Paper Trail: Working Papers and Recent Scholarship

Editor's Note: *In this edition we note two books—one by antitrust lawyers and one by antitrust economists—that discuss practical issues that arise in antitrust litigation, and one paper by Katz and Shelanski—on the role of innovation in formulating merger policy.*

Send suggestions for papers or books to review to: page@law.ufl.edu or jwoodbury@crai.com.

—William H. Page/John R. Woodbury

Book Notes

Winning Antitrust Strategies: Leading Attorneys on Mastering the Laws that Regulate, Promote, and Protect Competition (Aspatore Books, 2004)

This book collects eleven short articles, all by experienced antitrust practitioners, commenting on trends in contemporary antitrust law and on the characteristics of a successful antitrust practitioner. The pieces contain some useful generalizations about antitrust counseling and advocacy. But, because most of them are personal reflections on an entire field rather than essays on specific issues, they offer mainly impressions and conclusions, many of which are self-evident, rather than arguments or original research. Because the authors appear to have been given the same charge, they tend to cover much of the same ground. Most of the authors, for example, summarize the coverage of the antitrust laws. Many of the authors identify the same contemporary trends, such the importance of economic analysis, the internationalization of antitrust enforcement, and the rise of antitrust litigation in state courts. And many of them make the same observations about good practice, emphasizing that a lawyer should understand clients' business goals, stress to clients the importance of antitrust compliance, simplify the presentation of antitrust cases, and be forthright in dealings with enforcement officials. The book may be of some interest to new antitrust practitioners or to business executives.

Economics of Antitrust: New Issues, Questions, and Insights (Lawrence Wu, ed., NERA Economic Consulting 2004)

This book is an all-NERA effort: fourteen articles written by NERA economists, edited by one of those economists, and published by NERA itself. The articles initially appeared in the NERA newsletter, *Antitrust Insights*. All of the articles are short (about ten pages each, with a few endnotes) and discuss specific economic and statistical issues that arise in antitrust litigation or regulation. Half of the articles deal with issues in merger cases, and half deal with issues involving other practices, including predatory pricing, price discrimination, tying, and exclusionary contracts. The editor provides a preface, index, and useful abstracts for each of the articles.

The discussions are all in readable prose, and include no equations or diagrams, other than a few tables. Yet I would not call them strictly nontechnical, because they do deal with some advanced and topical issues. For example, Sumanth Addanki distinguishes the "residual" elasticity of demand implicit in the Lerner Index of monopoly power, and "Marshallian" elasticity of demand. The former

measure takes account of anticipated price responses of other firms; the latter assumes that prices of other products are held constant. When an econometric study estimates the Marshallian demand elasticity, which is appropriate for measuring substitution between products in market definition, it is likely to differ from the residual elasticity figure. If the study is used in litigation, this disparity will probably provoke questions for an expert on cross examination.

Most of the other essays likewise focus on the interaction of economic analyses with legal or regulatory requirements. Because many of the essays grow out of practical applications of economic theory and statistical methods in actual studies used in litigation, they will be interesting to economists who study antitrust issues. And, because of their topicality and accessibility, they will also be useful to economically informed antitrust practitioners and students.

—WHP

Paper Summary

Michael L. Katz and Howard A. Shelanski, Merger Policy and Innovation: Must Enforcement Change to Account for Technological Change? NBER Working Paper 10710 (August 2004), www.nber.org/papers/w10710 (fee to download)

The role of innovation in antitrust generally, and merger analysis specifically, has been the focus of numerous academic papers. This has been a discussion shaped by the insights of Joseph Schumpeter and his "gale of creative destruction" wrought by monopolist-pretenders seeking to dethrone an incumbent monopolist, by F.M. Scherer's views that the optimal amount of innovation requires an industry structure that is more oligopoly than competition or monopoly, and by the litigation surrounding Microsoft.

Against that backdrop, the Katz/Shelanski paper focuses on two seemingly different questions for merger policy. How should merger policy be informed if in fact some particular market is characterized by rapid innovation? Will a particular merger that, e.g., creates a more dominant firm, reduce or increase the incentives to innovate?

With respect to evaluating the antitrust impact of innovation on the competitive effects of any particular merger, the paper focuses on market-definition issues. Should the current products of the merging firms really be the focus of the merger evaluation or should the agencies seek to identify future product market competition? Are current shares a useful predictor of post-merger market performance? To be sure, there is nothing novel about these questions, but the paper highlights both the empirical and conceptual issues that such an approach raises, including the fact that it invariably takes us into the murky area of (ultimately) identifying future product rivals, i.e., assessing potential competition. Perhaps most interestingly, the paper notes that a presumption that an innovation-based forward-looking analysis invariably broadens the market is incorrect. As a result of innovation, products that are in one market today may be in distinct markets in the future (think of the competition between the telegraph and the telephone when telephony was in its nascent stages).

In turning to the discussion of the impact of competition on innovation incentives, the paper begins in the same way it did in addressing the first question—how to identify future market boundaries and potential competition. It's not hard for a reader to reach the conclusion that the answers to the two questions posed by the authors are so interrelated—the extent of market innovation on competition depends on the incentives of the incumbent firms to innovate—that it makes

one wonder whether the authors were too facile in their innovation-competition/competition-innovation dichotomy. In fact, the paper is likely accurate in distinguishing between exogenous and endogenous technical change. For example, innovations in computer technology revolutionized the banking industry and may shape our views on bank mergers. But those innovations were not generated by the banking industry. Nonetheless, that distinction is not always clear in the paper.

That issue aside, the paper reviews what we know about the role of market structure on innovation (and the important role that IP protection plays in evaluating a merger's effects on innovation incentives), although the cited paper by Cohen and Levin is far more comprehensive. Those who have any familiarity with this issue will not be surprised by the authors' conclusion: We have very little to say generally about the market structure/innovation nexus. Depending on the precise market model and the degree of IP protection, product market structures most conducive to innovation can range from monopoly to more robust competition.

Perhaps (in my view) the death-knell for any recommendation that the agencies evaluate the effect of a merger on the change in the innovation incentives of the combined firm is the paper's suggestion that these should be considered efficiencies. It is difficult enough to provide evidence on variable cost savings that the agencies will find verifiable. The difficulty of providing verifiable evidence of the merger's impact on innovation incentives is certainly orders of magnitude larger than providing cost-savings estimates. And this discussion seems far too focused on the impact of the merger on the combined firm's incentives to innovate rather than the impact on the total post-merger "production" of innovation by the market.

The most disappointing aspect of the paper is that it devotes so little space to the question posed in the title—whether merger enforcement should be more sensitive to innovation concerns—other than saying "yes," with a few tips. But interestingly, the authors do question the two-year horizon of the Merger Guidelines, arguing that by discounting the future so heavily, merger policy will inevitably result in underestimating the market importance of revolutionary changes wrought by innovation. The paper argues that the correct approach "would be to estimate probability distributions for alternative potential outcomes and then use the probabilities as weights in projecting an expected net present value of a merger's effects on consumer welfare." And I thought that demonstrating verifiable cost savings was difficult! It is a pity that the authors did not focus more of the paper on the costs and benefits of the two-year horizon, and propose meaningful rules or guidelines on when the two-year horizon should be relaxed (or made more restrictive).

All told, there is little that is novel in this paper. However, it does provide a useful and accessible overview of the important issues that arise in merger matters where innovation is a significant consideration. ●

—JRW