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DISCUSSION

THE ECONOMICS OF PASSING ON: A REPLY TO HARRIS AND SULLIVAN

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The Supreme Court in *Illinois Brick Co. v. Illinois* [1] held that only the direct purchaser from a price-fixing seller (or other antitrust violator) may sue for damages under the antitrust laws; indirect purchasers (that is, purchasers farther down the chain of production and distribution to whom some part of the cartel or monopoly overcharge may have been passed on) may not. In a recent article we argued that this rule promotes the compensatory, and especially the deterrent, objectives of antitrust enforcement.[2] Among the points we made were the following:

(1) Under *Illinois Brick* an indirect purchaser is indirectly compensated for the costs of antitrust violations affecting him because the direct purchaser will charge his customers less when his right of action against sellers to him is not subject to a passing-on defense; and it will not be subject to such a defense if indirect purchasers are denied standing—this is the *Hanover Shoe* [3] corollary to *Illinois Brick.*

(2) Enforcement incentives, and hence the likelihood of successfully detecting and prosecuting price fixers, are maximized by assigning to that party (direct or indirect purchasers) whose costs of enforcement are lowest the exclusive right to recover damages.

(3) The information costs of identifying and suing an antitrust violator, an important component of enforcement costs, are lower for the direct than for the indirect purchaser. Therefore, a rule—the rule of *Illinois Brick*—that does not dilute the direct purchaser's incentive to sue by giving indirect purchasers standing and thereby

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1 431 U.S. 720 (1977).

2 Landes & Posner, *Should Indirect Purchasers Have Standing to Sue Under the Antitrust Laws? An Economic Analysis of the Rule of* Illinois Brick, 46 U. CHI. L. REV. 602 (1979).

3 *See* Hanover Shoe Co. v. United Shoe Machinery Corp., 392 U.S. 481 (1968).

subjecting the direct purchaser to a passing-on defense in his suit will promote effective enforcement.

(4) Determining the amount of the damages passed on by a direct purchaser—an essential determination both in evaluating the passing-on defense in the suit by the direct purchaser and in measuring the damages in suits by indirect purchasers—would be a costly and difficult undertaking in the context of an antitrust litigation.

Shortly after our article appeared in print, Professors Robert Harris and Lawrence Sullivan published an article on the same subject in this Review.[4] Their article, like ours, uses economics to analyze the rule of *Illinois Brick* but reaches the opposite conclusion—that *Illinois Brick* disserves antitrust enforcement and should be overruled by Congress. Because their article was in galley proof when ours appeared, Harris and Sullivan added a number of supplemental footnotes in which they criticize our analysis.[5] All of their criticisms of us are incorrect or irrelevant; more important, their own analysis of the rule of *Illinois Brick* is based on a series of economic errors.

1. To our argument that indirect purchasers are indirectly compensated under the rule of *Illinois Brick,* so that even the compensatory objectives of the antitrust laws are served by the rule, Harris and Sullivan reply that we have

> confused marginal costs and fixed costs. Profit-maximizing price is determined by marginal cost; because neither a damage award nor the expected value of an anticipated damage award has any effect on marginal cost, the price charged by the direct purchaser will be unaffected by the assignment to that purchaser of the cause of action for the overcharge.[6]

This analysis is incorrect. The expected damage award to the direct purchaser affects his marginal, not his fixed, costs. A direct purchaser's antitrust damages are simply three times the overcharge multiplied by the number of units purchased. If, because of the threat of a damage award against the seller, the expected full price of a good to the buyer is lower than otherwise, from the buyer's standpoint this is equivalent to paying a lower price because the seller gave him an explicit price reduction. A reduction

[4] Harris & Sullivan, *Passing On the Monopoly Overcharge: A Comprehensive Policy Analysis,* 128 U. PA. L. REV. 269 (1979).

[5] *See id.* 294 n.61a.

[6] *Id.* 299 n.67.

in the price of an input whose use varies with the buyer's output will lead to a reduction in the marginal costs of the buyer. Thus, if a firm selling iron to a manufacturer of steel reduced its selling price by one percent, the steel manufacturer's marginal-cost schedule would fall because the costs of iron are marginal costs.[7] If, instead, the real price of the iron fell one percent because there was some possibility that the steel manufacturer would recover a part of that price (trebled) in an antitrust suit, his marginal costs would have fallen by just as much as when the seller of iron reduced his explicit price by one percent.

2. Harris and Sullivan argue that it is easy to determine the amount passed on by the direct purchaser to his customers because elasticities of supply are very high in the long run; if they were infinite, one hundred percent of the overcharge would be passed on. This argument fails to provide a ground for overruling *Illinois Brick* for several reasons:

a. Even if most of the overcharge were passed on in most cases, it would still be necessary in each individual case to determine how much of the overcharge was passed on, both in order to adjudicate the antitrust violator's passing-on defense in the direct purchaser's suit and to measure the indirect purchasers' damages in their suits. Later in the article, Harris and Sullivan set forth a methodology for determining the amount passed on in individual cases.[8] They woud not have had to do this if they had thought their earlier analysis of supply elasticities settled the passing-on question.

b. Even if elasticities of supply were always infinite in the long run (Harris and Sullivan do not suggest they are ever infinite, or nearly so, in the short run), it would not follow that, for purposes of computing antitrust damages, one-hundred-percent passing on should be assumed. That assumption would be appropriate only if the damages that accrued in the short run were not recoverable in an antitrust suit; however, this prospect is unlikely. Indeed, because the statute of limitations in an antitrust suit does not even begin to run if the violation is concealed by the violators—which is almost always the case with regard to price fixing, the principal offense to which the rule of *Illinois Brick* is applicable—the victims of an antitrust violation will often be able to seek damages accruing

[7] The marginal costs of steel would fall by one percent times the share of iron in the marginal costs of steel, holding constant the price of other inputs.

[8] Harris & Sullivan, *supra* note 4, at 317-20.

from the day the violation began, however long ago that was. Thus, even if a suit alleging price fixing were brought ten years after the price fixing had begun, the damages sought would be a composite of damages accruing in the short and in the long run. And the damages that accrued in the short run would not have been fully passed on even if the long-run elasticity of supply were infinite.

c. There is another reason why, even if supply elasticities are nearly infinite in the long run (say a year or longer), and even if the average duration of price-fixing conspiracies is several years, direct purchasers will not pass on the whole overcharge. The reason is that it is impossible to determine from data on duration alone whether price fixing was continuous or intermittent.[9] For example, if price fixing occurs at irregular intervals of several months each year over a twenty-year period, there is no presumption that direct purchasers fully adjust to the overcharge each time it occurs and thereby pass it on. Differently stated, we may have short-run adjustments to price fixing over the twenty-year period in which the relevant supply curve of direct purchasers is always relatively inelastic. If so, direct purchasers will always bear a nontrivial share of the overcharge.

d. A related point, which Harris and Sullivan also overlook, is that infinite or very high supply elasticities undermine the rationale for a per se rule (or for that matter any rule) against price fixing, and thus make the choice between *Illinois Brick* and a contrary rule irrelevant. Economic analysis tells us that an industry supply curve is more elastic when the supply curves of the indi-

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[9] Harris and Sullivan cite an unpublished study by M. Block, H. Demmert, and F. Nold of 49 price-fixing cases brought by the Antitrust Division of the Department of Justice between 1971 and 1976 in which the average duration was 5.5 years. Harris & Sullivan, *supra* note 4, at 291 n.56. They do not cite a more comprehensive study, Posner, *A Statistical Study of Antitrust Enforcement*, 13 J. LAW & ECON. 365 (1970), that examined antitrust cases over the period 1890 to 1969, and similarly found a long average duration. *Id.* 401 (table 25). Had they cited Posner's study, they would have noted the following statement:

> Table 25 indicates, surprisingly, that the conspiracies attacked by the Department are of long average duration and involve quite large annual sales. These findings, however, should be taken with a grain of salt. It is rarely clear from the Bluebook summaries whether a conspiracy alleged to have begun many years previously in fact continued throughout the period or was intermittent, or how much of the sales of the product in question were actually subject to the price-fixing agreement. . . . What is attacked, judging from the summaries, is the act of agreement—the attempt to affect the market price. The actual effect on price is not considered systematically, which is why the summaries are so lacking in good information about the gravity of the restraint.

Id. 399.

vidual firms that make up the industry are more elastic and the firms are more alike with respect to the minimum price at which they are willing to enter the industry. Thus, even if each firm has a U-shaped average cost curve and rising marginal costs, and hence an upward-sloping supply curve, the industry can still have an infinitely elastic or horizontal supply curve if a large number of firms are willing to enter at an identical price. Although it is conceivable that a high industry supply elasticity is due only to high supply elasticities of firms already producing, it is more likely to be due to a combination of that factor with a willingness of firms to enter the industry if there is any increase in price. If so, a cartel would be ineffective.[10] If the existing firms tried to raise the price above the competitive level, new firms would enter, forcing price right back down. Implicitly, therefore, a rule against price fixing rests on the belief that supply curves are not sufficiently elastic in the relevant range to make price fixing unattractive, so that Harris and Sullivan's rationale for allowing indirect-purchaser suits—high supply elasticity of direct purchasers—if carried to its logical conclusion would undermine the case for having any rule against price fixing.

e. Finally, even if the foregoing points are set to one side, at most all Harris and Sullivan have shown with their claim that the relevant supply elasticity is infinite is that the entire overcharge is passed on to indirect purchasers. That would solve the apportionment problem but would not solve any of the other problems that persuaded us that the *Illinois Brick* approach is superior to allowing indirect purchaser suits.

3. Harris and Sullivan accept our point that the direct purchaser has lower information costs of identifying and prosecuting the antitrust violator than a remote purchaser. But they offer three erroneous reasons why this insight does not support the rule of *Illinois Brick.*

a. The first is that a direct purchaser may be reluctant to jeopardize an advantageous relationship with his supplier by suing him. We pointed out in our article that any forbearance by the direct purchaser to sue will be compensated. The supplier must pay something to bind the direct purchaser to him and this payment is, functionally, a form of antitrust damages. Harris and Sullivan ignore this point.

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[10] This assumes that the cartel cannot prevent entry, for example by procuring from legislators licensing requirements that inhibit entry.

b. Harris and Sullivan argue that a direct purchaser's incentive to sue will not be affected by the possibility of his facing a passing-on defense because prospective litigants do not make refined cost-benefit calculations in deciding whether to sue. Even if the premise is correct, their conclusion is not—or, at best, it is inconsistent with their earlier argument that all or most of any monopoly overcharge will be passed on by the direct purchaser. If all is passed on, the direct purchaser has zero expected damages, and no incentive to sue. If most is passed on, he has small expected damages, and hence little incentive to sue.

c. Finally, Harris and Sullivan argue that corporate managers distinguish between a "real" loss and a lost opportunity, and so would have less incentive to sue if (because of passing on) they had incurred no loss than if they had not been able to pass on the overcharge. We are accused of misunderstanding "managerial mentality" in arguing that the incentives are the same in both cases.[11] But we were simply applying the standard apparatus of economic theory, which defines cost as a foregone opportunity. Under this definition, the loss of a windfall is the same kind of cost as an out-of-pocket cost. Harris and Sullivan are free if they like to reject the premises of economic theory; but then we question the appropriateness of their employing those premises to argue earlier in their article that most of a monopoly overcharge will be passed on.

Harris and Sullivan accuse us of "fantasiz[ing]" when we suggest that the incentives of a state attorney general to sue might be different from those of a private firm—that the former would behave more politically than the latter.[12] But the idea that behavior is determined by incentives—we cannot believe that Harris and Sullivan doubt that the incentives of an elected public official differ from those of a corporate manager—is again part of the basic apparatus of economic theory which Harris and Sullivan employ elsewhere in their article.

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[11] Harris & Sullivan, *supra* note 4, at 352 n.158a.

[12] *Id.* 342 n.138a.