THE RISE OF BIG BUSINESS

ECON 4524
The Rise of Big Business and Regulation

- 1870s: the value of output in agriculture was greater than in manufacturing
- By 1890: the value of manufacturing output was 3X that of agriculture
- By 1914: American manufacturing output > combined output of Britain, France & Germany
- Share of employment – peaked at 27% in 1920
Transformation of American Manufacturing

- In 1860: most mfg output was produced in workshops
  - Examples:
    - 20,000 sawmills, 14,000 flour mills, 7,500 blacksmiths, 3,000 cart & wagon makers
    - These firms AVERAGED about 2 employees
  - Why?
    - 1. high transportation costs – encourage local production
    - 2. natural resource availability
    - 3. few economies of scale
  - This began to change after the Civil War. Example 1850 shoes were exclusively produced in workshops, 1870 25% produced in factories
What changed?

- 1. Mass production – economies of scale
- 2. Mass distribution – improvements in communications and transportation (telegraph and rail)

<table>
<thead>
<tr>
<th>Industry</th>
<th>Output in 1920 relative to 1860</th>
</tr>
</thead>
<tbody>
<tr>
<td>Men’s clothing</td>
<td>4</td>
</tr>
<tr>
<td>Iron and steel</td>
<td>25</td>
</tr>
<tr>
<td>Boots &amp; shoe</td>
<td>40</td>
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<tr>
<td>Meat packing</td>
<td>13</td>
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Causes

- **Effect of new technologies & processes – increased capital intensity**
  - Continuous production
  - American system of interchangeable parts
  - Engineering capabilities – machine power, manufacturing processes (ex: Bessemer steel process)

- **Improving integration of capital markets**

- **Incorporation laws – limited liability, ease of merger**
How do small firms become giants?

- Like people you can grow horizontally or vertically.
- Vertical Integration – control over various stages of production & distribution process.
- Question is make or buy/sell?
- Problems of buying inputs: quality of inputs, timing of supplies.
- Problems of selling: quality of final product – may include service, e.g. sewing machines and meat pack in the late 19th century, computers today.
- Horizontal Integration
  - 1. economies of scale
  - 2. monopoly power
Era of mfg pools, cartels, trusts and mergers

1. Mfg Pool – purpose is to restrict output (if D curve is inelastic TR goes up) or divide and apportion the existing output
   - a) High water mark, 1870s: salt, cutlery, railroads
   - b) based on voluntary compliance and little enforcement mechanisms so cheating and entry

2. Cartel – International Pooling Agreement
   - 1. Most famous is OPEC
   - 2. 19th century: American Tobacco Co and Imperial Tobacco Co (British) carved up markets
   - 3. easier to enforce because of fewer players
   - 4. some received legal status: ocean shipping cartels are immune from anti-trust
Era of mfg pools, cartels, trusts and mergers

3. Trusts: high point – mid 1880s until late 1890s
   a) Stockholders in two or more firms deposit controlling portion of their stock (in return for trust certificates) in the hands of a trust who then controls all the companies
   b) Many trusts: Standard Oil (1882); Whiskey Distilling; Sugar Refining; Cotton-oil; Rope Producers…

4. Merger Movement – followed the E.C. Knight (Sugar Trust) Supreme Court Decision in 1894 – mfg is not commerce and hence trusts are legal but so too are mergers

5. Merger Movement a result of court decision: mere share and size does not indicate violation of the Sherman Act
As companies grew larger there emerged fears about monopolies:

1. monopoly rents: “it is not fair”

2. political power: government of the rich – see political cartoon in Hughes and Cain

Reaction was: Interstate Commerce Act (1887, dealt with railroads); Meat Inspection Act (1891); Sherman Act (1890, anti-trust?); and Clayton Act (1914, labor’s Magna Carta)
The Sherman Act

“Every contract, combination in the form of a trust or otherwise, or conspiracy in restraint of trade or commerce among the several states or with foreign nations is hereby declared illegal....”

- 1. either private parties or Justice Dept may sue
- 2. authorized court injunctions, fines and/or imprisonment
- 3. injured party may recover treble damages
- 4. left many openings for judicial interpretation
Early Applications of Sherman Act

1. 1894 – E.C. Knight Co. controlled 95% of the Sugar market
2. Court ruled in favor of E.C. Knight on the grounds that mfg is not commerce and mere size and share did not indicate a conspiracy in restraint of trade
3. Pullman strike of 1894- court used the Sherman Act to force an end to the strike
4. More explicitly in Danbury Hatters Case of 1908 (Loewe v Lawler) “The combination [the union] described in the declaration is a combination in restraint of trade or commerce among several states in the sense those words are used in the Sherman Act.” Held members of the union financially responsible for the full amount of their personal property
5. until 1901 only 18 federal suits
6. Teddy Roosevelt – the trust buster
   - 19 civil suits and 25 criminal suits
   - 1902 ordered suit against Northern Securities Co (holding company of railroads) successful in 1904
7. Taft - 80 cases
   - Upheld 1911 lower court ruling of break-up of Standard Oil
   - Broke up American Tobacco Co.
   - “Rule of Reason” principle – still much discretion
Was regulation in public interest or special interests?

1. Public interest – by preventing monopolistic behavior anti-trust increases social welfare

2. Special interest – by regulating larger, more efficient firms anti-trust acts as protection for small business harmed by “creative destruction”

Impact of monopolist: If economies of scale are sufficiently large consumers win with lower prices even though firm receives monopoly profits?

What is the counterfactual?

Small firms and high prices?

Regulated monopoly?

Unregulated monopoly?

Throughout the period of mergers and rise of “big business” prices fell
What did Legislators state as their rationales for the Sherman Act?

- **Senator George (MS) chair of Judiciary Committee**

  “By use of this organized force of wealth and money the small men engaged in competition with them are crushed out, and that is the great evil at which all this legislation ought to be directed”
What did Legislators state as their rationales for the Sherman Act?

- **Senator Sherman (OH)**

  “If we will not endure a king as a political power we should endure a king over the production, transportation, and sale of any of the necessaries of life. If we would not submit to an emperor, we should not submit to an autocrat of trade, with power to prevent competition and to fix the price of any commodity”
Do these statements imply that the legislation was pro-consumers?

- Consumers are at best a fragile constituency
- Evidence that legislation was anti-consumer but pro small business
  - 1. Votes on McKinley Tariff Act (1890) (anti-consumer) and Sherman Act (1890)
  - 2. 142 members of the House voted identically and only 17 crossed votes
  - 3. Meat Inspection Act of 1891 – Public Interest (health) vs. Special Interest (ranchers, small slaughter houses, local butchers)
Special Interests

- Ranchers
- small slaughterhouses
- Butchers
- farmers

were being driven out of business by large meat packers who reaped economies of scale and shipped refrigerated beef

1880: 872 slaughterhouses and 80,000 butchers
## Ratio of shipments of refrigerated beef to live cattle

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>1880</td>
<td>7%</td>
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<tr>
<td>1882</td>
<td>17%</td>
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<tr>
<td>1884</td>
<td>60%</td>
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<td>1885</td>
<td>82%</td>
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Cattle prices had been falling during the same period so ranchers thought that packers had market power.
What did the act do?

- Required inspection of beef that was shipped interstate — reassuring consumers (foreign and domestic) that beef was safe.
- Raised relative costs of large meatpackers because the small within state butchers and slaughterhouses not affected
  - a) Interest groups alleged that large meatpackers — Swift, Armour, Hammond and Morris - used diseased beef
Incentive of major meat packers to use diseased beef:

- 1) Just as a plane crash is bad for the airline business, food poisoning is bad for the refrigerated beef industry
- 2) Meat packers had large specific assets and reputation mattered — stockyards, centralized slaughter houses and refrigerated cars
- 3) No evidence from newspaper accounts that people were getting food poisoning
- Appears issue was small guy being driven out of business like today’s local pharmacist vs. Wal-Mart
Further Regulation

- **Clayton Act 1914**
  - 1. Prohibited predatory price cutting
  - 2. Prohibited tie-in sales, i.e. buy a copier and paper for the machine
  - 3. Stated that unions were not conspiracies in restraint of trade – Labor’s Magna Carta

- **Federal Trade Commission – 1914**
  - 1. Injunctive power: order business to cease “illegal” activities and can bring firms to court

- **Entry into WWI** ended anti-trust movement until the New Deal

- **Bottom line on regulation**: no fundamental change in competitive structure of American industry during this period