AN ANTITRUST ENFORCER CONFRONTS THE NEW ECONOMICS

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In my job as a government enforcer confronting the new economics and particularly the Chicago School, I try to keep in mind the essence of statement by the economist Paul Joskow, more than a decade ago. Commenting on the analytical and predictive value of both the Harvard and Chicago School economic models, Joskow observed:

In a sense, the ultimate test of the utility of the various models is whether they prove useful to the people involved in analyzing problems involving actual markets or groups of markets. I suggest that not only aren't they particularly useful, but also that they aren't really used.....Somehow one gets the distinct feeling that the important messages are being carried by the informal theories, stories and behavioral observations, and that the formal models are trotted out ex-post to demonstrate that some kind of formal apparatus can explain or incorporate some of what is actually being observed.2

Perhaps this is why Joskow and many of his "new" new economics colleagues at MIT are associated with a trend in economic thought which eschews the notion of itself as a "school" or "approach."

Before one begins to challenge the Chicago School, one should define what the term means and what theories it encompasses. I have often seen the term incorrectly used to embrace such ideas as the Areeda-Turner test for predatory pricing3 and the "contestability" hypothesis championed by Baumol, Willig, Panzar4 and others.

The core idea of Chicago School antitrust is simply that the antitrust laws were intended to and should focus exclusively on a "welfare" analysis of restraints of trade. Restraints are bad only insofar as they diminish "consumer welfare." The Chicago School definition of "consumer welfare" focuses on economic efficiency, not on wealth transfers from consumers to producers.5 The reduction in allocative efficiency that may result from a merger or other arrangement conferring market power may be easily offset quantitatively by even modest efficiencies realized by the arrangement.

That's it. The rest of Chicago School theory amplifies this core principle and seeks to identify the conditions necessary for the diminution of consumer welfare to be the likely or even plausible result of a particular trade restraints. Market forces are relied upon to expunge inefficient restraints which do not confer market power, or at least to do so more effectively than government intervention.6

Although not Chicago born, contestability theory proceeded from the same assumptions about what the law was intended to and should do.

As to what the antitrust law was intended to do, Bob Lande and Alan Fisher have decisively deflated Chicago School doctrine that the antitrust laws were intended to protect "consumer welfare" defined solely in terms of economic efficiency.7 Analysis of the legislative history of the Sherman Act makes it clear that Congress' sole purpose was to protect consumers from paying any more than a competitive price. No less an authority and leading Chicago School proponent

than Judge Frank Easterbrook provided the most candid assessment of the Chicago school's reading of the Sherman Act when he said, "Of course it's a post hoc rationalization, but it's the one I happen to favor."8

A law enforcer can properly address the various models, approaches, and schools only after recognizing the true purposes of the antitrust laws - the social and political dimensions as well as the specific economic harm to which the laws are addressed, which is to prevent wealth transfers from consumers to those who have or are likely to attain market or monopoly power by restraining trade. In this recognition of the multiple goals of antitrust, Chicago School theory provides an important and useful partial perspective on how to understand and apply the law. But to the extent that Chicago School economic theory is adopted as a "Weltanschauung," or world view, it should and must be challenged.

To illustrate, assume, as Chicago models do, a perfectly competitive market, now reduced to a pure monopoly by acquisition. Assume that the monopolist can engage in perfect price discrimination, charging each consumer a price just low enough to prevent the diminution of sales and, therefore, output. In this scenario, there would be no reduction in allocative efficiency (i.e., no reduction in consumer welfare), but there would be massive wealth transfers from consumers to the monopolist. Adoption of a Chicago School "world view" would require the conclusion that no intervention would be necessary in these circumstances. However, it is hardly likely that any American legislature, antitrust enforcer, or economist would seriously contend that the prevention or elimination of this result is not the proper subject of the antitrust laws.

If we extend this hypothetical proposition into the real world - a world rampant with bid- riggers - we get a paradoxical result. Applying the Chicago School world view to bid-rigging rarely, if ever, would result in a violation of the antitrust laws. When the lowest bidder wins a Defense Department contract by rigging the bid to double the price that would have been obtained under competition, there is no loss of allocative efficiency nor reduction in consumer welfare; there is only a redistribution of wealth.9 The government's loss of money to spend on future defense procurement, education, or AIDS research is balanced by the bid-rigger's gain in disposable income to invest in art treasures or swimming pools or in the development of a computerized bid-rigging software program. Yet such wealth transfers are, according to Judge Bork, merely "a shift in income between two classes of consumers [which] does not lessen total wealth, and a decision about it...could only rest upon tenuous moral ground."10

If that proposition were followed, Rick Rule and Doug Ginsburg could not have brought any of the hundreds of bid-rigging cases that constituted the centerpiece of their terms as Assistant Attorneys General at the Justice Department. Nor could Jim Rill, the Bush Administration's appointment as Assistant Attorney General, continue the emphasis on bid-rigging cases that he describes as "priority 1" in his term.11 But this proposition demonstrates the uselessness and harm of the Chicago School as a world view, rather than as a helpful partial perspective.

Consider another example of the danger of taking a helpful insight of the Chicago School and extending it to a world view. This example comes from the are of vertical restraints. To the extent that Dr. Miles12 and its progeny have been interpreted to say that vertical and horizontal price-fixing and market allocations are competitive equivalents, the Chicago School teaches - and correctly so - that these interpretations are wrong. This is not to say that vertical price-fixing and airtight territorial restraints should not be treated as per se or presumptively unlawful. They are

usually different from horizontal restraints, but often no less pernicious. Nevertheless, manufacturers and their distributors are bound together in some degree of integration. Their desire to agree upon certain terms for marketing a product is not only natural but, in certain cases, may spur interbrand competition. This is the insight offered by the "helpful" Chicago School.

The world view Chicago School exemplified by Judge Richard Posner, however, treats the manufacturer and distributor as the economic equivalents of fully integrated entities.13 This world view Chicago School approach takes a useful and realistic insight to an extreme in which reality is ignored. To regard a manufacturer of 100 products as the fully integrated partner of a retailer of 1,000 products, when their relationship extends to only one or several items, is simply bad economics. It not only leads to error in evaluating the full scope of antitrust concerns, but even leads to error in predicting whether vertical restraints might endanger the narrow of "consumer welfare," as defined by the Chicago School.

In actual practice, I have heard arguments from a manufacturer to the effect that, "The real competition is between the dealers, not the brands. They use us; they use the brands to kill each other ." This view is almost exactly opposed to the pure Chicago view. And this view is itself a partial perspective. The job of the antitrust enforcer is to measure each situation against various approaches to determine whether an enforcement action is warranted.

The area of predatory pricing also highlights how the "new economics" of the Chicago School can be helpful if used as but one tool among many and harmful if subscribed to as a belief system. The marginal cost-average variable cost test for predatory pricing formulated by Phillip Areeda and Donald Turner14 was a major contribution to antitrust law and has saved consumers untold sums of money. My office is on the verge of successfully applying the Areeda-Turner test in a Commerce Clause challenge to a New Jersey below-cost pricing statute.15 If the court's preliminary decision is made final, this case will represent a major incorporation of sound economic principles into negative Commerce Clause jurisprudence. It will also establish a constitutional basis on which to attack highly anticompetitive government-imposed trade restraints, which are now immune from direct attack under the antitrust laws because of the state action16 and Noerr-Pennington17 doctrines.

Chicago School theory was correct and helpful in this litigation, pointing out the difficulties faced by the predatory pricer who would be a monopolist. Traditional theories of predatory pricing explain that a would-be monopolist may charge below-cost prices in order to drive competititors from the market and, once competititors have been eliminated, charge monopoly prices to recoup and profit from the prior losses. Chicago School theory recognizes, however, that the same market forces that propel the exit of competitors or of others. When the predatory pricers try to recoup the revenues lost in the period of predation, competitors may be induced to enter and price below the predator's monopoly prices.

The harmful Chicago School "world view," by contrast, would extend this analysis to assert that predatory pricing is so unlikely to succeed that courts should exercise a strong presumption that it cannot happen, even in the face of compelling evidence that predatory pricing has taken place. Such evidence of predation existed in Matsushita Electric Industrial Co. v. Zenith Radio Corp.,18 There, plaintiff U.S. manufacturers of consumer electronic products maintained that competing Japanese manufacturers had conspired to drive U.S. firms out of the U.S. market by charging artificially low prices in the U.S. and recouping losses from those low prices by

charging artificially high prices in Japan. By a 5-4 margin, the Court held that the plaintiffs had submitted insufficient evidence to defeat defendants' motion for summary judgement. The Court closed its eyes to the overwhelming evidence that the Japanese electronics industry, with the cooperation of the Japanese Government, had priced below cost for decades in exports to the United States. Noting a Chicago School consensus that "predatory pricing schemes are rarely tired, and even more rarely successful[,]"19 the majority adopted a Chicago School world view and announced that "if the factual context renders respondents' claim implausible-if the claim is one that simply makes no economic

sense-respondents must come forward with more persuasive evidence to support their claim than would otherwise be necessary."20

The dissent strenuously objected to an approach that they believed elevated the economic theorizing of the majority above facts established in the record below.21 Those facts include, first, record evidence of coordinated below-cost pricing. Second, an entire American industry was eliminated. And third, the Japanese manufacturers were engaging in domestic price-fixing as one way of recouping the revenues lost by pricing their exports below cost.22 As the dissent noted, the Third Circuit had reviewed record evidence of 'cartel activity in Japan, collusive establishment of dumping prices in [the U.S.], and long-term, below-cost sales[,]" from which a jury properly could interpret various agreements among the Japanese manufacturers as direct evidence of a predatory pricing conspiracy.23

When confronting a belief system, I subscribe to the principles of the Athens School: "All things in moderation." The majority in Matsushita should not have permitted an erroneous Chicago School world view to obscure their perception of the record evidence.

I have one final example of the danger of adopting an economic theory as a world view-the "contestability" hypothesis identified with William Baumol and Robert Willig.24 The hypothesis states that the mere presence of competitors on the periphery of a monopolistic or oligopolistic market may restrain those with apparent market power from exerting it. The airline industry was proposed as the nearly perfect contestable market.25 Most airline passengers (and especially those unlucky enough to frequent Minneapolis or St. Louis) will vouch for the failure of that theory. To their credit, there were those in the Antitrust Division who pointed this out, and in several notable instances, tried to do something about it. What are Baumol and Willig saying now?

Specially, we will deny emphatically that it [the contestability hypothesis] offers carte blanche to mindless deregulation and dismantling of antitrust safeguards....

Contestability theory does not, and was not intended to, lend support to those who believe (or almost seem to believe) that the unrestrained market automatically solves all economic problems and that virtually all regulation and antitrust activity constitutes a pointless and costly source of economic inefficiency...[Contestability] is no whitewash and establishes no presumption, one way or the other, about the desirability of public sector intervention in any particular market of reality. For before anyone can legitimately use the analysis to infer that virtue reigns in some economic sector and that interference is therefore unwarranted, that person must first provide evidence that the arena in question is, in fact, highly contestable...Thus the conclusion that perfectly contestable markets require no intervention claims little more than the possibility (which remains to be proven, case by case) that some

markets in reality may automatically perform in a very acceptable manner despite the small number of rims that inhabit them.

Thus it is simply incorrect to associate our writings on contestability with an all-pervasive laissez-faire position on the role of regulation and antitrust. We disagree vehemently with such a view of the world.26

Baumol and Willig's comments imply many things, including an implicit criticism of Chicago School theory. About airlines, they are saying: "right theory, wrong market-you guys misunderstood us." They seem to be admonishing Chicago School theorists and others who propose their models as world views that can explain everything and thus relieve antitrust enforcers from performing their primary task of careful case-by-case analysis. Baumol and Willig now seem to recognize the limits of theory in the face of real business practices.

The case-specific analysis necessary for proper antitrust enforcement requires a heavy dose of fact-finding, a search for the intent of the parties, and the application of various economic perspectives-including Chicago School economic theory-as tools to guide the exercise of discretion. Responsible government antitrust officials have always recognized that their job involves taking into account the factual complexity of real life, as well as the use of economic theory as an aid in construing the facts. If Chicago school is used as such an aid-a partial perspective-then it can make substantial contributions. If adopted as a world view, Chicago School theory becomes a dangerous model that must be challenged.

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2 Joskow, Firm Decision-Making Process and Oligopoly Theory, 65 Am. Econ Rev.273 (1975).

3 *See* Areeda & Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 Harv. L. Rev. 697 (1975).

4 *See generally* W. Baumol, E. Panzar & R. Willig, Contestable Market and the Theory of Industry Structure (1982). Although this theory did not originate with Chicago School academics (both Baumol and Willig have been at Princeton), it proceeds from the same basic assumptions that underlie Chicago School theory about how markets work and what the antitrust laws were intended to and should do.

5 *See Generally,* R. Bork, The Antitrust Paradox (1978).

6 *See id.*

7 *E.g.*, Lande, Chicago's False Foundation: Wealth Transfers (Not Just Efficiency) Should Guide Antitrust supra this issue, at 631; Lande, Wealth Transfers as The Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged, 34 Hastings L.J. 65 (1982).

8 Easterbrook, Remarks at the national Association of Attorneys General Antitrust

9 At a recent conference held by Charles River Associates, on "Economists' Perspectives on Antitrust Today: Antitrust Policy in the Bush Administration, "Boston, Mass. (Oct. 13, 1989), John Peterman, Director of the FTC's Bureau of Economics, and James Rill, Assistant Attorney General, Antitrust Division, asserted that the bid-rigging in my example would cause output reduction and a loss of allocative efficiency in "the long run." Although output was constant within the confines of this particular Defense Department contract, they argue that the higher cost paid by the government would lead to less defense procurement in the future and thereby result in a reduction in output.

Their attempt to fit bid-rigging into the Chicago School orthodoxy falls short. The bidding on such a discrete contract fits the economists' definition of an auction market. In measuring allocative efficiency one should properly restrict the inquiry to the market at hand. Measuring effects in other markets would lead to the conclusion that any restraint would restrict output in some market at some place and at some time. The argument that bid-rigging involves output reduction in the long run brings to mind John Maynard Keynes' observation that "in the long run we are all dead."

10 *See* R. Bork, *supra* note 4m at 110-11.

11 *NAAG and Antitrust Division Set Up Executive Working Group for Enforcement*, Antitrust & Trade Reg. Rep. (BNA) No 1425, at 84 (July 20, 1989) (noting attacks on bid- rigging as the top priority).

12 Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911).

13 See Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. Chi. L. Rev. 6 (1981)

14 *See* Areeda & Turner, supra note 2.

15 *See* State of New York v. Brown, Civ. No. 88-1512 (D.N.J. 1988). In State of New York v. Brown, the State of New York sued to enjoin enforcement of New Jersey's Milk Control Act, which allows the State's Director of Milk Control to regulate the prices for milk sold in New Jersey Pursuant to this grant of authority, New Jersey milk officials have promulgated regulations that prohibit milk producers form selling below "cost," defined as the dealer's average total cost. This figure is intrinsically higher than the producer's average variable cost, the figure used in Arreda and Turner's predatory pricing test. Application of the average total cost test led New Jersey to deny at least 30 applications from New York dealers to supply New Jersey retailers. These New York dealers were selling at above average variable cost but below average total cost. See Antitrust Principles Guide Commerce Clause Analysis of Milk Pricing Regulation, Antitrust & Trade Reg. Rep. (BNA) No. 1419, at 842 (June 8,1989)

In this litigation, the State of New York has contended that to prohibit pricing between average variable cost and average total cost violates the Commerce Clause. The district court's preliminary decision concluded that although the regulation did not intentionally discriminate against interstate commerce, the Areeda-Turner predatory pricing theory and test indicated that the regulation might well have an unconstitutional discriminatory effect on interstate commerce. The court found that little support existed for New Jersey's average total cost test in light of the Areeda and Turner work showing that pricing between average variable cost and average total cost had negligible destructive effects on competition. The parties were given 30 days to provide more data on which the court will base its final decision. Id.

16 *See* Parker v. Brown, 317 U.S. 341, 350-51 (1943) (Sherman Act no intended to restrain state or its officers or agents from activities restricting competition that are directed by its legislature; state agricultural proration program valid).

17 *Eastern Railroad Presidents Conf. v. Noerr Motor Frieght, Inc, 365 U.S. 127 (1961); United Mine Workers of Am. v. Pennington, 381 U.S. 657 (1965) (Certain government petitioning immune from antitrust liability).*

18 475 U.S. 574 (1986)

19

20 *Id.* at 587.

21 *See, id.* at 599, 606 ("the Court makes a number of assumptions that invade the factfinder's province"; "the Third Circuit is not required to engage in academic discussions about predation; it is required to decide whether respondents' evidence creates a genuine issue of material fact") (White J., dissenting).

22 The Japanese FTC apparently established a case that the Japanese television manufacturers had engaged in domestic price-fixing, but "killed" the case in part because it would have supported Zenith's position in the Matsushita

litigation. Conversation between Lloyd Constantine and Misuo Matsushita, Professor of Law at Univ. of Tokyo (May 23, 1989). Prof. Matsushita was a consultant for the Japanese defendants in the Matsushita case.

23 475 U.S. at 605 (White, J., dissenting).

24 *See generally* W. BAUMOL et al., supra note 3.

25 See, e.g., Brodley, *Antitrust Policy Under Deregulation: Airline Mergers and the Theory of Contestable Markets*, 61 B.U.L. REV. 823 (1981).

26 Baumol & Willig, *Contestability: Developments Since the Boo*k, 38 OXFORD ECONOMIC PAPERS: SUPPLEMENTS 9-10 (1986).