Federal Trade Commission

The Next Challenges for Antitrust Economists

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Economists have had success setting forth a coherent – if not always accurate – framework for antitrust analysis through use of price theory. Price theory, or neoclassical economics, is based on a number of assumptions such as that business people are rational profit-maximizers, that demand curves are downward sloping, and that resources gravitate to the areas where they will earn the highest return.[1] Over the last thirty-five years, the Supreme Court and the lower courtv(the t Economists)4.reqghest r7u.S767 minar

subject to per se condemnation, including non-price vertical restraints (Continental TV v. GTE Sylvania - 1977), maximum resale prices (State Oil v. Khan - 1997), and minimum resale prices (Leegin - 2007).

More recently, so-called “post Chicago School” economists have questioned some of the claims of the Chicago School and offered a more interventionist approach. But those scholars simply expanded the range of conduct that might be considered rational and profit-maximizing to include some predatory conduct that would raise rivals’ costs, increase entry barriers, or exclude rivals cheaply. Although these theorists offered a more sophisticated, nuanced view of seller behavior, they have not challenged the basic assumption that sellers and buyers are rational. As Dan Crane aptly put it, “Most post-Chicagoans want to tweak Chicago’s arguments rather than to displace them.”[2]

In contrast to the substantial efforts to develop Chicago School and post-Chicago School theories, economists have devoted relatively little effort to developing a theoretical framework when one or more of the assumptions underlying price theory fails to hold, such as that businesspeople and consumers act rationally. In addition, it is

This trend can be seen most clearly in the evolution of the Horizontal Merger Guidelines, the most recent version of which discusses non-price consideration to a greater extent than its predecessor.

The economic theories embedded in the 1992 Guidelines emphasized price effects almost exclusively. For example, the introduction to those Guidelines stated that “[t]he unifying theme of the Guidelines is that mergers should not be permitted to create or enhance market power or to facilitate its exercise.”[3] Market power was defined as the durable ability to “maintain prices above competitive levels.”[4] Likewise, Section 2 of the Guidelines described the potential for elevation of price and the suppression of output as the competitive concerns in merger review.[5] Section 4 noted the possible benefits of “lower prices to consumers” from merger-specific efficiencies, but said nothing about other potential consumer benefits, such as new or improved products.[6] Nor were competitive effects the only place where the 1992 Guidelines relied on prices to the exclusion of non-price considerations. Section 1 of the Guidelines defined relevant product and geographic markets by reference to relative prices, specifically whether a hypothetical monopolist would be able profitably to impose a small but significant increase in price over a product or group of products. To be sure, the 1992 Guidelines did mention non-

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[3] Horizontal Merger Guidelines § 0.1 (1992).

[4] Id.

[5] Id. § 2.2 (“[M]erging firms may find it profitable to alter their behavior unilaterally following the acquisition by elevating price and suppressing output.”); id. § 2.21 (“A merger between firms in a market for differentiated products may diminish competition by enabling the merged firm to profit by unilaterally raising the price of one or both products above the premerger level.”); id. § 2.22 (“Where products are relatively undifferentiated and capacity distinguishes firms and shapes the nature of their competition, the merged firm may find it profitable unilaterally to raise price and suppress output.”).

[6] Id. § 4. The 1992 Guidelines also discussed the role of prices in encouraging entry. See id. § 3.0.

price effects two times. However, both of those references were in footnotes.[7] The main text of the 1992 Guidelines was devoid of any discussion of non-price competitive effects.

The 1997 revisions to the efficiencies section of the Guidelines expanded the role of non-price considerations. Those revisions acknowledged that merger-specific efficiencies could not only "result in lower prices," but also result in "improved quality, enhanced service, or new products."[8] The revisions went on to state that "efficiencies may result in benefits even when price is not immediately and directly affected."[9] But the 1997 revisions left the Guidelines in the odd position of recognizing the role of non-price factors as part of an efficiencies defense, while paying little attention to non-price effects as potential forms of anticompetitive harm.

The Merger Guidelines Commentary, issued in 2006 under the leadership of Debbie Majoras and Tom Barnett, went further in recognizing the role of non-price effects. The first page of the Commentary stated that the exercise of market power, which is the "core concern of the antitrust laws," can result "not only by raising price, but also, for example, by reducing quality or slowing innovation."[10] The Commentary went on to explain that "the Agencies examine whether the merger of two particular rivals . . . is likely to affect adversely the

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[7] Id. § 0.1 n.6 ("Sellers with market power also may lessen competition on dimensions other than price, such as product quality, service, or innovation."); Id. § 2.12 n.20 ("Similarly, in a market where product design or quality is significant, a firm is more likely to be an effective maverick the greater is the sales potential of its products among customers of its rivals, in relation to the sales it would obtain if it adhered to the terms of coordination.").

[8] Horizontal Merger Guidelines § 4 (1992 revised 1997).

[9] Id.

[10] U.S. Dep't of Justice & Fed. Trade Comm'n, Commentary on the 1992 Horizontal Merger Guidelines (Mar. 2006), available at http://www.ftc.gov/os/2006/03/CommentaryontheHorizontalMergerGuidelinesMarch2006.pdf.

with price effects, or can arise in their absence."[14] The revised Guidelines also state that documents or testimony from the merging parties indicating that they intend to "reduce product quality or variety, withdraw products or delay their introduction or curtail research and development efforts after the merger . . . can be highly informative in evaluating the likely effects of a merger."[15]

Perhaps the most significant development in the draft Guidelines with respect to non-price considerations is the new unilateral effects section on innovation and product quality.[16] According to Section 6.4 of the Guidelines, a merger that results in "a reduced incentive to continue with an existing product-development effort or reduced incentive to initiate development of new products" may constitute a substantial lessening of competition.[17] Likewise, the agencies may challenge a merger that gives the merged firm "an incentive to cease offering one of the relevant products sold by the merging parties."[18]

Another area where non-price considerations are mentioned is market definition. Section 4 of the draft Guidelines states that market definition under the Guidelines is based not only on "consumers' ability and willingness to substitute away from one product to another in response to a price increase" but also on consumers' response to a "non-price change such as a reduction in product quality or service."

[14] Draft 2010 Horizontal Merger Guidelines § 1.

[15] Id. § 2.2.1.

[16] Id. § 6.4.

[17] Id.

[18] Id.

You will not be surprised to hear that I am pleased that the draft 2010 Guidelines recognized non-price considerations to a greater extent than the 1992 Guidelines. However, in my view, the new Guidelines did not go far enough. The overwhelming impression from the revised Guidelines is that price effects remain paramount. For example, other than the new section on innovation and product quality, the draft Guidelines' discussion of unilateral and coordinated effects is silent with respect to non-price forms of competitive harm. And the revised Guidelines took a significant step backward by relying on prices and margins to a greater extent in some contexts.[19]

Another problem with the new Guidelines is the lack of a clear framework for analyzing non-price considerations. Let me give you some examples.

First, there is no explanation of how to apply the SSNIP market definition test based on non-price changes. The Guidelines define "small but significant" as a five to ten percent change in price.[20] But how do you determine what a "small but significant" change in quality or service is? The Guidelines do not say.

Second, there is scant guidance regarding how the agencies evaluate a merger's effect on product quality or service. The only assistance on this question is found in the introduction,

[19] For example, Section of 2.2.1 of the draft 2010 Guidelines asserts that "if a firm sets price well above marginal cost, that normally indicates either that the firm is coordinating with its rivals or that the firm believes its customers are not highly sensitive to price." Section 4.1.3 opines that "high pre-merger margins normally indicate that each firm's product individually faces demand that is not highly sensitive to price." Section 2.2 states that "a high purchase price may indicate that the acquiring firm is paying a premium to reduce competition."

[20] Draft 2010 Horizontal Merger Guidelines § 4.1.2 ("Where explicit or implicit prices for the firms' specific contribution to value can be identified, the Agencies typically use a SSNIP of ten percent of those prices. Where such implicit prices cannot be identified with reasonable clarity, the Agencies instead base the SSNIP on the price paid by customers for the products or services to which the merging firms contribute. In such cases, because the base prices will be larger, a lower SSNIP will normally be used, typically five percent but possibly lower.").

which states that the agencies "employ an approach analogous to that used to evaluate price competition."[21] I don't find this explanation helpful, and I doubt that federal judges will either.

Third, the draft Guidelines do offer a framework for analyzing the loss of product variety, but it will need significant fleshing out before it will be useful either to the outside bar or our own staff. Section 6.4 of the Guidelines states: "If a material reduction in variety appears likely following a merger, the Agencies may inquire whether the reduction in variety is largely due to a loss of competitive incentives attributable to the merger, and whether it leads to a demonstrable loss of significant value to consumers over and above any price effects."[22] That sentence raises a host of questions:

What is a "material" reduction in variety?

The sentence contemplates that a determination will be made "following a merger." How do you determine whether a merger is "likely" to reduce product variety?

How do you determine whether a loss of product variety is due to a loss of "competitive incentives"?

What reasons for reducing product variety following a merger are not anticompetitive?

How do you determine whether a loss of product variety will result in a "loss of significant value to consumers over and above any price effects"?

Fourth, the Guidelines provide a framework analyzing a transaction's effect on innovation, but leave a number of questions open. Section 6.4 says that the agencies "consider whether a merger is likely to diminish innovation below the level that would prevail in the absence of the merger." This is most likely to occur if at least one of the merging firms is developing new products that "would capture substantial revenues from the other merging firm."

[21] Id. § 1.

[22] Id. § 6.4 (emphasis added).

In other words, the agencies apply a diversion analysis to the likely results of their innovative efforts. Applying a diversion analysis to products that have not yet been invented is apt to be challenging, although Section 2.2.1 notes that direct evidence, such as the parties' documents and testimony, may be informative on this point.

Section 6.4 leaves a number of other questions unresolved. As the draft Guidelines themselves note, there may be cases where the predicted price effects of the merger suggest one enforcement outcome, but the innovation effects suggest a different enforcement outcome.[23] How should enforcers resolve this? On the one hand, it is widely asserted that technological progress benefits consumers to a greater degree than the elimination of noncompetitive prices.[24] This would suggest that the innovation analysis should trump short-run considerations. But on the other hand, public law enforcement agencies must be careful not to look so far in the future that they ignore price effects on consumers in the interim.

There are a number of other questions raised by the Guidelines' discussion of innovation effects:

> The Guidelines indicate particular concern if the merging companies are both innovating "in a specific direction." Is this different than the relevant market definition?

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[23] Draft 2010 Horizontal Merger Guidelines § [illegible]

At what point should the structural presumption play a role in analyzing innovation markets?[25]

Must the merging firms must have specialized assets or characteristics?

What role, if any, do entry and repositioning play in the analysis in innovation markets?

The Guidelines discuss innovation concerns only in the unilateral effects section. Does this mean that innovation concerns cannot arise as a result of coordinated behavior?[26]

I raise all of these questions not to denigrate the hard work of the drafters of the new Guidelines, but rather to point out that the discussion of non-price effects in the draft Guidelines will require significant fleshing out to be useful practitioners, the agencies, and the courts. And as I mentioned at the outset of my remarks, the primary responsibility for this, I suggest, rests with economists. In the next few years, I hope that we will see economists tackling these and other questions raised by the new Guidelines

of research has accumulated in, for example, the cognitive psychology, neuroscience, sociology, and finance disciplines indicating that individuals and firms are not in fact rational welfare maximizers.[27] This research shows that there are certain predictably irrational ways in which humans behave. Three of the principal findings of the behavioral economics movement is that people have bounded rationality, bounded willpower, and bounded self-interest.[28]

Bounded rationality refers to the insight that individuals exhibit systematic biases in their decision-making which lead them to use rules of thumb (or, in behavioral economics parlance, “heuristics”) and other decision-making shortcuts to simplify decision making.[29] For example, according to the “availeo“s

payment to part with that object than he would be willing to pay to purchase the identical object. Likewise, “framing effects” refer to the way a choice is framed—a choice that is cast as a “sure gain” or an “avoidable loss” alters the way humans make decisions.

Bounded willpower refers to the insight that individuals sometimes make decisions that are not in their long-term self interest. Overeating, overspending, and smoking are three examples. People who recognize their bounded willpower will sometimes take steps to counteract it by, for example, keeping tempting food out of the house, having automatic 401(k) deductions, or only carrying cash.

Bounded self-interest refers to the fact that an individual’s self interest may be broader than neoclassical economics assumes. In some market settings, people not only care about being treated fairly themselves, but also want other people to be treated fairly. Thus, if given the choice, some individuals will accept a lower salary so that a co-worker is not fired or will donate a kidney to a stranger.[31]

Some have argued that behavioral economics has little or no relevance to antitrust

their own which do not necessarily coincide with those of the enterprise as a whole" and, as a result, the incentives of these "employee agents can prompt conduct that does not maximize the profits of their employer."[33]

From my vantage point, behavioral economics has already offered some important insights for antitrust enforcers. For example, our enforcement guidelines assume that firms are usually driven to merge to achieve pro-competitive efficiencies,[34] yet the behavioral finance literature suggests that CEOs may suffer from overconfidence bias and may be driven by managerial goals rather than shareholder goals. When these biases appear to be present, enforcers would be wise to question merger projections prepared by the company and its advisors, including forecasts related to prices and efficiencies.[35] The behavioral literature may also help explain why the Antitrust Division continues to uncover so many criminal cartels, despite the complexity of some of the cartel agreements and the recent increase in penalties. According to the behavioral literature, part of the answer may be that, contrary to what we are frequently told by neoclassical economists, despite the low risk of discovery and punishment if they are caught cheating, some participants do not cheat out of loyalty to other cartel members.[36] (This is a perverse form of bounded self-interest.) Finally, concerns about asymmetric information have animated our standard-setting deception cases, such as *Rambus*.[37]

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[33] *Id.* at 609.

[34] Draft 2010 Horizontal Merger Guidelines § 10 ("[A] primary benefit of mergers to the economy is their potential to generate significant efficiencies . . . .").

[35] Michael A. Salinger, *Behavioral Economics, Consumer Protection, and Antitrust*, Competition Policy Int'l, Spring 2010, at 65, 82.

[36] Leary, *supra* note 32, at 609.

[37] In the Matter of *Rambus Inc.*, FTC Docket No. 9302, *available at* http://www.ftc.gov/os/adjpro/d9302/index.shtm.

observed, "there has been virtually no interest within modern industrial economics in applying behavioral economics."[44]

Third, behavioral scholars have not yet offered a comprehensive framework for analyzing antitrust issues.[45] Its imperfections notwithstanding, one of the virtues of neoclassical economics has been its ability to supply a consistent theoretical framework for analyzing competition issues. Even its supporters acknowledge that behavioral economics lack a similar organizing principle.[46] Until behavioral economics can do so, it may face an uphill battle gaining acceptance among enforcers and the courts in the way neoclassical economics was able to over the last forty years.

Fourth, there is concern that behavioral economics is too subjective to provide government officials with a serious tool to reach the right ends. Under this view, government regulators – like the individuals discussed in the behavioral economics literature – are also fallible and, if they get an intervention "wrong," the consumer or societal loss may be magnified.[47] If, for example, government regulators impose a default rule that is wrong, the

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[44] Michael Salinger, *Behavioral Economics, Consumer Protection, and Antitrust*, Competition Policy Int'l, Spring 2010, at 81.

[45] Id. at 66 (noting that "economic analysis necessarily relies on simplifying assumptions that sacrifice realism for tractability" and that "the rationality assumption plays so prominently in the literature because it is tractable . . . and yields some quite accurate predictions"); Ginsburg & Moore, *supra* note 43, at 97 (Behavioral economics "does not—at least not yet—provide or even promise to provide a general standard by which to decide any particular type of case.").

[46] Cass R. Sunstein, *Introduction*, in Behavioral Law and Economics 1, 9 (Cass R. Sunstein ed., 2000) (noting that "an enormous amount remains to be done" in the development of behavioral economics, including determining whether "behavioral economics [can] generate a unitary theory of behavior" or whether behavioral economics is "too ad hoc and unruly to generate predictions in the legal context").

[47] See, e.g., Richard A. Posner, *Treating Financial Consumers as Consenting Adults*, WALL St. J., July 23, 2009, at A15 ("Behavioral economists are right to point to the limitations of human cognition. But if they have the same cognitive limitations as consumers, should they be designing systems of consumer protection?").

wrong may have broad or perhaps universal application. One problem with this criticism is that it ignores the fact that, unlike human beings who make decisions in a vacuum, government regulators have the ability to study over time how individuals behave in certain settings (i.e., whether certain default rules provide adequate disclosure to help them make the most informed decision). Thus, if and to the extent that government regulators are mindful of the human failings discussed above, and their rules are preceded by rigorous and objective tests, it is arguable that they are less likely to get things wrong than one would predict.

Of course, it may be the case that the concern with behavioral economics is less that regulators are imperfect and more than they are subject to political biases and that behavioral economics is simply liberalism masquerading as economic thinking.[48] A response to that is that political capture is everywhere in Washington and that to the extent behavioral economics supports "hands on" regulation, it is no more political than neoclassical economics which generally supports "hands off" regulation. But perhaps the best way behavioral economics could counter this critique over the long run would be to identify ways in which the insights from behavioral economics suggest regulation that one would not expect from a "left-wing" legal theory.

So given the valuable insights offered from behavioral research where do we go from here?

My first suggestion is that FTC is one of the best institutions to consider the appropriate role of behavioral economics in antitrust enforcement. This is because of the agency's dual competition and consumer protection functions, both of which, as I have described, are at the

[48] Andrew Ferguson, Nudge Nudge, Wink Wink: Behavioral Economics—The Governing Theory of Obama's Nanny State, Weekly Standard (Apr. 19, 2009), available at http://www.weeklystandard.com/articles/nudge-nudge-wink-wink.

intersection of behavioral economics. This is a good example of former FTC Chairman Bill Kovacic's observation that the FTC is a better competition agency because of its consumer protection mission.[49]

practical matter, is that a firm with substantial market power should not be permitted to engage in practices or transactions that will adversely affect its rivals from constraining its power. That includes engaging in practices or transactions that rivals cannot or will not engage in. This could be due, for example, to a fear of violating the "unfair or deceptive prong" of Section 5. Or it could be due to self-regulation.

My third suggestion is that we need to pay more attention to the effects that actually result from a practice or transaction instead of what theory predicts may happen. Economic models should be used to corroborate empirical evidence but are not a substitute for empirical evidence. This is the approach many, if not most, courts already follow.[52] Moreover, an effects-based analysis may yield a trifecta: First, it has the benefit of bypassing the vexing issue of whether the practice or transaction is rational or irrational; second, if that analysis includes an analysis of the effect of a transaction on price – namely, whether and how the practice or transaction impacts output – that may give us the holy grail we are looking for – whether the transaction or practice affects consumer choice; and third, this approach may provide greater convergence with the EC.

I'd like to conclude by returning to the comment I made at the beginning of my remarks. Economists should not shy away from taking on this challenging topic, even though it calls into question some of the assumptions on which modern industrial organization is based. Indeed, if economists do not do it, my guess is that lawyers and/or courts will ultimately do so.

I look forward to discussing these and other ideas with the rest of the panel.

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