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INTRODUCTION

The year 2004 marks the ninetieth anniversary of the founding of the Federal Trade Commission, the twenty-fifth anniversary of its decision in the American Medical Association case, and the fifth anniversary of the Supreme Court's decision in the Commission's case against the California Dental Association. The AMA case was a landmark event for the FTC and for antitrust policy generally. It significantly extended the reach of the competition policy. It triggered evaluations of the competitive implications of conduct standards in many professions. It transformed the way that professional services are supplied in this country. Few actions by the FTC over its entire history have had more sweeping real-world consequences.

At the same time policy has continued to struggle with some basic questions: Are the professions really different from other services and products, and if so, how? Should nonprice advertising be treated identically with advertising that conveys price information? Does a "quick look" at bans on such practices suffice to determine antitrust liability, or is a more comprehensive evaluation necessary in each case? These issues await full resolution and agreement.

This paper will examine the FTC's record of accomplishment in the area of the professions. We will begin with a discussion of three cases that have defined the range of actions and strategies employed by the FTC against restraints on competition, and then offer some observations on the underlying economics of the professions. We conclude with a brief look ahead at what may await the Commission in its further pursuit of competition in this important area to which it has brought enormous benefit to consumers.

and order were upheld with only minor modification by a divided Appeals Court in 1980 and affirmed by a tie vote of the Supreme Court in 1982.¹

Together with the simultaneous and successful challenge by the Antitrust Division of the Justice Department to restrictions on bidding by the National Society of Professional Engineers,² the AMA case signaled a willingness of the courts to hold codes of conduct up to antitrust scrutiny, replacing traditional deference to self-regulation by the professions.³ These cases triggered agency reviews of codes of conduct and related state regulations governing the practices of numerous professions, including lawyers, optometrists, dentists, chiropractors, podiatrists, psychologists, physical therapists, obstetricians, gynecologists, veterinarians, anesthesiologists, dermatologists, accountants, fashion designers, arbitrators, music dealers, and many more listed in Table 1.

Ultimately, nonprice restraints on conduct in professional services would become a major new area of inquiry by the FTC.⁴ It would also represent one of the most wide-ranging and important competition initiatives ever undertaken by the Commission. The services enumerated in Table 1 dominate NAICS sectors accounting for nearly 19 percent of GDP in this country. Few actions by the FTC over the course of its entire history have had more sweeping

¹American Medical Assn, 94 FTC 701 (1979); modified and enforced, 638 F.2nd 443 (2nd Cir. 1980); affirmed 455 U.S. (1982)

²National Society of Professional Engineers v. U.S., 435 U.S. 679 (1978)

³ For discussion of self-regulation and antitrust, see Pitofsky (1998)

⁴Langenfeld and Silvia (1993), for example, credit the AMA case for some 81 horizontal restraints cases brought by the FTC between 1980 and 1992. Their recent update (Langenfeld and Silvia, forthcoming) counts another 84 horizontal restraints cases since 1992. About half have involved medical or other professional services.

consequences. As we shall see, however, neither the economic nor the legal path has always been straightforward.

MARKETS, INFORMATION, AND PROFESSIONAL SERVICES: THEORY

The case against restrictions on advertising and related nonprice activities might seem simple.

After all, advertising generally conveys information to consumers and is simultaneously a strategic variable in the competition among firms.⁵

⁵ This discussion focuses upon informative, as opposed to persuasive, advertising. In the case of the latter, rather different arguments would be necessary, and indeed perhaps a different policy would hold.

⁶ This holds to some degree even when there are standards for what procedures must be included in the professional service: the thoroughness still cannot be readily determined by the consumer.

⁷Akerlof (1970).

know only that some fraction of units on the market are of good quality, while the remainder are so-called lemons. Since buyers cannot distinguish quality, they are prepared to pay a single price for any unit, one which reflects the average quality of all units on the market. That single price is remunerative to sellers of low-quality units, of course, but not to potential sellers of high quality. The latter will therefore withhold their units from the market, unable to secure an adequate price. That in turn skews available units further toward low-quality products, lowering the single price that buyers (who know the overall proportions of good and bad products in the market) are prepared to pay.

The unraveling of such a market can now be foreseen: The lower price drives from the market additional units at the higher end of the remaining quality distribution. That further tilts the overall distribution toward low-quality units, lowering average quality and the price that buyers calculate as appropriate. The progressive reduction of price that buyers are prepared to pay and of quality that suppliers are prepared to offer results in an equilibrium in which all good units are driven from the market and only bad units (“lemons”) survive. In variations of this model with continuous quality (rather than just good vs. bad units), it is even possible that no units whatsoever will be traded in equilibrium: The market simply ceases to operate. In other variations where quality is endogenous—that is, under the control of the provider—providers who prefer to offer high quality may be forced to lower their quality in order to avoid being driven out of the market entirely.

Akerlof’s model would seem to support the “doomsday” concern expressed by the professions, but that conclusion seems too facile, perhaps even false, for three reasons. First, Akerlof himself recognized that this scenario can be forestalled by offsetting institutions or

mechanisms. In this connection, he noted the importance of warranties and guarantees, reputation effects, chain firms, and licencing in providing information or assurances to consumers—all of which exist in professional services. In fact, it is difficult to identify any real-world market that has followed the doomsday scenario—even Akerlof’s own example of used cars. For that reason, his work seems more important in explaining the role of these counteracting mechanisms in actual markets, than in explaining any real world market failure.

The second reason that Akerlof’s discussion is not dispositive is that it addresses the wrong question. The policy question is not whether markets for professional services are afflicted with informational asymmetry, but rather whether and how advertising exacerbates any adverse effect. For the professions to defend restrictions on advertising, they must demonstrate incremental adverse effects of advertising, and not simply reference Akerlof on asymmetric information. Their arguments have not met this burden, from either a theoretical or empirical perspective.

And third, there is considerable empirical evidence on the effects of advertising and commercial practice in the professions, and that evidence provides no support for the doomsday scenario. Among a number of studies of advertising and commercial practice in the professions, the one that has focused most closely on this question was a study of the optometry profession by the Bureau of Economics of the FTC in the late 1970s and described more fully in the next section.⁸

⁸ Two additional points should be noted. First, the above scenario does not depend upon the advertising being false or deceptive. Even truthful advertising that shifts consumers will produce these effects, but of course, the adverse consequences to consumers are larger to the extent that the advertising content is misleading or outright false.

Second, the professions also at times contended that, whatever its effect on quality, advertising would not even have the apparent benefit of lowering price. Rather, they have said,

ADVERTISING, PRICE, AND QUALITY OF PROFESSIONAL SERVICES: EVIDENCE

Economics has long analyzed the effects of advertising on price, profit, and concentration. Some work raised concerns that advertising can insulate incumbent providers from competition by new entrants, or even reduce competition among incumbents themselves.⁹ Examples involve primarily cases of oligopoly markets, with low overall demand elasticity and where advertising is persuasive rather than informative in orientation. A standard example is the brewing industry, where competition among the few incumbents is largely for market share and advertising contains nothing resembling information. Rather, it creates or enhances “brand loyalty,” that is, reduced elasticity of demand for particular brands, diminished competition among incumbents, and tougher entry conditions.

But where competitors are numerous and overall elasticity is higher, informative advertising—providing information on price, availability, etc.—is more common. And where advertising is effective in attracting new customers, it also puts incumbents in stronger competition with each other since customers become aware of more numerous alternatives available to them. The result is higher elasticity of demand facing each provider, with correspondingly reduced pricing discretion.

Evidence in support of this latter pro-competitive scenario in the professions dates back

the cost of advertising would have to be recouped through a price increase by those who choose to spend on it. Alternatively, they noted instances where advertising appeared to create strong consumer preferences for certain brands, diminished competition, and higher prices. In the face of overwhelming evidence, this argument has largely been abandoned.

⁹ Classic references are Comanor (1974) and Scherer (1990).

to studies by Benham and by Benham and Benham,¹⁰ who established an often-replicated methodology. Each examined optometry, which was at the time one of the few professions with significant state-to-state variation in permissible advertising and commercial practice. States were classified as restrictive or non-restrictive based on their laws and regulations. In the 1972 study, data from a national survey of consumers implied an average price paid for eyeglasses plus an optometric exam of \$33.04 in restrictive states vs. \$26.34 in non-restrictive states. Benham attributed the difference to eyeglass prices, since there was apparently little state-to-state variation in exam prices. Using different data, the 1975 study classified states based not only on their restrictiveness with respect to advertising, but also whether or not chain optical firms were permitted to operate. Once again, advertising resulted in a significantly lower price, as did the proportion of eyeglasses in each state purchased from commercial firms.

The importance of the Benham studies lay in establishing that informative advertising of products and services provided by professionals lowers price. In so doing, they—along with other studies of the time¹¹--largely put to rest the argument that advertising would have no price benefits, but they could not address the equally important issue of the effect of advertising on the quality of service. Prompted by the realization that the quality issue would likely determine the course of policy regarding the professions, in 1977 the Bureau of Economics decided to analyze this remaining issue. After much internal discussion and with assistance from two schools of optometry, the study went forward. What came to be known as the “BE study” merits further

¹⁰Benham (1972). Benham and Benham (1975).

¹¹ See Cady (1976), Marvel (1976), and Maurizi and Kelly (1978).

and the schools of optometry. The second quality dimension was the accuracy of the prescription, and the third the accuracy and workmanship of the eyeglasses.

Regarding thoroughness, the average score for all optometrists in restrictive cities was 58.5, whereas in nonrestrictive cities it was 61.6. While statistically insignificant, the difference ran counter to the profession's expressed concern that advertising and commercial practice would trigger a lemons-type process in which higher quality service was driven from the market. No such danger to service quality was apparent. The distinction among practitioner types in nonrestrictive cities revealed yet more intriguing results. The average score for advertisers in those cities was 47.4 and for chain firms 51.6—a finding that might seem to provide support for concern about such providers—but nonadvertisers in those same cities scored 70.0. This was well above their advertising counterparts in the same cities and indeed higher than the overall average in restrictive cities. Advertising was not causing exam thoroughness to decline throughout the market. Instead, roughly the same range of thoroughness continued to exist, but practitioners in nonrestrictive cities adopted modes of practice that reflected their own preferences with respect to advertising.

Completing this picture, there was no evidence that advertising and commercial practice resulted in a smaller percentage of prescriptions judged as accurate, of eyeglasses judged as correctly representing the prescription, or of eyeglass workmanship judged as adequate. Indeed, in each case the percentages slightly but insignificantly favored nonrestrictive cities. In most cases the percentages for various types of practitioners in nonrestrictive cities were close, implying that most optometrists do a good job on these basic, and more measurable, dimensions of eye care.

The BE Study was an important contribution to economics and policy. It provided compelling evidence that restrictions on the professions did not serve the interests of consumers, but instead raised price without affecting overall market quality. While aspects of the BE Study were challenged by some, it withstood critique and its findings were corroborated in later work.¹⁴ At the time it lent considerable weight to the growing number of FTC initiatives against restrictions on competitive practice in the professions.

FROM MASS BOARD TO CAL DENTAL

Beginning with the AMA case, restrictions on competitive practice in the professions were increasingly scrutinized. Some of the challenged restrictions involved advertising, others commercial practice. Some originated with state regulatory boards, while others came from professional associations. Some were addressed by Commission trade regulation rules, others by antitrust. Two of the latter had particular importance, since they raised procedural issues as well as matters of substance.

The first of these challenges involved the Massachusetts Board of Registration in Optometry, which had promulgated rules banning advertising of price discounts, all testimonials, all ads deemed “sensational” or “flamboyant,” and any mention of an affiliation between optometrists and opticians, including the names and availability of optometrists in optical establishments. The Commission’s complaint alleged that restrictions on truthfulness. Some of the

¹⁴ See surveys in Love and Stephan (1996) and Muris (2000).

advertising are routinely condemned under the antitrust laws “without elaborate economic analysis.” Despite this position with respect to the law, staff introduced into the record statistical evidence that bans on price and other informative advertising and on commercial practice had the actual and demonstrated effect of maintaining above-competitive price. A key piece of evidence was the BE Study and derivative analysis, introduced in day-long testimony by one of the authors of that study.

The ALJ’s decision held that all the restrictions were anticompetitive and illegal. The ban on advertising price discounts was found to be a per se violation, while the others—for which there was less judicial experience and precedent--were illegal under a rule of reason. A rule of reason standard was met by virtue of the absence of any justification, or any plausible justification, for the restraints imposed by the Mass Board on testimonials, advertising of affiliation, etc. On appeal, the Commission upheld the findings against the restrictions, but did so only after addressing the issue of the appropriate standard for evaluating such restraints. The opinion was written by Commissioner Terry Calvani and broke significant new ground.

Relying on work by Tim Muris,¹⁵ the Commission articulated a so-called “structured rule of reason.” Under this the first question to be asked about any restraint is whether it is inherently suspect. If not, traditional rule of reason applies, but if so, a second question is posed: Is there a plausible efficiency justification for the restraint? If not, it can be summarily condemned, but if so, an inquiry must be held into the validity of the justification. If it is valid, a full rule of reason analysis must be undertaken, but if not, the restraint can be condemned under a rule of reason without further inquiry.

¹⁵ This work was at the time unpublished but later appeared in modified form in Muris (1989).

This approach was an effort to fashion an administratively efficient decision rule for assessing restraints in an era in which the possibility of pro-competitive restraints was recognized by the courts. Full rule of reason analysis of all challenged restraints would be extremely burdensome, but also unnecessary to the extent that the apparently few pro-competitive cases could be identified. The structured rule of reason sought to do just that.

Using this approach, the Commission in 1988 found all of the restraints imposed by the Massachusetts Board to be anticompetitive and illegal.¹⁶ Since the Commonwealth of Massachusetts did not appeal this decision, this new approach was not reviewed by the courts but it was subsequently followed by the Commission in a number of cases involving horizontal restraints. The Commission would soon have another opportunity to address both restrictions in the professions and the issue of the appropriate standard, with quite different results.

The California Dental Association had promulgated a Code of Ethics prohibiting “false and misleading” advertising, which it defined as anything that is “likely to mislead because in context it makes only a partial disclosure of relevant facts” or “relates to fees for specific types of services without fully and specifically disclosing all variables and other relevant facts.” More generally, the Code required member dentists to “represent themselves in a manner that contributes to the esteem of the public.” These provisions were alleged in the Commission’s 1993 complaint to be used by CDA to virtually prohibit price and discount advertising, to ban totally claims about quality and superiority, to prohibit advertising of guarantees, and to enforce these restrictions by expelling offenders and other methods of coercion and punishment. The complaint concluded that all this adversely affected competition and prices to consumers.

¹⁶ Massachusetts Board of Registration in Optometry, 110 F.T.C. 549 (1988)

The trial focused on the inherent nature of CDA's restrictions and their conflict with the law. No demonstration was offered to the court as to the actual effects of the restrictions at issue, despite the fact that an expert witness had been prepared to testify as to the effects of such restrictions based on the BE Study. At the eleventh hour, that prospective witness was dropped from the proceedings, a decision that apparently reflected a preference for arguing the case in principle, rather than the usual strategy of offering corroborative evidence while maintaining it was not strictly necessary.

Relying upon Mass Board, the ALJ found that all the restrictions were per se violations of Section 5. The full Commission's opinion, written by Chairman Bob Pitofsky, adopted a different approach, reverting to the earlier per se/rule of reason dichotomy.¹⁷ Restrictions that burdened price advertising were condemned as per se violations. Those affecting nonprice advertising were given what the Commission termed a "quick look"¹⁸ and also condemned. The reason for this reversion appeared to be that since the courts had failed to endorse the structured rule of reason, the FTC's reliance upon it entailed significant risks to policy. By endorsing a less-quick but still-not-full inquiry into the restraints, but without record evidence of the effects of the restraints, however, the Commission was attempting to thread its way through a narrow passage.

The circuit court upheld the FTC's ultimate conclusions, but it rejected the Commission's per se finding with respect to the restrictions on price advertising. Instead, it found them to be anticompetitive based on the same quick look as employed to condemn restrictions on nonprice

¹⁷ California Dental Assn. 121 F.T.C. 190 (1996)

¹⁸ The "quick look" language appeared in two opinions of the Seventh Circuit authored by Richard Posner. See Gellhorn, et al (2004).

advertising. On appeal, the Supreme Court went much farther. In a 5-4 ruling, it overturned the circuit court finding in its entirety and remanded the case for evaluation under the full rule of reason.¹⁹ While the Court did endorse the principle of a quick look in some cases, it also stated that when “any anticompetitive effects of given restraints are far from intuitively obvious, the Rule of Reason demands a more thorough inquiry into the consequences of those restraints than the Court of Appeals performed.” The reason given as to why the effects of these largely familiar restraints were not obvious was that they arose in the context of a market for professional services. Here, the court asserted, the effects of advertising might be different from the case of other goods and services, or even from profession to profession. Their argument bears elaboration.

The Court agreed that the market for dental services is one where it is difficult for consumers to obtain information about the price and nonprice characteristics of services, but it expressed serious misgivings about the benefits of price advertising in such a market. Indeed, it argued that for professional services price advertising may be a bad thing because it constitutes inherently incomplete information in a setting where information is asymmetric to begin with. Without prompting from parties, the Court cited Akerlof’s lemons model in support of its concern with the hazards of price advertising.

Regarding nonprice advertising, the Court rejected the circuit court’s view that CDA’s ban was anticompetitive simply because it did not distinguish between truthful and false or misleading advertising. Moreover, the circuit was faulted for giving no weight to the “equally plausible[,] suggestion that restricting difficult-to-verify claims about quality or patient comfort

¹⁹ California Dental Assn., 119 S.Ct. 1604 (1999)

²⁰ In re Polygram Holdings, F.T.C. (2003)

²¹ Indeed, the Cal Dental court's endorsement of a quick look approach left unclear and

its conclusion. This Commission's opinion in this case has attracted much comment, indicating the lack of agreement about this standard and its application.²²

ADVERTISING AND THE PROFESSIONS: WHERE WE STAND

While aspects of the Supreme Court's opinion in *Cal Dental* offered support for the FTC's abbreviated analysis, the substantive ruling in the matter at hand was unexpected. The issues that underpinned the majority view were not those on which any lower panel had focused. The evidence in the record, particularly that offered by the FTC, was not designed to illuminate those issues. The economic literature relied upon by the Supreme Court was not cited by any party in the case.

True, in its 1975 *Goldfarb* case, the Court had hinted it might view restraints in the profession differently from those in other markets, but until *Cal Dental* it had never exercised that option.²³ Precisely what caused it to do so in this case is a matter of speculation.²⁴ Among the possibilities are:

- The indirect nature of the restraints, that is, not on price but on advertising, and not outright bans on but burdens on such advertising.
- The absence of corroborating evidence of the actual effect of those restraints, at least those particular restraints, on dentists, and in California.
- The Commission's legal strategy, which involved something of a quick look but

²² See, for example, Kolasky and Elliott (2004), Fox et al (2004), and McChesney (forthcoming).

²³ *Goldfarb v. Virginia State Bar*, 421 U.S. 773 (1975). See also Muris (2000).

²⁴ See Kattan (1996), Lande and Marvel (2000), and Calkins (2000).

without the usual record evidence introduced to reassure the reviewing court and allow for the possibility that a different standard would be applied.

The combined effect of these factors was that the court may have been confronted with too large a jump from its previous holdings to an endorsement of FTC action in this case. Balking in the face of its cumulative doubts, the majority harked back to a previously-expressed view that the effects of restraints in the professions might differ from those in “other business activities.” That view reflected the Court’s unease with permitting the market to operate in the “learned professions,” including its own. The result would appear to be that further FTC action in the professions may need to demonstrate that competition is itself desirable, in addition to showing that the restraint in question encumbers competition in the particular profession.

If this standard now governs, it would seem to be both inappropriate and unfortunate. It is inappropriate since it does not reflect current economic understanding of the effects of advertising and other competitive practices in the professions. Theory, for example, is quite clear about the benefits of information to consumers and the market process. Theoretical concerns about asymmetric information remain just that—theoretical, but without demonstrated relevance to the issues at hand, and without the empirical support required to confer policy legitimacy upon them.

Empirical work examining the effects of informative advertising in fragmented markets, or the effects of restraints on advertising and other practices in a number of professions, leaves no real room for doubt about the effects of these restraints: They are uniformly anticompetitive. Whatever grounds the Goldfarb court might have had for its misgivings and uncertainty some thirty years ago, those grounds have been put to rest by a wealth of subsequent empirical

research. Unless and until a particular restraint in a particular profession is convincingly demonstrated to be different in some relevant way, there is simply no reason to expect the effects to differ. Existing theory and evidence should be presumed to apply.

In light of this, the Cal Dental court's doubts about the applicability of this understanding are very unfortunate. They would seem to have reopened a largely settled question. They may have created an obligation to demonstrate the effect of each restraint, in each profession, in each jurisdiction before action can be taken. They do not reflect current understanding and evidence about such restraints. It can only be hoped that the full weight of this evidence will become clear to the court so that the Federal Trade Commission's longstanding and hugely important initiatives in this area are not be impeded.

TABLE 1
PROFESSIONS SUBJECT TO ANTITRUST ACTION, 1981 to DATE

Accountants
Anesthesiologists
Arbitrators
Automotive Dealers
Bid Depositories
Chiropractors
Customs Brokers
Dentists
Dermatologists
Doctors
Engineers, various
Fashion Designers
Hotel Associations
Interpreters
Language Specialists
Lawyers
Movers, various
Music Dealers
Obstetricians
Optometrists
Orthopedists
Osteopathic Physicians
Pharmacists
Physical Therapists
Podiatrists
Psychologists
Real Estate Agents
Veterinarians

Source: Langenfeld and Silvia (1993), Langenfeld and Silvia (forthcoming)

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