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The Antitrust Modernization Commission: Proposed Issues for Reform

A Comment by the Competitive Enterprise Institute Submitted to the Antitrust Modernization Commission*

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Founded in 1984, The Competitive Enterprise Institute (CEI) is a non-profit research and advocacy organization dedicated to advancing the principles of limited government. CEI works to educate and inform policymakers, journalists, and other opinion leaders on market alternatives to political programs and regulations, and has long been involved in antitrust issues as part of that broad effort. CEI also engages in public interest litigation to protect property rights and economic liberty.

OVERVIEW

Most observers believe that antitrust law protects consumers and has an important role to play in policing markets, whether old "smokestack era" industries or new technology sectors. But that acceptance deserves reconsideration.

For more than two decades, the willingness of policymakers to rethink the presumption that regulation benefits consumers has driven the deregulation of the transportation, communications, banking, and electricity sectors. Since economic regulations transfer wealth, they inevitably attract political entrepreneurs seeking entry or price regulation to hobble—or even preempt—competition. Antitrust regulation is similarly vulnerable to exploitation, and this vulnerability infects antitrust at every level.

Thus, a skeptical interpretation of antitrust policy—including recent challenges against Microsoft, Intel, Orbitz, the Oracle-PeopleSoft merger, the AOL Time-Warner merger, and the rejected EchoStar-DirecTV and Staples-Office Depot mergers—is that antitrust benefits political entrepreneurs rather than consumers. Antitrust enforcement, like any economic regulation, often *increases* price and *decreases* output by undermining misunderstood or disregarded efficiencies.

Antitrust advocates often compare real-world markets with what economists call "perfect competition," in which large numbers of buyers and sellers for each product exist, and no seller can raises price since consumers would merely switch to a competitor. Compared to this ideal, strategic rivalry, size, and a commitment to winning through voluntary activities such as "collusion" and "tying"—the hallmarks of ordinary competition, properly understood—can become unlawful. As the saying goes, if a firm's prices are higher than everyone else's, that implies monopoly power; if everyone's prices are the same, collusion is apparent; prices "too low" can signify cutthroat competition and predatory pricing. No one is innocent.

In defiance of basic notions of property rights and wealth creation, antitrust regards the economic pie as largely fixed and imagines that one firm can grab too much of the "social output" or otherwise unfairly restrain competition.

However, if the business practices routinely targeted by antitrust actually have efficiency justifications, that implies that enforcement itself creates inefficiencies and harm.

Regulators have deemed a range of business practices as anti-competitive and harmful to consumers—yet rational, pro-consumer justifications may exist for these practices. Rethinking the nature of these practices should be a goal of the Antitrust Modernization Commission.

PROPOSED ISSUES FOR STUDY

Restraint of Trade and Monopolization

The stated intent of antitrust law is to police restraint of trade and monopolization. The law also outlaws practices deemed anti-competitive under certain conditions, including tying arrangements, exclusive dealing, mergers, and interlocking boards of directors.

But the notion that restraint of trade characterizes the marketplace is suspect. As newspaper columnist Isabel Paterson wrote in her classic book, *The God of the Machine,* "Standard Oil did not restrain trade; it went out to the ends of the earth to make a market. Can the corporations be said to have 'restrained trade' when the trade they cater to had no existence until they produced and sold the goods?" Yet corporations still face similar accusations: Microsoft, which caters to a personal computer industry that it largely popularized; at AOL Time Warner's Instant Messenger service, which it indeed dominates but also happens to have created; and at telecommunications providers, who allegedly restrict access to the high-speed Internet services that didn't exist a few years ago.

The defining characteristic of monopoly is consumer harm caused by (1) lower output and (2) higher prices. But output generally expanded and prices generally fell during the late 19th Century, when antitrust law originated. Complaining that rivals' prices are falling and that their sales are increasing indicates protectionism more than efficiency.

In the most dramatic recent case, Microsoft was accused of attempting to maintain a monopoly by bundling a Web browser with its dominant Windows operating system, which runs most personal computers. Now overseas enforcers target the "bundling" of Media Player and security software, and seek requiring the firm to relinquish source code. Aside from being dismissive of property rights, trustbusters often narrowly and arbitrarily define markets and the competitive landscape. Microsoft's "monopoly" rested on defining the market as *single-user* desktop machines with *Intel* processors, which, as economist Alan Reynolds has noted, eliminated chief Microsoft competitors like Apple, Sun, and handheld computers from the market definition. Ironically, in 1998, when the suit was brought, fewer than half of Americans had embraced Internet access at home, leaving the market wide open to competitors.

Unfortunately, antitrust, as Fred Smith, President of the Competitive Enterprise Institute, put it, operates on the perverse principle that business has "no right in principle to dispose of its property as it sees fit, but only a conditional freedom so long as it helps maximize some social utility function."

Horizontal Mergers

When firms merge, the number of competitors in a particular line of business declines at least temporarily. But efficiencies generated may outweigh any decline in output. Moreover, the combination may be necessary to establish a platform from which to expand service.

As the late economist Murray Rothbard once noted, talk of mergers' "substantially lessening competition" is meaningless—competition is a *process*, not a quantity. Dynamic efficiency effects are important, yet merger challenges and conditions imposed are widespread.

But even if a merger doesn't make society better off, one must ask a more fundamental question: *Whose* output is restricted by a merger? In a free economy, producers may readily associate and are not forced to part with their goods on unfavorable terms—which itself has dynamic efficiency impacts.

Sometimes markets are defined in such a way as to magnify alleged dire merger consequences. Soda company mergers were attacked during the 1980s under presumed need to distinguish between "carbonated soft drinks" and "soft drinks" for assessing monopoly power. We see this now is supposed monopolizable markets in "jarred pickles," "premium ice cream," "intense mints," and a "chain store market" in eyewear.

An inefficient merger would generate higher consumer prices and would *benefit* competitors, who could sell more at current prices or even raise their prices while still undercutting the new monopoly. Thus, when merging firms' competitors object, that signifies a merger's efficiency.

To be sure, not all mergers work or make sense. But trial and error in business arrangements and combinations are vital in market processes and innovation, and are correctable choices, unlike antitrust in an "industrial policy" capacity.

Collusion: Price-Fixing and Market Division

Collusion or price fixing between competitors is seen as nothing more than a conspiracy to transfer wealth away from consumers, and enjoys little tolerance even from antitrust skeptics. Price fixing, as Robert Bork has argued, involves no integration of productive capacity as mergers do: thus merger-style efficiencies do not emerge, so nothing is lost by forbidding the practice.

But, except for the pre-existence of the companies involved, collusion resembles forming a partnership, entering a contract, or forming a company in the first place.

As a "partial merger" rather than a total integration, colluding "eliminates competition" less than merging does. Just as coordination between individuals has benefits, business coordination can help adjust to uncertainties, cope with imperfect information, minimize transaction costs, deal with fixed costs and economies of scale, or market oscillations that inhibit planning. Standards-setting will increasingly be a fixture in our technology-based economy, for matters such as software interoperability, digital music and video capabilities, copy protection technologies, “spam”-busting, and cybersecurity in general. *Prohibiting cooperation has costs*. Both competition and cooperation are legitimate features of a market economy that respects the property rights of producers. Those property rights mean more wealth creation to benefit consumers.

Even if most price collusion were deliberate anti-consumer mischief, markets would still curb it better than regulators could. Inefficient cartels are inherently unstable. Colluders can “cheat” by competing on the basis of quality, delivery or service, warranties, or other add-ons. Entry by newcomers also disciplines colluders.

Predatory Pricing

The aim of every competitor is to eliminate rivals and gain as many customers as possible. “Predatory pricing” seems a poor way of achieving this goal.

Predatory pricing refers to pricing below cost with intent to monopolize. A firm employs predatory pricing, it is argued, to drive out rivals, snatch their customers, and amass a larger market share. Then the predator begins charging monopoly prices. As aspiring rivals surface, the now-monopolist merely cuts price again.

The problem is that predation hurts a predator because it must expand output and bear losses in order to capture the rivals’ market, while servicing the additional demand that the new low price generates. And for every dollar lost, the predator must recoup more than a dollar in the future just to break even. That attracts new entrants. Customers also tire of wide price swings.

Courts and bureaucrats should not second-guess whether a price is a predatory price, rather than simply a low one. Ordinary marketing practices, like loss-leader or introductory discount pricing, or software giveaways, can be easily misconstrued as “predatory.”

Economists Donald Boudreaux and Andrew Kleit argue that markets can police predatory pricing. Any predator’s behavior would not go unnoticed by its upstream suppliers and downstream business customers who stand to lose from the predator’s monopolization and reduced wholesale purchases. These suppliers can discipline retailers by taking their business elsewhere. Economist George Reisman has noted that predators invite rivals and speculators to form endless numbers of small competing companies for the sole purpose of slashing the product’s price, forcing the predator to match, while shorting the predator’s stock.

Abuses of antitrust to secure protection from competition are far more likely to occur than successful predatory pricing itself.

Price Discrimination

The Robinson-Patman Act of 1936—also known as the “Anti Chain-Store Act”—was designed to protect small business by limiting the charging of different prices to similar buyers at the same time. It was enacted during an outcry against the great Atlantic & Pacific Tea Co., a grocer that tended to displace mom-and-pop grocers (perhaps the Wal-Mart of its time). But artificially protecting small business does not equate with protecting consumers.

Price discrimination is most commonly criticized when small retailers are unable to obtain the same volume discounts from suppliers that larger competitors receive. However, small sellers can form associations—or merge—to secure discounts. The Independent Grocers' Association is one example of this.

Attacking price discrimination protects inefficient competitors. For example, the American Booksellers Association (ABA) and a number of independent booksellers in 1998 filed antitrust complaints against the superstores Borders and Barnes & Noble for receiving volume discounts and favorable terms and promotion treatment from publishers. Note the anti-consumer sheen to this case: To qualify for volume discounts in the first place, the big chains must sell far more, which requires lower prices, better hours, a better shopping environment, and better service and selection.

Forced provision of discounts when it is not economical would lead to a cutback on overall discounts, injuring consumers by keeping prices charged by large retailers higher.

Manufacturer Price Restraints on Retailers

Vertical price restraints refer to contractual agreements between manufacturers and retailers either not to charge prices below some minimum, or above some maximum.

Opponents of vertical price fixing contend that manufacturers may impose price restraints in order to facilitate policing of a retail cartel: Cheaters on the cartel agreement can be easily detected.

But vertical restraints may very well enhance efficiency if quantity rises or if quality and services improve. Indeed, price caps imposed on retailers from upstream limit what can be charged, and are not automatically illegal.

But explicit agreements on *minimum* prices are illegal. Other less direct policies by manufacturers—such as distributing lists of recommended retail prices, or announcing consumer price preferences at the outset and then retaining retailers on that basis—may be acceptable. But not always. Recently, the FTC targeted record distributors for a “Minimum Advertised Pricing” (MAP) program that the distributors claimed protected music-only retailers from being undercut by discounters who would sell CDs as loss-leader products to get customers into the store.

A minimum price allows the manufacturer to assure a stream of financial compensation sufficient to assure that retailers provide quality assurance or control, repair services, additional promotional efforts or expand outlets. That helps protect the best interests of both manufacturers and consumers; but the FTC didn't think so.

Exclusive Dealing

Exclusive dealing arrangements are those in which a seller agrees to sell only the products of a particular manufacturer and not deal in competitors' goods. A variant is when a seller contracts to purchase all of the output of a supplier.

A common worry is that exclusive dealerships may force small retailers into exclusive arrangements at the behest of powerful manufacturers. But Robert Bork pointed out if a local store is the only seller of the manufacturer's product, *it* enjoys the "monopoly," and is in the better bargaining position. The retailer has alternative suppliers to which it can turn—but the manufacturer may not.

Exclusivity can secure special effort on behalf of a product by the retailer by giving him something of value—low wholesale prices, for example. Any dissatisfied retailer can refuse to renew an inefficient exclusive dealership contract.

Exclusive dealing may provide a retailer with specialized knowledge about a product, an unbroken inventory, and a greater ability and incentive to cater to customers. The retailer must balance those benefits with the disadvantages of offering an exclusive product and spurning other manufacturers.

Tying or Bundling

Tie-in sales are those in which a customer purchasing product A from a firm with market power is required to purchase product B as a condition of the sale. Antitrust proponents charge that such actions unjustifiably extend an existing monopoly into a new product. Microsoft's bundling of the Explorer Web browser with the Windows operating system is the most prominent recent example.

The error in the tie-in logic is the failure to recognize that monopoly profit, assuming it exists, can be collected only once. If a company exploits all its monopoly power from their primary, "monopolized" product and consumers regard the tied good as worthless, they will pay only the price for the monopoly good and no more. There is nothing more to be extracted for good B. Any higher price charged for good B, if the consumer regards it as worthless, is really only a part of the price of A rather than an addition to it.

Every product possesses more than one characteristic or consists of some bundle of products, making every sale a "tie-in" sale. Drills come with bits; cars come with engines (and now myriad computers); televisions come with remote controls; cable television comes with channels no one wants.

Tying arrangements can help ensure the primary product's longevity, functionality, integration, and perceived quality by "discouraging" the purchaser's use of products offered by the seller's rivals. Tie-ins can help a seller avoid warranty expenses and product complaints.

Tie-in sales also can encourage customers to try something new, and help small firms who lack the financial wherewithal of larger rivals to avoid duplicating selling and administrative expenses across their products.

While Robert Bork ended up as a critic of Microsoft's business practices, it is he that properly characterized the tying issue: "[T]here is no viable theory of a means by which tying arrangements injure competition, and there are several obvious ways in which they benefit both seller and consumer."

Strategic Predatory Behavior

So-called predatory pricing allegedly lowers price and thus the revenue and profits of rivals. But rivals' profits can also be reduced by such strategies as "non-price predation," which includes such behaviors as altering advertising intensity or product quality to induce one's rivals to suffer increased costs (or decreased revenues). Or companies can seek strategic exclusive dealing arrangements to shut out competitors.

Manipulating rivals' profitability is the very essence of business and indistinguishable from ordinary, healthy, competitive rivalry. Yet it has spawned a veritable academic industry devoted to identifying competitive strategies as means of monopolization.

Aggressive competition can become a crime under theories of strategic predation. A firm's guilt depends on an enforcer's opinion that its successful efforts to serve the market—and, hence, to force rivals to work harder—has a "dangerous probability of success" in creating a monopoly. But the entire purpose of competition necessarily is to oust or supplant less efficient rivals, leaving the least-cost producers in place. Price, quality and other features are and must be manipulated in order to serve consumers as part of the market's discovery process.

All market participants are equally free to act in their own self-interest, as well as mobilize against a renegade firm's efforts to monopolize. The alleged predator is never the only one capable of strategizing in a "predatory" manner.

There is, however, one form of non-price predatory behavior that genuinely is anti-consumer and anti-market. Bringing nuisance antitrust suits against more efficient rivals is perhaps the most effective ways of "raising rivals' costs."

Exploiting Technological Lock-In

Some goods gain value the greater the number of users. Phones, email, and instant messaging, for example, are useless if possessed by only one individual, but increasingly valuable as ownership spreads. Some worry that this value-in-adoption mechanism can lead to inefficient products becoming locked in—by either chance, luck, or manufacturers' scheming. Microsoft's Windows operating system and AOL's Instant Messenger are prominent examples. Yet there are no examples of network effects locking in an inferior technology in the marketplace.

To illustrate: The victory of the "QWERTY" typewriter keyboard layout is often presented as an example of bad technology winning out. But tests in the early days of the typewriter proved QWERTY to be inferior to none, and the story of inferior lock-in to be a myth, according to economists Stan Liebowitz and Stephen E. Margolis in their 1990 *Journal of Law & Economics* article "The Fable of the Keys." Even today, if competing key layouts were truly ergonomically superior, large companies could switch to save money.

Liebowitz and Margolis debunk other examples of lock-in. Betamax videotape was not inferior to the VHS since both used the same underlying technology and had a patent-sharing agreement. Both, however, were superior to the "locked-in" reel-to-reel systems they replaced. For typical office word processing and spreadsheet functions, the extra expense of Macintosh computers relative to Windows/DOS machines has been hard to justify, largely because the reliance on one vendor for both hardware and the operating system is risky. Yet both types of computers are superior to the "locked-in" slide rules, calculators, and mainframes they replaced.

A world of "inefficient lock-in" would be one without compact discs, cars, and color television, since earlier technologies were entrenched. Theories of path dependence under-appreciate the fact that undesirable lock-in presents intense profit incentives for entrepreneurs to deliver a new standard.

Conclusion

Antitrust law has long been perceived as protecting consumers by taming the excesses of the free market. But, as its recent history shows, antitrust has become a tool for regulatory pork—and this transformation is going global. Indeed, many of the practices disparaged by antitrust law and targeted by enforcers are, in fact, good for both competition and for consumers—albeit bad for competitors. In the information economy of today and the frontier economy of tomorrow, we must challenge the conventional thinking regarding "smokestack era" antitrust law and the allegedly harmful practices it targets—and not just with superficial reforms.