Volume 4 | Number 2 | Autumn 2008

Competition Policy International

Competition and Innovation: Dangerous Myopia of Economists in Antitrust?

Christian Ewald

Copyright © 2008
Competition Policy International, Inc.

Published in Competition Policy International (print ISSN 1554-0189, online ISSN 1554-6853), Autumn 2008, Vol. 4, No. 2. For articles and more information, visit www.globalcompetitionpolicy.org.

Competition and Innovation: Dangerous "Myopia" of Economists in Antitrust?

*Christian Ewald**

It seems fairly unlikely that the seminal papers of Professor Joseph A. Schumpeter would today have a good chance to be published in one of the leading journals specialized in industrial organization. This judgment, however, is a remarkable contrast with his still profound relevance in the world of antitrust. His warning that putting too much emphasis on static efficiency may risk killing endogenous technological change and growth has already inspired numerous policy debates in the past. A new paper by David S. Evans and Keith N. Hylton[1] ("Evans & Hylton") provides telling evidence that this is still true exactly 100 years after Schumpeter, for the first time, outlined the basis of what is known today as "Schumpeterian tradeoff".[2]

1. David Evans & Keith Hylton, *The Lawful Acquisition and Exercise of Monopoly Power and its Implications for the Objectives of Antitrust*, (4)2 COMPETITION POL'Y INT'L (Autumn 2008) [hereinafter Evans & Hylton].

2. Schumpeter's famous concept of "creative destruction" was first presented explicitly in 1942; *see* JOSEPH SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY, 83 (1942), Schumpeter's major steps were however already performed and anticipated in JOSEPH SCHUMPETER, WESEN UND HAUPTINHALT DER THEORETISCHEN NATIONALÖKONOMIE (1908). This never translated German-language book which might have the English title *"Essence and Limits of Equilibrium Economics"* was already published in 1908; for further details *see*: ESBEN ANDERSEN, THE ESSENCE OF SCHUMPETER'S EVOLUTIONARY ECONOMICS: A CENTENNIAL APPRAISAL OF HIS FIRST BOOK, (Paper for the International Schumpeter Society Conference, Rio de Janeiro, July 2008).

*Head of Section "Economic Issues," Bundeskartellamt (Federal Cartel Office), Bonn, Germany; the views expressed in this article are those of the author alone, and do not represent the views of the Bundeskartellamt.

Despite this long period of discussion, the views on the implications which should be drawn from Schumpeter's notion that some degree of monopoly power[3] is a necessity to keep the process of innovation going are still far from unanimous. A very pronounced position can be found in the recent U.S. Department of Justice Report on the assessment of unilateral conduct under Section 2 of the Sherman Act ("Report")[4]. In particular, the Report's assessment of the risks of over- and underdeterrence shows that the positive dynamic effects of monopoly power highlighted by Schumpeter are obviously considered to be the most relevant concern of antitrust enforcers. Accordingly, the focus of the Report is much more on the negative consequences of overdeterrence and the risk of creating dynamic inefficiencies by undermining innovation.[5] The (static and dynamic) inefficiencies emanating from underdeterrence are, on the contrary, only mentioned in passing.[6]

At least from a transatlantic perspective, many other public statements currently seem to indicate that in the United States—at least in the Justice Department's Antitrust Division[7]—the Schumpeterian tradeoff provides the major intellectual underpinning for an extremely cautious "hands-off" approach in antitrust. Using the words of the current Assistant Attorney General for Antitrust:

> "Dynamic efficiency is a particular focus, and helps explain why U.S. antitrust enforcers have devoted so much time to issues surrounding innovation. Their work has a clear policy implication: antitrust enforcers must be careful not to pursue immediate, static efficiency gains at the expense of long-term, dynamic efficiency improvements, since the latter are likely to create more consumer welfare than the former. Accordingly, U.S. enforcers

3. In the following, I use the term "monopoly power" in its strict economic sense, i.e. a company's ability to raise price above marginal costs. Therefore, in particular, the term should not be equated with the legal concept of "dominance" or "significant market power".

4. U.S. Department of Justice, Competition and Monopoly: Single Firm Conduct under Section 2 of the Sherman Act, 2008 [hereinafter Report]; *available at* www.usdoj.gov/atr/public/reports/236681.htm

5. *Id*. at 14.

6. The Report explicitly mentions dynamic inefficiencies resulting from persistent monopoly power only in one very short paragraph which summarizes quite generally the impact of monopoly power on consumer welfare: *"Firms with ill-gotten monopoly power can inflict on consumers higher prices, reduced output and poorer quality goods or services. In addition, in certain circumstances, the existence of a monopoly can stymie innovation. Section 2 enforcement saves consumers from these harms by deterring or eliminating exclusionary conduct that produces or preserves monopoly"*; *Id.* at 10.

7. For quite skeptical statements by the FTC on the Justice Department's Section 2 Report, *see* P. Harbor, J. Liebowitz, & J. T. Rosch, *Statement of Commissioners Harbor, Liebowitz, and Rosch on the Issuance of the Section 2 Report by the Department of Justice* 5 (Sept. 8, 2008) [hereinafter Harbor, Liebowitz, and Rosch] *available at* http://www.ftc.gov/os/2008/09/080908section2stmt.pdf.

> approach practices that bear on innovation incentives with something close to the medical principle of "first, do no harm."[8]

Evans & Hylton provide some very interesting but—at least from an economist's point of view—quite provocative arguments in favor of such an approach. They argue that a very cautious enforcement approach might be inevitably necessary to compensate for the increased involvement of potentially "myopic" economists in antitrust enforcement. Due to a severe deficiency of antitrust economics, economists emphasize the risk of overestimating short-term static inefficiencies at the expense of the tremendous long-term blessings stemming from all the innovations fostered by the prospect of monopoly power. Because Evans & Hylton found such apt words to describe the deficiency, it is appropriate to depict their core argument as a quote:

THEY ARGUE THAT A VERY CAUTIOUS ENFORCEMENT APPROACH MIGHT BE INEVITABLY NECESSARY TO COMPENSATE FOR THE INCREASED INVOLVEMENT OF POTENTIALLY "MYOPIC" ECONOMISTS IN ANTITRUST ENFORCEMENT.

> "The dynamic competitive process and its role in promoting economic progress are at the heart of antitrust policy. The big issues in antitrust have to do with whether the global benefits from the competitive struggle, that may well lead to the creation of significant and durable market power, are outweighed by local costs that result from the restriction of output in specific markets. Industrial organization economics has paid little attention to dynamic competition and, therefore, has had little systematic knowledge to contribute to the design of antitrust rules [...]. Industrial organization—from the early price theory work by the Chicago School to the most recent game theory work—largely considers static competition in a market. [...] Modern economics is based largely on developing mathematical models. [...] It is easy to use words to talk about dynamic competition [...], but it is much more difficult to use mathematics. When realism and relevance butt heads with analytical tractability, tractability almost always wins out in economics. [...] This "tractability bias" leads to "static competition" bias in antitrust economics."[9]

8. THOMAS BARNETT, MAXIMIZING WELFARE THROUGH TECHNOLOGICAL INNOVATION, (Presentation to the George Mason University Law Review 11th Annual Symposium on Antitrust, 15, October 31, 2007) *available at*: http://www.usdoj.gov/atr/public/speeches/227291.pdf

9. Evans & Hylton, *supra* note 1, 232–233.

My comments on Evans & Hylton's arguments are twofold: First, I consider it necessary to put at least two question marks behind their diagnosis that there is a severe risk of a "myopic" application of state-of-play antitrust economics. Second, in my view at least two further qualifications have to be made regarding Evans & Hylton's perception of the scope and limitations of antitrust enforcement which—explicitly or implicitly—drives their argument. Both pillars together carry my view that—to stay within the picture—prescribing antitrust enforcers strong glasses which are in the risk of leading to a severe hyperopia or even blindness seems not to be a suitable therapy for an alleged myopia in antitrust; the Schumpeterian tradeoff should not provide the justification for an overly cautious "hands-off" approach.

I. On the "Myopia" of Economists in Antitrust

To avoid any misunderstanding as regards the first pillar of my argument: I do not argue against Evans & Hylton's highly welcome appeal that more effort in academic economics should be directed toward a better understanding of the dynamic dimension of competition. It seems beyond doubt that the marginal benefits of increased research efforts are most likely to be higher than by producing further refinements of highly sophisticated models to add a small increment to an already huge bulk of literature.

My critical assessment is, rather, based on the following points: First, in my view Evans & Hylton exaggerate an indisputably existing asymmetry in theoretical economics. Second, I want to stress that Evans & Hylton's fear of a "static competition bias" only materializes if antitrust enforcement is based on a wrong idea of the role of economics and economists in antitrust enforcement.

First, in my view Evans & Hylton exaggerate an indisputably existing asymmetry in theoretical economics.

On the first point: Evans & Hylton judge that there is a severe risk that antitrust enforcement systematically underestimates the merits of monopoly power for dynamic efficiency mainly from the fact that the level of mathematical formalization in dynamic theory is significantly lower than in static analysis. But—as Evans & Hylton correctly spotted—the reason for what they call "tractability bias"[10] is by no means intentional but the consequence of the complex issues concerned. But at least we have some basic models on dynamic efficiencies[11] and economics already has moved far beyond the times when the seminal papers of Schumpeter were published. Ironically, the fear of a "static

10. *Id*. at 233.

11. *See* e.g. the nice presentation in Massimo Motta, Competition Policy: Theory and Practice 60 et. seq (2004), with some further references.

competition bias" in antitrust would be most convincing if Schumpeter hadn't entered the stage to butt the then prevailing paradigm of "perfect competition" from the throne of antitrust and the very productive (admittedly mostly non-technical) following discussion had never taken place.

Because the gap between high performance formal modeling and the focal point of what Schumpeter famously called "process of creative destruction" is still so large, it is currently only a pious hope that this gap may be closed a little bit by further research. The argument, however, that until the gap has vanished sufficiently only a cautious "hands-off" approach in antitrust can avoid a very harmful "static competition bias" deserves no support since its advocates pretend to be able to anticipate what is impossible to know: the outcome of the future academic work Evans & Hylton so forcefully ask for. Should the relevant research results finally confirm that—as Jonathan Baker puts it—"the push of competition spurs more innovation than the pull of monopoly,"[12] any caution would not only be useless but simply wrong.

To stress the core of my argument, it might be useful to refer to another Austria-born professor[13] with (at least) the same worldwide impact as Professor Schumpeter: Sir Karl R. Popper.[14] His seminal work on the theory of science[15] can be summarized as follows: the truth of our economic theories, even the best of them, cannot be verified by scientific testing but can only be falsified. He also held that theory, and human knowledge generally, is irreducibly conjectural or hypothetical, and is generated by the creative imagination needed to solve problems. Accordingly, Popper's view of scientific progress is essentially driven by the same "process of creative destruction" Schumpeter has highlighted.

If Popper's premise is accepted, there is only one reasonable approach of integrating economics and economists in antitrust: to use the relevant state-of-play of antitrust economics (to be stressed: all of it!) to make sure that the outcome of an antitrust investigation is economically sound and the best possible decision at that point in time. I am quite sure that Professor Popper would strongly support such an approach; and he would also be very reluctant to accept a policy approach in antitrust which just bets on some possible future results of an inherently open and never-ending research process.

This brings me directly to my second point: When first reading Evans & Hylton's claim that "the static-ization of antitrust is particularly problematic" in

12. Jonathan Baker, *Dynamic Competition' Does Not Excuse Monopolization*, 4 (2) Competition Pol'y Int'l at p. 245 (Autumn 2008).

13. Joseph A. Schumpeter was born in 1883 in Triesch (Austria-Hungary).

14. Karl R. Popper was born in Vienna in 1902.

15. Karl Popper, The Logic of Scientific Discovery (1959, original published in Vienna in 1935).

jurisdictions outside the United States where—like on the EU-level or in Germany—the competition authority acts "as investigator, prosecutor, and judge,"[16] two questions immediately jumped into my mind. First, do Evans & Hylton really assume that the recruitment policy of competition authorities as regards economists is so poor? And second, is it really true that in other jurisdictions the risk of an inappropriate definition of the role of economists in antitrust enforcement is higher than in the United States? Since no chief economist of any competition authority in the world would consider the first question to be a relevant one, I decided to think more deeply only about the second one. And the answer I arrived at is "No."

THE QUESTION WHETHER THE CHALLENGE OF INTEGRATING ECONOMIC ANALYSIS PROPERLY IN ANTITRUST ENFORCEMENT IS MANAGED SUCCESSFULLY IS NOT LINKED TO A SPECIFIC INSTITUTIONAL FRAMEWORK OF LAW ENFORCEMENT.

The question whether the challenge of integrating economic analysis properly in antitrust enforcement is managed successfully is not linked to a specific institutional framework of law enforcement. Adversarial enforcement systems like in the United States and administrative systems like in the European Community or Germany may develop different views of how a successful integration should look. The underlying principles are, nevertheless, the same.[17] My critical assessment of Evans & Hylton's hypothesis of a static bias and the "static-ization" of antitrust stems from my conjecture that they overestimate the risk that these principles are disregarded.

One of the most important lessons economists have to take to heart is the quite obvious fact that an antitrust case cannot be translated into a list of elegant formulas and equations and then solved mechanically with something like the quantitative impact on consumer or total welfare being the output. The scenario in which the Evans & Hylton's fears would really have some relevance is, however, just the one in which this lesson is totally disregarded: some number-crunching economists who are caught in the world of "highly technical, clever, and useless static analysis"[18] feed their computers with data of dubious quality and then present one single figure as the relevant evidence which should give the lead.

16. Evans & Hylton, *supra* note 1, 240.

17. For a very good description of these principles and the EU-Commission's approach of integrating economists in competition law enforcement *see*: Lars-Hendrik Röller, *Economic Analysis and Competition Policy Enforcement in Europe*, in MODELING EUROPEAN MERGERS: THEORY, COMPETITION POLICY AND CASE STUDIES 13 – 26 (Peter Bergejk & Erik Kloosterhuis ed., 2005) for some very apt considerations based on the specific institutional setup in the United States, see: HERBERT HOVENKAMP, THE ANTITRUST ENTERPRISE: PRINCIPLES AND EXECUTION (2005).

18. Evans & Hylton, *supra* note 1, 240.

Accordingly, I also think that Evans & Hylton's statement that there is some irony in the fact that "because of the tendency to focus on static welfare models at the expense of dynamic competition, the enhanced stature of economists in [...] enforcement agencies may not be sufficient to lead to a substantial improvement in the quality of enforcement decisions"[19] misses the point. What really should be seen by economists with some irony is the fact that it is necessary to refer to a worst-case scenario of an unsuccessful integration of economists in antitrust enforcement to underpin the fear of its systematic myopia.

Or to put it in another way: The recommendation of a cautious "hands-off" approach in antitrust should not be based on the general assumption that economists are not able to reasonably apply the state-of-play in antitrust economics. If there is some empirical evidence that they did so in the past, it seems much more appropriate to think about a more suitable integration of economic analysis in antitrust enforcement than to stop enforcement.

II. On the Scope of Antitrust Enforcement—and Its Limits

In addition to these more general thoughts on the role of economics and economists in antitrust enforcement, I believe that Evans & Hylton's argument deserves at least two further qualifiers:

1. Evans' and Hylton's paper does not properly reflect the scope of antitrust and its concept of (abuse of) monopoly power or monopolization.

2. What Evans & Hylton consider to be the objective of antitrust is too far away from being operational to form the guard rail for practical antitrust enforcement.

To develop the first point, I intend to use a method economists are very familiar with: to think in terms of an ideal world. In an ideal Schumpeterian world of competition, which in particular leaves aside the risk of failing innovation efforts, each company would, at any point in time, get exactly the reward it can reasonably expect for its innovation efforts. This is the core of the perpetual motion machine of economic progress highlighted by Schumpeter. All companies (including those not even existing today) have the same question driving their incentive to innovate: Will I get—due to some monopoly power—what I can reasonably expect as a reward for my innovation efforts?

So far, in this ideal world, no antitrust enforcer is present. But if he or she enters the stage, the relevant scope of his/her task could be described as follows:

19. *Id*. at 240.

to make sure that companies with some significant monopoly power (or let us say a "dominant market position") cannot successfully implement a strategy to get more reward for innovation than they can reasonably expect also taking into account the profits and incentives to innovate of all other companies inside or close to the relevant market concerned. The antitrust enforcers in our ideal world are therefore just focused on the monopoly profits a company with significant monopoly power intends to get at the expense of the profits and hence the incentive to innovate of other companies.

To use a quite prominent antitrust case to illustrate my point: the relevant (and much disputed) antitrust issue of the Microsoft case was not whether Microsoft has some monopoly power. The relevant question was whether Microsoft's conduct had to be assessed as an abuse of it[20]—an abuse of monopoly power in the sense of an attempt to effectively reap more profits from monopoly power than needed as a reward for its innovation efforts in the past.

Accordingly, in the context of a Schumpeterian world, the tradeoff antitrust enforcers are mostly interested in is not one of static versus dynamic efficiency; the core issue of antitrust and innovation is exclusively a dynamic one. In their analysis, Evans & Hylton lost sight of this important point which results from the quite common knowledge that static monopoly power by no means only creates static inefficiencies but also severely damages dynamic efficiency.[21] The reason for this is quite simple: the innovation effort fueled by the prospect of monopoly power significantly cools down should the prospect become reality. When monopoly power becomes reality and even goes along with significant market power ("dominance"), a company's interest in maintaining this comfortable situation as long as possible is stronger than its sense that only the pressure from other companies which follow the same "pursuit of happiness of monopoly power" has brought it into the position it currently enjoys.

Based on the (static) illustration of the famous Williamson tradeoff[22] Evans & Hylton develop the intriguing concept of a "bounty equal to the residual surplus to bring the private and social returns from innovation closer to each other."[23]

---

20. For this reason I consider the term "monopolization" used in U.S. antitrust law a little bit misleading. The terms "abuse of monopoly power" or "abuse of a dominant position" seem to better fit this issue.

21. *See*, for a nice and quite simple formal representation presented under the heading "Monopoly gives fewer incentives to innovate: An Example": Massimo Motta, Competition Policy: Theory and Practice, 58 (2004). One may also refer to the quite famous hypothesis of an inverted-U shaped relationship between the degree of static market power and dynamic efficiency and innovation; see Philippe Aghion, et al., *Competition and Innovation: an inverted-U relationship,* 120 Q. J. Econ. 701-728 (2005).

22. Oliver Wlliamson, *Economies as an Antitrust Defense: The Welfare Tradeoffs*, 58 Am. Econ. Rev. 18-36 (1968).

23. Evans & Hylton, *supra* note 1, 236.

For all those companies, however, which are under scrutiny of antitrust enforcers, the likelihood of a positive bounty is close to zero. Or can we really assume that a company which finally reached the paradise of significant monopoly power suddenly strives to nothing else than being driven out of it? Quite the opposite seems to be much more likely, i.e. a very strong incentive for dominant companies to barricade the doors of the paradise against all other companies wanting to come in. The objective of antitrust is to keep the door open to the paradise of monopoly power; to expect that this is deliberately done by the most powerful of all its occupants is an illusion.

THE OBJECTIVE OF ANTITRUST IS TO KEEP THE DOOR OPEN TO THE PARADISE OF MONOPOLY POWER; TO EXPECT THAT THIS IS DELIBERATELY DONE BY THE MOST POWERFUL OF ALL ITS OCCUPANTS IS AN ILLUSION.

With my last qualifier, I leave the field of the theoretical discussion laid out by Schumpeter and look into the practical limitations of antitrust enforcement. In this regard, a further expansion of the already established virtual panel of Austria-born Professors may help a bit. The new participant I would like to welcome is Professor Friedrich A. von Hayek.[24] The support I expect from Professor Hayek would probably look like this:

While reading or hearing Evans & Hylton's statement that the objective of antitrust law "is economic progress broadly defined or, in the language of economics, long-run economy-wide consumer welfare,"[25] Professor Hayek may first show a frown. Afterwards he would probably say something like: "Gentlemen, I would strongly recommend you be a little bit less ambitious and more humble." And then he would highlight some of the main elements of his work. Because his good old friend Professor Popper also recently joined the panel, he would most likely refer to his own philosophy of science which is also highly critical of what he terms scientism, i.e. pretending to know what in fact cannot be known.[26] But in any case he would make the point that all the professors of industrial organization and antitrust enforcers taken together still would know much less than what a benevolent social planner would need to know to maximize welfare in the long run.

To avoid again any misunderstanding: as an economist, I am far from disputing that the welfare standard currently provides the only suitable point of reference for sound theoretical analysis. But considering only some of the issues connected with this concept, strong doubts arise whether it is also a good practical point of reference for antitrust enforcers. How can the consumer benefits of future innovation be measured? And even if we would know how, what should

24. Hayek was born in Vienna in 1899.

25. Evans & Hylton, *supra* note 1, 220.

26. See e.g. Friedrich A. Hayek, *The Use of Knowledge in Society*, 34 AM. ECON. REV 519-530 (1945).

be the discount factor to take them properly into account? How to take on board all the indirect dynamic effects across markets? And so on and so forth.

At this point, one may see in our virtual panel probably Professor Schumpeter himself asking for the floor. And he would mention that all this reminds him very much of a rather fierce dispute he has had with a British professor—admittedly in the field of macroeconomics and not in antitrust. In the course of this discussion, Professor John M. Keynes had stated:

> "Now 'in the long run' this is probably true. [. . .] But this long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again."[27]

Schumpeter would surely stress that he is—like me—far away from asking for a "Keynesian Revolution" in antitrust. But if applied to the world of antitrust, Keynes' famous words may nevertheless provide the basis for a strong warning: to argue that antitrust intervention is horribly dangerous because one cannot exclude that an intervention today may probably hinder or postpone innovations in the future, is not far away from asking consumers today to pay the bill for hoped-for innovations of already very powerful companies which will probably never materialize.

III. Conclusion

The most severe issue connected with the Schumpeterian tradeoff is—that it is a tradeoff. I intended to show that adding the thoughts of some other Austria-born professors to the seminal work of Professor Schumpeter must lead to the conclusion that it's wrong to ask antitrust enforcers to be mainly concerned about monopoly power as the carrot and less concerned about competitive pressure as the stick.

The most suitable policy approach to cope with a tradeoff should be to be neither myopic nor hyperopic but to have the clearest view possible. To get this view, however, it is useful and even indispensable to have a very intensive and controversial discussion. Therefore, the current debate on the right view of antitrust on innovation can be interpreted as a "process of creative destruction of antitrust enforcement approaches." I am quite confident that Professor Schumpeter would appreciate this outcome of his work very much.

27. John M. Keynes, A Tract on Monetary Reform ch. 3 (1924).