A Matter of Antitrust

The debate over the role of government as referee of market competition

BY DAVID VAN DEN BERG AND STEPHEN SLIVINSKI

On May 12, 2009, Christine Varney, the assistant attorney general of the Department of Justice's antitrust division, made a speech to the U.S. Chamber of Commerce. She declared a renewed interest by the federal government in pursuing more aggressive action against companies with substantial market power. "As antitrust enforcers, we cannot sit on the sidelines any longer — both in terms of enforcing the antitrust laws and contributing to sound competition policy as part of our nation's economic strategy."

Varney, known for her career as a prominent Washington attorney and member of the Federal Trade Commission (FTC) between 1994 and 1997, was referring to what she saw as a neglect of the government's role in policing some types of corporate business activity. The last time the federal government actively pursued a number of high-profile antitrust cases was in the 1990s. That period, however, was a temporary change from the long-term decline in the number of government-launched antitrust cases — a trend that started as early as the 1970s.

The policy debate now hinges on assumptions about whether the modern market economy is especially prone to harming consumers or whether markets are vibrant enough to punish firms that try to engage in anticompetitive behavior. In other words, whether the government should play an active role as a referee of competition in the marketplace.

Economists and legal scholars have pondered these issues for decades. While there is wide agreement that cartels reduce consumer welfare and should be dismantled, they have proven hard to maintain in a modern developed economy with low barriers to entry. Today, disagreement instead exists over the ability of individual firms to act in a near-monopolistic fashion. Whatever consensus has formed on that issue, however, suggests that government might have only a limited ability to improve on market outcomes.

The Evolution of Antitrust

The first U.S. antitrust statute was the Sherman Act of 1890. It outlawed cartelization of industries — or, in the words of the law, any "conspiracy" among multiple companies that would result "in restraint of trade" — and monopolization. The law didn't really provide a working definition for either of these concepts. It is, however, the statute that gives the power, in Section 2, to the government to pursue legal action against a single firm acting as if it were a monopoly. (Modern-day antitrust actions tend to be Section 2 prosecutions.)

In 1914, Congress passed the Clayton Act and it served to clarify the Sherman Act. It went so far as to prohibit specific actions that were seen as anticompetitive, like mergers that "substantially lessen competition." The same year saw the passage of the Federal Trade Commission Act that created an executive branch agency able to launch investigations and issue cease and desist orders to corporations engaged in what were considered unfair trade practices. It also created a system by which private firms could lodge complaints against their competitors and, if the FTC deems it appropriate, trigger investigations of those against which complaints were filed. After 1914, only a few other laws have honed the scope of government action and the tools it can use to police competition in the marketplace.

Yet, while policymakers and judges pondered what qualified as competition-squelching business activity, economists were largely silent in the policy debate for the next 30 years. While most scorned the Sherman Act and its subsequent modifications, that's usually as far as they went. "At best, the statute seemed a harmless measure incapable of halting an irresistible trend toward firms of larger scale and scope," write George Washington University law professor William Kovacic and University of California, Berkeley economist Carl Shapiro in the *Journal of Economic Perspectives*.

An era of aggressive governmental action against businesses, particularly in the realm of corporate mergers, began in the mid-1930s. A number of major antitrust decisions breaking up companies and hindering mergers handed down by the Supreme Court and lower courts continued generally unabated until the 1970s. The lopsided nature of the case law that emerged from this period even spurred Supreme Court Justice Potter Stewart to describe the era's merger decisions in a 1966 opinion by a simple formulation: "The government always wins."

By the early 1970s, economists and legal scholars based largely at the University of Chicago — among them current federal judge Richard Posner, former judge Robert Bork, and economist George Stigler — began to counter the level of activism present in court rulings. "The Chicago School approach used the tools of microeconomics to explain business arrangements with an eye toward carefully understanding the markets and institutions within which the arrangements were generated," says George Mason University law professor Joshua Wright.

This was a contrast from the legal consensus at the time that applied the notion of "per se illegality" in antitrust cases. This meant that certain business practices were by definition a violation of the law regardless of the justification for the arrangement or its effect on consumers. As Bork described it his seminal book on the Chicago approach, *The Antitrust Paradox*, published in 1978: "Behavior is illegal per se when the plaintiff need prove only that it occurred in order to win his case, there being no other elements to the offense and no allowable defense." A good example — and one that would still be prosecuted today on this same basis — is the behavior engaged in by members of a cartel.

In most cases, the Chicago School critics argued that a better standard was one that eventually became known as the "rule of reason" — a real-world assessment in which market realities and corporate structures are to be viewed in light of actual outcomes. Bork describes this as being "judged by the standards of the party's intent or the effect his behavior was likely to have, considering the market context."

An example would be a large firm that has high fixed costs but passes along lower prices to consumers if they are able to spread the costs over a larger base of customers. When judgments based on per se illegality were the norm, the mere fact that this firm is so large and dominated such a large share of the customer base might be enough to spark a legal rebuke and a stiff penalty.

The Chicago School analysts would point out that a large firm's presence might actually make consumers better off relative to its absence. That consideration, they argued, should be the focus of antitrust analysis. Indeed, Bork suggested that the "only legitimate goal of antitrust is the maximization of consumer welfare."

A related concern was whether increased action by government to punish firms for what was perceived as anticompetitive behavior might stifle market innovation. In such a scenario, new business arrangements that merely ran the risk of running afoul of an ill-defined legal standard might never see the light of day and consequently make consumers worse off in the aggregate.

The Chicago approach gained prominence just as economists started to take a greater role in antitrust jurisprudence. Involvement of economists in the practice of antitrust law reached its current peak in the 1980s and 1990s when economists — particularly those with a Chicago School bent — were appointed to prominent positions with the FTC. Today the broad consensus in antitrust law has been defined by economists or legal scholars with substantial economics training. "Most commentators, even those who are now critical of the Chicago School contribution to antitrust economics, agree that the Chicago School dramatically improved the state of affairs," says Wright.

A Question of Market Power

The thinking in modern antitrust circles that supports a more activist role for government goes like this: A firm doesn't need to be the only provider of a good to damage competition — it merely needs to be the dominant firm in that market and act as if it was a monopoly by exercising its "market power." That could potentially result in behavior that reduces consumer welfare and drives out competition.

Straightforward as this may seem, it's often a difficult situation to identify in practice. "Monopolization is the most vexing problem for antitrust lawyers precisely because it is so difficult to confidently and accurately identify and distinguish conduct that will help consumers from conduct that might harm them," says Wright.

To prove a firm's dominant power, the first task is to define the scope of the relevant market, both geographically and in terms of which products are considered substitutes within that defined market. Then the general rule is to determine whether a company could increase the price of its product by 5 percent without losing profit. According to standard antitrust legal definitions, being able to do so would indicate the existence of a firm with monopoly-like power.

But defining the relevant size of the market is tricky and fraught with peril. "There's a tendency for the Department of Justice and the Federal Trade Commission to push for definitions of the market that in hindsight look to be inappropriately narrow," says William Shughart, a professor of economics at the University of Mississippi who served as an economist at the FTC from 1979 to 1983.

A recent example is the debate in 2007 around the merger of the supermarket chains Whole Foods and Wild Oats, both of which specialized in selling organic produce and food products. The FTC challenged the merger on the grounds that it would create a firm that was much too dominant in its relevant market. But Shughart notes that the FTC was defining the relevant market as existing mainly of the two specialty chains in question. "The market is probably much wider than that and might include all grocery stores, many of whom at the time

A Short Guide to Major Antitrust Statutes

1890
Sherman Antitrust Act
The first federal antitrust law. Prohibits agreements that restrain trade and prohibits monopolies obtained by anticompetitive methods.

1914
Clayton Antitrust Act
Designed to clarify the Sherman Act. It specifically outlaws certain actions like "tying" and mergers that substantially decrease competition.

1914
Federal Trade Commission Act
Established the independent regulatory agency tasked with enforcing antitrust statutes.

1936
Robinson-Patman Act
An amendment to the Clayton Act. It allows the government to penalize firms for practicing "price discrimination" — the act of charging different prices to similar buyers — if such discrimination decreases competition.

1976
Hart-Scott-Rodino Antitrust Improvements Act
This law requires companies to furnish the Federal Trade Commission and Department of Justice with information about large mergers and acquisitions before they occur. A mandated waiting period applies to each merger to allow the federal government to investigate the effects it might have on competition.

were beginning to introduce sections devoted to carrying organic consumer products."

Coming up with an answer to the question of how to define the scope of a market also suffers from a potentially insurmountable information problem. "Rarely in an antitrust case do the economists on either side have all the data that they would like to have to help them develop a sound market definition," says Shughart.

In the meantime, as the economy becomes more complex and barriers to competition fall, economists note it becomes difficult to make the case that most firms can maintain any sort of monopoly pricing power they might have for very long. The market can provide a check on behavior that might be anticompetitive or harm consumers. The risk of rival firms entering the market and offering lower prices or better service and products could be enough to discipline the incumbent firm if the barriers to entry in a market are low enough.

Fit to be Tied?

Another business practice that antitrust enforcers look to as evidence of anticompetitive behavior are "tying" or "bundling" arrangements. That's when a company makes the purchase of one of its products conditional on the purchase of another. Tying is seen by some antitrust scholars as reducing consumer welfare because it inhibits competition in related goods. Such was the basis of the Justice Department's case against Microsoft in the late 1990s. The Department of Justice and the FTC alleged that the company had monopoly power over certain types of personal computing platforms because it required the purchase and installation of its Internet browser on any computer that also ran Windows, its operating system.

Yet the existence of bundles is more prevalent than many people realize. In fact, it's quite plausible they are so prevalent for a good reason. To explain this reality, the Chicago School critics of antitrust have long sought to inject into the discussion of antitrust analysis a real-world understanding of the corporate arrangements and pricing structures that allow new products to be brought to market.

One reason tying arrangements might persist is that they enhance the ability of companies to create new markets through the cross-subsidization of two products. Usually this occurs when a good with high costs to produce is paired with another good that is relatively cheap to produce. Prohibiting a tying arrangement — or a flat price for selling the two goods bundled together — might result in a decline in consumer welfare. The cross-subsidy might, at least in the short term, be the only way for the firm to efficiently provide the product.

Pondering whether a tying arrangement might be a drag on competition, however, can become a "metaphysical" task, writes Bork. "Every person who sells anything imposes a tying arrangement. This is true because every product or service could be broken down into smaller components capable of being sold separately, and every seller either refuses at some point to break the product down any further or, what comes to the same thing, charges a proportionally higher price for the smaller unit."

Bork uses the examples of a car dealer who refuses to sell a customer only the automobile chassis or a grocer who sells the pears and the can they are stored in together for one price. Giving the courts broad latitude to determine whether one product or two is being sold would put judges in the position of "determining an efficient way to run a business, a subject in which they have little expertise," he writes.

Incidentally, Robert Bork shocked many of his colleagues and admirers when he favored the government's action against Microsoft in 1998. By his reasoning, those tying agreements were enough to squelch competition in the browser market. It was a controversial argument at the time, not least because it seemed to contradict his earlier writings on the subject. Many noted that rival browsers already existed and could compete with Microsoft's product. Today, in a world where browser competition is lively and technological innovation is rapid, it may seem quaint to think that a single company would be able to dominate for long — or that a judge would be able to accurately predict the future course of the market, the optimal arrangement of firms within a specific industry, or the rationality of a business decision.

Costly Errors and Political Influence

In antitrust enforcement, like any area of life, errors can and do occur. When antitrust enforcers make mistakes, those errors could be quite costly to the economy and to consumer welfare.

There are two types of errors to consider. False positives occur when judges mistakenly impose penalties on firms that are engaged in practices which don't actually constitute anticompetitive behavior. False negatives occur when actual anticompetitive practices are not punished.

As Wright points out, "it is well accepted that false positives are more costly than false negatives." That's because mistakenly punishing a firm also eliminates the contribution it was making to consumer welfare. When decisions handed down by a court can include measures as extreme as ordering the breakup of a company perceived to be acting as a monopolist, you can see how consumers would be worse off if you assume that the composition of existing firms is rational in an economic sense. The redistribution of the market shares would lead to an economic loss.

Conversely, as Northwestern University law professor Fred McChesney writes in a 2003 issue of the *Emory Law Journal*, false negatives will have a less severe long-term impact so long as entry barriers into markets are low. "As prices rise because of anticompetitive contracts or practices, new entrants emerge to alleviate or even eradicate the problem," he notes. The error of inaction on the part of courts is actually "a self-correcting problem," McChesney writes.

The question then becomes whether the antitrust system is more prone to the costly type of errors. And some economists view antitrust enforcement as not just error-prone — they see it as the product of a system that can also be gamed, thereby increasing the odds that costly errors occur. "There is a great deal of political influence on the process which is instigated by competitors of the firms that have a big stake in the outcome," says Shughart.

Recall that individual firms can lodge complaints against their business rivals through the FTC, and this opens up the door to using the government as a tool to beat up on their competition. "Antitrust enforcers must be very skeptical of claims brought by competitors against one another and do a much more thorough investigation in those cases than they might otherwise do to rule out the possibility the initial complaint was just self-serving," notes Shughart.

He also points out that there is substantial evidence to show that competitors of defendant companies in antitrust cases are the main beneficiaries. This "abuse of antitrust," as New York University economics professors William Baumol and Janusz Ordover characterized it in the *Journal of Law & Economics*, comes with costs that might well exceed any pro-competitive benefits of antitrust law.

This concern has its roots in the Chicago School critique as well. George Stigler made the case that regulatory agencies — especially those vested with the power to punish companies — risk being "captured" by the businesses they are supposed to regulate. When government has the power to determine when there are too few firms in an industry, every firm in the industry will vie to influence the decisions of the regulatory body and attempt to use regulation for private rather than public benefit.

The Future of Antitrust

What used to be known as the Chicago approach might now be more aptly described as the modern consensus. Daniel Crane, a law professor at the University of Michigan Law School, has noted that, at least for the time being, nonintervention is the default assumption among antitrust judges.

There are criticisms to this consensus from a new breed of legal scholars and some economists. These "post-Chicago" scholars, while acknowledging the importance of the neoclassical model for developing coherence in antitrust policy, have launched critiques of some of the assumptions of the consensus. The result is advocacy of a more activist approach to antitrust and making the case for when more extensive government intervention may be justified.

One key difference between the Chicago School and its critics is the concern that the market won't react quickly enough to discipline dominant firms. "Competition is a public good," argues Jonathan Baker, an American University law professor and former head of the FTC's Bureau of Economics from 1995 to 1998, in a 2003 article in the *Journal of Economic Perspectives*. Over the long term, rival firms may arise to compete with the dominant firm. But it won't happen quickly and in the interim the costs to consumers will be too high.

Nevertheless, judicial and academic consensuses are hard to dislodge in the short term. Any activist enforcement of antitrust statutes will likely meet resistance from a judiciary steeped in the Chicago approach.

Besides, antitrust cases take a long time to prepare, Shughart says. That means it may take years before a governmenzt case sees the light of day. Yet, many years is a lifetime in a rapidly changing and innovative economy, notes Shughart, "and what the market looks like after the case is brought will be completely different from what it looked like when they started." Any company that seems to have dominant market share today may not have such market power years later — or, for that matter, exist at all.

So the most significant problem for a more activist antitrust enforcement may not come from any particular academic discipline or school of thought. Instead, it may come from the simple reality of a fast-changing modern economy — characterized by technological advancement and generally lower barriers to entry. **RF**

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