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# The Basing Point System, by Fritz Machlup

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# BOOK REVIEWS

THE BASING POINT SYSTEM. By Fritz Machlup. Philadelphia: The Blakiston Company, 1949.

## I

When the Supreme Court, in April 1948, handed down its decision in the *Cement Institute* case, a temporarily dormant controversy concerning the basing point method of pricing flared into renewed prominence. When the court, shortly thereafter, affirmed this decision in the *Rigid Steel Conduit* case,<sup>1</sup> a furor of protest broke loose in some of the more influential and politically vocal sectors of American industry. As a result, the Senate Committee on Interstate and Foreign Commerce (80th Congress) appointed a special Subcommittee on Trade Policies—the Capehart Committee—to study the problem of delivered pricing systems and to recommend legislation which would remove the “confusion” and “uncertainty” surrounding the law.

Of all the legislative proposals which resulted from the committee’s investigations the most significant was S.1008—the so-called O’Mahoney bill—which stated as its avowed objective “to define the application of the Federal Trade Commission Act and the Clayton Act to certain pricing practices.” The heart of the proposed bill provides that, under Section 2a of the Clayton Act (as amended by the Robinson-Patman Act), “it shall not be an unlawful discrimination in price for a seller, acting independently . . . to absorb freight to meet the equally low price of a competitor in good faith.”<sup>2</sup>

As this bill was being railroaded through Congress, two “crippling” amendments were passed, one in the Senate and one in the House. The Senate amendment (introduced by Mr. Kefauver of Tennessee) provided that non-systematic freight absorption shall not be unlawful “except where the effect of such absorption of freight *will be* to substantially lessen competition.”<sup>3</sup> The House amendment (introduced by Mr. Carroll of Colorado) provided that non-systematic freight absorption shall not be unlawful “except where the effect of such absorption of freight *may be* to substantially lessen com-

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1. See *Triangle & Cable Co. v. Federal Trade Commission*, 168 F.2d 175 (1948). This decision was eventually sustained by the Supreme Court with a 4-4 vote.

2. As far as Section 5a of the Federal Trade Commission Act is concerned, the proposed bill provides:

it shall not be an unfair method of competition or an unfair or deceptive act or practice for a seller, acting independently, to quote and sell at delivered prices or to absorb freight: *Provided*, That this shall not make lawful any combination, conspiracy, or collusive agreement; or any monopolistic, oppressive, deceptive, or fraudulent practice, carried out by involving the use of delivered prices or freight absorption.

3. Emphasis supplied.

petition."<sup>4</sup> Needless to say, adoption of the Carroll amendment by both Houses would have been a much greater blow to the pro-basing point forces than acceptance of the Kefauver amendment. Therefore, in spite of the fact that Senator Kefauver declared himself in favor of the Carroll amendment, the conservative Senate-House conferees recommended adoption of the Kefauver version of the bill. It was this version which the House passed by a comfortable margin, but which the Senate—bent on the avoidance of controversial issues for the sake of expediting adjournment last fall—post-poned for consideration until the present session of Congress.

It is problematical how the bill will fare when it comes up for another round of debate in the Senate. One thing, however, seems certain: the supporters of basing point pricing will derive little aid and comfort from Professor Fritz Machlup's recent book, *The Basing Point System*. It seems equally certain that the opponents of S.1008 will rely heavily for their ammunition on the economic analysis and legal interpretation of the basing point system which is presented in this timely and authoritative work.

## II

"Economic authorities sometimes are engaged in a shady 'prostitution of economics'; at other times they indulge in highly technical theorizing; not seldom they exhibit a refreshing degree of honest common sense."<sup>5</sup>

Professor Machlup's new book definitely belongs in the third category. It demonstrates with clear and simple exposition, brilliant analysis, subtle humor, and sophisticated sarcasm the economic evils and monopolistic character of the basing point system. Since its primary aim is to influence public policy on one of the most controversial industrial issues of the day, the book is essentially a polemical piece. This is not said in deprecation of the book or its author. Indeed it is intended as a compliment to a distinguished economist who has forsaken the opportunity of impressing the "professional grandstand" with esoteric abstractions and who has consciously avoided what this reviewer likes to call the fallacy of non-committalism. *The Basing Point System* is a book with a definite point of view, presented forcefully, logically and with a considerable degree of objectivity. It is a treatment of the basing point controversy that no economist, lawyer, businessman or legislator can afford to ignore.

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4. Emphasis supplied. This amendment was passed in spite of the vigorous opposition of the House Judiciary Committee which supported the bill in its original form. (See Report No. 869 to accompany S.1008, House of Representatives, Eighty-first Congress, First Session). The support for the amendment was based mainly on *Small Business Objections on Basing Point Legislation, Particularly S.1008*, Hearings before the Select Committee on Small Business, House of Representatives, Eighty-first Congress, First Session.

5. MACHLUP, p. 91.

Professor Machlup indicts the system of uniform delivered prices in concentrated industries on the grounds that it:

- (1) reduces the degree of competition in the sale of the products concerned;
- (2) causes wastes in transportation by encouraging shipments over unnecessarily long distances and by unnecessarily expensive means;
- (3) raises the level, reduces the flexibility, and distorts the structure of prices;
- (4) facilitates the increase or maintenance of concentration of control in the industry;
- (5) reduces the utilization of productive capacity in the industry;
- (6) severs the price-connection between expansion of capacity and the growth of demand;
- (7) distorts the location of productive capacity in the industry by retarding its decentralization; and
- (8) distorts the location of fabricating industries by fostering undue centralization.<sup>6</sup>

For these reasons, Machlup recommends the abolition of the basing point system in concentrated industries. As an alternative thereto, he favors the imposition of compulsory f.o.b. mill pricing—at least until the industries concerned have gone through a period of “psychological reconditioning” and have again acquired the long-lost “propensity to compete.” Only by a drastic break with the past, only by complete abstention from price discrimination in any form, does Machlup see any hope for frustrating collusion and conspiracy in the basing point industries. He adds, however, that in industries where the concentration of control is not high “it may well be possible to adopt pricing methods which involve discriminatory freight absorption without being collusive.”<sup>7</sup> Thus the guiding consideration in Machlup’s public policy recommendation is not the abolition of the basing point system *per se* but rather the termination of the system under those circumstances where it has been or can be employed in a monopolistic or anti-competitive manner.<sup>8</sup>

6. MACHLUP, p. 248.

7. MACHLUP, pp. 250-1.

8. Professor Machlup’s position, in this respect, is identical with that of the Federal Trade Commission. While the Commission does not consider the basing point formula illegal *per se*, (i.e. when used by one or a few producers independently), it considers the formula to become unlawful when it serves to implement collusion and price fixing among all the producers in an industry. Thus the Commission holds that “the geographic pricing formula, though not unlawful in itself, becomes unlawful by virtue of the unlawful use to which it is put” . . . for it is an “obvious fact that the economic effect of identical prices achieved through conscious parallel action is the same as that of similar prices achieved through overt collusion.” (Federal Trade Commission, *Notice to the Staff*, October 12, 1948, pp. 2, 3).

Professor Machlup's conclusions concerning the manner of operation and economic effects of basing point pricing are adequately documented with the findings of several recent court decisions. They are richly supported by the literature amassed over the last twenty-five years by distinguished economists and government agencies. The Machlup recommendations, based on a careful analysis of this literature, seem eminently sound.

### III

Nevertheless there are two basic criticisms that can be leveled against the author's treatment of the basing point problem, namely that 1) he underestimates the importance of structural organization in the industries employing basing point pricing and 2) he fails to recognize the basing point system's virtues, from the producer's point of view, as an adaptive mechanism to the threat of depression-born cut-throat competition. Let us examine these criticisms in turn.

1) The first and most fundamental criticism of Machlup's book is that it exaggerates the basing point practice out of all proportion to its importance in the field of market structure and price policy; that it represents essentially an attack on a symptom rather than on the disease itself. Nowhere does Machlup give adequate emphasis to the fact that a pricing system is often nothing more than a mere manifestation of an industry's peculiar form of market organization and basic characteristics. As a result, he leaves the reader with the false impression that the abandonment of basing point pricing is likely to suffice in forcing highly concentrated industries to adopt techniques of effective price competition.

Machlup seems to overlook the fact, or else he does not stress it sufficiently, that the desire to curb open and direct price competition in an industry like steel, for example, is not likely to disappear with a mere abandonment of basing point pricing; for the attractiveness of geographical price discrimination implicit in the system is, in good measure, due to the fewness of sellers, the standardization of steel products, the significance of overhead costs, the economic difficulties of entry into and exit from the industry, the substantial concentration on the buyer's side of the steel market, and the danger of retaliation and cut-throat competition in response to open price cutting (especially when firms are hungry). A mere switch to f.o.b. mill pricing will not, in and of itself, remove these factors which have made the basing point system so attractive in the past.

Thirty-five years of enforcing the Federal Trade Commission and the Clayton Acts should have convinced us that the problem of pricing goes much deeper than most contestants in the basing point controversy are willing to admit. The fundamental fact of life in such highly concentrated industries

as steel and cement is not the pricing system as such but rather the degree of concentration implicit in an oligopolistic market structure. From the public's point of view it seems of secondary importance whether the *effects* of collusion be achieved by means of a uniform delivered price system or via some less sophisticated pricing technique.<sup>9</sup> From the public's point of view the basic danger lies in the concentration of control in the industries concerned, and the power implicit in such concentrated control, rather than in the collusive price making machinery which these industries happen to employ.

If public policy is aimed at the achievement of a competitive structure and a competitive level of prices, it must go beyond the regulation of pricing methods. It cannot rely on the fact that, quantitatively speaking, compulsory f.o.b. mill selling will make the process of collusion more difficult than the basing point system has in the past. If public policy is concerned with the results which effective competition tends to guarantee, it must deal qualitatively with the types of structural organization which permit and encourage the use of non-competitive pricing techniques.

The basic problem confronting us in our concentrated industries is "size" and the structural significance of oligopoly. What is needed in an effort to cure the disease is not the application of patent medicines such as compulsory f.o.b. selling but rather the resort to delicate surgery—a selective and careful application of the dissolution, divorcement and divestiture remedy.<sup>10</sup> A mere enforcement of the antitrust laws against restrictive and collusive practices—while necessary and desirable—is not enough.<sup>11</sup>

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9. It is important, however, to recognize that pricing formulas in concentrated industries are significant in the sense that they largely determine the *ease* with which it is possible for each oligopolist to follow the policies of the whole group. Thus, while it would still be possible under the f.o.b. mill system for large producers controlling geographically decentralized production units to discipline local competitors without resorting to a general slash of *all* mill prices, such retaliation would be more costly than under the basing point system where a price cutter could be punished by the simple expedient of establishing a basing point at his mill door—regardless of whether the dominant producer or producers had an actual production unit at the site. (See MACHLUP, p. 218.) Furthermore, under f.o.b. mill pricing, it would be immeasurably more difficult than under the basing point system to 1) allocate leadership to one firm or a group of firms; 2) enforce acceptance of the leader's policies; and 3) communicate the orders of the leader to his followers. This means that collusion or conspiracy—in the economic sense—would be rendered more difficult, but it does not mean that collusion and conspiracy would be eliminated, or even substantially curbed. Best proof of this contention is the recent increase in steel prices, uniformly instituted by the major companies. This would seem to indicate that compulsory f.o.b. mill pricing is not adequate to insure the absence of monopolistic influences in the price policies of concentrated industries.

10. See the reviewer's testimony in Hearings before the Subcommittee on Study of Monopoly Power of the Committee on the Judiciary, House of Representatives, Eighty-first Congress, First Session, pp. 349-56; also the reviewer's proposal for an antitrust law to implement dissolution, divorcement and divestiture in concentrated industries, presented to the same committee, December 1, 1949.

11. It seems rather fruitless, for example, for the Federal Trade Commission to engage in extensive basing point litigation with the steel industry, while at the same time

2) The second criticism of Professor Machlup's study is that it underestimates the basing point system's virtues—from the producer's viewpoint—as a technique for combatting cut-throat competition in times of depression.

To be sure, Machlup admits that “the wish to avoid losses in depression periods is the most potent motive for cartelization in any form, including the basing-point method of quoting identical delivered prices. If basing-point cartels are liquidated, the industries in question may be threatened by losses during depression.” “But,” he adds, “there is little danger that this will ‘destroy’ these industries.”<sup>12</sup>

This statement disposes too glibly of a central issue in the basing point controversy. Producers, after all, can quite legitimately question the abandonment of a pricing system which has permitted them to avoid the dangers of competitive price cutting in an economy where depressions have been a rather regular phenomenon in the past. Until we can demonstrate that such dangers can be obviated without preserving a monopolistic and discriminatory pricing technique like the basing point system, they are justified in clamoring for a legalization of basing points and/or discriminatory freight absorption.

It seems to this reviewer that most industry leaders now advocating a legalization of freight absorption would probably be quite content under an f.o.b. mill system, if they were assured that the full employment conditions of the 1940's would continue indefinitely. What many of them, no doubt, fear at this moment is deflation and the spectre of destructive competition concomitant therewith. This fear is especially pronounced in industries like steel and cement where a highly standardized product is manufactured by a handful of large producers under conditions of heavy overhead costs; for it is in such industries that price competition, in times of depression, often degenerates into cut-throat competition.<sup>13</sup>

So pathological is the fear of unbridled price competition in a business cycle infested economy, that Judge Gary, former president of U. S. Steel, was even willing to accept a strict governmental supervision of prices as an alternative thereto. Said Judge Gary as long ago as 1911:

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the Attorney General of the United States (pursuant to his powers under Section 205 of the War Mobilization and Reconversion Act of 1944) approves the disposition of surplus steel plants to leading firms in the steel industry, thus intensifying the concentration of control which has made collusive pricing possible in the past. See W. ADAMS, *THE STRUCTURE OF AMERICAN INDUSTRY*, New York: Macmillan, 1950, pp. 158-60.

12. MACHLUP, p. 253.

13. It can hardly be denied that “any industry which has heavy investment exposed to the danger of cut-throat competition is bound in time to develop adaptive reactions, and that any industry which can protect itself against this danger must have some control over the lengths to which price cutting goes during depressions. J. M. CLARK, *THE ECONOMICS OF OVERHEAD COSTS*, Chicago: University of Chicago Press, 1923, p. 404.

"I realize as fully, I think, as this committee that it is very important to consider how the people shall be protected against imposition or oppression as the possible result of great aggregations of capital, whether in the possession of corporations or individuals. I believe that is a very important question, and personally I believe that the Sherman Act does not meet and will never fully prevent that. I believe we must come to enforced publicity and governmental control, even as to prices, and, so far as I am concerned, speaking for our company, so far as I have the right, I would be very glad if we had some place where we could go, to a responsible governmental authority, and say to them, 'Here are our facts and figures, here is our property, here our cost of production; now you tell us what we have the right to do and what prices we have the right to charge.' I know this is a very extreme view, and I know that the railroads objected to it for a long time; but whether the mere standpoint of making the most money is concerned or not, whether it is the wise thing, I believe it is the necessary thing, and it seems to me corporations have no right to disregard these public questions and these public interests."

"Your idea then," said Martin Littleton of the committee, "is that cooperation is bound to take the place of competition and that cooperation requires strict governmental supervision?"

"That is a very good statement," replied the Judge.<sup>14</sup>

This statement would seem to indicate that the drive towards monopoly and the institution of restrictive pricing practices is not merely the result of original sin and human selfishness, but is also a desperate, though rather misguided, attempt to cope with the problem of deflation and the danger of destructive competition concomitant therewith.<sup>15</sup> What then is the solution?

While we can concede that the fear of deflation constitutes a plausible enough motive for the erection of bulwarks against the threat of cut-throat competition, this does not mean that public policy must accept an artificial, wasteful, discriminatory and monopolistic pricing system as a cure. The solution to the problem which, at its roots, is one of depression does not lie in a return to basing point pricing and/or legalized freight absorption. Neither does the solution lie in an acceptance of the Judge Gary formula. A more suitable solution—and one which, I am sure, Professor Machlup would support—is to be found in the government's adoption of appropriate monetary and fiscal measures designed to stabilize the general level of demand (for all commodities), in order to mitigate the violent overall fluctuations in business activity. Given the assurance that, come what may, full employment will be maintained, producer groups will be at once deprived of their primary motive and most persuasive argument in defense of such restrictive pricing practices as the basing point system.

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14. See *Hearings before the Committee to Investigate the United States Steel Corporation*, House of Representatives, Sixty-second Congress, 2d Sess., 1911.

15. See K. E. Boulding, *In Defense of Monopoly*, *QUARTERLY JOURNAL OF ECONOMICS*, August 1945.

## IV

In conclusion, it should be noted that the above criticisms do not, in any way, vitiate Professor Machlup's public policy recommendations concerning the basing point system and systematic freight absorption. These recommendations should be accepted and S.1008 (in its original form) defeated in the Senate, because: 1) the bill would, from an economic point of view, legalize a pricing system which facilitates collusion in concentrated industries, results in wasteful cross-hauling of commodities, and distorts the optimum location of both primary producers and fabricators; and 2) the bill would, from a legal point of view, deprive Section 2a of the Clayton Act (as amended by the Robinson-Patman Act) and Section 5 of the Federal Trade Commission Act of whatever effectiveness they now possess in combatting price discrimination the effect of which is to substantially lessen competition. If any legislation is enacted to clarify the law as presently interpreted in the courts, it should be some bill such as S.1008 with the Carroll amendment included as a safeguard against the lessening of competition. In no case should the burden of proof placed on the Federal Trade Commission in its prosecution of offenders be made any more onerous than it now is.

As far as the outlook for the future is concerned, let us realize that, regardless of the outcome of the legislative battle over basing points, a mere abolition of this pricing technique is not likely to prove a panacea for the monopoly problem in our concentrated industries. Abolition of basing point pricing and/or freight absorption in such industries should be but the first step in a comprehensive attack on *structural* impediments to effective and vigorous competition. If we are to succeed with a program of that sort, however, our antitrust agencies shall have to be equipped with more potent weapons than they now possess. The Sherman Act is a blunt axe—a relic from a paleolithic age. To meet the industrial challenge of today, the anti-trust agencies must be provided with a set of fine surgical instruments.

WALTER ADAMS†

LEGAL PHILOSOPHY FROM PLATO TO HEGEL. By Huntington Cairns. Baltimore: The John Hopkins Press, 1949. Pp. xvi, 567. \$7.50.

I have long thought that "legal philosophy" or "jurisprudence" would frighten fewer people away if it were more attractively labeled; "thorough-going-talk-about-government" is a descriptive phrase I once suggested.<sup>1</sup> This remarkable book makes the phrase apt, for Cairns here reports, with painstaking fidelity, much of what thirteen thorough-going, renowned thinkers

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1. Frank, Book Review, 52 YALE L. J. 934 (1943).