Insight

A History of Failure: Government-Imposed Corporate Breakups

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Executive Summary

A number of outspoken advocates are pressing for the government to break up the biggest tech firms, yet today is not the first time large and powerful companies have been the targets of such action. During the Progressive Era of the early 20th century, the Department of Justice (DOJ) and the Federal Trade Commission broke up a number of different companies, including Standard Oil and American Tobacco. In the 1980s, after years being regulating by the Federal Communications Commission, AT&T was broken up through a lawsuit against the DOJ. Each case provides valuable lessons for those seeking to break up tech companies today. In total, they show how ineffective this method is at creating competitive markets.

AT&T

In the 1870s, Alexander Graham Bell patented a series of innovations that became the telephone, and from these inventions the American Bell Telephone Company of Boston was formed. Like other companies of the time, the company was loosely organized and faced constraints on its access to capital. Instead of building out telephone networks directly, local agents or entrepreneurs would establish a regional company and then contract with Bell in Boston to lease the technology. As one author explained of its early form, "The so-called Bell System was thus not a single entity before the 1910s, but rather an association of affiliated operating companies, each with considerable autonomy."

Because the Boston company didn't have the capital to bring the technology into homes across the United States, it also didn't have the ability to build long-distance lines, which were prohibitively expensive. The long-distance system came from the American Telephone & Telegraph company, a Bell subsidiary in New York City. Because New York had far fewer restrictions on companies, AT&T came to acquire Bell and then bought out the franchises that Bell has established, . In spite of being subsidiaries, many of the companies within the Bell system still retained autonomy. In practice, the Bells were the regional system, while AT&T was the long-distance carrier.

The breakup of AT&T was most precisely a forced divestiture of the Bells from AT&T, the holding company. AT&T retained the long-distance component and much of the research component. What came of this divestiture were nine "Baby Bells," which were formed from the 22 operating companies that had effectively existed since the beginning of the company in the 1890s.

Just a year after the breakup was finalized in the early 1980s, *The Wall Street Journal* ran a piece on the "painful and bewildering repercussions for nearly everyone" in the telecom industry. While the breakup did produce some benefits, it also caused significant economic damage. As it noted,

> As the first year of the breakup nears its end, some benefits that divestiture's advocates promised have yet

> to appear. Although long-distance telephone rates have fallen 5% to 6% under pressure of increased competition, that has failed to offset new rate increases obtained or likely to be granted for local telephone service.

By the end of the decade, consumer prices for long distance had dropped significantly and local calls also saw a relative decrease, but usage ticked up, so the total household expenditures for telecom remained effectively the same. Based on these data points, the breakup might seem to have been a success. Yet, in the years between the breakup and the new regulatory system put into place by the Telecommunications Act of 1996, FCC economists argued that regulatory reforms could have effectively achieved the same end as the much more dramatic antitrust-induced breakup. The victory of the AT&T breakup—which is the only successful breakup of its kind, as the examples below show—may in fact be illusory.

Standard Oil

Standard Oil faced a similar situation to AT&T. In 1870, John D. Rockefeller founded the Standard Oil Company with business partners Maurice B. Clark and Samuel Andrews in Ohio. By 1880, the Standard Oil Company controlled the refining of 90 to 95 percent of oil produced in the United States.

After Standard Oil lost a Sherman-related antitrust lawsuit in 1892, the company incorporated as a holding company in 1889 with 34 subsidiaries. Eventually, the Department of Justice filed a federal antitrust lawsuit against Standard Oil in 1909, which the government won in 1911. This decision forced Standard Oil to split into 34 independent companies spread out across the country. In theory, the 34 companies were no longer operated by the same board, but the original owners, including John D. Rockefeller, still retained shares in the separate companies.

In the years since, research has confirmed that the breakup had little effect on consumer prices. Moreover, as John McGee's 1958 paper, "Predatory Price Cutting: The Standard Oil (NJ) Case," suggested, the very core of the suit might not even have been correct. As he explained, "Judging from the record, Standard Oil did not use predatory price discrimination to drive out competing refiners, nor did its pricing practice have that effect."

In other words, the breakup of Standard Oil did not help consumers.

American Tobacco

To see how these cases can differ, it is instructive to compare AT&T and Standard Oil with the American Tobacco Company. The American Tobacco Company was also organized as a trust and came to acquire nearly 75 percent of the total market by acquiring both the Union Tobacco Company and the Continental Tobacco Company. In 1908 the federal government filed and eventually won a lawsuit under the Sherman Act, which dissolved the trust into three companies, which in theory matched the original three companies.

Yet, the breakup wasn't as easy as simply splitting the larger company into its original three companies, since the successor companies had intertwined processes. A single purchasing department managed the leaf purchasing. Processing plants has been assigned to specific products without any concern for their previous ownership. In short, the single firm was tightly integrated. For eight months over tense negotiations, the government pulled apart factories, distribution and storage facilities, and name brands. Office by office, the company was pulled apart by government fiat.

As historian Allan M. Brandt details in *The Cigarette Century*,

> It was one thing to identify monopolistic practices and activities in restraint of trade, and quite another to figure out how to return the tobacco industry to some form of regulated competition. Even those who applauded the breakup of American Tobacco soon found themselves critics of the negotiated decree restructuring the industry. This would not be the last time that the tobacco industry would successfully turn a regulatory intervention to its own advantage.

The effect on the market wasn't what regulators hoped. The new companies didn't compete on price. Real cigarette prices for consumers remained stable. The price paid to farmers for tobacco didn't change either. In short, competition didn't come to the market.

Conclusion

When taking stock of all of the efforts to break up companies, antitrust scholar Robert Crandall found this method to be the worst among all possible options of antitrust regulation. As he explained in a piece for the Brookings Institution about mandated corporate breakups,

> [W]ith one exception, the breakup of AT&T in 1984, there is very little evidence that such relief is successful in increasing competition, raising industry output, and reducing prices to consumers. The exception turns out to be a case of overkill because the same results could have been obtained through a simple regulatory rule, obviating the need for vertical divestiture of AT&T.

The history of government-imposed structural separation should leave everyone skeptical. While many think the result of breaking up firms today will be a more competitive landscape, the past is instructive. This method simply does not achieve competitive markets.