IS IT LIVE OR IS IT MEMOREX?
MODELS OF VERTICAL MERGERS AND ANTITRUST ENFORCEMENT

by

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sound public policy requires that we put the emPHASis on the right sylLABles. If we focus too much on theoretical exceptions to the general rule – and there is a real risk of doing so simply because they are intellectually more interesting – then we will get the emphasis wrong.

The basic dilemma in vertical merger policy is how to identify the presumably small number of vertical mergers that might be harmful to competition. What sort of evidence should be brought to bear on the question, and what exactly does the evidence have to show for us to conclude that a vertical merger is likely to be harmful to competition?

In some industries, markets are local and th0215Tj12 0 0 12 122.93062 570.9608 Tm(e)Tj12 0 0 598S362 1 think I can safely make three predictions. First, there would be general agreement that the Microsoft's software and Intel's microprocessors are complements. Second, many people would argue that both firms are, to use European terminology, dominant, or, to use U.S. terminology, in possession of monopoly power. Third, many people would argue that such a merger should be blocked. The merger opponents would no doubt include some who just object to concentration of "economic power," but I am confident it would also include some who fully understand the Cournot/Spengler

So how do we conclude that model predictions are real? My thesis advisor urged his students to write about the economy, not the economics literature. I think that advice would serve us well in the area of vertical mergers. If we start with the existing models and modify the assumptions, we are analyzing the literature. If we start with cases and incorporate what appear to be the most important features of those cases into a model, I think we have a chance of identifying real effects of mergers. In my previous brief stint at the FTC, I was assigned to work on a series of mergers by Coke and Pepsi with their bottlers. Most Coke and Pepsi bottlers handled other brands, and the effect of the mergers on the so-called allied brands was a cause of potential antitrust concern. Having recently derived the successive Cournot model, I initially considered applying it to those mergers, but realized that the fit was not good. Instead, it seemed that the essence of the situation was a downstream multiproduct firm that purchased the inputs from different suppliers and that the mergers entailed the downstream firm with one of those suppliers. I still think it was a good match.[11]

In addition to the process by which it came about – i.e., matching the model to the case instead of vice versa - there are two features of that model I would like to point out. First, the model has a monopoly rather than an oligopoly structure. To use modern enforcement terminology, it is a unilateral effects model that captures how a vertical merger changes incentives. Put another way, the model began with the businesses involved, not the industry. Such a model is, I believe, less prone to "economic Memorex" effects. Second, and related, the model predicts that vertical mergers can result in all prices going up, all prices going down, or an increase in some prices and a decrease in others. Which of the possibilities occurs depends on demand and cost conditions that can, in principle, be measured. Of course, when I derived the model in 1986, my views in the Bureau of Economics were perhaps less influential than they are now; and my arguments that we should try to parameterize the model with data from the industry did not prevail. Still, most of the literature surveyed by Professor Church and BLRY rests on highly stylized demand and cost assumptions. That striking feature, which I believe is the result of trying to make game theoretic assumptions tractable, limits the practical policy implications of the models. What are we to do when we have a model that says that some but not all vertical mergers are harmful, but the model is formulated in such a way that it is hard to match it to the factual setting of a particular case in a way that would stand up to cross-examination? No matter how many models of this sort we have in the literature, they are not going to form the foundation of a valid basis for challenging vertical mergers.

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If I had prevailed in 1986 to get the Bureau of Economics to calibrate the model I suggested to the soft drink industry, I am now confident it would have predicted that the mergers posed no threat to competition. In a merger retrospective, my predecessor as Bureau Director David Scheffman in collaboration with former FTC Chairman Tim Muris and Pablo Spiller concluded that those mergers were indeed beneficial to competition.[12] In citing this example, I am not giving a case in which a model was used successfully to challenge a vertical merger. I am simp