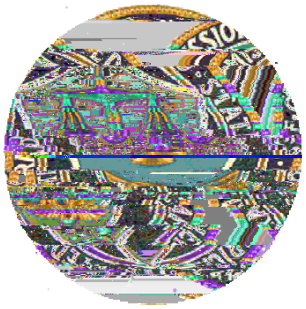

Federal Trade Commission

Antitrust Law Enforcement: What To Do About The Current Economics Cacophony?

Remarks of J. Thomas Rosch[1]
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before the

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Good evening. My remarks tonight will focus on the proper intersection between economic theory, on the one hand, and antitrust doctrinal analysis, on the other. I have been giving this topic some thought for quite a while. Indeed, my attorney advisor, Mandy Reeves, was likely surprised in April when I called from an airport to say that a New York Times book review that I had just read on the origins of quantum physics should inform our thinking on this topic.[2] In that book, The Age of Entanglement: When Quantum Physics Was Reborn, the author explains that for more than half a century, physicists were of sharply different views as to whether general relativity or quantum mechanics should supply the organizing principle to describe the relationship between atoms and subatomic particles. But in the 1960s, the discord

[1] The views stated here are my own and do not necessarily reflect the views of the Commission or other Commissioners. I am grateful to my attorney advisor, Amanda Reeves, for her invaluable assistance preparing this paper.

[2] Peter Galison, "Sons of Atom," New York Times (March 26, 2009) (reviewing Louisa Gilder, The Age of Entanglement: When Quantum Physics was Reborn (2009)).

began to ebb with the contribution of a new generation of physicists who suggested that a modified version of quantum mechanics could sensibly coexist with a theory of relativity.

What does all of this have to do with antitrust? I believe that we are on the brink of a similar moment in the history of antitrust. While the orthodox Chicago School of economics has long been at the forefront of antitrust analysis, there are several other economic theories percolating under the surface that I believe supply a better understanding of how market participants—more specifically sellers and buyers—actually behave. But the fundamental issue for those of us responsible for enforcing the antitrust laws remains the same—when should the conduct of those firms be viewed as anticompetitive? While I remain far from having all or any of the answers, this evening I would like to offer you some initial though

formulae.[5] Likewise, economists who testify before judges and juries themselves insist on using words of one syllable to explain their conclusions. And with good reason: in a recent piece published by Competition Policy International, Judge Vaughn Walker, who presided over the Oracle trial, argued that generalist judges lack economic training (and often interest) and that, as such, if economic evidence is to be persuasive, it must be communicated in a way that a generalist can understand and must be consistent with other evidence.[6] Complex economic theories are simply not comprehensible to many specialists like myself, let alone to a generalist.

This is all to say that, while I think that economics are an important ingredient in applying the antitrust laws, they are no substitute for the laws themselves. In this regard, I find support not only in Judge Walker's views, but in Justice Breyer's comments in his dissenting opinion in Leegin when he opined that "economics can, and should, inform antitrust law. But antitrust law cannot, and should not, precisely replicate economists' (sometimes conflicting) views."[7] I think it is safe to say that I share that view.

[5] In his annual letter to Berkshire Hathaway shareholders earlier this year, Warren Buffet harshly criticized the impenetrable mathematical formulae that were fashionable in business before the

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Next, I would like to discuss the role economic theory has played over the last forty years in antitrust analysis and highlight some strengths and weaknesses of the competing economic theories that already do or arguably should play a role in antitrust analysis.

To be sure, the most dominant school of economic thought in antitrust analysis is the orthodox Chicago School. As I see it, there are two fundamental premises that underlie that school: first, markets if not perfect, correct themselves quickly; and second, firms accordingly generally act rationally, which is to say that they generally act to maximize profits, instead of engaging in predatory behavior which will be nullified by market corrections.[8]

These principles, which have their origins in Friedrich von Hayek's and Milton Friedman's views, began bubbling to the surface in the late 1960s through, among other things, Nobel Prize winning economist George Stigler's 1964 article "A Theory of Oligopoly" in which he explained that it was improper to assume that firms in an oligopolistic market would find a way to agree to raise prices above competitive levels.[9]

The Chicago School came to the forefront of antitrust law in the late 1970s. During this period, the Supreme Court embraced the Chicago School way of thinking in its 1977 GTE Sylvania decision where the Court overturned its 1967 decision in Schwinn and held that non-

[8] See J. Thomas Rosch, "The Common Law of Section 2: Is it Still Alive and Well?" Remarks at George Mason Law Review 11th Annual Antitrust Symposium, Washington D.C. (Oct. 31, 2007) (discussing influence of Chicago School on Roberts Court antitrust de

price vertical restraints were subject to the rule of reason.[10] The Court cited then Professor Posner's 1976 book, Antitrust Law: An Economic Perspective, as support for the proposition that economists had identified several ways in which manufacturers use non-price vertical restraints to compete against other manufacturers.[11] The following year, Robert Bork penned The Antitrust Paradox which collected the Chicago School's basic tenets in one place and provided one of the most—if not the most—significant contributions to antitrust law in the 20th Century.[12] Bork asserted that many of the then current cases applying the antitrust laws were irrational and actually hurt consumers. He also argued that consumers were often beneficiaries of corporate mergers. With Ronald Reagan's victory in 1980 and Posner and Bork's appointments to the federal appellate bench in 1981 and 1982, respectively, the Chicago School's ascendancy as providing the predominant organizing principles for antitrust law was complete.

With the recent financial crisis, however, one has to wonder if the Chicago School's fundamental presumptions are still tenable. In a January speech before the New York Bar Association, I suggested that, in light of the economic crisis, the Chicago School was on life

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[10] United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967), overruled by Continental T.V., Inc. v. GTE Sylvania, 433 U.S. 36 (1977).

[11] GTE Sylvania, 433 U.S. at 54–55. The Court noted that

> Economists have identified a number of ways in which manufacturers can use such restrictions to compete more effectively against other manufacturers … Service and repair are vital for many products, such as automobiles and major household appliances. The availability and quality of such services affect a manufacturer's goodwill and the competitiveness of his product. Because of market imperfections such as the so-called "free rider" effect, these services might not be provided by retailers in a purely competitive situation, despite the fact that each retailer's benefit would be greater if all provided the services than if none did.

Id. at 55. Relying solely on economic theory, the Court found that a manufacturer's limitation of intrabrand competition actually aided that manufacturer in the interbrand market. Id. at 56.

[12] Robert H. Bork, The Antitrust Paradox: A Policy at War with Itself (1978).

self-healing powers – of laissez-faire capitalism."[16] If Judge Posner is arguing that the markets failed to self-correct, it is safe to say that the Chicago School is indeed teetering on the edge of collapse.[17]

Apart from the current economic crisis, though, the more I read about alternative economic theories, the more I am certain that the Chicago School does not even accurately portray how buyers or sellers behave. The truth is—I doubt that there is any one economic theory respecting the way that buyers or sellers behave that accords with the real world. I have, however, identified three

some instances). Some examples are Salop's "raising rivals' costs" theories,[18] Whinston's "tying" theories,[19] and Creighton's "cheap exclusion" theories.[20] Although it's a closer call, I would also add to this list Einer Elhauge, in light of his recent thought-provoking article, Tying, Bundled Discounts, and the Death of the Single Monopoly Profit Theory,[21] to the category of post-Chicago School theorists. Although these theories do offer a more sophisticated, nuanced view of seller behavior than the orthodox Chicago School, the post-Chicago School theorists still principally subscribe to the view that profit-maximization is the organizing principle around which antitrust law should evolve.

The second economic theory is the one that Professor Joe Farrell, the FTC's new Director for the Bureau of Economics, has espoused in a piece called Complexity, Diversity, and Antitrust that appeared in the Spring 2006 issue of The Antitrust Bulletin.[22] I call his theory "experimentation" theory. Under that theory, which focuses on the sell-side of markets, most business firms do not engage in behavior that they consider profit-maximizing from the get-go. Instead, Farrell argues, firms engage in a trial-and-error process to identify which conduct will be

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[20] See, e.g., Susan A. Creighton, et al., Cheap Exclusion, 72 Antitrust L.J. 975 (2005). 21

Einer Elhauge, Tying, Bundled Discounts, and the Death of the Single Monopoly Profit Theory, available at http://www.law.harvard.edu/programs/olin_center/papers/pdf/

[22] See, e.g., Joseph Farrell, Complexity, Diversity, and Antitrust, 51 Antitrust Bull. 165 (Spring 2006).

profit-maximizing for themselves over the long run. Sometimes their experiments are successful, and sometimes they are not.

David Teece has also set forth a similar theory in the context of discussing the economics that underlie innovation.[23] Teece has argued that the concept of static competition, which looks only at price competition by rational agents for existing products, "reflects an intellectual framework" and "not a state of the world." In contrast, he argues, dynamic competition is driven by the trial and error efforts of innovators and institutional structures that support innovation. Again, speaking frankly, the theories that Farrell and Teece have posited are most consistent with my own real world experience. Perhaps that is because the behavior of most firms is determined by the decisions of middle managers, not senior executives, much less economists.

Third and finally, there are the behavioral economists, who contend that many, if not most, business firms, as well as consumers, behave irrationally or, at the very least, do not always behave in a perfectly rational manner. That literature has been gathered together by, among others, Professor Maurice Stucke.[24] Although behavioral economics bears some similarities to Farrell and Teece's experimentation theory in that it can inform understandings of behavior on the sell side, behavioral economics is arguably most useful in informing an analysis of the motives of parties on the demand or buy side of any given transaction.[25] Indeed, I think that one of the most significant insights from the behavioral economics literature is the

decisions based on factors other than price and quality—when there is a situation with less or imperfect competition, the government should engage in consumer protection efforts in those cases rather than sitting back and waiting for a market to heal itself.[26]

Dennis Carlton has told me that while behavioral economics may be very useful in analyzing the behavior of individuals, it has little application to firm conduct. But I wonder about that distinction. After all, firms—and particularly the middle managers in firms—are just collections of individuals. There is recent literature that confirms that view. Economists George Akerlof and Robert Shiller of Berkeley and Yale, respectively, have just published Animal Spirits in which they resurrect behaviorally-informed Keynesianism to show that free-market ideology is fundamentally incomplete because it fails to account for the fact that human irrationality infects human decision-making and, thus, decisions that govern how the market actually (as opposed to hypothetically) functions.[27] Likewise, in Jones v. Harris, a securities case which is now at the Supreme Court, Judge Posner himself has recently advanced a behavioral economics approach—and sharply rejected Chief Judge Easterbrook's free-market theory—in his dissent from the Seventh Circuit's denial of rehearing en banc.[28] Consistent with the behavioral

[26] Id. ("We know that the competitive process will protect consumers even if they are myopic and don't realize what's going on. So if there is lots of competition, we should worry less about consumer protection. If there is less competiti

economics literature, Posner observed that, in the absence of a competitive market, regulation is needed to protect consumers because market participants are not infallible.

United States. Third, it is also consistent with

or firms engaging in the practices enjoy monopoly or near monopoly power in a relevant market. The Court's decisions in NCAA v. Board of Regents and Indiana Federation of Dentists are examples of those cases.[32] In other instances, however, experience with a practice does not teach that the practice is likely to injure consumer welfare. Then, it may be appropriate to look to circumstantial evidence of that probable effect, such as whether the practice was intended to have that effect;[33] or whether, in Section 2 cases, the practice is accompanied by other exclusionary practices.[34] Or, as in California Dental Association v. FTC, it may be necessary to prove that the firm or firms engaging in the practice enjoy monopoly or near monopoly power.[35] Otherwise, consumers can turn to alternative suppliers in order to avoid injury from the parties. Or, put differently, absent monopoly or near-monopoly power, the practice is not likely to have market-wide effects on prices, output, quality and/or innovation that are harmful to consumers. The fundamental point is that in any case, a practice can properly be considered to be "inherently suspect" because it is likely to injure consumer welfare, regardless of whether the practice is rational, irrational or experimental.

Efficiencies, however, are a second essential element in a structured rule of reason analysis. They may take many forms, including lower prices, superior quality, and enhancement of innovation. Again, moreover, whether the practice was rational, experimental or irrational is irrelevant. If it produces efficiencies that outweigh the likely consumer injury, the practice should not be condemned. That said, though, in order to rebut the presumption arising from proof

that a practice is inherently suspect, the defendant must bear the burden of proving offsetting efficiencies.

Structured rule of reason analysis is consistent with U.S. antitrust case law generally. It is plainly consistent with the law in Section 1 cases. Indeed, it has its roots in the Section 1 case law. Section 1 of course also requires proof of an agreement, and as a technical matter, it may be argued that monopoly or near monopoly power will never exist in a Section 1 case because monopoly is a term of art that presupposes single firm conduct. But firms who are participants in a duopoly or a tight oligopoly market collectively enjoy power that is akin to monopoly power in the sense that that they have the power to increase prices and reduce output in the market as a whole. Thus, the fact that injury to consumer welfare is likely to flow from a collective exercise of monopoly or near monopoly power instead of from single firm conduct may be considered a distinction without a difference. That is probably why the analytical framework has been applied in Section 1 cases without any mention of the issue.

It may be argued that insofar as proof of collective monopoly or near-monopoly power is required, structured rule of reason analysis imposes on plaintiffs a higher burden of proof than they would bear in a traditional rule of reason case. I am not sure that is true. Absent proof that experience established that a practice is likely to injure consumer welfare, the regional appellate courts have generally required proof of that kind of power, reasoning that otherwise the practice is unlikely to adversely impact market-wide competition, which is what the antitrust laws were designed to prevent.[36] Moreover, the structured rule of reason framework certainly casts a lighter burden on plaintiffs than does a traditional unstructured rule of reason requirement, in which the

[36] R.C. Dick Geothermal Corp. v. Thermogenics, Inc., 890 F.2d 139, 151, 153 (9th Cir. 1989) (en banc); Capital Imaging Assocs. v. Mohawk Valley Med. Assocs., 996 F.2d 537, 546 (2d Cir. 1993).

plaintiff bears the burden of proof throughout the analysis, without the burden ever shifting to the

have that effect, the practice can be justified by proof of efficiencies.[41] In short, there is nothing in the Section 2 case law that differentiates among kinds of exclusionary conduct based on whether it is rational, experimental or irrational.

Structured rule of reason analysis has not been used historically in Section 7 cases. Again, however, there is no reason it cannot be. Proof of a Section 7 violation requires proof that a transaction is likely to result in an exercise of monopoly power or a substantial lessening of competition. That is exactly the kind of effects-based proof of the kind I have described, except that it results from the transaction rather than a single firm practice or agreement.

Finally, it may be argued that under the case law proof of efficiencies is not permitted under Section 7. Courts have so held in merger cases.[42] However, since the 1992 Merger Guidelines, the agencies have permitted respondents to adduce offsetting efficiencies, just as they are under a structured rule of reason analytical framework.[43] Thus, use of a structured rule of reason analytical framework in Sherman Act cases is not inconsistent with Section 7 law enforcement.

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[41] See, e.g., Multistate Legal Studies v. Harcourt Brace Jovanovich Legal and Prof'l Publications, Inc., 63 F.3d 1540 (1995).

[42] FTC v. Procter & Gamble Co., 386 U.S. 568, 580 (1967) (rejecting efficiencies claims and declaring that "[p]ossible economies cannot be used as a defense to illegality") (citing Brown Shoe Co. v. United States, 370 U.S. 294, 244 (1962)); United States v. Mercy Health Servs., 902 F. Supp. 968 (N.D. Iowa 1995) (rejecting efficiencies defense to a claim that a merger was anticompetitive); cf. FTC v. Staples, Inc., 970 F. Supp. 1066 (D.D.C. 1997) (noting that in light of the 1992 Merger Guidelines, whether efficiencies "may be used to rebut the government's prima facie case is not entirely clear").

[43] See 1992 Merger Guidelines, § 4 ("The Agency will not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market.").

Structured rule of reason analysis is also consistent with the European Commission's recent Article 82 Guidance.[44] Indeed, the major underlying theme in the Guidance is that Article 82 may be violated when a dominant firm engages in exclusionary practices that threaten consumer welfare by eliminating or crippling rivals or would-be rivals from constraining the dominant firm's exercise of its power.[45] That is one of the central concerns that is addressed in structured rule of reason analysis, and it would be squarely addressed by applying that analytical framework in Sherman Act Section 2 cases.

The Guidance is also quite clear that both direct and circumstantial evidence may be used to prove that this has occurred. More specifically, direct evidence in the form of evidence that the practice at issue has actually had that effect, as well as historical evidence respecting the likelihood that it will have that effect, may be adduced but it is not required. Circumstantial evidence may suffice instead.[46] For example, proof that that effect was intended or that the practice at issue was just one of multiple exclusionary practices employed may be used.[47] In the case of refusals to license or deal, proof that th

United States permits use of this kind of circumstantial evidence.[49] There is nothing in the case law applying structured rule of reason analysis to indicate that such circumstantial evidence would be excluded from that analytical framework.

Finally, the EC's Guidance permits defendants to prove that there are offsetting efficiencies.[50] However, as in structured rule of reason analysis, the efficiencies must be shown to outweigh the anticompetitive effects that make the practice inherently suspect in the first place.[51] The EC's principal legal officer, Philip Lowe, has made it clear that although the Commission will generally consider whether the practice at issue has excluded competitors who are as efficient or more efficient than the defendant, it will take into account whether an excluded rival that is a less efficient rival is only that way because of the defendant's superior economies of scale or scope.[52] Again, however, there is nothing in the United States case law to rule out that kind of flexibility.

What role for economists is there in this analysis? I would suggest that it is very much the same role that economists have heretofore played in antitrust cases. Although market definition and market shares are not the only way to prove the existence of monopoly or near-monopoly

[49] See, e.g., Microsoft, 253 F.3d 34 (D.C. Cir. 2001) (holding that evidence of intent is

power, like dominance in the EC, monopoly or near-monopoly power can be proved by evidence of actual anticompetitive effects.[53] As such, that is one way to prove or disprove its existence. In pricing cases, the proper measure of costs will continue to be debated. And whether there are offsetting efficiencies will remain a subject of controversy. In all of these areas, economists have traditionally made substantial contributions. There is no reason why they will not continue to do so. For this is essentially old wine in new bottles. The economic theories respecting the way that markets and business firms behave may have changed. But there is no need to change the legal framework in which business practices and transactions are evaluated under the antitrust laws. Indeed, arguably the proper legal framework is more generally applicable than we have supposed.

In sum, while I do not believe that antitrust law has yet to settle on the right economic theory (or group of theories as the case may be) to accurately account for the complexities of rational and irrational seller and buyer conduct, I think in the last few years, developments in economic thinking have brought us much closer to that objective. And just as in the 1960s, quantum physics was reborn stronger than ever, I am hopeful that as these ideas are incorporated into the mainstream thinking among members of the judiciary and the antitrust bar, we will soon see new life breathed into the antitrust laws through a doctrinal framework that can best identify

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