. II, Chart Studies, p. 57 (1940). After mid-1938 price reductions, United States Steel fixed the break-even point at 50-55 per cent of capacity. See *id.* at 63.

Burns notes a report that in 1934 steel prices were such that the industry could obtain profits if they operated at 50 per cent of capacity. A. R. BURNS, *THE DECLINE OF COMPETITION* 543 (1936).

⁵² The Cement Institute, 37 F. T. C. 87, 190-191 (1943).

product, nurturing the cooperative spirit, and the like, are apt to replace in part, at any rate, expenditures for lowering costs and improving the product.

That something like this has happened to Big Steel is suggested by its continued loss of relative position in steel production from its organization to World War II. In 1902, the United States Steel Corporation produced 65.7 per cent of the total domestic tonnage of steel ingots and castings. In 1937, it produced only 36.8 per cent. In 1902, it produced 65.4 per cent of Bessemer steel rail tonnage, 59.4 per cent of plates and sheets, and 71.5 per cent of wire rods. In 1937, it produced only 35.2 per cent of all rolled and finished products.

The Corporation's concern with protecting property values by keeping prices high has been notorious. In the words of *Fortune*:⁵³

The fact that the Corporation, simply because of the magnitude of its conception, had from the beginning so many hundreds of millions of its dollars in plant worked strongly against change. And so the chief energies of the men who guided the Corporation were directed to preventing deterioration in the investment value of the enormous properties confided to their care. To achieve this, they constantly tried to freeze the steel industry at present, or better yet, past levels.

As late as 1938, the Corporation's subsidiaries are said to have lacked a comprehensive system of modern cost accounting and to have had cost and production control methods far below the customary standards in other industries. According to *Fortune*, as of 1936 the Corporation had contributed very little to the art of steel making and the steel industry was one of the most technologically backward of our major industries.

Both costs and cost-price margins are likely to be higher in industries using a basing point system to restrict competition than they would be without concerted action. Prices therefore could scarcely yield monopoly results—i.e., maximize earnings. In truth, a live-and-let-live policy may even be extended to include an industry's customers. At any rate, as previously indicated, Clark finds that in establishing base prices in cement, price leaders have tried merely to obtain a fair return on their investment.⁵⁴ According to an analysis of prices, costs, and profits jointly prepared by Price, Waterhouse & Co. and Ford Bacon & Davis and offered by respondents as evidence in proceedings before the Commission but refused by the Commission, the respondents earned on actual cost of assets an average of less than 3 per cent over the ten year period, 1928-37.⁵⁵

C. Basing Point Pricing Has Meant An Uneconomical Use of Resources

Both the cement and steel industries had a lot of unused capacity in good years and bad throughout the period between the two wars. Unused capacity in cement

⁵³ *Fortune*, March, 1936, p. 170. According to *Fortune*, the steel industry as of 1936 was one of the most backward of our major industries.

⁵⁴ Clark, *Basing Point Methods of Price Quoting*, 4 CAN. J. ECON. AND POL. SCI. 477 (1938).

⁵⁵ See Brief for Respondents, p. 241, *Federal Trade Comm'n v. Cement Institute*, 333 U. S. 683 (1948).

ranged from 15 per cent of the total in 1924 to 77 per cent in 1933. Unused steel ingot capacity ranged from 80.5 per cent in 1932 to 35.3 per cent in 1939. The restriction on price competition that basing point pricing exerted under these circumstances tended to make for an uneconomical use of resources in two ways: (1) It has tended to keep surplus resources in the industry and to prevent their being used economically; and (2) it has tended to insure an uneconomic use of transportation facilities.

It is beyond the scope of this study to analyze the circumstances that resulted continuously in unused capacity in cement and steel during the period under review. Capacity is not a very precise term and the figures—although based on the industry's own calculations—may be somewhat misleading. Moreover, the figures are average annual figures. Demand for both cement and steel may fluctuate seasonally and geographically, and hence over-all annual figures may conceal the fact that at certain times and in certain places plants were operating very much closer to capacity than the annual figures reveal. Recognizing this fact, it nevertheless seems reasonable to conclude that these two industries suffered from a surplus of facilities or from an underuse of facilities from 1920 to 1940. In short, resources were not used economically in these industries. By restricting output through concerted action business leaders were able to shift the burden of unused capacity from the industry to the public. This is reflected in the 3 per cent earnings of the cement industry during the period 1928-37, and a return of about 3.4 per cent on net assets of the United States Steel Corporation during the period from 1920 to 1938.⁵⁰ When viewed from the interests of these industries, this moderate rate of return suggests that price leaders have exercised such discretionary controls as they possess with considerable restraint, as does the fact that steel in post-war markets has continuously sold for less through the regular channels of trade than it has in the "gray" markets.

Nevertheless, even the moderate rate of returns realized over the period between the two wars is difficult to justify on strictly economic grounds. Continuous surplus capacity in an effectively competitive economy would have tended to drive prices so far below total unit cost as to shrink capacity. That steel ingot capacity increased by about 30 per cent from 1920 to 1939 and cement capacity increased by about 74 per cent suggests strongly that discretionary controls raised prices above a socially justifiable level. In view of the difficulty of shifting such highly specialized and fixed capital as is found in cement and steel, it is quite possible that below-cost prices would not have established a long-run "competitive equilibrium" within the period under review. Possibly, also, without any concerted action, rational oligopolistic behavior would have checked a price decline above the level of marginal costs. This analysis indicates that prices in the absence of concerted action, however, would have been lower than they have in fact been. The most important consequence of lower prices in these industries throughout the 1930's would probably have been a different distribution of income, a redistribution more favorable to spending and less favorable

⁵⁰ Exhibit No. 1391, *Hearings before the TNEC*, pt. 19, 76th Cong., 2d Sess. 10717 (1940).

to saving; and, since this was a period of under-investment, more favorable to a high level of employment and a high level of national income. The redistribution, moreover, would have reflected more accurately the unobstructed evaluation of buyers of the services rendered by cement and steel producers. Lower prices throughout this period would probably have increased somewhat the use of these products and thereby increased the real income of the community.

A defense offered by some economists for the maintenance of surplus capacity in steel and cement is that a smaller capacity would have seriously embarrassed us in the emergency of World War II. As for cement, this is not true. Only since the war has the cement industry operated at capacity. The steel shortage during World War II would have been more serious had steel prices sunk so low during the interval between the wars as to have reduced capacity. It is doubtful that non-conspiratorial oligopolistic pricing would have forced such low levels, but even if it had, it is no convincing argument for leaving price-making to the joint discretionary controls of a relatively few private producers. To shape an economy for war calls for a different type of control than to shape it for peace. Few policy makers in a democracy will want to rely on private arbitrary price making to insure adequate facilities to fight a world war. Planning for total war is a public not a private matter. It is total not fragmentary planning.

D. Basing Point Pricing Has Retarded Expansion of Low-Cost Facilities

But basing point pricing as a means of restricting competition in an industry organized and controlled as is the steel industry has resulted in an uneconomical use of facilities in a more specific way. It has retarded the expansion of facilities that could most economically serve particular geographic areas, for the benefit of facilities less favorably located.⁵⁷ For example, basing point pricing in steel has enabled Chicago and Pittsburgh producers to supply continuously markets for certain steel products that could be laid down for less by the Birmingham producers. Birmingham is a low-cost producing area. It is the only important producing center which contains within the immediate area adequate supplies of the essential raw materials—iron ore, coking coal, and lime for fluxing. It can supply not only the Texas market by cheap water transportation but the Atlantic Coast and Western markets as well. Naturally it could be expected to supply not only its home markets but other nearby markets. That it has not been permitted to do “what comes naturally” is indicated by data covering all shipments of heavy structural shapes during the month of February, 1939, by mills owning 81 per cent of total domestic capacity.⁵⁸ During this month, Birmingham received from all sources included in the sample 1,623 tons of heavy structural steel shapes. Birmingham mills supplied

⁵⁷ For an excellent discussion of this aspect of the problem, see Johnson, *The Restrictive Incidence of Basing Point Pricing on Regional Development*, 37 GEO. L. J. 149 (1949); and Edwards, *Geographic Price Formulas and the Concentration of Economic Power*, *id.* at 135.

⁵⁸ These data are obtained from unpublished returns from questionnaire Form B submitted by the TNEC. For a description of this questionnaire and a statement of its coverage, see *Hearings before the TNEC*, pt. 27, 76th Cong., 3d Sess. 14133 ff. and 14350 (1940).

only 1,017 tons of this, or 63 per cent of the total. Far away Chicago supplied 453 tons, the more remote Pittsburgh-Johnstown area supplied 122 tons, and even most distant eastern Pennsylvania supplied 31 tons. Average freight costs on shipments by Birmingham producers to buyers in that area were 94 cents a ton; for Chicago shipments \$11.62 a ton; for Pittsburgh-Johnstown, \$12.81 a ton; and for eastern Pennsylvania, \$15.16 a ton. Basing point pricing made deliveries profitable to remote producers but it prevented the most economical use of the best situated facilities.

Birmingham with its home markets thus invaded, sought business elsewhere. It turned to nearby Texas where again it had a substantial delivered-cost advantage over rival producers. Nevertheless, although operating well below capacity during the period under review, Birmingham supplied only 467 tons of the total Texas market of 3,788 tons during February, 1939. The Rocky Mountain area, Chicago, Pittsburgh-Johnstown, Buffalo, and St. Louis supplied the balance in that order. The delivered price was high enough to make it profitable for such remote suppliers to reach the Texas markets by absorbing substantial amounts of freight. Average actual freight charges on shipments from Birmingham were \$11.04 a ton; from eastern Pennsylvania, \$12.49 a ton; from the mountain states, \$13.22 a ton; from St. Louis, \$14.91 a ton; from Chicago, \$15.54 a ton; from Pittsburgh-Johnstown, \$16.43 a ton; and from Buffalo, \$22.23 a ton.

There can be little doubt that basing point pricing in steel—with all its complementary price fixing paraphernalia—has retarded the expansion of iron and steel producing facilities in the low-cost Birmingham region and prevented the economical use of existing facilities.

E. Basing Point Prices Make for Uneconomical Use of Transportation Facilities

But basing point pricing has also made for an uneconomical use of transportation facilities. Apparently Stigler overstates the case in concluding that market interpenetration is practically non-existent and in holding that market penetration is primarily a result of geographical fluctuations in demand, with products flowing from areas of low demand to areas of high demand, the direction of shipments reversing with geographic changes in demand. Actually it has been a continuous characteristic of cement and steel with a tendency to increase in periods of depression and to decrease in boom times.

The basing point system is designed to insure identical delivered prices by rival producers. It encourages producers to compete for business on a service basis rather than a price basis. It is a form of price discrimination that, when systematically practiced by all sellers, does not seriously threaten the price structure. In periods of generally slack demand, rival producers prefer to get business by reducing their mill nets on a relatively small part of their total sales and by absorbing freight, than to get it by lowering their base price to all buyers. In such periods, freight absorption increases. In boom times, when producers can get business without absorbing freight, except to keep business connections they have no incentive to accept

less on remote sales than they get on nearby sales. The post-war experience indicates that when demand outruns supply, remote buyers may find it difficult to find a supplier. Remote suppliers find it more profitable to accept only non-freight absorbing business. Nearby suppliers prefer to supply their old customers.

A single example will suffice to show that market interpenetration and freight absorption have been a two-way phenomenon in normal times. The Board of Investigation and Research discovered that during one day in November, 1939, at least 245,380 pounds of tin plate started by rail from Baltimore to Chicago and that on the same day at least 42,809 pounds of tin plate started by rail from Chicago to Baltimore.⁵⁹

Basing point pricing makes for an uneconomical use of transportation facilities in two ways. (1) It encourages needless cross-hauling by rail freight; and (2) it discourages the use of cheaper modes of transportation—water and trucks.

Under a basing point system, delivered prices are quoted on a basis of railway freight. Buyers have not generally been free in industries where basing point systems are rigidly adhered to, to buy at the plant and deliver by the cheapest method of transportation.

Business rivals, in the absence of concerted action, would no doubt permit buyers to buy f.o.b. at such prices as the sellers customarily charged and ship the product by whatever way they chose. Business rivals no doubt also would at times prefer to absorb freight to get business rather than to try to get it by reducing their base prices to all comers. In oligopolistic industries, therefore, freight absorption with price discrimination is apt to continue even without collusion among rivals, but it is apt to be on a reduced scale.

On the whole, non-collusive, discriminatory f.o.b. pricing would likely have led to lower-price margins, more flexible prices, lower costs, and more economical use of production factors during the period between the two wars than did basing point pricing through concerted action.

IV

SHOULD THE LAW BE CHANGED?

Whether or not any change in the law is required to permit freight absorption at the discretion of business firms acting independently will depend largely on the wisdom with which the Federal Trade Commission uses the administrative powers which the Congress and the courts have given it.

Despite all the furor that the Supreme Court's decision in the *Cement* and the circuit court's decision in the *Rigid Steel Conduit* cases raised, the Commission has tried to make it clear that it will not proceed against basing point pricing under Section 5 of the Federal Trade Commission Act unless there is evidence of collusion.⁶⁰ What constitutes collusion, however, may not always be clear. In all cases

⁵⁹ CHARLES E. LANDON AND WILLIAM P. MCLENDON, *THE ECONOMICS OF IRON AND STEEL TRANSPORTATION* 85 (1945), printed as letter from the Board of Investigation and Research transmitting A REPORT ON THE ECONOMICS OF IRON AND STEEL TRANSPORTATION, 79th Cong., 1st Sess (1945).

⁶⁰ See statement of Commissioner E. L. Davis prepared for delivery before the Senate Subcommittee

that have thus far come before the Commission under Section 5, the record has revealed unmistakable evidence of concerted action. But the courts have indicated that the pattern of pricing behavior may itself be evidence of conspiracy. The difficulty of proving overt acts of conspiracy plus the difficulty of enforcing cease and desist orders against a practice which conspirators have learned pays, no doubt accounts for the Commission's having extended the scope of its charges and its orders in the *Rigid Steel Conduit* case to cover parallel action by rivals when the effect of the action is to restrict competition.⁶¹ Some of the Commission's staff, who accept the Mund-Fetter philosophy, are apparently convinced that parallel action by business rivals cannot be achieved without agreement and that the only way to prevent it is to write orders that in effect leave no means of compliance but f.o.b. selling.

If this analysis is sound, such a policy is unsound. In most cases to prohibit conspiracy and ban the agencies through which it has been achieved should eventually insure independent f.o.b. pricing with sellers absorbing freight at their discretion. Where sellers are so few and so well disciplined that they will continue to act as they have jointly disciplined themselves to act, the remedy lies not in mandatory f.o.b. selling but in changing the structure of the industry so that business rivals will behave like competitors. This would involve dissolution suits, and would require cooperation between the Commission and the Department of Justice. If the Federal Trade Commission, the Department of Justice, the courts, and the electorate are not prepared to support such a program, the remedy obviously lies in other directions. But it lies in other directions because society is unwilling to pay the price of obtaining effective competition, not because it is impractical to achieve it.⁶²

If the aim of public policy is to insure effective competition in the production and sale of commodities, the Federal Trade Commission will have to limit its attack on basing point pricing under the Robinson-Patman Act to two sets of circumstances: (1) where it results in phantom freight (whether obvious or concealed in price differentials) and injures competition among the buyers of the product as in the *Corn Products Refining Company* case; and (2) where a multi-plant firm engages in local price discrimination by absorbing freight, the long-run effect of which is to lessen competition by putting a local rival out of business. Again, a wise application of the law to predatory price cutting requires cooperation between the Department of Justice and the Commission, for here the basic difficulty is not price discrimination, but the concentration of economic power. Again the remedy lies in changing the structure of the industry so that survival in the competitive struggle rests on economic efficiency, not on financial power.

on Trade Policies (January 24, 1949); and Edwards, *Basing Point Decisions and Business Practices*, 38 AM. ECON. REV. 828 (1948).

⁶¹ See, for example, Sheehy, *The Legal and Factual Content of Recent Geographic Pricing Cases*, 37 GEO. L. J. 183-200, esp. 200 (1949).

⁶² This statement is based on the historical fact that oligopolists have generally achieved their position in the market by merging with rivals and on the belief that they can be separated into several production units with no loss in efficiency. Something far short of perfect competition will suffice.