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Chicago on Vertical Restrictions

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The title of this panel is 'The law and economics of tying, bundling, and other vertical restraints: Does (and should) the Chicago School rule?'. You are in Chicago. Naturally you expect an exponent of the Chicago School to put in an appearance. Well, here I am, a live specimen—though I left my rose-coloured glasses at home.

Since we are in Chicago, and talking about it, the best way to begin is to lay out the hallmarks of the Chicago School. There are not many.

- Antitrust is about the promotion of social wealth. Usually this means consumers' welfare. It is never, ever, about the promotion of producers' welfare. What is good for small dealers and worthy men, in Justice Peckham's phrase, usually is bad for everyone else. Competition is a gale of creative destruction (this is Joseph Schumpeter's memorable line), and it is by weeding out the weakest firms that the economy as a whole receives the greatest boost. Antitrust law and bankruptcy law go hand in hand.

- The goal of antitrust, to be more precise, is to prevent the allocative loss that comes about when firms raise prices over long-run marginal costs, and thus deprive consumers of goods for which they are willing to pay more than the cost of production. This implies a programme for antitrust law: look for situations in which firms can increase their long-run profits by restricting output.

- When looking for these situations, assume rationality. When will a rational, self-interested producer find that money can be made by restricting output? This is not to say that everyone is rational. Instead the point is that the law's sanctions are directed to such people. Those who figure out how to lose money by restricting output need not be penalised. Their conduct is self-deterring. For example, antitrust law does not impose penalties on people who make bad product-design decisions, even though they drive consumers away and reduce output.

- Be exceedingly suspicious of claims that new products or low prices or novel means of distribution injure consumers. Innovation is one thing that we seek to promote. Claims that the long run will depart from the short run are easy to make but hard to prove. As Yogi Berra put it, 'It is always hard to make predictions, especially about the future.' Instead of making predictions that are impossible to test—and will injure consumers if wrong—wait to see what happens. If monopolistic prices happen later, prosecute then.

Consider for a moment the claim in litigation against Microsoft that the provision of Internet Explorer at zero price would drive other browsers out of the market. (If you hail from the European Union, mentally substitute 'Windows Media Player' for 'Internet Explorer'.) The issue is trivial unless accompanied by a claim that, after the rival producers vanish, Microsoft will raise prices and decrease output. So what has happened? Certainly Internet Explorer's market share went up for a while. But did Microsoft raise prices and cut output? Of this there is no evidence. Nor could it do so any time soon. Its share is shrinking, and the price of browsers to consumers remains zero. Many other browsers are available—I have Firefox, Safari, Opera and OmniWeb installed on my computers, and there are others that I haven't tried. On the media-player front, think iTunes and RealPlayer. Output continues to rise, price stays low. Claims that prices will rise later cannot be refuted—the future lies ahead—but a very long delayed return can never repay the gains foregone. This is why the Supreme Court held in Matsushita, the TV case, that a low-price-now strategy by Japanese producers could not be condemned as predatory. From today's perspective the argument of the 1980s that Japan would use below-cost sales to monopolise consumer electronics seems absurd. Prices of electronic gizmos continue to fall, just as economists predicted. Any attempt by the Japanese producers to raise prices works to the advantage of manufacturers in Korea and China.

Similarly, claims that free software is predatory generally are feeble, because prices won't rise later.

- Consider all sources of supply. Producers are constrained not only by demand elasticity but also by supply elasticity. In a world of reasonably free trade across international borders, it makes no more sense to ask whether a particular merger unites all aircraft producers in the United States than it would be to ask whether a particular merger unites all producers in Chicago. Imports from other jurisdictions protect...
consumers. (This also implies that the principal antitrust risks today are in service industries, where imports are difficult.)

- Test your models and discard those that don’t work. I have mentioned some informal tests of predictions about browsers and TV sets, but more rigour is needed. The Journal of Law & Economics was created to test the predictions that antitrust enforcers and judges made in major antitrust prosecutions, and a cascade of articles showed that they were unreliable whenever they got away from simple rules such as ‘don’t form cartels’ and ‘don’t merge to monopoly’ – and there was a high error rate even in the application of the simple rules. Perhaps the most distinctive feature of Chicago today is the belief that the future will be like the past: the ability of judges and other regulators to second-guess markets has not improved. Economic models may have improved, but it is real-world performance that matters. If ‘choose better regulators’ or ‘educate the judges’ has not been a successful prescription for the last 116 years (since the Sherman Act of 1890), it will not become a good prescription tomorrow.

- It is worth noting that the Chicago School has never assumed Adam Smith’s model of perfect competition, with tiny rivals and perfect information all around. That was the Harvard School of antitrust, which dominated the 1940s through the 1960s, but it has neither adherents nor descendants today. Chicago never made the error of assuming simple, static, atomistic competition. George Stigler won the Nobel Prize for his invention of the economics of information, the careful study of what happens when we assume that information, like iron, is costly and scarce. Nor has Chicago disdained strategic models. Richard Posner’s analysis of oligopoly in 1969 is all about strategy, as was my analysis of predatory practices in 1981.

- For distribution in particular, the principal insight associated with Chicago is the proposition that the producer is on the consumer’s side. Why so? Because the expense of distribution – which is to say, the difference between the wholesale and retail price – is from the producer’s perspective just like the cost of steel or labour. The producer wants to keep that cost as small as possible, yielding either a lower retail price (= more sales) or a higher wholesale price. If the producer does something that increases the gap, such as resale price maintenance, that must be because the retailer is delivering value worth more than the increase. Perhaps there is some point-of-sale service that the manufacturer cannot provide on its own. Consider the service of displaying and explaining a flat-panel TV. If the customer can get the explanation from Circuit City and buy the TV for less from a website, then the retailer may omit the information and everyone will be worse off. The Chicago prescription: let manufacturers freely choose distribution methods. Protection of consumers comes from horizontal competition among products and sales methods, not from regulation. Apple’s integrated iPod-iTunes model competes against Microsoft’s à la carte model. On this front, at least, Apple is winning; intervention to penalise the winner can only hurt consumers. Maybe this is why Microsoft has switched to an integrated model with its new Zune player. Let the competition flourish!

If this is Chicago, what’s the alternative? Not rejection of any of these propositions, surely. Today almost everyone (at least in the United States) uses economic theories that seek to identify the rules that maximise social wealth. As evidence I give you the Supreme Court’s decision last March in Illinois Tool Works Inc v Independent Ink, Inc, which held that a producer that lacks market power is free to engage in tie-in sales, and added that a patent does not show market power: it may create a monopoly but usually doesn’t. The Court recognised that tie-ins and other bundling may be efficient. After all, what one person calls a ‘tie-in’ is from another perspective just the definition of a product. When you buy a computer with a hard disk inside, is this a ‘tie-in sale’ or just the components needed to make the gizmo work well? So attacking tie-ins is like asking judges to determine what ‘really ought’ to be in products, and that would do no one any good. Judges are not selected for marketing acumen and cannot be fired for business mistakes. The Court unanimously preferred the Chicago approach of letting competition work, so long as there is no horizontal monopoly or cartel.

If relying on judges to be good entrepreneurs is not a plausible alternative to Chicago, how about neoclassical economics with the addition of guile? Models that include strategic elements and rational ignorance characterise much of what is called post-Chicago thought.

I see the main difference between Chicago and other approaches as the role of models versus data. Much of the non-Chicago mindset is captured by the proposition: ‘Here is a model in which bad results can happen; therefore we should use the legal system to search for them.’ That’s the Nirvana Fallacy in operation. Things can go wrong, to be sure, but don’t assume that the legal system is better. It may well be worse!

Do not seek to test theory in the halls of government, where academics’ and judges’ errors may be inflicted on the populace. Test models the professional way: by gathering data, running regressions, and publishing in
judges and juries will acquire a comparative advantage at identifying practices that reduce welfare — one must do empirical testing. Government fared poorly between 1890 and 1980 even when the rules were simple. Why should we think that regulators (including judges) will do well when the rules become complex, when strategies are designed to conceal relevant costs, and so on? Strategies that conceal matters from competitors conceal them from judges and other regulators as well.

Just as Chicago insists on proof that a given practice is bad for consumers, so it insists on proof that a given legal regimen implied by an economic model does better than the unregulated market. To point to a competitive failure is not to show that regulation is better. Government has its own costs and errors, which may be worse (and harder to correct) than the problems of markets.¹ Do not invoke a theory of market failure unless you also have a theory of regulatory failure — and a way to show that the costs of the former exceed the costs of the latter.

So where are the tests? Ever since Bill Baxter became Assistant Attorney-General for Antitrust in 1981, the dominant programme of the federal government in the United States has been that of Chicago: challenge cartels and big mergers, but otherwise leave markets alone. Microsoft is one of the rare exceptions and, as I have suggested, it is not an exception that should give comfort to the non-Chicago theorists.

Every time Baxter or his successors declined to challenge a practice, this set up a natural experiment. Would the strategic conduct and low prices today lead to higher prices tomorrow? Consider, for example, the models suggesting that price-matching programmes reduce welfare. The idea is that if Southwest Airlines enters a market, and United matches its price, then United gets the business and Southwest is unable to capitalise on its lower costs; the implication is that discount carriers will be foiled. A similar prediction is made for price-matching programmes by retailers. Best Buy may say something like: ‘If you find a lower price within 30 days, we’ll match it.’ That reduces rivals’ incentives to lower their prices and makes it especially costly for Best Buy to reduce its own prices, because it owes an immediate rebate to old customers. Thus the device could be used to facilitate or enforce a cartel.

The national antitrust enforcers in the United States have not filed suit against these price-matching systems, and private or state litigation against them has been unsuccessful. So have average prices per seat-mile risen? No, they have not; they have fallen and continue to fall. Discounters such as Southwest and Jet Blue are growing; United and the old trunk-line carriers are shrinking. A recent exploration in retailing showed that the chains offering price-matching guarantees are not the high-price outlets; they are generally the lowest-price outlets in the market, and markets with more price-match guarantees are characterised by lower average prices.¹² This is understandable through the lens of a different model: low-price outlets need to identify themselves to consumers, and a price-matching guarantee is a good way to do so. If you offer (and plan to continue offering) the lowest prices in the market, then the guarantee is cheaper for you to make than it is for a rival to make. Your offer is credible and profitable; consumers act on the information by inferring that you are the low-price seller. This solves an important problem in the economics of information at the same time as it drives down average prices.

What Chicago wants — what I want, at least — is to use data to winnow wheat from chaff among models. Once we have done this — and only after we have done this — use the models to form rules that can be applied by regulators. The process of testing and winnowing should precede litigation. Otherwise my prediction is that the future will be like the past, and government errors will continue to raise rather than lower costs.

Let me give you a few more characteristic examples from the history of antitrust, in order to pose the question whether fancy-pants theories will lead to a brighter tomorrow. I invite you to think of another vertical issue: bottleneck monopolies. Today we might be tempted to name a computer operating system. The old story is one of natural monopoly in the telephone switch, or of unnatural monopoly via merger (as when Jay Gould bought the two bridges and the ferry system in St Louis and thus acquired a chokehold over train traffic across the Mississippi River).¹³

The antitrust response to bottleneck monopolies has been to create either joint ownership or a must-carry duty (for example, to ‘wheel’ power or information over land lines).¹⁴ Joint ownership, the approach taken to the Mississippi River bridges, proved to be monopoly fortified by law: the bridge company made its monopoly profit. A duty to ‘wheel’ leaves the price term open, so it fails to handle monopoly unless the court becomes a rate regulator — and few think that the isolated examples of judicial rate regulation, such as the blanket licence decree for copyrights,¹⁵ have been successful. The only other apparent judicial solution is disestablishment — but that is a loser if the reason for the bottleneck is either natural monopoly or efficiency, for then the cost savings are squandered.

If handling claims of bottlenecks is not something that antitrust has traditionally done well, it has done
even worse when the bottleneck concerns information and developing technology. Do any of you remember the IBM case that ran from 1969 to 1982? The Antitrust Division’s fundamental claim was that IBM had become a monopolist in computing services, and that its platform was a bottleneck to vendors of complementary products, such as disk drives. The bottleneck was not only IBM’s mainframe computers, but also the devices used to move information in and out of them—devices (and protocols) called interfaces. A central claim in both the government’s suit and a cloud of private litigation was that IBM monopolised the market for peripherals, such as disk drives and printers, by continually changing its interfaces. In other words, it engaged in partial vertical integration through product design. Peripherals vendors no sooner figured out how to connect their disk drives to IBM’s mainframes than IBM changed the interface specification and made the vendors start all over again. The supposed consequence was that IBM maintained a huge share of both mainframes and peripherals. Plaintiffs sought judicial decrees that would produce stability in the interface, so that third-party vendors could have a level playing field with IBM in selling peripherals. Suits lasted until it became clear that IBM mainframes were no longer a large share of any interesting market; and of course IBM’s share was eroded by technological developments, not legal rules.

But the claim of ‘interface predation’ (today it would be called ‘raising rivals’ costs’) never identified a monopoly. What the Antitrust Division had wanted the Court to enjoin was progress. Newer protocols were faster or had other benefits. Most of you observe the process with your own computers. Ten years ago computers came with rs-232c serial and SCSI interfaces; some also came with older parallel connectors. The serial port could transfer data at a blazing 256 kilobits per second. The SCSI interface, about 100 times faster, could support up to five megabytes per second. Later generations of SCSI have increased that speed by a factor of 16. But SCSI operates at the rate of the slowest connected peripheral, requires each to have an ID, is limited to seven devices and often encounters problems with termination. Newer machines are likely to come with USB (universal serial bus) and 1394 (FireWire). Both are faster; both allow longer chains and cheaper cables than their predecessors; both avoid device ids and termination. They provide some power to attachments, allowing many peripherals to omit plugs and power bricks. Improvements to both protocols are frequent; almost before the installed base of first generation devices becomes substantial, faster versions of each appear. Such restless change is exactly what IBM was accused of doing. That competitive markets are revising interfaces even faster than the bad old ‘monopolist’ shows the danger of believing that we can identify exclusionary practices. IBM’s problem may have been that it did not change fast enough and thus could not keep up with the competition!

One other story about the ability of antitrust to identify bottleneck monopolies in information technologies. I know of only one case in which such a monopoly has finally been identified in litigation. The offender was an operating system, which the court concluded was a monopoly. No one software or hardware manufacturer could compete, the Court held, without access to that operating system, which the owner therefore had to open to general use without regard to its copyrights and contracts. And who is that vicious monopolist that beset the information age? Why, it is the Data General (DG) Corporation, and the bottleneck is DG’s RDOS, an operating system for the nova chip that DG included in a line of mini-computers! Yes, you heard me right. The Court of Appeals was confident that nova chips were a separate market, that DG was a monopolist, and that it therefore had to license its operating system for use on chips made by Fairchild Instruments. I must confess bias because I was involved in that case as a lawyer, but this seemed fantastic to me even in 1984, when the decision was made. If anyone had market power in mini-computers, it was DEC, not DG. But from the perspective of hindsight the Court’s decision seems merely quaint. DG soon went into bankruptcy; the segment of the market in which both DG and DEC competed was overtaken by workstations such as those now made by Sun, if it ever was a distinct segment. Perhaps the court’s decision contributed to that demise; perhaps the demise was inevitable. Confident conclusions about who is a monopolist, and what is a bottleneck in operating systems, were converted to a source of humour in a few years. As Santayana observed, those who fail to learn from the past are condemned to repeat it. We need to learn from IBM and DG just how acute the legal system’s senses in detecting technological monopolies are. That is the point of view that most clearly separates Chicago from post-Chicago perspectives—and it is one in which the lessons of the past speak loudly, and across international borders.

Notes

4 This short talk, prepared for a panel of the IBA’s meeting in Chicago on 18 September 2006, is © 2006 by Frank H Easterbrook. It incorporates portions of earlier work, though original material has been added for the occasion.
1 See United States v Trans-Missouri Freight Ass’n, 166 US 290, 323 (1897).
2 Capitalism, Socialism and Democracy (3rd ed 1950) 84.
3 Schor v Abbott Laboratories, 457 F 3d 608, 612 (7th Cir 2006), is among many decisions making this point.
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4 See Brooke Group Ltd v Brown & Williamson Tobacco Corp, 509 US 209 (1993); Matsushita Electric Industrial Co v Zenith Radio Corp, 475 US 574 (1986); R J Reynolds Tobacco Co v Cigarettes Cont'ed, 462 F 3d 690 (7th Cir 2006).


6 Like other supposed ‘victims’ of predatory or exclusionary conduct, they did not have any trouble raising capital. Money markets are large, competitive, and liquid; no more is required. No one supposes that capital markets are ‘perfect’ in the sense that all profitable ventures are funded, and no others are. Life is full of chances, and errors can be caused by fraud, costly information, or the stochastic quality of competition. But these errors are not systematic: it is no more likely that a good project will fail to find suppliers of capital than that a bad project will do so. (In competition, if errors were biased, the lenders making such errors would go out of business.)

7 See Wallace v International Business Machines Corp, 467 F 3d 1104 (7th Cir 2006) (holding that firms that provide Linux do not violate the antitrust laws just because Linux and its derivatives are, and always will be, free of charge).


10 126 S Ct 1281 (2006).


13 United States v Terminal Railroad Ass’n of St Louis, 224 US 383 (1912); but see Curtis M Grims, Clifford Winston & Carol A Evans, Foreclosure of Railroad Markets: A Test of the Chicago Leverage Theory (1992) 35 J L & Econ 295.


15 I refer to the consent decree to which the performing rights societies subject are. This decree is discussed by the Supreme Court’s decision in BMI v CBS, 442 US 1 (1979).


17 Digidyne Corp v Data General Corp, 754 F 2d 1356 (9th Cir 1984).