

Paper Trail: Working Papers and Recent Scholarship

Editors' Note: *In this edition, we offer notes on three new papers, as well as an author's response to a note from the last issue. The first new paper is by Fred McChesney, who critically surveys developments in antitrust over his career as an antitrust scholar. The second paper is a theoretical analysis of the deadweight welfare losses associated with coupon and discount remedies in overcharge class actions. The third paper adds another view to the debate on the usefulness of critical loss analysis. The response is by Alan Meese, who clarifies his usage of the term "price theory" in his article, Price Theory, Competition, and the Rule of Reason, 2003 Illinois L. Rev. 77, which we noted in the November 2003 issue.*

Send suggestions for papers to review, or your comments, to Editors William Page: page@law.ufl.edu or John Woodbury: jwoodbury@crai.com.

—WILLIAM H. PAGE

Papers and Summaries

Fred S. McChesney, Talking 'Bout My Antitrust Generation: Competition for and in the Field of Competition Law, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=428641

In this paper, McChesney comments on some of the forces at work in the evolution of antitrust law over the past three decades. He characterizes those forces using the metaphors of competition *for* the field of antitrust and competition *within* the field. In the former category, he discusses the competition between theoretical paradigms for dominance as the standard for antitrust decision making, and the competition between the Supreme Court, which had adopted "nonsensical" liability rules, and rebellious lower federal courts, which adopted various stratagems to limit the rules' perverse effects.

In the category of competition *within* the field, McChesney discusses the competition between property rules and antitrust rules, and the competition among antitrust authorities. He notes that the long-recognized tension between antitrust and intellectual property is part of a larger tension between antitrust strictures and collective efforts to clarify or to enforce property rights. Property seeks to maximize welfare in the long run by creating incentives to create wealth even at the expense of higher prices; antitrust seeks to maximize (static or short-term) welfare by increasing output and reducing prices. No one has yet proposed a practical way of quantifying and comparing the two welfare effects in particular cases. McChesney points out, for example, that Easterbrook's famous "filters" aimed at identifying practices most likely to reduce welfare (market power, profit at consumers' expense, etc.) may operate perversely in cases in which the scope of property rights is unclear.

McChesney also considers the costs of having multiple antitrust enforcers, both within the United States and internationally. Following Posner, McChesney is particularly critical of state antitrust enforcement on public choice grounds. He suggests that, because of their unique political incentives, states will either free ride on federal enforcement, as in the *Microsoft* case, or will bring easily-won cases that would not interest federal enforcers. Typical of the latter, he contends, was the suit by states, including New York and Illinois, against Salton, Inc., alleging resale price maintenance on the George Foreman grill. According to McChesney, the case challenged an economically beneficial

practice and produced a settlement fund that was not distributed to consumers. He concludes that “suspicion abides that state antitrust enforcement is mostly about politics.”

McChesney also criticizes EU antitrust enforcement on public choice grounds. As a bureaucracy substantially independent of member states, the EU enforcers have an incentive to stake out positions that are more aggressive than those of U.S. enforcers in cases with major international impact, such as *Microsoft* or the GE/Honeywell merger. Mere deference to the United States does not, he argues, give enforcers the power to “control economic resources.”

A. Mitchell Polinsky & Daniel L. Rubinfeld, Remedies for Price Overcharges: The Deadweight Loss of Coupons and Discounts, http://papers.ssrn.com/paper.taf?abstract_id=471001

Polinsky and Rubinfeld examine the effect on economic welfare of coupon and discount remedies, which are commonly used in settlements of price-fixing class actions. A coupon remedy awards overcharged buyers coupons, redeemable for a fixed period, allowing them to purchase the affected good for less than the competitive price. A discount remedy gives all buyers of the affected good a discount for a fixed period. The authors assume that both remedies seek to compensate consumers for both the total overcharge and the deadweight loss in consumer welfare from reduced output during the damage period. Some have criticized these sorts of remedies for giving attorneys for the class a perverse incentive to settle the case on terms that are unfavorable to the class members. Polinsky and Rubinfeld consider the separate objection that, by setting prices temporarily below competitive levels, these remedies may reduce economic welfare. Consumers may purchase more of the good than they would at a competitive price. Such a consequence reduces welfare because consumers value the marginal units (purchased above the competitive output) less than those units' cost of production.

Discount remedies inevitably reduce welfare to some extent by reducing prices below the competitive level to all buyers, regardless of whether the buyers ever paid an overcharge. But the amount of the welfare loss depends on the magnitude of the discount (and the length of the remedial period). To compensate consumers for the overcharge plus the deadweight loss, in a period comparable to the damage period, the discount will be smaller than the overcharge because the quantity demanded at the discounted price will be higher than the quantity demanded at the overcharge.

Coupons may also reduce welfare, but only if the coupon-holder's demand is lower during the remedial period than it was during the damage period. If his demand remains high during the remedial period, the coupon holder will use up his coupons on intra-marginal purchases, and purchase only an optimal amount of the good, paying the competitive price for the marginal units. If, however, his demand is lower, the coupon-holder will use the coupons to purchase more than the optimal amount of the good.

Which remedy creates the greater welfare loss depends on a number of factors. The discount applies to all buyers, and is smaller than the overcharge. The coupon only applies to a subset of buyers, but it must be larger than the actual overcharge to allow a full recovery for the class, because the marginal consumers who were deterred from purchasing the good at all by the overcharge do not receive coupons. The critical point to note, however, is that the coupon remedy only generates a welfare loss if the coupon-holder's demand is lower in the remedy period than it was in the damage period. When there is a high probability that this key condition is met, the coupon remedy is correspondingly more likely to create a higher welfare loss than the discount remedy.

The authors also consider the effect of extending the time in which coupons or discounts can be used. The analysis becomes considerably more complex, but the authors conclude that increasing the number of remedy periods tends to reduce the welfare loss for both types of remedy (though not to zero), and that essentially the same factors determine which remedy is preferable.

In a concluding section the authors note that a cash remedy is preferable to coupons, because it does not distort prices and is no more costly to administer. The discount remedy, however, is less administratively costly than either cash or coupons because it does not require identification of particular recipients.

Malcolm B. Coate and Mark D. Williams, Generalized Critical Loss for Market Definition (October 2003), available on request from mcoate@ftc.gov

As readers of the *Antitrust Source* are aware, there has been recent debate about the usefulness of critical loss analysis for purposes for market definition, much of it stemming from research by the staff of the FTC's Bureau of Economics (O'Brien and Wickelgren, Scheffman and Simons). The Coate/Williams paper joins that debate by exploring the implications of non-constant marginal costs for critical loss analysis. As the authors note, if the marginal costs are rising, then the standard critical loss analysis, which assumes constant marginal costs, will result in markets that are too broad. Coate and Williams explore a number of possibilities for incorporating increasing marginal costs into the critical loss analysis, culminating in a table in which, for any given snippet, the magnitude of the critical loss depends on both the contribution margin and the elasticity of marginal cost with respect to output. (The authors also conclude that if the products being evaluated are differentiated, then "firm-level modeling," not standard critical loss analysis, is the appropriate means for assessing competitive effects.)

It's not obvious what the practical import of the Coate/Williams analysis might be. In the standard critical loss analysis, the assumption of constant marginal costs is made because the typical accounting data—which are usually the only cost data available—do not provide enough information to trace out the marginal cost relationship within the vicinity of the price increase. Thus, the usefulness of this paper is not in changing the way practitioners calculate the critical loss but rather in evaluating how sensitive that calculation might be to the assumption of constant marginal costs. While this paper is not nearly as technical as the original O'Brien/Wickelgren papers, more work is needed to make it truly accessible to lawyers.

Author's Response

Editors' Note: In our last Paper Trail, <http://www.abanet.org/antitrust/source/nov03/trail.pdf>, Bill Page's note on Alan Meese's article, Price Theory, Competition, and the Rule of Reason, 2003 *Illinois L. Rev.* 77, questioned Professor Meese's use of the term "price theory" in a way that excluded transaction costs—a usage different from that of Chicago School analysts. Professor Meese responds:

I'm sorry you found my discussion and/or definition of "price theory" somewhat "confusing[]" in your words. As you said, I certainly used "price theory" in a manner different from some in the Chicago School. This was deliberate. In so doing, I tried to use that term, and the framework it describes, in the same manner that Williamson, Langlois, and even Coase have used it. These

economists, I submit, use “price theory” in a manner quite different from the way in which Judges Bork and Posner have used the term, for instance. Moreover, it seems to me that both Bork and Posner use the term in a way that deprives it of any real utility in this context.

Here is what I mean. As you know better than I do, both Bork and Posner argue that the Chicago School of antitrust analysis is based upon “price theory,” and that the Chicago approach is therefore superior to prior approaches such as that associated with the “Harvard School” of Kaysen, Turner, Bain, and Mason. There are two problems with this, in my view. First, if you asked Kaysen, Turner, Bain, and Mason what economic framework they were applying back in the 1940s, 1950s and 1960s, they would certainly say “price theory.” Indeed, Joe Bain’s text on *Industrial Organization* begins by asserting that the subject is really just applied price theory. Second, “price theory” as understood in the 1960s and 1970s, when Posner and Bork were first writing about antitrust, referred to just that, the theory of how price can (or cannot) allocate scarce resources between competing uses. Price theory as such had no theory of the firm, but instead treated the firm as a black box, which pursued the unitary interests of its owners. At the same time, price theory ignored information costs and opportunism and implicitly assumed a perfect specification of property rights. (Some of these assumptions were first associated with the perfect competition model, but as Hayek and Langlois have pointed out, price theorists embraced most of these assumptions even when analyzing concentrated markets or markets characterized by product differentiation.) Price theory treated the operation of markets as costless and thus could not explain various non-standard contracts like rpm, tying and exclusive dealing. For these and other reasons Professor Coase criticized both Bain and George Stigler for treating industrial organization as “applied price theory.”

Telser, Bork, and Williamson came along and explained how non-standard contracts could, in fact, further social welfare in many instances by reducing the cost of transacting, i.e., relying upon the market to conduct economic activity. Note that Telser does not, I think, invoke “price theory” in his 1960 article on minimum rpm. Moreover, Williamson’s 1971 article on vertical integration and market failure does not invoke “price theory” to help explain such contracts. There is simply nothing about the price theoretic industrial organization paradigm as reflected in the work of Bain, Turner, or Stigler for that matter that can help explain minimum rpm, exclusive territories, or exclusive dealing. In fact, by assuming a high cost of negotiation between manufacturers and dealers, Telser, Williamson, and Bork departed from the price-theoretic assumption that such bargaining was costless, with the result that manufacturers could simply contract with dealers to provide services they desired. (See William Comanor, *Vertical Territorial and Customer Restrictions: White Motor and Its Aftermath*, 81 Harv. L. Rev. 1419 (1967) (assuming that manufacturers can costlessly negotiate with dealers)). All also rejected price theory’s tendency to assume away opportunism.

Against this background, Bork and Posner’s invocation of “price theory” seems to me a bit misplaced. There is nothing about the price theory contained in textbooks in the 1940s, 50s, or 60s that helps one properly interpret minimum rpm, exclusive territories, or exclusive dealing agreements. The same is true for tying contracts. (The price discrimination account of these contracts is really a transaction cost account and thus is not grounded in price theory.) Like Telser, Bork, and Posner implicitly reject price theory’s assumption of no transaction costs and well-specified property rights. Moreover, Bork’s early work actually cites Coase’s “Nature of the Firm” and thus implicitly rejects price theory in an important respect, i.e., its theory of the firm. Indeed, when Bork and Posner get done with “price theory,” the only thing left seems to be its rationality assumption.

For what it’s worth, I made a similar argument in the context of vertical restraints. See Meese, *Price Theory and Vertical Restraints: A Misunderstood Relation*, 45 UCLA L. Rev. 143 (1997).

Ironically, many scholars have attacked Chicagoans for their purported reliance on price theory, claiming that Chicagoans equate price theory with perfect competition. I claim that this argument demolishes a straw man, and that Chicago's approach to vertical restraints rests upon all sorts of departures from perfect competition and price theory. I also argue that Bork and Posner claim to be relying on price theory when in fact they are relying on Transaction Cost Economics. Put another way, Bork and Posner's most important contributions involved a rejection of price theory in many respects. I realize that some of this is semantics, but it seems to me that we can improve the antitrust conversation if terms like "price theory" have fixed meanings, so we know what sort of framework we are talking about if we invoke price theory. ●