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ECONOMIC POLICY STUDIES / BRIEFING PAPER

Hudson Institute

Antitrust Policy in an Age of Rapid Innovation

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October 2011

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October 2011

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Hudson Institute is a nonpartisan policy research organization dedicated to innovative research and analysis. Founded in 1961, Hudson is celebrating a half century of forging ideas that promote security, prosperity, and freedom.

Antitrust Policy in an Age of Rapid Innovation

> "The information economy is populated by temporary, or fragile, monopolies. Hardware and software firms vie for dominance, knowing that today's leading technology or architecture will, more likely than not, be toppled in short order by an upstart with superior technology."[1]

So antitrust lives, to the consternation of the powers-that-be at AT&T who persuaded themselves that their plan to acquire T-Mobile for $39 billion would escape challenge. Yes, they might have to make a few meaningless disposals in especially concentrated local markets, but that would be a small price to pay for all that spectrum AT&T would acquire. Besides, if their economic argument was not persuasive to the antitrust authorities, there is all that political clout created by the finely honed lobbying apparatus in which AT&T takes such pride. It takes no stretch of the imagination to believe that we have another case of hubris preceding nemesis: the management of AT&T was so optimistic that it agreed to pay T-Mobile a $6 billion break-up fee if the deal fell through.

It is possible, of course, that the merger might survive judicial review. The courts might decide that the high concentration ratios are less relevant than other factors; or that challenges by powerful incumbents, regional competitors, and new entrants will constrain the pricing power of a combined AT&T and T-Mobile; or that the smaller company, hobbled by European ownership reportedly with little interest in investing in this country, can never be a truly competitive force if left as a stand-alone business;[2] or that for some other reason consumers would be well served by this merger. Or it might well turn out that AT&T, less confident of success and eager to avoid a $6 billion break-up fee, will go the last mile to make concessions that will persuade the Department of Justice to withdraw its objections[3] to a merger that, according to the Antitrust Division, "would combine two of the four largest competitors in the marketplace, and would eliminate T-Mobile, an aggressive competitor, from the market."[4]

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[1] Carl Shapiro and Hal R. Varian, Information Rules: A Strategic Guide to the Network Economy. Boston: Harvard Business School Press, 1999.

[2] T-Mobile USA, Inc. is the United States-based subsidiary of T-Mobile International AG, a German-based holding company for Deutsche Telekom AG's various mobile subsidiaries outside Germany.

[3] "We have been and remain interested in a solution that addresses the DOJ's issues with the T-Mobile merger," AT&T said in a statement. The Wall Street Journal, September 9, 2011.

[4] Remarks by Deputy Attorney General James M. Cole, Washington, D.C., August 31, 2011. Sprint Nextel has filed its own lawsuit aimed at blocking the merger, on the ground that they are the injured party in this merger. See "Sprint Adds Hurdle to AT&T Deal", The Wall Street Journal, September 8, 2011.

Policy Lessons from the Merger Challenge

Regardless of the outcome, however, we already have had two enduring policy lessons. The first is that the antitrust laws are once again deemed a weapon to be used if competition is threatened. For reasons I will discuss in a moment, this is a powerful force on the side of long-run improvements in the economy's efficiency and in the fairness with which income is distributed in the United States—both macroeconomic issues of considerable importance.

The second lesson is that even in this highly political Department of Justice, the Antitrust Division remains impervious, or so it seems to the outside observer, to political pressure from what in Washington is called "The Hill." AT&T has long been admired by its competitors and others for its ability to get what it wants from Congress, or at least prevent what it doesn't want from ending up on the statute books. But the Antitrust Division's willingness to attack what the company deems its most important move in decades demonstrates that while legislative clout is one thing, the ability to influence the fine professionals in the Antitrust Division is quite another. I say that with some fear and trembling, because no one can be certain that the Division's superiors will maintain their hands-off attitude: an election is coming up, the Department has not proved unresponsive to direction from the White House in other matters, and no island of virtue can count with certainty on not being swamped by electoral necessity in this town. But, and this is no small achievement for the Division, so far, so independent of political pressure.

That this independence should have been exerted in dealing with what is generally classed as a high-tech industry is even more encouraging. Some critics of antitrust policy—including those who disliked what they see as a sort of "regulation" even when ours was a lower-tech economy—argue that what was good for the days of steel-making and a brawn-driven economy is bad for a high-tech, brain-driven economy. They might have a point when it comes to how the antitrust laws are applied, as I shall explain below, but that is a detail, and although of some significance, remains a detail. The main point is that the practices at which antitrust policy has traditionally been aimed remain as dangerous to the performance of our economy as they were in the good old days when prosperity could be measured by the volume of smoke coming out of the smokestacks of Pittsburgh.

Traditional Antitrust Concerns Remain Relevant

It is as important as it was when the antitrust laws were drafted not to permit a firm with substantial market power to leverage that power by tying the availability of its products in other markets to the one sold in the market it dominates; not to allow it to make the availability of its products contingent on agreements by its customers not to deal with its rivals, or to devise pricing schemes that accomplish the same objective; not to allow it to add to an existing dominant position, or create one, via acquisition.

Indeed, in the current circumstances in which the American economy finds itself, these truths are more self-evident than ever. Our economy is staggering under the weight of debt, public and private sector mismanagement, intensified global competition, and social strains created by a widening sense that incomes are no longer related to economic performance, and that they are increasingly not only unequally distributed, but inequitably distributed. It would be foolish to argue that vigorous competition policy alone can restore growth, bring down unemployment, increase our international competitiveness, and repair the torn social fabric. But it is not an exaggeration to say that sensibly conceived and enforced competition policy can contribute to those goals—and at no strain to the federal pocketbook.

The importance of competition to the performance of the macroeconomy need not be belabored here. Competition for customers forces firms to innovate, to lower costs and prices, and to produce goods and services that optimize the use of the nation's human and natural resources. Productivity and living standards rise as a result. The economic pie grows, and with it the flow of revenues to the Treasury, reducing the need to borrow. All might not be for the best in that best of all possible worlds, but it is a darn sight better than in a highly cartelized economy in which levels of output are constrained, the levels of prices set so as to maximize monopoly profits, and the pace of innovation determined by the slow pace at which the fixed assets of incumbents are depreciated.

The importance of competition policy's effect on the rate of innovation has never been as great as it now is. One need not be a professional shopper to know that it is innovation that has become the consumers' best friend, increasing his or her range of choice of products and services, making a few minutes at a computer an alternative to a long drive to the supermarket but giving him a more fuel efficient vehicle if he prefers to stalk supermarket aisles; a wireless cell phone as an alternative to a fixed line telephone, with all that means for mobility and (some would say, "alas") for keeping in touch; a quick search for a fact using a search engine rather than a troll through a library card catalogue; multiple sources of news and views, including the hundreds of cable channels that now offer an alternative to what once was a three-network news oligopoly—I leave it to readers to complete the list.

These innovations, tumbling onto markets at an accelerating pace, destroy what J.R. Hicks identified as the greatest of monopoly profits—a quiet life.[5] It is important that companies seeking such a life, seeking relief from the pressures of innovation, not be allowed to do so by engaging in anticompetitive acts. In the early days of antitrust, when potential cartelists with gold chains stretched across ample midriffs stitched together monopolies and manipulated markets, anticompetitive practices were not difficult to identify. Indeed, they were often trumpeted by the conspirators. Today, it is more difficult to separate competitive tactics that result in the race being won by the efficient from anticompetitive acts that allow the merely dominant and cunning to prevail. Is a price cut made in response to falling costs and with a desire to expand markets, or is it a predatory reduction to discourage entry? Is a merger likely to increase consumer welfare by making a supply chain more efficient, or extend dominance from one market into another? Is a patent suit designed to protect intellectual property and thereby make innovation more profitable, or an attempt to raise the cost hurdle that a potential entrant must clear?

[5] J.R. Hicks, Value and Capital. Oxford: Clarendon Press, 1939.

These distinctions are crucial, and can only be made on a case-by-case basis. But they must be made if we are to continue to benefit from what Joseph Schumpeter some 75 years ago called a "cluster."

> "Why", he asked, "should the carrying into effect of innovations ... *cluster* at certain times...? One answer suggests itself immediately: as soon as the various kinds of social resistance to something that is fundamentally new and untried have been overcome, it is much easier not to do the same thing again ... so that a first success will always produce a cluster.... This is indeed the method of *competitive* capitalism..."[6]

Competition Beats Regulation

The chore of distinguishing competitive from anticompetitive acts, and determining post-merger structures and behavior in order to preserve competition is also essential to minimize regulation. Where competition is inadequate, government has more often than not substituted its long arm for the absent invisible hand. And not without reason; the alternative is to allow the monopolist to work his will on consumers who have no choice but to submit to his decisions. Once monopoly power is acquired, wrote F.A. Hayek,

> "the only alternative to a return to competition is the control of the monopolies by the state - a control which, if it is to be made effective, must become progressively more complete and more detailed…. Capitalist organizers of monopolies … are … shortsighted … in believing that they will be allowed not only to create but also for any length of time to run such a system. "[7]

Indeed, Hayek goes on to argue that even if regulatory supervision of monopolies results in a deterioration of the quality of service, "this would be a small price to pay for an effective check on the powers of monopoly."[8]

The problem with such regulation is that it often outlives its usefulness. Regulators have a tendency to view the companies they regulate as clients, to see the possible failure of any of these companies as a failure of regulation—indeed, as a personal failure. So when a change in technology, or a change in our understanding of the economics of a regulated industry makes competition possible, regulators tend to be skeptical about opening the door to free entry. They see ruin for the incumbents as a certainty, and benefits to consumers as akin to "pie in the sky in the sweet by and by," to borrow from Joe Hill.

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[6] Joseph A. Schumpeter, "The Analysis of Economic Change," Review of Economic Statistics, May 1935, reprinted in Richard v. Clemence (ed.), Essays on Entrepreneurial Innovations, Business Cycles, and the Evolution of Capitalism. New Brunswick, New Jersey: Transaction Publishers, 1989, pp. 141-142.
[7] F.A. Hayek, The Road to Serfdom. Fiftieth Anniversary Edition, Chicago: University of Chicago Press, 1994, pp.47 and 214.
[8] *Ibid.*, p.217. Hayek adds, "Personally, I should much prefer to have to put up with some such inefficiency than have organized monopoly control my way of life."

Which is where competition policy comes in. Few regulators willingly follow the example of the late Alfred Kahn and close shop when competition becomes possible in the industry they have been regulating. In a 1988 reissue of his classic two-volume work on regulation[9] Kahn wrote:

> "The logic of opening any industry to free entry ultimately demands de-regulation of the incumbent companies as well: wherever we decide we can safely rely on competition, we must, logically, abandon public utility-type regulation. The only way to find out where competition is feasible and where it is not, ultimately, is to permit it to take place and let the market tell us the answer; and the longer we postpone that determination the greater the cost to the public."[10]

It is fair to say that when regulation was replaced by competition—imperfect regulation by imperfect competition—in the trucking, airline, power generation, natural gas, and other industries, consumers benefited significantly. Not as much as many had hoped nor as little as detractors of deregulation predicted, but benefited substantially.

These benefits, and the tendency of regulation to outlive its welcome are the reasons to make every effort to prevent the accumulation of the monopoly power that begets such regulation. Critics of vigorous antitrust enforcement surely prefer competition, maintained if necessary by preventing some mergers, and by moving against some anticompetitive tactics by dominant firms, to innovation-stultifying regulation, most often the alternative to competition. Or if not, they should make the case for the superiority of regulation!

The Social Consequences of Antitrust Policy

But there is still another reason to support enforcement of our antitrust laws.[11] A proper competition policy produces a variety of desirable social effects—the diffusion of economic power and the maximization of economic and social mobility. In an economy in which incumbent firms cannot create artificial barriers to entry, either by deploying their own market power or by colluding with others, fledgling entrepreneurs are more likely to flourish. This is important not only to maintaining a high rate of invention and innovation—competitive entry, after all, inevitably destroys the value of existing investments, and is therefore anathema to powerful incumbents—but to maintaining a society that is deemed to be fair and open by its citizens.[12] In America, the relative ease of entry has contributed to the economic and social mobility that has prevented the class warfare so common in other countries. Note, however, that

[9] Alfred E. Kahn, The Economics of Regulation: Principles and Institutions, Volumes 1 and 2, 1970-1971. New York: John Wiley & Sons Inc.
[10] Alfred E. Kahn, The Economics of Regulation: Principles and Institutions, "Introduction: A Postscript, Seventeen Years After". Cambridge, Massachusetts, and London: The MIT Press 1988 re-issue in one volume, p.xxxvi.
[11] I borrow here from a lecture delivered in London at The Smith Institute some years ago.
[12] In this connection see John H. Shenefield and Irwin M. Stelzer, The Antitrust Laws: A Primer. Washington, D.C.: The AEI Press, 2001(fourth edition), pp. 10-14. See also Stephen Martin, Industrial Economics: Economic Analysis and Public Policy. Englewood Cliffs, New Jersey, Prentice Hall, 1994, pp. 45-50.

it is precisely this result of competition policy that generates opposition to it by those in government who prefer to manage the rate of change in society, by those classes that prefer the status quo to a society in which *arrivistes* can eventually despoil the neighborhoods of those with "old money" by moving there, and by businessmen with undepreciated sunk investment that will never be recovered if barriers to entry are eliminated.

Antitrust in High-Tech Industries

All of this said, those who worry about the applicability of the antitrust laws to high-tech, Internet industries, where entry barriers appear to be low and economies of scale high, do raise concerns that must be considered.[13] The first of these worries is that so much of antitrust policy depends on correctly defining the market in which a firm is held to be dominant, or a merger held to create unacceptable levels of concentration. Many quite respectable academics, from Oxford's George Yarrow to Harvard's Louis Kaplow, question whether that process is either necessary or sensible. Kaplow makes the "immodest claim" that:

> "the market definition process is incoherent as a matter of basic economic principles and should be abandoned entirely. This conclusion is based on the inability to make meaningful inferences of market power in redefined markets; … the impossibility of determining what market definition is best in a sensible manner without first formulating a best estimate of market power, rendering further analysis pointless and possibly leading to erroneous outcomes…."[14]

I have some sympathy for that point of view, but in the end veer back towards making some use of, or at least not ignoring, market definition. Several nations' antitrust authorities continue to begin the process of applying competition policy by struggling to define the relevant market with which they feel they are dealing. Joaquín Almunia, the European Commissioner in charge of competition policy enforcement, insists that market definition is one of the useful tools in his "toolbox." It allows him to "discard unproblematic cases early in the process," and is "complementary" to "snazzier analytical tools" used to determine the impact of mergers.[15] And there is the small matter that our courts must apply a statute that requires any lessening of competition to be in a defined "line of commerce." This surely demands some sort of market definition, perhaps as "part of the organizing framework for the competitive assessment."[16]

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[13] In this connection see Robert D. Atkinson and David B. Audretsch, "Economic Doctrines and Approaches to Antitrust," Research Paper No. 2011-01-02, School of Public and Environmental Affairs, Indiana University, January 2011.
[14] Louis Kaplow, "Why (Ever) Define Markets?", The Harvard John M. Olin Discussion Paper Series, Discussion Paper No. 666, March 2010. I draw here on ideas presented earlier in seminars at Merton College, Oxford, and in an EU competition policy workshop in Florence, Italy
[15] Speech delivered at Fordham Competition Conference, New York, September 8, 2011.
[16] Alison Oldale, "Market definition is dead. Long live market definition?" Paper presented at 15th Annual EU Competition Law and Policy Workshop, Florence, 12-13 November 2010.

Therein lies the problem: market share analysis remains a necessity, even in industries in which the pace of change is far more rapid than was the case when the statutes were drafted and the concept developed. Market share is a snapshot, the structure of a market, and the share of its participants, at a particular point in time. Attention to that fact in industries in which technology is more or less static, or moving at a glacial pace, is one thing, perhaps appropriate. But a snapshot of a runner in the midst of a race tells little about his standing only moments later. So, too, with market shares, the durability of which when facing a Schumpeterian gale of creative destruction, is open to serious question. In short, in addition to asking, "Does this company have a dominant market share?", it is important to inquire, "Is that market share likely to prove ephemeral?"

This latter question provides the organizing principle for an inquiry into whether switching costs are high, or the incumbent is in a position to make entry difficult by discouraging potential investors in the new enterprise, or has a history of relying on anticompetitive tactics. More important, is the industry one in which new entrants can only nibble around the edges of the dominant incumbent's market power, or one in which the gale of creative destruction can blow it away, as we have seen in the case of Myspace.

This consideration is especially important in merger cases, where the larger market share being acquired might substantially lessen competition if it is likely to prove durable, but less of a concern if the industry is the sort that has seen successive waves of innovation eliminate companies that only recently had large market shares, or at least seriously erode their market power. Where "innovation is constant and fast", notes Almunia, the demands on the regulator multiply. "Preserving and boosting innovation must lie at the heart of competition policy in general, which poses a specific challenge in merger control, because it is harder to predict the likely evolution of markets in dynamic industries."[17]

Put in more traditional terms, it may well be that when dealing with industries subject to rapid technological change we need to place less emphasis on existing, and more on prospective market shares, despite the greater difficulty of the latter assessment. This is especially true in the case of industries that have most recently attracted the attention of antitrust authorities here, in Europe, and in several other countries.[18]

This is not to deny that antitrust authorities have always attempted to divine the effects of their actions on the future structure and behavior of industries with which they deal. But it is only recently that we are dealing with markets in which previously unimagined and unknown businesses can suddenly attract a half-billion users, while others that only yesterday seemed likely to dominate the future are no longer thriving, or even in existence tomorrow. And we have an unusual confluence: firms in these fast-changing industries are also awash in cash. The Googles, Microsofts, and Apples are sitting on huge piles of cash, and the Twitters and Facebooks appear able to get whatever sums they need. If they are to grow at anything like the rates to which they aspire, they will have to make acquisitions that enhance the products and

[17] Speech previously cited.

[18] "New leaders on both sides of the Atlantic are showing renewed interest in scrutinizing innovators. Competition agencies ideally help consumers by ensuring open, competitive markets while eschewing actions that impede innovation and competition. But the accelerating pace of technological change makes their task more difficult." Timothy J. Muris, "Antitrust in a High-Tech World," *The Wall Street Journal*, August 12, 2010. One such firm, Google, is a client of this writer.

services they have on offer, or expand the range of those offerings. Deciding whether these acquisitions accelerate innovation, or create barriers to the entry of newcomers, will be no easy task. The authorities will inevitably be informed by the competitive history and culture of the acquiring company—whether it has a history of business practices such as competition authorities have found were deployed by Microsoft and Intel.[19] Or at least one hopes they will.

These analytical chores associated with antitrust enforcement are the sort that have long been ignored by serious economists, perhaps because antitrust enforcement in the past many years has been dormant, and macroeconomic problems have dominated the attention of economists. We can thank AT&T and the Department of Justice for reminding us that a competitive economy is essential to economic growth—in economists' jargon, intelligent microeconomic policy can contribute to successful macroeconomic policy—and the policies to preserve competition deserve some attention.

[19] The writer served as a consultant to AMD, which challenged many Intel practices before several competition enforcement agencies.