The Economic Roots of Antitrust

An Outline by Thomas B. Leary [*]

I. Introduction

- I am pleased to join Hew Pate on this first high-level visit by U.S. Antitrust officials to China, following a number of staff visits in the last year and a half. We understand that China will soon adopt a national competition law. Our goal in the meetings here is to start a more formal dialogue with key agencies and officials here.

- The United States is a young country - - particularly, when compared to China. Competition law is one of the very few areas where we have had a longer experience than most, so it is not surprising that we are proud of it and like to talk about it. We hope that other countries will benefit from a discussion of our experience, including a candid admission of some mistakes that we have made.

- With that objective in mind, I would like to provide a brief overview of how competition law principles have evolved in the United States, from early populist concerns to the present emphasis on economics.

II. A Summary History of Competition Law in the United States.

- U.S. competition law is based on the Sherman Act, which was passed in 1890. The statute, which is still the bedrock of our law, broadly prohibited contracts "in restraint of trade" (Section 1) and actions to "monopolize" (Section 2). The language of the statute is general enough, and the legislative history is vague enough, to support varied interpretations in the intervening 114 years.

  - It is noteworthy that in 1890, 65% of the people in the U.S. lived in rural areas. (The figure is under 25% today.) These people had limited experience with large business institutions and were suspicious of them.

  - The U.S. was then a huge and thinly populated country, relatively isolated by distance from the rest of the world. It is therefore not surprising that early interpretations of the law reflected these insular attitudes.

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- In later years, additional competition laws were passed. The idea was to add some specificity to the Sherman Act's very general language and to deal with some practices at an early stage, before they had caused significant competitive harm. Thus, mergers were first specifically addressed in the 1914 Clayton Act. In the same year, the Federal Trade Commission (FTC) was created to provide administrative guidance on what was and what was not acceptable business conduct.

  - Standards of illegality, however, continued to be expressed in general terms. The Clayton Act's test for a merger was whether the deal would "substantially . . . lessen competition, or . . . tend to create a monopoly," without further elaboration (Section 7).

  - Similarly, the Federal Trade Commission Act prohibited "[u]nfair methods of competition," without further elaboration (Section 5).

  - General standards of this kind have the advantage of flexibility, and they have allowed the law to evolve with advances in the understanding of the commercial world.

  - General language, however, has also permitted application of competition law in ways that we now believe were profoundly mistaken.

- The interpretation of U.S. competition law as recently as thirty years ago was characterized, first and foremost, by a substantial concern over the sheer size of some business enterprises. Size and substantial resources alone were considered troublesome because - -

  - They would allow a company to "subsidize" some operations with profits from other operations, and thereby permit below-cost pricing and other aggressive tactics to drive targeted competitors out of business.
  - They would allow a company to invest in state-of-the-art facilities, or engage in research to develop better products or production methods - - in short, to become more efficient. This efficiency would confer a "competitive advantage" that could make it harder for smaller companies to survive.[1]

  - They would allow a company to shape consumer demand by extensive advertising and promotion, and even to affect the political environment, to the detriment of small enterprises and of society as a whole.

[1]Continental T.V. Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977).

- Other antitrust principles were based ultimately on a suspicion of size and special concern for small businesses.

  - It was assumed that so-called “concentrated” industries, dominated by a few large competitors, would inevitably be less competitive - - with excessive profits and less innovation.

  - All so-called “vertical” restraints that limited a dealer’s choices in the resale of products were assumed to be anti-competitive.

  - Intellectual property laws, which can confer some market power, were narrowly construed as contrary to basic antitrust principles.

- Beginning in the late 1970s, there was a dramatic change in the applications of competition law in the U.S. There were various contributing factors, but two are worth special mention:

  - Certain basic U.S. industries - - like steel, autos and consumer electronics- - were dramatically affected by efficient foreign competition. It became apparent that the U.S. could not continue a domestic competition policy that was fundamentally hostile to efficiency.

  - Policymakers became aware of emerging economic theories - - the socalled “new learning” - - which reflected a deeper understanding of the ways that industries operate. These theories demonstrated that certain business strategies, previously considered harmful, were in fact beneficial or benign. (Exclusive dealing or vertical restraints, for example, could be pro-consumer in many circumstances.)

  - At the same time, further economic research suggested that the higher profitability of large companies in concentrated industries was explained by their superior efficiency.

- In 1977, this “new learning” was embraced by the U.S. Supreme Court in the landmark Sylvania decision.[1] The narrow question before the Court involved the legality of territorial restrictions on dealer sales but the Court took the opportunity to endorse broad economic principles. Thereafter, lower courts and government prosecutors had to follow the Court’s direction.

III. Key Economic Principles that Guide Competition Policy in the U.S. Today

There was some initial resistance to the principles set out in the Sylvania case and similar decisions that followed. There is, however, general bipartisan agreement today on the following propositions:

- Competition law should be based on the economic welfare of consumers.

Consumer welfare is defined primarily to mean competitive prices and freedom of choice, not more nebulous social and political concerns.

- This does not mean that other social or political objectives - - like employment, balance of payments, health and safety, or environmental protection - - are unimportant. It does mean that these matters are not relevant when interpreting competition laws.

- It is also appropriate for the competition law agencies openly to advocate that other government agencies, which do have direct responsibility for these social and political matters, consider regulation that relies to the greatest possible extent on private incentives rather than detailed controls. We call this "competition advocacy."

• Efficiency is good and efforts to preserve efficiency should be encouraged, not condemned.

  - Sheer size can be beneficial because it may enable companies to achieve economics of scale and scope.

  - We want companies to grow and to earn higher profits that flow from superior efficiency.

  - On the other hand, a large enterprise that is shielded from competition - - either as a result of its own predatory behavior or, perhaps, a government-granted monopoly - - is likely to become progressively more inefficient over time.
  - If any company - - even a monopolist - - has achieved its market position by superior efficiency or by innovation, it is free to charge whatever prices it wants.

• Consumer welfare depends on the health of the competitive process overall, not the survival of an individual competitor or group of competitors.

  - The competitive struggle means that there are "winners" and "losers."

  - The important thing is to preserve competitive opportunities for efficient enterprises, not to preserve competitors that have fallen behind.

• Competition laws focus on effects within the United States and make no distinctions based on the nationality of enterprises.

  - Foreign companies which do business in the U.S. are subject to the same rules as purely domestic concerns.

  - We do not regulate the competitive conduct of U.S. firms abroad, unless there are some spillover effect in the U.S., and expect that these firms will be governed by the competition laws of the countries in which they do business.

- Improvements in consumer welfare are ultimately dependent on innovation and innovation itself ultimately depends both on aggressive competition and the protection of intellectual property.

  - U.S. competition law accommodates the protection of intellectual property - - even though there may be some immediate cost to consumers - - because it will encourage innovation over the long run.

  - Laws that protect intellectual property are no longer regarded as anticompetitive anomalies and they are no longer interpreted narrowly.

- Consumer welfare economics also explains the link between what we think of as “competition” laws and those that deal with “consumer protection.”

  - The FTC shares jurisdiction with the Department of Justice (DOJ) in competition law matters (“unfair methods of competition”) and, in addition, has jurisdiction over consumer protection matters (“unfair or deceptive acts or practices”)(FTC Act, Section 5).

  - Basic economics teaches that the prices and quantities of goods or services supplied depends on the interrelationship between “supply” and “demand.”

  - Competition law deals, for example, with agreements to fix prices or predatory efforts to eliminate rivals. These practices distort the supply side of the equation because they tend to elevate prices.

  - Consumer protection law deals, for example, with fraudulent or misleading sales promotions. These practices distort the demand side of the equation because they induce consumers to believe that they are buying something that is more valuable than it really is.

  - Competition law and consumer protection law therefore complement each other. Competition laws promote free and competitive markets, which provide consumers with lower prices, innovation and multiple choices. Consumer protection laws promote the exchange of accurate information, which enables consumers to make better informed choices.

- The present consensus on basic economic principles in the U.S. does not meanthat every case can be decided on a purely objective basis by the manipulation of statistics, or that there is no room for future evolution.

- Economics is itself an evolving science and the job of competition authorities is to apply, “whatever we know at any particular moment about the economics of industrial organization.”[2]

- Many, if not most, competition cases involve an effort either to predict the future or to reconstruct a past that never was. They may also require a balance between potential anticompetitive effects and potential efficiencies. Despite advances in our ability to measure and to model alternative scenarios, these decisions will always contain elements of uncertainty and subjectivity.[3]

IV. An Illustrative Case: The Evolution of Merger Policy

- The developments in competition law, generally outlined above, apply specifically to merger cases.[3] Merger law in the 1960s, and early 1970s, was dominated by a number of propositions that have since been abandoned:

  - It is important to preserve small-scale enterprises, even if they are less efficient and consumers therefore pay higher prices.[4]

  - There is a firm correlation between market “concentration” (i.e., a small number of competitors) and ineffective competition, and courts can simply assume this without proof in individual cases.[5]

  - Relatively insignificant competitive overlaps should be condemned[6] and an overall industry “trend toward concentration” was particularly troublesome.[7]

  - The acquisition of a supplier or customer was a matter of concern because it could “foreclose” competitors’ access, even if the market shares were small.[8]

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[2]This quotation is from a speech by William Baxter, the head of the DOJ’s antitrust Division in the early 1980s.

[3]For a more detailed account of merger law evolution, see Thomas Leary, The Essential Stability of Merger Policy in the United States, 69 Antitrust L.J. 105 (2002).

[4]Brown Shoe Co. v. United States, 370 U.S. 294 (1962).

[5]Stanley Works v. FTC, 469 F.2d 498, 504-05 (2d Cir. 1972).

[6]U.S. v. Von’s Grocery Co., 384 U.S. 270 (1966).

[7]U.S. v. Pabst Brewing Co., 384 U.S. 549, 552-53 (1966).

[8]Brown Shoe v. United States, supra n.4.

- Efficiencies were an aggravating rather than a mitigating factor because the resultant "competitive advantage" would lead to further concentration.[9]

- Underlying all of these doctrines was the unspoken premise that a decentralized economy served social and political goals.

• In the post-Sylvania environment that has prevailed for the last twenty-five years, merger policy has been based on entirely different assumptions. The principles that the antitrust agencies apply have been set forth in a series of Guidelines issued in 1982, 1984, 1992 and 1997. It is fair to say that the 1982 Guidelines were revolutionary and abrupt; the changes in successive versions have been evolutionary and gradual.

• The following themes are basic in the current application of merger law.

  - Mergers "should not be permitted to create or enhance market power or to facilitate its exercise."[10] This language signals three things: (1) Since "market power" is an economic concept, the Guidelines are grounded in economics; (2) merger law is still based to some extent on the statistical probability that markets structured in a particular way are likely to perform in a certain way; and (3) the law is therefore preventive and seeks to head off problems in advance.

  - Although the different versions of the Guidelines have subtle variations in the way that they define markets and describe the significance of market shares, they all require some identification of the principal competitors in the product or geographical markets that are the focus of concern.

  - Market concentration is still important, and substantial increases in already high levels of concentration will give rise to a presumption of illegality. Hwever, the importance of concentration measures hasdeclined over time, and the current version of the Guidelines cautions that market shares are only the "starting point for analyzing the competitive impact of a merger." This evolution makes it easier to defend a merger.

  - Efficiencies are uniformly recognized as factors in mitigation and the Guidelines have become progressively more hospitable to efficiency evidence that the parties present, in order to justify a transaction. This evolution also makes it easier to defend a merger.

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[9]Foremost Dairies, Inc., 60 F.T.C. 944, 1059, 1080-81 (1962).

[10]This language appears in all versions of the Guidelines, including the most current. More extensive quotations and full citations to these Guidelines are contained in the Leary article, supra n.3. In addition, excerpts from the 1989, 1992 and 1997 Guidelines are contained in ABA Section of Antitrust Law, Antitrust Developments (5th ed. 2002).

- Mergers are of less concern in industries that are easy for competitors to enter, for obvious reasons. There has, however, been an evolution that requires more rigorous proof that entry is likely. This evolution makes it harder to defend a merger.

• Although recent merger enforcement has focused on so-called "horizontal" mergers between actual or potential competitors, there have been some isolated examples of attacks on "vertical" mergers between suppliers and customers. The principal concern with vertical transactions is the possibility that outsiders will be denied significant access to suppliers and customers. Examples are limited, however, because most vertical mergers simply result in a realignment of supplier/customer relationships, rather than outright foreclosure.

• Some process issues should be mentioned. All mergers above certain size thresholds must be notified in advance both to the DOJ and the FTC, but only one will ultimately review the matter.

  - The allocation of responsibility between the two agencies is based on historic experience with different industries. (For example, the DOJ is likely to review a merger in the defense industry and the FTC is likely to review a merger in the pharmaceutical industry.)

  - There is a two-step filing process: (1) an initial, relatively modest submission that is required of all and (2) a more detailed "second request" that is required in a limited number of cases.\

  - The vast majority of cases are closed without agency action or even final compliance with a second request. Statistics covering the last 20 years, and the Administrations of four Presidents, indicate that the challenges by either the DOJ or the FTC have been relatively rare and remarkably consistent throughout the period (generally, in the 1% to 2% range).[11] This not only suggests stability of antitrust enforcement throughout this period but also a high level of predictability.

• The competition agencies make no distinctions based on the nationality of either party to a merger. The agencies focus exclusively on competitive effects in the United States, not effects in other areas of the world. Therefore, differences of opinion between the U.S. agencies and the agencies of other countries may be based on different substantive standards but may also be based on the fact that there are different effects in different areas.

  - We maintain an active dialogue with our counterparts in other countries, not only in general meetings like those we will engage in here but also in

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[11] See statistics set out in the Leary article, supra n.3.

the consideration of actual cases with an international dimension.

- We hope to lay the groundwork for similar interchanges with China.

- We believe that it is desirable to seek convergence in the application of merger law (or competition law generally), consistent with the needs and objectives of individual sovereign nations. An active and ongoing interchange will be helpful in achieving this objective.

• This is not to say that we are entirely satisfied with our current efforts or that we believe further changes are unnecessary. As mentioned above, merger enforcement before the fact always involves predictions of the future - - a process that we must always seek to improve but can never perfect.

Conclusion

I hope that this overview of competition policy generally, and merger policy in particular, has been of some interest to you and now I look forward to your questions and comments.