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A View from Chief Economists

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On February 21, 2007, the Jevons Institute for Competition Law and Economics at University College London hosted its Annual Antitrust and Regulation Forum. The forum covered two broad topics: the relationship between antitrust and regulation and the use of an effects-based approach.

We are privileged to reprint the remarks made by Dennis Carlton, who was then Deputy Assistant Attorney General for the Antitrust Division of the U.S. Department of Justice, and Michael Salinger, who was then Director of the Bureau of Economics at the U.S. Federal Trade Commission), as well as those by Amelia Fletcher, Chief Economist of the U.K. Office of Fair Trading, who moderated the discussion. (The event was recorded and the remarks were transcribed; very few of their words have been altered to preserve the integrity of the conversation that day.)

On behalf of the Jevons Institute and *Competition Policy International*, I would like to extend my sincere thanks to Amelia, Dennis, and Michael for their time and excellent contributions.

David S. Evans
Executive Director, Jevons Institute for Competition Law and Economics
Editorial Board Chair, *Competition Policy International*

This article is a transcript of the presentations given by Dennis Carlton and Michael Salinger at the University College London's Annual Antitrust and Regulation Forum held on February 21, 2007 and hosted by the Jevons Institute for Competition Law and Economics. At the time of the event, Dennis Carlton was a Deputy Assistant Attorney General in the Antitrust Division of the U.S. Department of Justice. He is currently Professor of Economics at the University of Chicago. At the time of the event, Michael Salinger was the Director of the Bureau of Economics at the U.S. Federal Trade Commission. He is currently Professor of Economics at Boston University School of Management. The views expressed here are their own and do not necessarily reflect the views of the agencies with which they were, or are now, associated.

EVANS: I'm David Evans and on behalf of the Jevons Institute for Competition Law and Economics at the University College London [UCL], I'd like to welcome you to the 2007 edition of the UCL Antitrust Forum. This is our third forum in the last three years. This evening we're going to be discussing two broad topics. The first is the relationship between antitrust and regulation, and the second is effects-based approaches and when a business process should be deemed anticompetitive. We really couldn't have a better group of individuals to debate those subjects.

Tonight's topics are quite far-flung. They're part of a very vibrant discussion on the purpose and practice of competition law that's raging these days on both sides of the Atlantic. Yesterday, the U.S. Supreme Court issued its opinion on predatory bidding, and one of the four antitrust cases that has taken this term, and that's a record for the U.S. Supreme Court, which takes one about every five or ten years. So it's really quite a record this year.

In addition, both the U.S. Congress, through the Antitrust Modernization Commission, and the U.S. enforcement agencies have been holding very detailed hearings on core issues and antitrust. In Brussels, we await the next version of the Article 82 Discussion Paper, and likely much more. Alas, in Luxembourg we're still awaiting the *Microsoft* decision, which likely will address all sorts of important topics in the law on abusive dominance.

Now these topics could really carry us through the night, but this evening we're looking to Amelia in a role that the U.K. Office of Fair Trading [OFT] is very good at, as a regulator, and she'll use her full powers. So with that, I'll turn it over to Amelia, who is going to be moderating our program this evening.

FLETCHER: Thanks, David. I should probably start by disputing that the OFT is a regulator. That is not how we see ourselves. Now, it is very exciting to be here on the platform with these influential chief economists, particularly given their previously formidable reputations as academic economists as well.

David has already explained the two issues that we are going to be covering. The first is on regulation and antitrust, and the complementarities between those two areas of policy, and the tensions and the policy implications of those complementarities and tensions. It will be very interesting, given that the approach taken in the U.S. is very different to the approach taken in the U.K., and that there are differences within the EC member states as well. So it will be interesting to get that transatlantic perspective.

The second session is going to be on effects-based approaches, incredibly topical here for various reasons, but including the Article 82 Discussion Paper and the debate around that. Also in the U.S., given the work of the Antitrust Modernization Committee and recent movement on issues such as price discrimination and RPM [resale price maintenance].

With that, I will turn it straight over to Dennis, who starts the first session.

CARLTON: Thank you very much. It's a pleasure and an honor to be here.

Let me start with a disclaimer. My views here are only my own and don't necessarily represent those of the Department of Justice. I'm going to start with some remarks about antitrust and regulation that are based on a paper that I've written with a colleague at the University of Chicago, Randy Picker, and that paper, entitled "Antitrust and Regulation" [forthcoming in *Economics of Deregulation* (N. Rose ed., Nat'l Bureau of Econ. Res.)] is focused on the U.S. Obviously I will be quite interested in hearing about the EU's experience and talking about that more.

Antitrust and regulation can be viewed as two different mechanisms to control competition. They can be viewed as substitutes in that either one can be the mechanism by which you try and control and limit the way firms compete against each other. But more recently, at least in the United States, we've seen that antitrust and regulation can be used as complements in which you use antitrust as a restriction on what regulators can do.

In the United States, the main regulatory and antitrust institutions were created at about the same time. The Sherman Act was passed in 1890, and the Interstate Commerce Commission was formed at about the same time, 1887. It was a time when the U.S. economy was going through dramatic changes in structure, and people, quite frankly, were unsure how in the world to rein in some of these large trusts that were being created.

In the United States, within the last 40 years, antitrust has gotten much better and has become economically coherent. I think the implication of this has been that there's been a dramatic move away to rely on regulation as a method of controlling competition. There's been, in those industries where it's recognized you still need regulation, a complementary use of antitrust and regulation in order to take advantage of the comparative advantages of each. I'll also talk a little bit about what the Antitrust Modernization Commission is likely to say about that as I am one of its Commissioners.

Let me start out from a theoretical basis. What are some of the different properties you can expect between regulation and a general antitrust statute, from a theoretical basis? The first point to begin with is that there's a literature in political science, using game theory and principal agent theory, in which you try and figure out what are the different attributes of regulation versus antitrust.

Imagine there's an industry that wants to get some law passed that's favorable to it, and it's wondering about how the law will be enforced over time. Well, the industry could say to the legislators "construct a regulatory agency," because if it does that, then once it's established, if the regulatory agency starts deviating from the original intent that the industry had in inducing legislators to set it up, it can

go back to them and tell them, influence them, to reappoint regulators, different regulators, and get them on track.

Now this ignores the fact that in order to get a regulatory agency or legislation passed, you need a consensus among different political groups. And those political groups may understand that if a regulatory agency is constructed, once its set up there can be regulatory drift. That is, the regulatory agency might start pursuing policies different than what the industry, or say the Congress, wanted to achieve when you initially vote for the regulation. The industry might say to itself, “once that regulatory agency is established it’s going to be a) hard to get it abolished, and b) I might not have enough influence to alter who the regulators are.” And, therefore, “in order to avoid regulatory drift, maybe what I want is, instead of a regulatory agency, I want to construct a law that will get administered by judges who are more immune from political pressure.” Those are sort of the tradeoffs between regulation and antitrust.

But there are other properties that distinguish regulation from antitrust. Regulatory decisions are typically coordinated across one point in time. If I’m regulating the railroads, I can introduce a regulation that will affect the entire industry at a point in time. Across time, as different political regimes come in and appoint new regulators, there could be a lack of continuity of policy.

The courts, in contrast, are the reverse. Court decisions in the United States will apply to local jurisdictions and to the local parties bringing the decision. Over time, maybe they’ll converge as the U.S. Supreme Court takes on cases, but generally courts are not coordinated at any one point in time, though they may achieve coordination ultimately over time.

Regulators are also proactive. They can do something if a problem arises. Courts, on the other hand, are reactive. They can only do things if someone brings it to their attention. What that really means is, if you’re thinking about a network industry, like railroads for example, and you had to guess: “Am I going to apply the Sherman Act or a regulatory scheme?” Then you would say: “Gee, I need coordination across railroads, they have to interconnect with each other and therefore I am going to regulate them.” Regulation requires specialized knowledge that gets accumulated. Courts don’t have that. Regulation reflects social values, which a court really is not set up to reflect. So how much do you value safety? How much should the rate of return be so that you can provide a safe product or a product you like?

Regulation is often a compromise among competing interest groups, consumers plus producers. That means that if an industry is really strong and powerful, it won’t get a regulatory agency established, because a regulatory agency may have to pay attention to consumers. Instead, it will get an exemption from the antitrust laws with a bar to rivals entering, and we’ve seen that in the United States.

Let me turn briefly to the history. What does history tell us? It turns out antitrust, as I said, was a hot political topic around the turn of the century. It was the subject of presidential debates as to what the proper antitrust policy should be. Initially, Theodore Roosevelt wanted a regulatory-type agency that he would be able to call upon to regulate an industry, and if there was a problem he could try and fix it. That ultimately manifested itself in the passage of an act in 1914 that established the U.S. Federal Trade Commission. The Federal Trade Commission did not turn out to be the regulatory agency that industry thought it would become and which they could control. In 1914 the Clayton Act was enacted. The Clayton Act made more specific to the court what exactly were the violations of the antitrust law.

In terms of the different properties, what we found is that network industries did tend to get regulated. Regulators generally were not very good at efficiency, and in most regulated industries we saw cross-subsidies from one group of consumers to another. Excess labor was employed, and in terms of technological change it was often impeded. In order to engage in a cross-subsidy, you often had to have entry restrictions. The entry restrictions protected incumbent firms. In antitrust we saw that when courts tried to regulate prices they didn't necessarily do a very good job because they lacked the experience. Behavioral remedies, imposing a duty to deal, may not be particularly effective unless one continuously sets a price at which a firm must deal.

In the mid 1970's, to quote Judge Posner, the antitrust laws were "an intellectual disgrace." What we saw is a movement in the last 30 or 40 years, as antitrust got better, away from regulation to antitrust. For the deregulated industries, we generally saw lower employment, wages falling, cross-subsidies ending, and massive horizontal and vertical consolidation. In the U.S. Supreme Court's recent *Trinko* decision [540 U.S. 398 (2004)], we saw that the courts, I think correctly, said there was no general duty to deal under our antitrust laws. Antitrust is ill-suited to regulating duties to deal at a fixed price. And now you can view antitrust as a way to constrain what regulators can do. For example, if there's a merger case, you can require that the antitrust authority have the ability to stop regulators from approving an anticompetitive merger.

I mentioned I'm on the Antitrust Modernization Commission. One of our recommendations is going to be that you should only allow regulators to be affecting the competitive environment when that turns out to be necessary in order for them to pursue whatever are the other social goals that Congress deemed appropriate when they were set up.

Right now in the United States there is something called an antitrust savings clause, which means that you're subject to the antitrust laws. This turns out to be something that, I think, is desirable because it means the antitrust laws can be constraining, not only what firms do, but also what regulators are doing.

Just to sum up regarding competition policy, I think what you want to do is, you want to constrain regulation to only those areas where you think competition won't work. And when you're doing that, you have to explain whether those areas require that the regulators have the ability to use profits from, say, the creation of market power to achieve their objectives. If they don't, then there's no need to, for example, give them authority over mergers. And if there's no need for that, you can rest that with the antitrust authorities.

The question I would like to end with is, whether the relative use of antitrust and regulation in the United States—as it's evolved over time and in particular as antitrust has improved, causing a greater reliance on antitrust—is the appropriate policy for Europe and the rest of the world. And that, of course, depends on the comparative advantage of regulation versus antitrust. Thank you.

FLETCHER: Thanks. [...] Let's turn to Michael, who is going to talk about two particular U.S. cases of interest.

SALINGER: Thank you. As I'm going to begin in a somewhat offbeat way, I'd better get in the disclaimer that what I say today does not reflect the views of the Federal Trade Commission or any of the individual Commissioners.

Amelia promised me that you would all know who Dennis the Menace is. I hear some laughs, so you do. It's a comic about an impish five-year-old boy. My favorite Dennis the Menace strip is one where Dennis is talking to his father and he asks his father what causes the tides. His father says, "the moon." And Dennis says, "I don't believe that." His father says, "what do you think causes the tides?" And Dennis says, "I think there's a whale in the middle of the ocean, and the whale flicks his tail one way and the tide comes in, the whale flicks his tail the other way and the tide goes out." And Dennis' father says, "you don't really believe that, do you?" To which Dennis replies, "no I don't, but it makes a lot more sense than the moon."

Now I recount this story because the concept that it's the moon that causes the tides is a little bit like the concept that we should basically have faith in the outcome of competitive markets. That's a very abstract concept and one that a lot of people struggle with. And it's not just impish five-year-old boys who struggle with it, but the public at large struggles with it and the politicians who represent them struggle with it.

As you think about the relative use of antitrust and regulation, it's important to keep in mind, I think, that we come at this with some basic faith that the competitive outcome is usually the outcome that we want, but that it is sometimes a very tough sell.

I thought I would talk about these ideas with respect to two very specific examples that I've had to deal with in my time at the Federal Trade Commission [FTC]. One is gasoline prices. This is an industry where, as a matter of econom-

ics, you would think that antitrust would work pretty well and that you wouldn't need all that much in the way of antitrust intervention. At least in the United States, if you look at the industry nationally, it's a pretty competitive industry. That's not to say that if you look at particular regions and particular levels of the industry, that things might not be a little more concentrated than ideally you would like. That's why the FTC has forced divestitures in a variety of the mergers that we've seen. Yet, there's still a great distrust that the outcomes we see are competitive outcomes and there's something efficient about them.

Whenever prices go up significantly, Congress asks the FTC to study why. Indeed, sometimes when prices go down, Congress asks it to study why they did not go down earlier or faster. These inquiries by themselves are not economic regulation. These inquiries do have value because the public needs to have its faith in the competitive process reaffirmed and it needs to know that there's someone in the government looking after the industry. Given how important the industry is, of course, we shouldn't just assume that the industry is behaving competitively. We do need to continue to check up on it.

But as the FTC is asked to study each ebb and flow of prices, I worry that we're getting closer to regulation than anyone thinks we are. Indeed, behind the request for these inquiries is a veiled threat that we might get some sort of regulation. It is quite plausible that Congress will pass federal price gauging legislation that is similar to laws already enacted in several of the individual states.

The mere threat of this regulation has some of the undesirable consequences of regulation. We want companies to be thinking about how they can hold supplies and deliver them to places that have shortages. Now just as we don't rely on the benevolence of the butcher, the baker, and the brewer for our evening meal, we can't rely on the benevolence of the oil companies to deliver petroleum products to areas that have shortages or in times of shortage. We should expect them to do that because there will be a profit opportunity to exploit. But if there's a threat that we're not going to let prices rise to the level that they need to, to provide that opportunity, then we're not going to see the sorts of supply responses that we need in order to ameliorate or alleviate whatever shortages arise.

The other example I wanted to talk about tonight is the debate that's raging in the United States about so-called net neutrality. If you think people are skeptical about the benefits of the competitive outcome with gasoline, which is a pretty unconcentrated industry, imagine the lack of faith in the competitive outcome in something like the Internet. This is surely a harder problem than the problem with the gasoline industry.

Right now, many American homes have access to high-speed Internet service from two providers. They can get DSL service from the telephone company or they can get high-speed access from the cable company. There are prospects one hears of electricity companies getting into the business. There are various wire-

less solutions that might materialize, but we need to, I think, entertain the notion that we're going to have competition among two providers, at least in a lot of areas for a significant period of time. This raises a host of issues, including: Are Internet access providers going to be allowed to charge differentially for different kinds of services? Are the Internet access providers going to be able to block certain kinds of service? Are the Internet access providers going to be able to provide content themselves? These all interact because the concern is if they're allowed to provide content themselves, then they're going to charge differentially high pricing for their competitors and they're going to try and block the content of their competitors.

So this is a problem that you can imagine trying to solve in a regulatory fashion, setting up some rules *ex ante*. Or you can say, "Well, we think we've learned the lessons of the past from regulation." The deregulation movement in the United States that started in the 1970's, arose largely because of the recognition that economic regulation is often highly inefficient. It's particularly inefficient in industries where there's a prospect of rapid technical change. So should we just let competition play out, not regulate, and then rely on antitrust should problems arise? I think the answer to this question depends in part on what sort of errors you're going to make, because we're not going to get this policy perfect.

Antitrust is inherently a softer kind of regulation. It is true that once you get a case, it can become very heavy-handed. But in antitrust cases, if you're going to bring an action, you do have to actually show that the company violated the law, that there is some line that was crossed. So there's a presumption that what the company has done is okay unless you can prove otherwise. With antitrust, there's a greater risk of what the decision theorists call false negatives. That is, that we might let through some sort of anticompetitive behavior.

On the other hand, if you go with regulation, then there's a greater risk, I think, of chilling pro-competitive conduct. I'll give you one specific example, which is this issue of whether or not you can charge differentially for different kinds of access. Some kinds of Internet applications—like voice and some kind of video applications—are time-sensitive. Other kinds of access—like email—aren't. You want to get your email pretty quickly, but it doesn't have to be instantaneous the way a voice conversation has to be. We've lived in a world where the Internet hasn't been capacity-constrained, so that hasn't been much of an issue. But people tell us that it's going to become an issue.

If we rely on *ex ante* regulation, there are going to be pressures to limit the extent to which companies can charge differentially for the kind of access. And if they restrict that, then we're going to get congestion. We're going to get congestion because people overuse the high-quality service, and we're going to get congestion because we're going to limit the incentives to invest in the capacity needed to deliver the high-quality services.

I started with Dennis the Menace, which might seem too unsophisticated for an audience of this sort, but I believe you can find an analogy between economic forces and the effect of the moon on tides in the works of Alfred Marshall. To build on that analogy, if you're in the business of regulating economic activity, either as antitrust enforcers or as sector regulators, it's important to recognize that there are market forces beyond your control. Now if you think of an economic sector as being a boat on the ocean in proximity of a whale, it might be affected by movements of the whale. So if you think of regulators as being the whale, the first challenge is to make sure that you don't capsizize the boat, something that can be very hard if you're in turbulent seas, that is if you're in a market environment that is changing rapidly. If you can manage to avoid capsizing the boat and you can help the boat along its desired path, then so much the better. With that somewhat strained analogy, I will sit down. Thank you.

FLETCHER: Thanks. I hope that Dennis the Menace is not related to anyone on this panel. I thought the point that was just made, particularly about the balance between false positives and false negatives, was a very interesting one. We have to recognize that a lot of what firms do is pro-competitive. Firms have to be recognized for making pro-competitive choices, taking risks. The competition authorities, although it's very hard to admit it, inherently will sometimes get things wrong. As such, we do veer towards relatively hands-off policies and we will occasionally let through false negatives. Now, if you're trying to open up a previously nationalized market to competition, you might actually want to veer the other way. You might actually not want to worry about false negatives so much. You might want to be very proactive about encouraging competition.

[...]

SALINGER: A comment on your original question about whether if you have a former state monopoly do you somehow want to jumpstart the competition. We in the U.S. had less experience with that. Probably the closest analogy in the U.S. is with the telephone sector and I don't know if Dennis agrees with me, I think the consensus in the U.S. is that the jumpstarting of competition in the long distance sector was a success. But the attempt to deregulate the local telephone exchange was much less of a success.

What happened was because there were these different components of telephone service the U.S., Congress, and then the FCC [U.S. Federal Communications Commission], tried to set up the system where you could compete by buying a lot from the incumbent. It was billed as a deregulatory approach but in fact it just made the regulation much more complex because instead of just regulating the price to the final consumer you were regulating all of these individual wholesale components. It was done in the name of jumpstarting competition, but it was done in such a way that it really eliminated a lot of the incentive to invest in facilities by new entrants. I would think that the same issues would arise often when you're deregulating a state-owned entity.

CARLTON: It seems to me there's a difference between privatizing versus privatizing and then setting up competition through structural separations or structural dismemberment of the previously regulated monopoly. I think there have been studies—there's at least a survey in the *Journal of Economic Literature*, where they talk about the difference between privatization and privatization combined with competition. There's no question that privatization combined with competition produces much greater gains in productivity than simply privatizing.

Given that you have engaged in some sort of structural dismemberment of a previously regulated national monopoly, and assuming it's not a natural monopoly, it's not obvious to me you want to be intervening more. It seems to me that what you certainly want to do is set up safe harbors where certain activities are immune, both in a regular industry as well as in this newly created industry. So if you do things, you don't have to worry that you're going to get dragged into court. In our *Trinko* decision, the Supreme Court made a very sharp line between a regulated activity and an activity subject to the antitrust laws. I am wary of the ability of the antitrust authorities to set prices and that's what you have to do if you created duties to deal.

In the environment of network industries, if you start deregulating and you don't totally deregulate but you have a network industry in which you need interconnection pricing, then it is clear to me that you don't want an antitrust judge, or a judge in a general court, to try to figure out what that price should be. It seems to me you do want a regulatory agency, at least as regulatory agencies are structured in the United States, to set prices when those prices have to be set. Otherwise it seems to me that you're taking big risks.

Now if the regulator's doing an awful job and in the scheme of things the judges aren't doing as terrible a job as the regulator, you know, maybe that's a stop gap, but I worry about it. I think we would probably agree the right way to fix the problem is to try and fix the regulation, not to try and deal with it through antitrust. Although, if you have no other alternative maybe you have to use whatever tools you have available.

Energy policy in Europe is actually very interesting. Today an issue at the OECD [Organisation for Economic Co-operation and Development] is energy security. When you're talking about regulating a network industry, and the network industry spans national boundaries, then I do think you have this spillover problem and you have to have coordination to deal with it, otherwise you can't deal with it and there's a problem. This happens in the United States also. In energy regulation, how do you create the right incentives for transmission investment? This is really a hard problem, and they have that as a really hard problem in the United States. In Europe, in general, there's this separate issue of: "Are we really one group or if I have a transmission bottleneck should I use that to basically tax the rest of the European countries where I would just capture the rents?" There is a difference between regulating Europe as your objective versus getting

wealth for the particular country that's lucky enough to have the bottleneck. That strikes me as a really hard problem.

I would point out that you actually have a very similar problem in the United States if you look at our individual states. Under the state action doctrine, a state can do something like allow a group of farmers to get together and determine how many raisins to produce and then those can be exported to the rest of the United States. (Since I'm not a lawyer I'm always hesitant to specify what a legal principle is because I always find economists don't quite get it right, but I'll take that risk.) There's a case, *Parker v. Brown* [317 U.S. 341 (1943)], in which that behavior is allowed because raisins are produced in California and therefore it's a state action. Consumers consuming raisins in California consume a lot of raisins so therefore if the state legislature wants to allow it, it's okay.

Of course raisins are consumed elsewhere and you have a similar type of spillover and the question is: How should you deal with those spillovers? I don't think there's an easy answer. There has to be some overriding mechanism to constrain how one state can take advantage of other states in the United States and I don't think we have such a great mechanism right now. It can be improved. It's one of the things the Antitrust Modernization Commission is going to look at. But in Europe, where it's also in a regulatory setting, I could see how it's a more severe problem.

[...]

FLETCHER: Thanks very much. We'll go straight on to the second session which is on effects-based approaches to antitrust. So we are leaving regulation behind now.

[...]

SALINGER: Last fall there was a session at the American Bar Association fall forum titled "Monopolization and Abuse of Dominance, with the U.S. and the EU Both Contemplating New Approaches, Will the Best One Win?" Now I found that to be an interesting title.

In the U.S., the closest thing that we have to your [the United Kingdom's] rivalry between Oxford and Cambridge is the rivalry between Harvard and Yale, who compete against each other both intellectually and on the athletic fields. The annual game between them in what we in the U.S. call football used to be quite a big event. Legend has it that many years ago—back in the days when telegrams were the fastest form of written communication—the Yale team the night before what they immodestly call "The Game", capital "T", capital "G", sent a telegram to the Harvard team saying, "May the best team win." To which the Harvard team responded with a telegram of its own saying, "May the better team win." The point of course is that best refers to the top-ranking among three or more possibilities, whereas better refers to the ranking between two alternatives.

The reason I tell the story is that one asks, “Well, will it be the U.S. approach or the European approach that wins out? Or will it be a form-based approach as opposed to an effects-based approach that wins out?” But there aren’t just two of these approaches. There’s at least a third approach, which is the structured rule of reason. We don’t talk about forms-based versus effects-based so much in the U.S., but the distinction seems to be similar to the distinction between per se rules and the rule of reason.

As I’m sure you all know, we’ve largely backed away from per se rules, except that the per se rule against price-fixing persists and market allocation scheme, that persists and is uncontroversial. But we have two legacy controversial per se rules, both of which may disappear soon. One is the per se ban on maximum resale price maintenance. As I’m sure many of you know, the Supreme Court has accepted the *Leegin* case [127 S. Ct. 2705 (2007)], which will require it to revisit that rule. We, of course, don’t know how that’s going to turn out, but certainly there’s a lot of speculation that if the Court weren’t anxious to overturn the per se rule, it wouldn’t have granted a writ of certiorari in the case.

The other per se rule that persists is the per se ban on tying in certain circumstance. The Court limited the scope of that rule last year on the *Independent Ink* case [547 U.S. 28 (2006)] when it ruled that in the ownership of a patent, the tying good does not create the presumption of monopoly power needed to trigger the per se rule. It did not overturn the per se rule altogether, but some read the wording of the decision to suggest that it might do so when the opportunity arises.

Getting rid of the per se rules on RPM and tying will be a positive development in U.S. antitrust law, but by itself, the switch to a rule of reason will create its own problems. We have to figure out how we’re going to conduct this rule of reason. The per se bans against these practices were formulated at a time when we did not understand as well as we do now some of their pro-competitive uses. But while we do understand the practices better than we used to, it overstates matters considerably to say that we now completely understand their use and that we know exactly how to tell when they are pro-competitive and when they are anticompetitive.

Last fall I was asked to speak about the legacy of the *Matsushita* decision [475 U.S. 574 (1986)]. The United States Supreme Court decided *Matsushita* twenty years ago, so it was a big anniversary. It was a landmark decision in the U.S. in large part because it laid out a key role for economics. What I said about the *Matsushita* decision last fall was that you can read it as implying two quite different roles for economics antitrust, and it relates to this issue of the structured rule of reason versus an effects-based approach.

One possible reading of the decision is that on a case-by-case basis you have to try to understand whether the case makes economic sense. You have to come up

with a model for each case. But there's quite another reading of the decision, which is that the role of economics is to help inform somewhat more formulaic rules. And these are rules that would be based explicitly on a recognition of the risk of error. In several recent Supreme Court decisions, including *Matsushita, Brooke Group* [509 U.S. 209 (1993)], and yesterday's *Weyerhaeuser* decision [127 S. Ct. 1069 (2007)], a judge has stated priors. The *Weyerhaeuser* decision begins by essentially saying that this is the kind of conduct which is normally competitive conduct and we don't want to take the risk of chilling that kind of behavior.

So with these abuse-of-dominance kinds of issues in the U.S., we have a bunch of these inappropriate per se rules in place, and the form-based approach in Europe probably has comparable inappropriate rules. But it's not clear that we want to go all the way on a case-by-case basis to trying to understand the effects. One of the criticisms I've heard of the Discussion Paper is that you are going to have economists running rampant. As much as I think it would be in some sense a good thing to have economists running rampant, I would have to say that there is a real risk of that.

I think what we might see emerging is this more structured rule of reason. I don't think it's going to be a new set of per se rules. I think we've learned that if you put the wrong per se rule in place, that it could take a very long time to get rid of it. It will materialize as a set of practices which are inherently suspect, but where you can rebut the presumption that under certain circumstances they're illegal. And likewise, you're going to have some safe harbors on the other side—that is practices that are presumed usually competitive, but that are also sometimes rebuttable.

Now one of the problems when you try to establish safe harbors is that, if it's a really safe harbor, there is a reluctance to make it very big. So I wonder whether it would be a good idea, instead of having safe harbors, we'd have pretty safe harbors. The advantage of pretty safe harbors is that, as the antitrust agencies try to articulate what are the structural conditions under which you fall into this, that you would have a more relaxed set of structural standards if you made them pretty safe instead of completely safe.

One of the questions we often get is, "If we agree on consumer surplus as the objective of antitrust, and if we agree on a use of economics, is policy in the U.S. and Europe going to converge?" I think it will converge somewhat, but I don't think we're going to get all the way there, and there are a couple of reasons for that. My sense is that in the U.S. there's more of a concern with the false positives, the concerns that our rules will chill competitive behavior, than is the case in Europe. There's been discussion about the impossibility of having measures of the relative frequency of pro- and anticompetitive uses, so that you have to rely on so-called ideology. I would call them prior beliefs. There's really no way around that. There's great value, I think, in trying to articulate what your prior beliefs are, because in articulating them, you might actually find that you get some convergence.

In Europe, there's also a greater willingness to consider what are sometimes called dynamic effects, but which from a different perspective might be termed uncertain future effects. As a professional economist, perhaps you might think I'm bound to endorse the dynamic standard rather than the merely static standard. But I would caution that the use of the word "dynamic" in antitrust is akin to the use of the word "fair" in international trade. Whatever legitimate role the terms have, and they both have legitimate roles, they pose the risk of being misused to support restrictions on competition.

Given those differences in perspectives, both on the role of dynamic long-run versus short-run effects and the relative tolerance for false positives and false negatives, I don't think we're going to get complete convergence. I do hope that both jurisdictions will have learned that you can mess things up for a long time if you lock yourself into too rigid a policy. I hope rather than having rules that are stated as per se rules, that we'll have these somewhat more flexible standards that will allow the presumptions embodied in the standards to be rebuttable.

FLETCHER: Thanks. Now I'd like Dennis to talk about a couple of areas where the ideologies or prior beliefs are changing, and where there seems to be a bit of a move away from these per se rules.

CARLTON: Well, I have several responses and reactions, and if I have enough time while I'm talking, I'll give them. If not, during the discussion.

What I wanted to talk about were rules aimed really at pricing under the antitrust laws, and see how those types of non-vertical policies have emerged and what we think about them. I mentioned that I'm on the twelve-member Antitrust Modernization Commission, which is a Congressional Commission that was charged with answering the question: "Does antitrust need to be modernized?" We're about to issue our report within the next few months and we have several recommendations. The one I want to talk about is our recommendation to repeal our [the U.S.] Robinson-Patman Act. The Robinson-Patman Act was an amendment in 1936 to our Clayton Act, and it basically forbids price discrimination where the effect is to essentially harm competitors. The law was passed with the strong support of small stores, grocery stores mainly, who were worried about A&P [U.S.-based grocery store] and A&P's buying power. The defense in a Robinson-Patman case is that your price differentials are cost-justified.

Now it's true that while we haven't had a lot of Robinson-Patman cases recently, they, one, impose costs on firms and, two, give firms an excuse not to discount. There have been studies of the Robinson-Patman Act, and what they basically conclude is that it is an act that inhibits discounting to large stores, and therefore prevents the large stores from lowering their prices, with the effect being that consumers wind up paying higher prices.

Other commissions have recommended repeal of the Robinson-Patman Act, and Congress has not listened. Whether they will listen to us, I have no idea. But there's another suggestion the Commission has heard, that I think is just as good, or maybe almost as good. And that is if we can't get repeal of the Robinson-Patman Act, then it should be a requirement of a Robinson-Patman case that the same antitrust injury be shown as is shown in other antitrust cases. My own sense is, that would be enough to gut the Act of its most serious harmful effects, and that might be the most effective way to get rid of a law that is, I think, an anachronism, and based on the notion that you have to have a level playing field in order to have competition on the merits. Whenever I hear the term "level playing field", I get nervous because that usually means you, my rival, shouldn't be able to take advantage of your comparative advantage over me. It's not, quote, "fair".

Let me talk a bit about price discrimination, because a lot of violations or alleged violations of the antitrust laws, I think, confuse price discrimination with harm to competition. Price discrimination is really a way in which you can compete for individual customers. By giving an individual discount to a customer, it's a way that you can get that customer's business. It's ubiquitous even in places where you think there's lots of competition. In the United States at least—I don't know whether the same is true in England—if you go to a movie theater and you're 65 years or over you get a lower price. Why? You're watching the same movie. You're taking up the same seat. If we count that as price discrimination, are we really worried about market power at the level of movie theaters?

There's very little possibility, without enormous cost, of monitoring price discrimination because there are lots of ways in which you can price discriminate and give secret discounts. You can tie services to the product or give free samples. We know that price discrimination can allow expansion of sales to low value customers. If you don't allow price discrimination, the firm will charge a high price and shut out of the market those consumers not willing to value the service that much. Or, if you do allow price discrimination, those customers can be served.

From economic theory, we know that it's quite ambiguous what the effect on total welfare is, but we do know that the closer you get to perfect price discrimination, total welfare, not necessarily consumer welfare, goes up. A separate question, I don't have time to address it now, is whether you want a consumer surplus standard or a total welfare standard. I think total welfare makes more sense.

In the United States, we allow a monopolist to charge whatever price he wants. I know in England or in the European Union there can be an exploitive violation, but at least in the United States, a monopolist who has achieved his position legally can charge a monopoly price. That means if you charge a high price, it's okay. It also seems to mean, to me, that you should be allowed to discriminate freely. Therefore, at least under our antitrust laws in the United States,

price discrimination, that is pure price discrimination, should not trigger an antitrust violation.

Let me turn to exclusionary conduct. Exclusionary conduct, which is conduct that excludes a rival, may or may not be harmful to competition. Consider tie-ins, and Michael talked about, I think, the ambiguous per se rule of the *Jefferson Parish* case [466 U.S. 2 (1984)]. In fact, I spoke about tie-ins this morning at Oxford University, and my own sense is, at least that in the United States, our laws on tie-in need to be reexamined. We know that one very convincing reason for tie-ins, in addition to efficiency, is to achieve price discrimination. If price discrimination is not an antitrust violation, then use of tie-ins should not trigger any problems. How, then, can tie-ins be harmful? If it's important to distinguish price discrimination from harm to competition, then what's a way to distinguish them?

You should really ask yourself the question: "Is the price to some group of individuals higher than it would be if there was pure price discrimination?" That means if you're the monopolist of some product A, and everybody has to use A in conjunction with B, then as long as you can engage in price discrimination there's no need for you to tie B because you can get all the monopoly rents out of A. If you do tie B because it's a convenient way to engage in price discrimination, it seems to me that should be completely legal.

I want to distinguish that case from the case where there are other consumers of B who have nothing to do with A. A good example, due to Robert Gertner, that I like to use of when that would occur is if there's a resort island. Suppose there's a resort island in which there's a monopolist of a hotel. It also has a restaurant. On this island are native workers who work and live on the island. They work in the hotel and they eat at local restaurants. They don't stay in the hotel. So then what happens? If the hotel ties hotel services to restaurants and makes their guests eat at their restaurant, that could deprive the local restaurants of so much business that they go out of business. That leaves the hotel restaurant as the only one that can serve, not just its guests, whom it could take advantage of anyway, but also the natives. That is harm to competition, or could be harm to competition. Therefore, the right question to ask is: "Does someone's shadow price go up for consumption of the good, and as a result are they harmed relative to what they would have been under price discrimination?" If the answer to that question is: "No", then it seems to me there's no harm to competition. A lot of cases in the United States don't make that distinction.

Let's turn briefly to a recent case, *Leegin*, which the Supreme Court is examining. This is a case in which minimum resale price maintenance is being examined. In fact, the Supreme Court is revisiting whether the per se rule against it should be overturned. As a logical matter, it seems to me that per se can't possibly be correct because we know that resale price maintenance can, under certain circumstances, encourage sales effort that wouldn't otherwise occur. That sales effort can benefit some consumers who will be induced to consume the product

and, therefore, it can theoretically expand output. That just means that there are examples where resale price maintenance is being used in a way that may benefit one group. You can decide whether the increased price paid by customers is a net benefit to society when it's compared to the benefit that occurs from expanding output to new consumers.

Leegin is a case involving resale price maintenance of which there have been lots of studies. Earlier Michael talked about prior beliefs. You may start out with prior beliefs, but evidence comes in and you should be updating your priors. So rather than talking about priors, which may be ideology or could be defined as ideology, I'm going to talk about updated priors. Now you can say that's refined ideology, but I would say it's sort of your beliefs that have been improved by looking at the data. That doesn't mean your priors don't matter, but it means if you have enough data, that's going to dominate. And hopefully that's a situation we can eventually get in.

So we have lots of studies of resale price maintenance. Maybe not the greatest studies, but we have lots of them. Here's what some of the evidence shows, and the reason I know this is because I worked on the *Leegin* brief—the amicus brief—that the [U.S.] Department of Justice submitted and it was actually a lot of fun. I held a mini seminar at the Department of Justice where you have this concentration of lawyers and economists who like to talk about antitrust, even when they don't have to. So I reviewed these studies, and here's what the evidence shows, and I thought it was pretty compelling.

First, both internationally and in the United States, there have been times when resale price maintenance has been allowed and when it's not been allowed. We can actually look where it's used and where it's not used. When resale price maintenance is used, it's often used in non-concentrated industries. That immediately tells you something. It means that it must be being used for efficiency reasons, because if it weren't, if it was being used for monopolization purposes, then you wouldn't expect it to be used in these unconcentrated industries.

In general, resale price maintenance leads to increased sales effort. It can lead to higher prices and sometimes significantly higher prices, especially at discount stores. There are few cases that support the economic theory that resale price maintenance by and large is used primarily to facilitate either a dealer cartel or a manufacture cartel. That doesn't mean there are no such cases, but it does mean that if you compare those cases relative to all the other cases, they're a small fraction, under 10 percent or 15 percent. Therefore, resale price maintenance based on this evidence is more popularly viewed as a way to control distribution, which then induced a sales effort, or some other effort, advertising, et cetera, in order to better sell the product. Therefore, I don't think that when you talk about resale price maintenance and you look at the evidence, that the presumption should be that it's per se illegal. Based on this evidence, I would say that you would make the presumption be it's legal unless you could show a harmful effect.

But this does seem to be one of those cases where there is lots of evidence on the practice, and we should let it inform our updated priors.

As a general matter, we do not control how a manufacturer chooses to produce its good. I don't tell General Motors, "you're producing too many red cars, I want them green." Why then, as a general matter, should we tell General Motors how it should distribute its cars? They're really part of the same process of bringing a good to market. If you generally think one is okay, you should think the other is okay.

[...]

FLETCHER: I'm going to tie up because we really should at this stage. It may not be great for legal certainty—that economists don't always agree with each other—but it makes for a good debate, I think. So I hope everyone will join with me to thank our speakers.

EVANS: Thanks Amelia and again thanks to everyone on our panel. ▼