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## Comment on Cooper et al.'s "Vertical Restrictions and Antitrust Policy"

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This paper provides a critical analysis of the paper on vertical restraints and competition policy by James Cooper et al. The author expresses mild disagreement concerning the origins and content of the relevant theory, although he agrees that theory offers ambiguous guidance to antitrust enforcers. Instead of the go/no-go decision-theoretic framework advocated by Cooper et al., the author endorses the nuanced sequential decision-making approach used in the real world of antitrust enforcement. And most importantly, the author argues that the sample of empirical studies Cooper et al. propose to use as the underpinning of their decision-theoretic guidance is seriously biased toward arguably benign cases. Some important cases ignored by the authors, but in which vertical restraints had serious anti-consumer effects, are also summarized.

The author is a Professor Emeritus at Harvard University. The suggestions of William S. Comanor and Robert L. Steiner are gratefully acknowledged.

## I. Introduction

This paper comments on a paper by James Cooper, Luke Froeb, Daniel O'Brien, and Michael Vita on antitrust enforcement approaches to vertical restraint practices.<sup>1</sup> It agrees with Cooper et al. that theory provides guidance too complex to be of much help when used unaided in selecting cases, but dissents on some detailed theoretical points. It suggests that instead of the one-stage decision-theoretic approach proposed by Cooper et al., a sequential decision-making strategy is preferable. It argues that the survey of papers on vertical restraints by Cooper et al. is severely biased, ignoring important cases in which vertical restraints had significant anti-consumer consequences. Even if a decision-theoretic framework were adopted, biased evidence would be an inappropriate foundation.

Cooper et al. make three important points:

- 1) Existing economic theory on the welfare consequences of vertical restraints is at best “fragile.” In effect, the models are so sensitive to assumptions and parameter variations that anything is possible.
- 2) Given the fragility of theory, agencies responsible for enforcing antitrust policy should base their strategies on a generalized weighing of possible beneficial and adverse effects, with prior experience playing a key role in the weighting.
- 3) The prior experience, or so-called empirical evidence, that should be factored into that weighting reveals vertical restraints to be preponderantly benign.

This paper will address each point in turn.

## II. The Theory

I concur in most respects with the authors' pessimism about the predictive power of economic theory,<sup>2</sup> adding only three quibbles.

- 1) First, Cooper et al. attribute the change in theoretical views toward vertical restraints to the Chicago School. This, I believe, is a gross oversimplification. Lester Telser's 1960 paper<sup>3</sup> was an important contribution, but at the time there was already an extensive economic lit-

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1 J. Cooper, L. Froeb, D. O'Brien, & M. Vita, *Vertical Restrictions and Antitrust Policy: What About the Evidence?*, 1(2) COMPETITION POL'Y INT'L 45–63 (2005) [hereinafter Cooper et al.].

2 See also the concurring view of F. Fisher, *Organizing Industrial Organization*, in BROOKINGS PAPERS ON ECONOMIC ACTIVITY, MICROECONOMICS (M. Baily & C. Winston eds., 1991), at 201–225.

3 L. Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. ECON. 86–105 (1960). I confess negligence in not citing it in the first (1970) version of my industrial organization textbook (F. M. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE (1970)).

erature on vertical restraints, pro and con, from all parts of the academic and legal worlds. One of the most powerful early critiques of tying came from a former University of Chicago economics professor, John McGee.<sup>4</sup>

- 2) Second, I agree with Cooper et al. that vertical integration can sometimes solve a serious problem: double (or pyramided) markups. I have endorsed that inference in print for at least 35 years, but on each occasion, I erred in identifying the first correct economic analysis of the problem. My latest attribution is that Alexander Hamilton had the correct insight first in his analysis, in *Federalist Paper No. 22* (1787), of multiplied river tolls in Germany. And in that very important case, which as Hamilton recognized impeded German economic development, the remedy was not vertical integration, but abolition of the Raubritters' toll-setting monopoly power.<sup>5</sup> Hamilton speculated that the genius of the American people would guard against such restraints on trade.
- 3) Third, Cooper et al. accept the conventional, Borkian view that if vertical restraints such as resale price maintenance are output-enhancing, they are also welfare-enhancing. I confess frustration that virtually no one acknowledges (and no one has challenged) my proof, and the parallel one by William S. Comanor, that the Bork theorem is not true in generality.<sup>6</sup> It is interesting that Cooper et al. twice emphasize the case—when extra services induce consumers to purchase an item when otherwise they “are indifferent between purchasing or not”—in which vertical restraints are likely to be welfare-reducing.

### III. The Decision-Theoretic Tradeoff

Given the ambiguities of theory, Cooper et al. propose that in deciding whether to challenge particular vertical restraints, antitrust enforcers should follow the metaphor of statistical decision theory, weighing all the empirical evidence (summarized as “prior beliefs”) one has on the adverse welfare effects of vertical restraints, ignoring which would lead to false negatives, against the welfare-enhancing effects, ignoring which would lead to false positives. In doing this, decision makers would be cramming together huge amounts of heterogeneous past experience, much of it different from, or irrelevant to, the specific practice at issue. That in itself is a problem. But ignoring that point, such general rules

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4 J. McGee, *Compound Pricing*, 25 *ECON. INQUIRY* 315–39 (1987).

5 See F. M. Scherer, *Vertical Relations in Antitrust: Some Intellectual History*, 49 *ANTITRUST BULL.* (Winter 2004), at 852.

6 F. M. SCHERER & D. ROSS, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* (3rd ed. 1990), at 541–48 (recasting a 1983 article) and W. Comanor, *Vertical Price Fixing and Market Restrictions and the New Antitrust Policy*, 98 *HARV. L. REV.* 990–98 (1985).

are no better than the quality of the evidence weighted, and as I shall argue in Section IV, severe biases pervade the weighting—call it the garbage compactor approach—proposed by Cooper et al.

More importantly, Cooper et al. show no recognition of how actual antitrust enforcement actions are taken and, therefore, propose a faulty decision-making approach. The true and correct model—much like the way both private enterprises and government agencies pursue research and development under uncertainty<sup>7</sup>—applies sequential decision-making theory. The process begins with an external complaint or a media exposé. Especially in government agencies, the next step is to assign an economist or attorney to spend at most a few person-months preparing a preliminary analysis using all the evidence readily and inexpensively at hand, mostly from public sources. Only if the analysis predicts public benefit from an enforcement action—and from my experience at the U.S. Federal Trade Commission (FTC), most proposals founder at that early stage—are complaints and subpoenas issued, escalating costs but still causing no long-term consequences (unless the respondents' own analysis reveals that they bear a substantial risk of losing a litigated case). More analysis follows, permitting an able staff to make reasonably well-considered judgments about the costs and benefits of full-scale litigation. (“Able” implies *inter alia* the ability to select suitable theoretical constructs.) Respondents are likely to settle at this point only if they consider the costs of settlement—including the profit losses from abandoning a restraint—less than the cost of fighting. Cooper et al. wrongly compress all of these stages into a single global go/no-go decision.

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Cooper et al. wrongly compress all of these stages into a single global go/no-go decision. The costs of litigation can of course be substantial, but if the litigation is sensibly conducted (not all cases are, to be sure, and improvements are much to be desired), remedies with adverse long-term consequences (false positives) are likely to be minimized. And even when litigation is expensive, the costs in well-managed proceedings are usually modest in relation to the benefits from more effective competition. In the fully litigated *Toys “R” Us* case,<sup>8</sup> for example, which involved a narrow array of products, the estimated annual sacrifice of gross margins (i.e. the price reductions competition could force upon Toys “R” Us (TRU)), avoidable through a success-

7 L. BRANSCOMB & P. AUERSWALD, *TAKING TECHNICAL RISKS: HOW INNOVATORS, EXECUTIVES, AND INVESTORS MANAGE HIGH-TECH RISKS* (2001), at 44–54.

8 *Toys “R” Us v. FTC*, 221 F.3d 928, 937 (7th Cir. 2000).

ful campaign to have manufacturers boycott warehouse clubs, was estimated by TRU at US\$55 million per year.<sup>9</sup>

## IV. The Empirical Evidence

Urging application of an approach I suggest to be wrong-headed, Cooper et al. proceed to inform decision makers' "prior beliefs" through a survey of 22 "empirical" studies.<sup>10</sup> I enclose the word "empirical" in quotes because economists use the word as shorthand to connote econometric analyses of large data sets. I shall argue that this criterion is too narrow. My own preference is to follow the first definition in my *Webster's New 20th Century Dictionary Unabridged* (1980) which states, "relying or based solely on experiments or experience, as, an *empirical* method" (emphasis added).

A second criterion applied by the authors in selecting their evidence is that the studies were published in peer-reviewed economics journals. From considerable experience being peer-reviewed and as an editor utilizing peer reviewers, I am not convinced that peer review is a guarantor of quality. On this I am not alone. As the editor of the prestigious *British Medical Journal* observed at a conference on the subject, "We know that [peer review] is expensive, slow, prone to bias, possibly anti-innovatory, and unable to detect fraud. We also know that the published papers that emerge from the process are often grossly deficient."<sup>11</sup>

Nor does selection only of empirical studies from economics journals ensure that these studies provide unbiased estimates of some underlying reality. It is well-known that economists are like the inebriated person searching for his lost wallet at night under a street lamp, when he dropped it in the dark 50 yards down the street. Economists, and especially (because funds for special surveys are seldom available) industrial organization economists, focus their econometric research where the data are available, and not necessarily in the areas of greatest policy interest. Among other things, most of the cases egregious enough to draw federal antitrust challenges were covered by protective orders making it difficult

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9 See F. M. Scherer, *Retailer-Instigated Restraints on Suppliers' Sales: Toys "R" Us (2000)*, in *THE ANTITRUST REVOLUTION* (J. Kwoka Jr. & L. White eds. 2004), at 376 (summarizing *In the matter of Toys "R" Us*, Docket No. 9273, 126 F.T.C. 415 (1998), *aff'd* at 221 F.3d 928 (2000)).

10 The studies are described in much more detail in J. Cooper, L. Froeb, D. O'Brien, & M. Vita, *Vertical Antitrust Policy as a Problem of Inference*, *INT'L J. INDUS. ORG.* (forthcoming 2005). For evidence that even in the studies chosen, vertical restraints were sometimes absent or had less benign effects, see W. COMANOR, F.M. SCHERER, & R. STEINER, *VERTICAL ANTITRUST POLICY AS A PROBLEM OF INFERENCE: THE RESPONSE OF THE AMERICAN ANTITRUST INSTITUTE* (American Antitrust Institute, Working Paper No. 05-04, 2005), available at <http://www.antitrustinstitute.org/recent2/408.pdf>.

11 R. Smith, *Peer Review: Reform or Revolution?* 315 *BRIT. MED. J.* (Sep. 1997), available at <http://www.bmjournals.com/archive/7111/7111e3.htm>.

for economists to secure the data needed for a quantitative study that could generate an economics journal article.

This leads to my strongest criticism of the Cooper et al. study—their striking neglect of published research on situations in which it was well-known, and often demonstrated through trial by fire, that vertical restraints did have serious anti-consumer or welfare-reducing effects. Many of the cases have been discussed, even if not analyzed econometrically, in law journal articles, books, collections of industry studies, FTC staff reports, and (without the provocation of formal litigation) reports of the U.K. Competition Commission. But none of that substantial literature analyzing the negative side of vertical restraints is surveyed by Cooper et al. In the *Toys “R” Us* case mentioned earlier, the U.S. Court of Appeals for the Seventh Circuit broadly affirmed the FTC’s finding that TRU’s boycott of warehouse clubs “was illegal under a full rule of reason analysis because its anticompetitive effects ‘clearly outweighed any possible business justification.’”<sup>12</sup>

There are several other examples of this in addition to the *Toys “R” Us* case. Early in the 20th Century, Coca-Cola, Pepsi-Cola, and other soft drink firms assigned their franchised bottlers exclusive territories adapted to the economic conditions of the time. But with the shift in emphasis from bottles to cans, advances in canning technology, the decline in transportation costs, and the rise of supermarkets, the minimum efficient scale of a soft drink bottling plant rose sharply, and as a result, the old territorial allocations became wildly uneconomic. The syrup makers could have been rescued from this obsolete equilibrium when the FTC declared their exclusive franchise arrangements illegal in 1978.<sup>13</sup> However, in 1980, the bottlers secured special legislation from the U.S. Congress invalidating the FTC’s decision. The syrup makers were forced to attack their problem by buying out franchised companies or having their largest franchisees acquire them at prices reflecting the acquired entities’ local monopoly power. Only then could obsolete plants be closed and territories reallocated.

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12 They are abridged from COMANOR ET AL., *supra* note 10. On *Toys “R” Us*, compare SCHERER, *supra* note 9, and D. Carlton & H. Sider, *Market Power and Vertical Restraints in Retailing*, in *THE ROLE OF THE ACADEMIC ECONOMIST IN LITIGATION SUPPORT* (D. Slottje, ed, 1999), at 67–93.

13 *In the matter of Coca Cola Co. et al.*, 91 F.T.C. 517 (1978) and *In the matter of Pepsico Inc.*, 91 F.T.C. 680 (1978).

That another geographic exclusivity system harmed consumers is evident from the *Sealy* case.<sup>14</sup> Sealy had granted exclusive territorial franchises to 29 geographically dispersed mattress makers, eight of whom in turn owned Sealy. The price-fixing and territorial restraints were condemned by the U.S. Supreme Court, altered, and again found to violate the Sherman Act.<sup>15</sup> A few licensees saw the territorial limitations as an impediment to their growth. They avoided the restraints by shipping into others' territories, opening bulk warehouses, and merging with other franchise holders. Willard F. Mueller's (1989) analysis of the litigation record revealed that prices were lower, and that Sealy's share of the relevant markets was higher, in cities where competitive inter-territorial penetration was most extensive.<sup>16</sup>

Similarly, after other resale price-fixing tactics were ruled illegal, General Electric and the other leading U.S. light bulb manufacturers adopted a consignment system which in effect fixed retail prices and maintained exclusivity among chosen retail outlet-agents, who handled three-fourths of GE's bulb sales. In 1973, the U.S. Department of Justice prevailed in having the policy declared illegal.<sup>17</sup> However, the dominant position of the Big Three (General Electric, Philips, and Osram Sylvania) persisted at first, despite the presence of smaller producers who priced their products at substantially lower levels. Eventually, prodded by (among other things) FTC lawyers and economists, and in turn the White House, major grocery chains introduced lower-priced private label light bulbs. The generic competition led to sharp declines in branded and (given the rising generic share) non-branded bulb prices, with an estimated reduction in General Electric soft white bulb prices of more than 30 percent between 1980 and 2002.<sup>18</sup>

Cooper et al. ignore much of the literature on the effects of resale price maintenance (RPM), including inter alia the admirable survey by Thomas Overstreet (1983), which found RPM to be used in both socially desirable and undesirable ways.<sup>19</sup> Overstreet's analysis was published when RPM-induced output increases were assumed (we now know erroneously) to be unambiguously welfare-increasing. But there may be another important reason for the heterogeneity of effects.

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14 *United States v. Sealy, Inc.*, 388 U.S. 350 (1967) and *Ohio-Sealy Mattress Mfg. Co. v. Kaplan et al.*, 745 F.2d 441 (1984), cert. den. 471 U.S. 1125 (1985).

15 *Id.*

16 W. Mueller, *The Sealy Restraints: Restrictions on Free Riding or Output?* 6 *Wisc. L. Rev.* 1255–321 (1989). Professor Mueller was a member of Michael Vita's Ph.D. dissertation committee.

17 *United States v. General Electric Co.*, 358 F. Supp. 731 (1973).

18 R. Steiner, *Exclusive Dealings + Resale Price Maintenance: A Powerful Anticompetitive Combination*, 33 *Sw. Univ. L. Rev.* 468–75 (2004).

19 T. OVERSTREET, *RETAIL PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE* (Federal Trade Commission Staff Report, Nov. 1983), especially at 161–63.



It seems plausible that the larger and more diverse a national market is, the more likely it is that large-scale retailing innovations can take root (at first, erratically) despite such impediments as resale price maintenance. The reason lies partly in Adam Smith's division of labor logic and also in the political faction logic of James Madison's *Federalist Paper No. 10* (1787).

In an earlier era, RPM was both pervasive and legal in most nations, but legislative support has gradually been withdrawn because of its recognized innovation-impeding effects. In the United Kingdom, it was initially adopted in response to pressure from small retailers seeking to protect themselves from more efficient large-scale merchandisers. It lost support after World War II when branded good manufacturers found that the smaller outlets satisfied consumer preferences less effectively than the newly emerging self-service stores, causing a loss of RPM-adhering manufacturers' sales.<sup>20</sup> Grocery retailing was a leading change agent, with adherence to RPM dropping precipitously between 1956 and 1958, influenced in part by the passage of the generally permissive Restrictive Practices Act in 1956. The number of self-service food stores rose from 3,000 in 1956 to 10,830 in 1962. More broadly, RPM coverage had declined to cover only 33 percent of consumer goods distribution when the Resale Prices Act of 1964 rendered it presumptively illegal.

In France, manufacturers responded to pressure from their smaller retailers after RPM was outlawed by refusing to supply retailers who discounted below recommended prices. The refusals were challenged by President de Gaulle and declared illegal in 1962, after which further legislation-based restraints against the spread of supermarkets endured for several years.<sup>21</sup> From a careful study of the less complicated history in the small, relatively homogeneous Swedish economy, Trolle (1966) concluded that:

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“The year 1954 marked the beginning of a series of dramatic changes in the structure of Swedish distribution. Although it cannot be proved conclusively, there does not seem to be any doubt that most of these changes would not have taken place without the abolition of r.p.m. (in its earlier form of rigidly fixed prices) and of the restrictions on entry of new firms. The changes have to such a great extent manifested themselves in the development of new types of retail outlets in conjunction with price competition on branded articles that it seems safe to assume a cause-and-effect relationship. As far

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20 See B. Yamey, *The Origin of Resale Price Maintenance: A Study of Three Branches of Retail Trade*, 62 *ECON. J.* 522–45 (1952); J. PICKERING, *RESALE PRICE MAINTENANCE IN PRACTICE* (1966), at 116–30; and J. Pickering, *The Abolition of Resale Price Maintenance in Great Britain*, 26 *OXFORD ECON. PAPERS* 522–45 (1974).

21 W.J. ADAMS, *RESTRUCTURING THE FRENCH ECONOMY* (1989), at 208–29.

as the author is aware, no one seriously contends that these changes would have taken place if the restrictions had not come to an end....Suffice it to say that low-cost distributors today [1965] operate on low margins which were unheard of in the early 1950s."<sup>22</sup>

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In the United States, lobbying in favor of state and federal laws authorizing RPM was led by the National Association of Retail Druggists.<sup>23</sup> A U.S. government taskforce found that passage of the RPM laws during the 1930s was a significant factor in the cessation of chain drug store growth.<sup>24</sup> Although fair trading had eroded despite legal permissiveness in most product lines, it was still widely applied in pharmaceuticals when federal support for RPM was withdrawn in 1975. (In the United Kingdom, too, drug distributors were among the last two trades to retain RPM, having successfully sought a legal exemption.) The average retail margin on U.S. pharmaceutical product sales in 1966, before RPM was outlawed, conformed to the traditional 40 percent.<sup>25</sup> By 1989, average margins at retail had declined into the 31 to 32 percent range,<sup>26</sup> and by 2003, according to the National Association of Chain Drug Stores, they had dropped to an average of 20 percent.<sup>27</sup> Some of the decrease would undoubtedly have occurred even if RPM had not been outlawed as RPM contracts were overridden by Medicaid requisites and by pharmacy benefit managers' bargaining. A 20 percentage point reduction in pharmacists' margins implies consumer (or health-care reimbursing) savings at 2003 volume levels of US\$40 billion.

To avoid overkill, I add only one further case, ignoring among other things the plethora of documented vertical restraint problems in the automobile industries of the United States and European Community.<sup>28</sup> In response to an FTC com-

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22 U. af Trolle, *Sweden*, in *RESALE PRICE MAINTENANCE* (B. Yamey ed., 1966), at 134–35, 140.

23 See F.M. Scherer, *How U.S. Antitrust Can Go Astray: The Brand Name Prescription Drug Litigation*, 4 *INT'L J. ECON. BUS.* (1997), at 244–45.

24 U.S. DEPARTMENT OF HEALTH, EDUCATION, & WELFARE, *TASK FORCE ON PRESCRIPTION DRUGS, THE DRUG MAKERS AND THE DRUG DISTRIBUTORS* (1968), at 68. See also L. WEISS, *ECONOMICS AND AMERICAN INDUSTRY* (1961), at 385.

25 *Id.* at 54–55.

26 Scherer, *supra* note 23, at 245.

27 National Association of Chain Drug Stores, *Facts and Resources*, at <http://www.nacds.org/wmepage.cfm?parm1=507>.

28 On automobiles, see F. M. SCHERER, *INDUSTRY STRUCTURE, STRATEGY, AND PUBLIC POLICY* (1996), at 295–98, 308–12. See also D. Lawsky, *EU New Price Gap Narrows*, *REUTERS*, Mar. 8, 2005. Cooper et al. acknowledge the European Community's concern with the conflict between exclusive territories and the EC's "paramount" goal of market integration, which, they imply (wrongly, I believe) may ignore efficiency goals.

plaint in 1976, Levi Strauss ended its policy of vertical price restraints, leading to large price savings for consumers. It is estimated that the annual gain in consumer surplus from these changes exceeded US\$200 million for men's jeans alone.<sup>29</sup> Robert Steiner found further that, "Levi's supra-competitive retail margins and prices had held an umbrella over the prices of competing makers and apparel dealers alike," so that when the restraints were eliminated, the prices and margins of rival brands were also reduced.

## V. Conclusion

Many additional examples of vertical restraints that raised prices to consumers and inhibited the growth of least-cost marketing methods can be found in the literature. The survey method employed by Cooper et al. systematically overlooked or excluded the cases summarized here and other examples at odds with their conclusion that vertical restraints are almost uniformly benign. Their sample is severely biased. No amount of statistical decision theory and weighting of prior beliefs will yield good decisions if the evidence that goes into formulating the prior beliefs is biased. Nor is a global decision-theoretic approach appropriate for legal strategy toward specific vertical restraints. Prejudicing one's enforcement decisions on the basis of average empirical evidence is like suggesting that the health authorities refrain from combating influenza because relatively few deaths are attributable to it for the period on which we have the best statistics, and that most deaths resulted not from influenza per se, but from complications. One expects more subtlety from economists associated with a federal enforcement agency. And there are times, as in the uniform enforcement of resale price maintenance, when the restraints can impose massive anti-consumer burdens. In contrast to Cooper et al., I see a sequential decision-making approach as the proper and economical method of identifying that minority of cases in which antitrust intervention is warranted.<sup>30</sup> There is no rational basis for a presumption that vertical restraints should receive blanket antitrust exemptions. ▼

MANY ADDITIONAL EXAMPLES OF VERTICAL RESTRAINTS THAT RAISED PRICES TO CONSUMERS AND INHIBITED THE GROWTH OF LEAST-COST MARKETING METHODS CAN BE FOUND IN THE LITERATURE.

29 R. Steiner, *The Nature of Vertical Restraints*, 30 ANTITRUST BULL. 143–97 (1985), at 180. As the former president of a consumer goods manufacturer and later an FTC economics staff member, Steiner is arguably the most perceptive student of vertical restraints and their consequences. See *The Implications of the Work of Robert L. Steiner* (symposium), 49 ANTITRUST BULL. (Winter 2004).

30 My own view has long been that vertical restraints are benign or efficiency enhancing more often than not, leading me to recommend that a rule of reason be applied. See F.M. Scherer, *The Economics of Vertical Restraints*, 52 ANTITRUST L.J. 706–07 (1983).