

## ANTITRUST LAW AND POLICY: AN INTRODUCTION

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### 1 The Role of Competition in a Market Economy

In the midst of the devastation brought by the Thirty Years' War, the idea took root that *everyone* could enjoy a decent standard of living. Such universal opulence, not the treasures hoarded by the King, not the size of armies and navies, determined the wealth of a nation. Achieving a decent standard of living for everyone required peace and a dramatic increase in production: food, clothing, shelter, education, etc. The social arrangements capable of producing universal peace and wealth were (a) the social contract in the political sphere and (b) the market in the economic sphere.

Altruism and self-interest, philosophers argued, motivate people to transition from a (nasty, brutish) state of nature to an orderly state of peaceful productivity. Both sentiments are universal, but each has intrinsic limitations. Altruism creates incentives for peaceful and productive cooperation among family and friends, but it doesn't scale beyond a small circle. Among strangers, self-interest is a more robust motivational assumption, but it does not automatically lead to peaceful exchange and division of labor. Rather, the pursuit of self-interest may just as well result in widespread deception, exploitation, and violence. Savages, after all, are self-interested, too. In other words, altruism points in the right direction but doesn't scale. Self-interest scales, but doesn't reliably point in the right direction.

What to do?

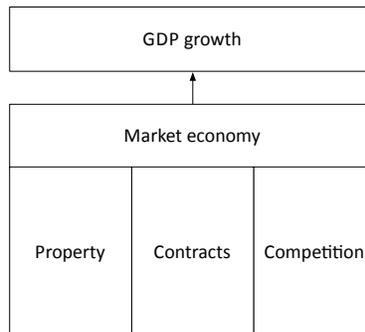
One school of thought focused on *improving human nature*. If we were better people, then altruism would scale. This is the

tradition of Jean Jacques Rousseau. Another school was less sanguine about the malleability of human nature. Rather than trying to scale altruism, it focused on designing social institutions to align self-interest with the common good. This is tradition of Thomas Hobbes and Adam Smith.

Their basic idea was that properly designed social institutions combining elements of (1) private property, (2) freedom of contract, (3) competition, and (4) a central authority to enforce the basic rules, would reliably compel, trick, or at least nudge everyone into that sub-set of self-interested actions that *also* promote the public good, defined as a peaceful life and an ever-increasing standard of living.<sup>1</sup>

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<sup>1</sup> Some of the persistent controversies about modernity can be traced back to this early mission statement. First, *everyone* had to be recruited into the nation-wide production effort – there is no opting out. Contracts property, and competition permeate every aspect of *everyone's* lives and “contributing to society” requires playing by those rules. This is the root of the *commodification* argument. Second, while the creation of the authority to enforce property, contract, and competition rules may have involved some form of express, implied, or imputed original contract, most later generations can confidently claim that they never agreed to anything of this sort. This is the central weakness of our contractual derivation of political legitimacy. Third, creating social institutions that use people's self-interest to promote the public good unbundles motive and effect of our actions. From a base motive (self interest) springs a moral good (universal opulence), irrespective of whether the individual actors *want* to promote the public good or not. This is disquieting, because motive is generally highly significant to our judgment of the moral value of an action. Some therefore feel that removing motive from consideration for the most basic organizing principle of a society lowers the moral status of modern society as such. Lastly, growth is part of the definition of the public good. A market society is designed to



Competition, the focus of our inquiry, is essential for a functioning market system. It creates the incentives for firms to increase (a) productive efficiency, i.e., to produce more with less, (b) allocative efficiency, i.e., to deploy resources where the value placed on a good by the consumer is greater than the cost of making it, and (c) to invest in innovation. In addition, competition disperses private power. Dispersion of private power protects (d) smaller firms from being deprived of their freedom to compete by more powerful firms, and (e) the democratic process.<sup>2</sup> Lastly, (f)

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continuously improve living conditions, not to merely maintain them. But what if there are limits to growth – practical or moral limits? Sustainability has thus been promoted as an alternative to the growth paradigm.

<sup>2</sup> *Northern Pacific Railway Comp., v. U.S.*, 356 U.S. 1, 4 (1958) (“The Sherman Act was designed to be a comprehensive charter of economic liberty aimed at preserving free and unfettered competition as the rule of trade. It rests on the premise that the unrestrained competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress, while at the same time providing an environment

competition ensures that contracts are not only economically efficient but also generate distributive outcomes that can plausibly be presumed to be fair. The fairness-generating properties of contracts are essential to the moral legitimacy of the economic and the political system.<sup>3</sup>

However, competition only creates such incentives *if everyone has to compete*. This is a problem, because a fair fight in the marketplace may not always be the most profitable strategy for each individual player. The potential mismatch between the societal goals (improving the *overall* standard of living) and individual goals (maximizing *firm* profits) creates incentives for firms to avoid market competition and to engage in anticompetitive strategies instead. At this point the antitrust laws step in *to protect the legislative decision for competition as the rule of trade from being undermined by private market participants*.

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conductive to the preservation of our democratic political and social institutions.”)

<sup>3</sup> As long as contracts are entered into voluntarily between competent parties, absent fraud, error, and vastly unequal bargaining power, we may plausibly presume the distributional outcome of an agreement to be fair. From a rights-based perspective, voluntary agreements among equals create obligations in an autonomy-preserving way, because no injustice is done to the willing (*volenti non fit injuria*). (Kant). From a consequentialist viewpoint, voluntary agreements are likely to be mutually beneficial, because otherwise at least one of the parties would have withheld its consent. (Hobbes). Both the rights-based approach (with the exception of a Nozick-style formalism) and the consequentialist approach require some measure of procedural and substantive equality for an agreement to be morally justified as fair. Antitrust seeks to prevent systemic inequality in bargaining and thus does its part in protecting the institution of the contract as a justice-generating procedure.

## 2 Antitrust Law's Basic Two-Prong Structure

Most antitrust offenses require (1) a minimum degree of market power and (2) anticompetitive conduct, except for a small set of hardcore offenses, where the conduct is so overwhelmingly likely to harm competition that it is conclusively presumed illegal, irrespective of the actor's market power level.<sup>4</sup>

## 3 Market Power

Market power is a measure of *how important* a market participant is to its trading partners. The only provider of broadband services in a city is an indispensable trading partner for those who seek to use the Internet. Similarly, there are few viable alternatives to Google for online search advertisers. Companies whose products are indispensable, essential, or otherwise hard to replace have greater pricing flexibility than sellers of commodity products. They have market power.

Because the degree of market power enjoyed by a product depends on (a lack of) available alternatives, the number of firms producing competing products and their relative shares of the relevant market has emerged as proxies for market power. The more firms there are producing substitute products, the less essential trading with any of them becomes. Market power declines as alternative sources increase. Relative share is important as well, because a market with four firms of roughly equal market share (30%, 25%, 25%, 20%) is more competitive than a market with a lopsided distribution (e.g., 80%, 10%, 5%, 5%). Today, most courts and agencies consider markets with at least *four serious*

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<sup>4</sup> Further exceptions to this rule are §5 FTC Act, which does not have an express market power requirement, the conspiracy to monopolize offense (§2), and certain provisions of the Robinson-Patman Act.

*competitors* as competitive. Competitors are serious, if they compete head-to-head with the other market participants and either are established and have a market share of about 20% or are aggressive entrants with a plausible potential of disrupting competition.

As a practical matter, there are three market power levels in antitrust law: low (0-29%), medium (30-59%), and high (60%-100%). Broadly speaking, antitrust law does not interfere with the conduct of low market power firms.<sup>5</sup> Successfully executing anticompetitive strategies requires a certain minimum weight that a firm can throw around. Firms within the medium market power category are subject to a set of baseline prohibitions against anticompetitive conduct. These firms have sufficient market power to harm the competitive process but are not so powerful that a special regulatory oversight would be warranted. Firms in the high market power category have to abide by the baseline prohibitions and have additional special obligations not to harm the competitive process. Thus, depending on the market power level, the antitrust laws impose different sets of conduct requirements.

Power level	Conduct requirements	<i>Per se</i> prohibitions
Low	—	<i>Per se</i> conduct
Medium	Baseline conduct prohibitions	prohibitions apply irrespective of market power levels
High	Baseline conduct prohibitions and special obligations	

#### 4 Conduct

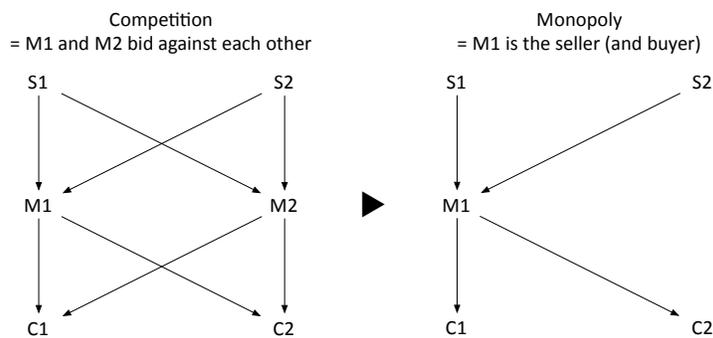
There are three basic anticompetitive strategies: combination, exclusion, and leveraging.

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<sup>5</sup> Except for *per se* offenses that operate independent of market power.

#### 4.1 Combination

Suppose that in a market with two firms of equal size (M1 and M2), one firm acquires the other. The merger replaces a duopoly with a monopoly (“two-to-one merger”). The combined firm has the incentive and ability to raise prices, because M1’s customers can no longer defect to M2 if they are unhappy with M1. A similar result obtains if M1 and M2 enter into an agreement not to compete on price, quality, or product development. In the latter case, the effect of the (*per se* illegal) cartel agreement is the creation of a *de facto* monopoly, the profits of which M1 and M2 share.<sup>6</sup>




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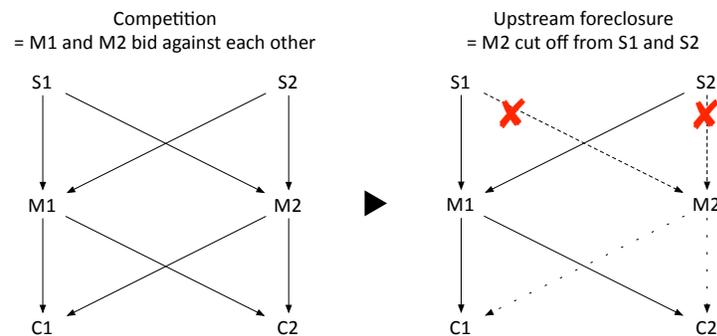
<sup>6</sup> From a welfare economics standpoint, cartels are usually worse than monopolies, because one huge firm (monopoly) is more likely to realize efficiencies of scale than two large firms that merely agree not to compete (cartel). The potential for creating efficiencies is the key rationale for the “merger privilege,” that is, the reason for the more lenient treatment of mergers, even though the result of a horizontal merger is the elimination of a competitor.

## 4.2 Exclusion

Suppose that M1 does not want to share potential monopoly profits with M2 or M2's shareholders. Rather, M1 seeks to eliminate M2 altogether. To that end, M1 can strike at M2's *upstream* access to suppliers or at M2's *downstream* access to customers.<sup>7</sup> Note that exclusionary strategies will likely fail if M1 and M2 are evenly matched players, so assume that M1 has a significantly greater market share than M2 for purposes of the following examples.

### a Upstream Foreclosure

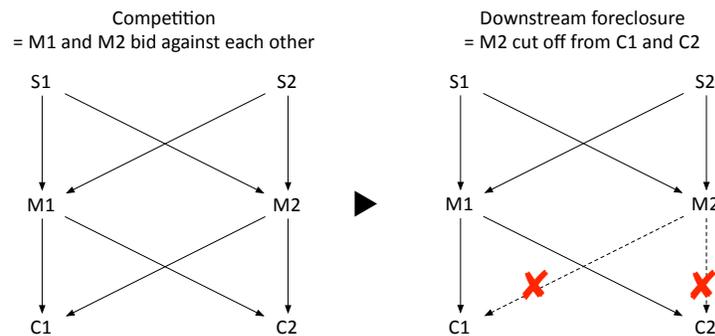
M1 enters into exclusive supply contracts with the only two available suppliers S1 and S2 such that S1 and S2 agree to only sell to M1. As a result, M2 is denied access to essential inputs and will exit the market once its inventories are depleted. Once M2 has left the picture, M1 enjoys monopoly power.



<sup>7</sup> Traditionally, we follow the flow of goods to determine who's upstream and who's downstream. Goods flow from a less finished state (upstream) towards a more finished state (downstream). Ultimately, there are used up (consumed) by the consumer.

*b Downstream Foreclosure*

Downstream foreclosure follows the same logic as upstream foreclosure. M1 enters into exclusive supply agreements with the only two available customers C1 and C2 such that C1 and C2 agree to satisfy their entire demand with M1's products. Here, M2 continues to have access to supplies and can still produce its goods, but it has lost access to its customer base. Unable to generate revenues, M2 will exit the market and M1 will remain as the monopolist.

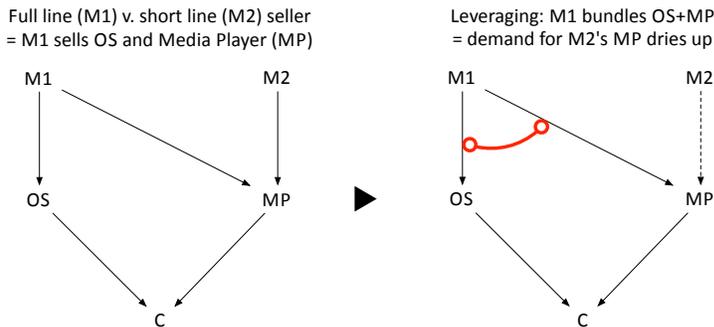


Of course, in reality there will almost always be alternative channels of distribution, substitute supplies, and great reluctance on the part of the suppliers and the distributors to support M1 in its quest for increased market power. Exclusion, however, does not have to be absolute in order to slow the growth of a competitor, and to allow the excluding firm to enjoy significant supra-competitive profits. It is often sufficient for the predator to relegate its prey to less desirable channels of distribution or second-tier customers. Raising a rival's cost and flattening the growth trajectory of a nascent threat are often enough to defend a dominant market position.

### 4.3 Leveraging

Exclusionary conduct is aimed at protecting a firm’s market position from encroaching competitors. It is *defensive* in nature. Exclusion involves a single market (A) that the excluding firm seeks to defend against competitors who seek entry or expansion.

Leveraging is different. It involves *two* markets, one in which the leveraging firm has meaningful market power (A) and another in which it faces more competition (B). Leveraging is *offensive* in nature, because a company projects its market power from one market (A) into another (B). The two markets are connected in that *the same customers purchase products A and B*. Most leveraging conduct therefore occurs with complementary products (e.g., operating systems and browsers, film projectors and film, printers and ink, canning machines and salt, etc.)



Suppose that M1 sells its “must have” operating system (“OS”) to customer C. In order to play media files, C also needs a media player (“MP”). Both M1 and M2 offer media players and compete for C’s business. M1 now bundles a media player with its operating system, i.e., instead of selling “OS” and “MP” separately, C now sells a bundle of “OS + MP.” As a result, demand for M2’s

competing media player will dry up, because everyone who may want a media player also needs an operating system, and everyone who has (a new copy of) an operating system, already has M1's media player. Over time, M2 will exit the "MP" market, and M1 will enjoy a monopoly position in *two* markets: OS and MP.

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