

Paper Trail: Working Papers and Recent Scholarship

Editors' Note: A recent paper by four FTC staffers—including the current Director of the Bureau of Economics—offers a decision-theoretic framework for guiding vertical antitrust policy. That paper has stimulated a lively exchange between its authors and three economists responding on behalf of the American Antitrust Institute, two of whom are former Bureau Directors. Get ready to rumble.

And looking towards European enforcement, we review a paper that proposes a model for predicting the effects of EC Regulation 1/2003 as a result of the changed role of the member states' national courts.

Please send any comments or suggestions for papers to review to: Bill Page (page@law.ufl.edu) or John Woodbury (jwoodbury@crai.com).

—WILLIAM H. PAGE AND JOHN R. WOODBURY, EDS.

Recent Papers

Director vs. Director: Vertical Antitrust Policy

James C. Cooper, Luke Froeb, Daniel P. O'Brien, and Michael Vita, Vertical Antitrust Policy as a Problem of Inference (Vanderbilt Law and Economics Working Paper No. 05-12, Feb. 18, 2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=699601

The Cooper et al. paper proposes that the basis for vertical antitrust policy should depend on a comparison of the expected losses from incorrectly challenging a practice that benefits consumers (Type I error) versus the expected losses from incorrectly failing to challenge a practice that harms consumers (Type II error). The expected losses from incorrectly challenging a practice that benefits consumers are the benefits of the practice times the probability (likelihood) that the practice is competitive, given the evidence. Similarly the expected losses from failing to challenge a merger that harms consumers are the harm from the practice times the probability that the practice is anticompetitive, given the evidence.

This is a Bayesian framework for inferring whether a practice might be anticompetitive, one that begins with one's priors on the likelihood that a practice (in general) is anti- or procompetitive, priors that are then adjusted by the evidence of the harm or benefits of a practice. As the paper notes: "A decision to challenge a given restraint is more likely if: (1) the cost of type-II errors is high relative to the cost of type-I errors; (2) there are strong priors that a practice is anticompetitive; and (3) theory suggests a strong likelihood that the evidence was generated by an anticompetitive rather than a procompetitive or benign practice." The paper notes that the values that one places on these three components may vary with the particular restraint at issue (although there is nothing in their Bayesian framework that technically requires that, e.g., one has a "strong" prior that the practice is anticompetitive, only that (other things equal) it be sufficiently strong to result in net expected losses from failing to challenge the practice).

Up until this point, the authors' approach is both even-handed and potentially even helpful to antitrust enforcers. But it's the application of the approach that has generated and no doubt will continue to provoke some controversy. At the outset, the authors note that in the absence of a natural experiment (where there is a "control" group without the vertical restraint that can be compared to an "experimental" group with the restraint) that provides clear evidence of the consumer effects of the vertical restraint, the antitrust enforcer and the courts must infer what the "but-for" world would have been based on the evidence available and the theories offered. But the Cooper et al. paper asserts that as a practical matter, the decision maker may not be able to verify the assumptions of the theories or the likely effects of the practice. If that is true, then game, set, match. Because there is no basis on which to decide whether the practice is anticompetitive (or procompetitive), the default presumption (presumably) is that it is procompetitive.

While it's difficult to disagree with that conclusion (and I, for one, won't try to), the paper's review of the theories describing the possible anticompetitive effects of vertical restraints may lead the reader (or at least this reader) to infer that it is almost impossible to empirically verify any of those theories. Which would immediately lead to the conclusion that the only viable vertical antitrust policy is one that challenges vertical practices maybe once in a millennium.

Assuming the decision maker does have evidence bearing on the relevant conduct, the paper then considers whether there is a greater likelihood that the evidence is generated by anticompetitive behavior than by procompetitive practices. As the authors put it, "this may be a close to an empty set" because vertical theory suggests that many practices can have ambiguous competitive effects—both costs and benefits to consumers. Importantly, the author's substantial discounting of the possible anticompetitive effects of vertical practices results in part from the fact that different assumptions can generate different results. Thus, as the authors point out, some theories of anticompetitive harm depend upon whether competition is assumed to be Cournot or Bertrand, whether pricing is assumed to be linear or non-linear, whether contracts are assumed to be observable or not. It's not clear why the reader should be both surprised and nihilistic because our models depend on assumptions.

Assuming, then, that the likelihood of the evidence being generated by anticompetitive behavior is no higher than the likelihood of it being generated by procompetitive behavior (so at best, it doesn't figure into the cost-benefit calculation), the decision maker must look to prior beliefs and the losses associated with making Type I and Type II errors. To determine what those prior beliefs should be, the paper offers a brief review of twenty-two papers recently published in economics journals and concludes that only one of those twenty-two "purports to find unambiguously an instance where vertical integration was harmful to consumers. And in this case, the losses are miniscule . . ." While "a few" of the studies have results consistent with either a pro- or anticonsumer effect, the review concludes that "instances where vertical controls were unambiguously anticompetitive are difficult to find" and therefore "given strong priors that vertical restraints are efficient, enforcement against vertical restraints should be rare absent direct evidence of harm to welfare."

Finally, the Cooper et al. paper devotes only minimal space to the likely magnitude of the losses from Type I and Type II errors, relying, in a note, on the now-familiar Easterbrook statement that market self-correction of the failure to challenge practices that harm consumers tends to reduce or eliminate the losses associated with Type II errors—without acknowledging the length of time it might take the market to self-correct.

In a response to this paper, three economists, including two former Directors of the Bureau of Economics, raise questions about the survey of empirical work. (William S. Comanor, F.M. Scherer,

and Robert L. Steiner, Vertical Antitrust Policy as a Problem of Inference: The Response of the American Antitrust Institute, Working Paper No. 05-04 (April 2005), <http://www.antitrustinstitute.org/recent2/408.pdf>). First, Comanor et al. suggest that drawing any generalizations about the impact of vertical restraints on consumers is misplaced. Nearly half of the studies deal with practices in only two industries, gasoline and cable television.

Second, the Comanor et al. paper takes issue with the conclusion that the twenty-two studies were virtually unanimous in finding no empirical support for any clear-cut adverse competitive effects of vertical restraints, using the words of the studies' authors as evidence: "the studies [Cooper et al.] review are less than consistent with a one-sided conclusion on the issue."

Third, Comanor et al. argue that there were other studies not reviewed by Cooper et al. that concluded that in fact there could be a risk of anticompetitive effects from vertical restraints, suggesting that the selection of studies in the Cooper et al. paper may not be representative of the universe of empirical studies. And nowhere does the Cooper et al. paper address any of the findings in significant vertical cases (in which prominent economists testified as to competitive effect), such as *Aspen Ski*, *Kodak*, *Toys "R" Us*, *Microsoft*, or even *Trinko*.

In an untitled reply to the Comanor et al. response, Cooper et al. take issue with this last criticism (James C. Cooper, Luke Froeb, Daniel P. O'Brien, and Michael Vita, untitled <http://www.ftc.gov/ftc/economic.htm>). First, the authors argue that only reviewing empirical papers published in peer-reviewed journals (as opposed to book chapters, law journal articles, court opinions, agency studies, and working papers) can insure that the results comply with "the highest standard of evidence." Cooper et al. explain that they did not sample the universe of recent papers—they reviewed all recent peer-reviewed journal papers, with the exception of a paper by Comanor and Riddle (William Comanor and Jon Riddle, *The Costs of Regulations: Branded Open Supply and Uniform Pricing of Gasoline*, 10 INT'L J. ECON. BUS. 135 (2003)), which Cooper et al. characterize as providing additional empirical support of their views on vertical antitrust policy.

Second, the authors take issue with the claims of Comanor et al. that Cooper et al. mischaracterized any of the studies reviewed. Cooper et al. note that they do not always draw the same inferences as the authors of the papers from the evidence presented: "Our goal in writing the paper was to report each study's *evidence*, . . . *not* each study's conclusions (if any) as to enforcement policy."

In response to this reply, Comanor et al. argue that by focusing only on papers in peer-reviewed economics journals, Cooper et al. have set the evidentiary bar far too high. (William S. Comanor, F.M. Scherer, and Robert L. Steiner, Vertical Antitrust Policy: The AAI Reply (Apr. 30, 2005), <http://www.antitrustinstitute.org/recent2/413c.pdf>). There are numerous highly respected papers in, e.g., law journals, law reviews, and books, that should not be ignored simply because they were not published in the "right" place. They note that in their reply, Cooper et al. ironically cite as evidence for their conclusions a working paper by two highly respected economists. And perhaps not surprisingly, Comanor et al. take issue with the view that the Comanor and Riddle paper supports the views of Cooper et al.

At bottom, this debate is identical to many other economic policy debates and most antitrust litigation: It is a debate over the model, the parameters of the model, and the interpretation of the underlying evidence. In particular, among economists today, the prior for various forms of vertical control is that they are more likely than not to benefit consumers. The debate between Comanor et al. and Cooper et al. is about the magnitude of that prior. In the absence of natural experiments demonstrating the contrary, Cooper et al. seem to argue that the prior that these benefits are likely is so large that the best vertical antitrust policy is (virtually) no antitrust oversight.

While I have not reviewed all of the twenty-two studies cited by Cooper et al., it would certainly be impressive if the evidence in every recent study supported the authors' conclusions (although, in my view, Cooper et al. should have, where appropriate, distinguished their non-peer reviewed conclusions from the peer-reviewed conclusions of the reviewed papers' authors).

Comanor et al. seem to believe that the prior that vertical control benefits rather than harms consumers is lower than that suggested by Cooper et al. and the Type II error losses larger than Cooper et al. contend. And I find it difficult to disagree with Comanor et al. that the Cooper et al. literature review was far too narrowly focused. Based on a reading of this broader literature, Comanor et al. conclude that there is justification for a more interventionist policy than that which is suggested by Cooper et al., a policy that relies on a conventional balancing of costs and benefits of a practice, as is done today. This is certainly a policy I would agree with, although I would not necessarily conduct the balancing in the same way as Comanor et al.

Debates about models and the empirical basis of their parameters is one important path to developing some consensus on which models are appropriate when and on the value of the parameters. Which is why this kind of exchange is important in developing policy, even if the debates sometimes result in more heat than light.

My thanks to Bert Foer and Luke Froeb for providing me with the various rounds of replies. All of these papers can be found at www.antitrustinstitute.org.

—JRW

Modeling Post-Modernization Effects

Ben Depoorter & Francesco Parisi, Modernization of European Antitrust Enforcement: The Economics of Regulatory Competition (George Mason Law & Economics Research Paper No. 05-09), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=699802

This short paper proposes a model for predicting the effects of EC Regulation 1/2003 governing European antitrust enforcement. The topic is certainly important. The Regulation abandons the requirement that companies notify the European Commission of certain practices, a procedure that was burdensome for the Commission and that had interrupted some national antitrust proceedings. In addition, it makes Articles 81 and 82 of the EC Treaty “directly applicable” to the member states. Consequently, the national courts of member states now have authority to enforce these provisions, subject to EC coordination and supervision. This authority extends to Article 81(3), which allows regulators to grant “exemptions” for restrictive practices “where the pro-competitive advantages of the licence outweigh any negative impact of the restrictions contained in the agreement.”

The paper's authors argue that these changes are likely to influence negatively the development of the substantive law because of what they characterize as “regulatory externalities.” Under the new system, the national courts are “alternative” rather than “concurrent” authorities because each of them is competent either to condemn or to exempt a practice. According to the authors, a decision to confer an exemption imposes negative externalities on other regulators because it “reduces the value and exploitable rent of another agency”; a decision to condemn a practice imposes a negative externality because it “make[s] a second restriction irrelevant.” Because the first court to act fails to take account of these external effects, the authors suggest that the regulatory actions are likely to be “overprovided” as compared to the actions of a single enforcer. Thus, the authors predict that, paradoxically, both the number of exemptions and the number of findings

of infringement are likely to increase. The authors also argue that decentralization and the elimination of notification gives plaintiffs both the ability and the incentive to shop for the national court with the strictest interpretation of competition law. While coordination and supervision might mitigate regulatory externalities and forum shopping, the “Modernization Package” the EC has instituted for these purposes is, according to the authors, inadequate to the task. The authors conclude that while “the precise direction of substantive competition law is unclear, the overall effect is higher levels of regulatory activity” and “higher expenses for legal counsel and litigation.”

The paper leaves the nature and significance of the “externalities” it identifies unclear. The externalities appear to be related to an assumption that regulators seek (undefined) rents, and the actions of one regulator can affect the rents that are available to others. Even if this were true, however, it is not clear why limiting the rents available to a particular agency is an external cost that results in overprovision of regulatory activity relative to some optimum level. Perhaps these issues, and other possible effects of regulatory competition, can be developed further in a later version of the article. ●

—WHP