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Market Dominance: A Problem For Competition Authorities.*
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by
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If we needed any reminding, the controversy over the decision by the Court of First Instance to uphold the EC finding against Microsoft has reminded us that the application of competition policy to dominant firms remains an area of wide disagreement among academics, competition authorities, businessmen, and practicing lawyers. I shall attempt in this paper to lay out some of the problems associated with the application of competition policy to dominant firms, and suggest some solutions.

The Modern Corporation

Long before 1890, when Senator John Sherman persuaded his colleagues to adopt legislation to control the monopolies of his

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day, and President Benjamin Harrison signed Bill S.1 into law, Americans found it difficult to come to grips with what Irving Kristol has called the “accidental institution” that is the modern corporation.¹ Designed to permit an agglomeration of capital that would create firms large enough to take advantage of economies of scale, while limiting the liability of its investors, the corporation is, again quoting Kristol, “a quasi-public institution ... which liberal democracy never envisaged, whose birth and existence have been exceedingly troublesome to it, and whose legitimacy it has always found dubious.”² These entities were easier for a liberal democracy to accommodate when they existed for a single purpose, such as the construction of a canal, than when they became all-purpose businesses—“persons” with eternal life and virtually limitless reach. As two astute observers of the American scene put it, the power of these companies stems from the fact that “they possess most of the legal rights of a human being, without the attendant disadvantages of biology: they are not condemned to die of old age and they can create progeny pretty much at will.”³ Little wonder that they were seen as “strange,

¹ Irving Kristol, “On Corporate Capitalism in America,” *The Public Interest* 41 (Fall 1975).

² Kristol, “Corporate Capitalism.” Each joint-stock company originally “existed for a very particular purpose, which needed to be defined in its statutes.” Harold James, *Family Capitalism* (Cambridge, Mass. and London: The Belknap Press of Harvard University Press, 2006), 380.

³ John Micklethwait and Adrian Wooldridge, *The Company: A Short History of a Revolutionary Idea* (New York: Random House, 2003), 2.

gigantic, ruthless and awe-inspiring” by the time Senator Sherman turned his attention to them.⁴

With reason. First, the corporation may be and is “a person” in the eyes of the law, but it has no form that the citizenry can identify and hold accountable. The public needs to have “real people” such as John D. Rockefeller to blame when the accretion of market power threatens the public’s ability to rely on the market to protect its interests and welfare. Second, the modern corporation exerts substantial power, not necessarily in the market for its output, but over the lives of its employees and suppliers, as the recent downsizing of the American automobile industry indicates. Third, the modern corporation, for all its protestations of social responsibility, still has—or should have—the goal of maximizing shareholder value, whereas the smaller, often family-controlled firms it replaced could and sometimes (but far from always) did adopt a more paternalistic attitude towards their employees and the communities in which they operated.⁵

At some point in their history, corporations, already deemed worrisome institutions by many, grew to a point where they created two problems for society: control slipped from their

⁴ Hans B. Thorelli, *The Federal Antitrust Policy, Origination of an American Tradition*, 226-27. First published by the Johns Hopkins Press (Baltimore) in 1954, it is now available from University Microfilms International, Ann Arbor, Michigan, Out-of-Print Books, 1992.

⁵ This is not to say that employees are in fact worse off working for the modern corporation, with its health-care plans, day-care facilities and other benefits, than they were working for the mineowners of the late nineteenth century. It is just that the corporation somehow seems more remote, more difficult to raise a fuss with, than many of the old pre-corporate entities.

owners to a cadre of managers whose interests were not at all times (if ever) aligned with those of the shareholder-owners; and in some cases monopoly power was acquired by means other than sheer efficiency and serving the interests of consumers.

This nervousness about the corporation increases when a company acquires monopoly power. Hence the body of law that constitutes what we call competition policy. The 1890 Sherman Act, whether conceived originally merely to maximize consumer welfare, as some contend,⁶ or having broader social and political goals, as others argue,⁷ did succeed in bringing some of the worst corporate actors—the “malefactors of great wealth,” as Teddy Roosevelt dubbed them—to heel and, as amended, succeeded in placing limits on mergers that have the potential of substantially lessening competition.

But its critics contend that the antitrust laws have done more than constrain those worst actors; the statutes and the body of judicial decisions associated with them have often stifled “hard” competition by placing unnecessary constraints on the ability of firms with large market shares to engage in a variety of practices that are pro-competitive, for example, by creating a fear in

⁶ The best statement of this position is to be found in Robert H. Bork, *The Antitrust Paradox: A Policy at War With Itself*, originally published in 1978 by Basic Books to much gnashing of teeth by economists not taken with the arguments of “the Chicago school” and others, and reprinted in 1993 with a new introduction and epilogue by Judge Bork by New York’s Free Press.

⁷ See, for example, John H. Shenefield and Irwin M. Stelzer, *The Antitrust Laws: A Primer*, 4th ed. (Washington, D.C.: The AEI Press, 2001), 10-14. For a fuller treatment, Joel B. Dirlam and Alfred E. Kahn, *Fair Competition: The Law and Economics of Antitrust Policy* (Westport, Connecticut: Greenwood Press, 1970).

executive suites that competitive price cuts will be deemed “predatory.”⁸

This is not the place to resolve the dispute between those who worry that the antitrust laws stifle competition, and those who argue that without the constraints they impose on the use of abusively acquired market power, competition will be weakened. Suffice it to say here that the courts in the United States have consistently made clear that size alone is no offence, and that market power acquired only “as a consequence of superior product, business acumen, or historic accident” is not objectionable.⁹ Authorities in the EU hold a similar view. In a recent paper they note that the purpose of their regulations is “not to protect competitors from dominant firms’ genuine competition based on factors such as higher quality, novel products, opportune innovation or otherwise better performance, but to ensure that these competitors are also able to expand in or enter the market and compete therein on the merits, without facing competition conditions which are distorted or impaired by the dominant firm.”¹⁰

⁸ Use of the laws by competitors to deter price cuts by more efficient rivals has prompted Judge Frank Easterbrook to propose that only consumers be allowed to sue for and recover damages based on any overcharges resulting from successful predation. Stephen Martin, *Industrial Economics: Economic Analysis and Public Policy*. (Englewood Cliffs, New Jersey: Prentice Hall, 1993), 482-83.

⁹ *United States v. Grinnell Corp.*, 384 U.S. 563 (1966).

¹⁰ European Commission, DG Competition, “DG Competition discussion paper on the application of Article 82 of the Treaty to exclusionary abuses,” Brussels, December 2005, 17-18.

But it is the place to attempt to resolve another question: whether the body of competition policy that has evolved over the years can usefully be applied to the fast-changing, high-tech world of today, peopled by the likes of Microsoft, and if so, by whom.

Applicability of Competition Policy to Today's Economy

It is testimony to the durability of the economic concepts underlying antitrust policy that it has been able to adapt to the changes in the American economy over almost 120 years without interfering with—indeed, continuing to contribute to—the forward march of the economy.¹¹ Neither the increased importance of high-tech industries, nor globalization requires abandonment of these core concepts.

As for new technologies: Peter Freeman, Chairman of the UK Competition Commission and a lawyer with a lifetime of experience in antitrust matters, put it after considering just how “new” the “new economy” is, “Our main concepts and tools of analysis—which are themselves becoming increasingly sophisticated and quantitative over time—are likely to remain generally suitable for the task ... [of] dealing with technology issues.”¹² Surely, the threat to the durability of monopoly positions

¹¹ Theodore Roosevelt’s “trust-busting” was “designed to foster the free-market competition that has more than any other single factor been the key to American greatness. Roberts, *English-Speaking Peoples*, 13.

¹² Peter Freeman, “The Enterprise Act and Innovation,” a talk to Confederation of British Industries Competition Conference, March 5, 2004, p.10 (mimeo). In this connection see also Robert Pitofsky, “Antitrust at the Turn of the

from the increased pace of technological change can be accommodated by taking account of the effect of potential competition, or the “contestability” on the durability of entrenched positions.

As for the emergence of international competition, it is also easily accounted for by expanding the definition of the geographic market in which competition occurs to include sources of products with unimpeded and economic access to the domestic market.

But are these adaptations sufficient to ensure the continued relevance of traditional competition policy to so-called high-tech, global industries? This is a question surely worth considering now that these industries play such a prominent role in our economy.

The New Critics

The new critics of competition policy worry that even with realistic definitions of such concepts as the scope of geographic markets and the extent of contestability, traditional competition policy cannot cope with the fact that monopoly power, when it does emerge, is so transient that any attempt to cure it by recourse to the antitrust laws will do more harm than good. Yes, they say, some firm in a high-tech industry might use its market

Twenty-First Century: The Matter of Remedies,” *The Georgetown Law Journal* 91, no. 1 (November 2002), 177-78. Pitofsky, former chairman of the FTC, argues that the enforcement agencies are quite able “to take the special qualities of intellectual property into account” and to prevent abuses of market power while preserving incentives of dominant firms to innovate.

power to disadvantage a competitor, or to create barriers to entry, but that market power will soon wilt in the face of new technology. To take drastic measures to reduce the market power before natural market forces do the job is somewhere between futile and counterproductive.

In my view, that argument fails for two reasons. First, it ignores the fact that even if all markets are, in the long run, contestable, the long run can be very long indeed. Certainly, it can be long enough to allow a dominant firm to earn substantial monopoly profits, and to leave the corpses of several potential competitors strewn across the economic landscape, or at least to keep the survivors on life support.

Second, and more important, it is not the case that all market power is transient. Dominant firms, freed of the constraints imposed by competition policy, can engage in practices that create virtually insurmountable barriers to entry¹³ and the development of more than token competition, with a consequent loss of consumer welfare. As three international scholars recently put it after an extensive review of the economic literature, “It seems to us that there are no strong normative conclusions in this literature to calm the apprehensions of those who have never been persuaded that the unregulated activity of large, dominant

firms which characterize many modern markets has benign effects on welfare.”¹⁴

Market Dominance and Innovation

Moreover, if innovation is indeed now more than ever an important driver of productivity and, therefore, of advances in our standard of living, it is more important than ever that dominant firms not be allowed to control the pace at which innovations are developed and introduced by deploying tactics that create barriers to entry or artificially limit the growth of firms that do succeed in wedging themselves into the market.

I would proceed from that reasonable assumption to another, equally reasonable in my view: rapid diffusion of innovation can be assured only by preserving a competitive marketplace. There is no denying that “despite the very extensive literature on the subject, the issue of the links between market power and innovation is still not settled.”¹⁵ As between those who argue that only large firms have the optimal scale for innovation, and those who argue that dominant firms have little incentive to innovate, I come down on the side of the latter.

¹³ It should be noted that defining barriers to entry is no easy task. A good summary of the difficulties confronting the antitrust analyst can be found in Harold Demsetz, “Barriers to Entry,” in *The Organization of Economic Activity* (Oxford, UK and Cambridge, Mass.: Basil Blackwell, 1989), vol. 2, chap. 2, 25-39.

¹⁴ David Encaoua, Paul Geroski and Alexis Jacquemin, “Strategic Competition and the Persistence of Dominant Firms: A Survey,” in *New Developments in the Analysis of Market Structure*, ed. Joseph Stiglitz and G. Frank Mathewson (Cambridge, Mass.: The MIT Press, 1986), 75.

¹⁵ George Symeonidis, *The Effects of Competition: Cartel Policy and the Evolution of Strategy and Structure in British Industry* (Cambridge, Mass. and London: The MIT Press, 2002), 224.

First, any sensible comparison of economies in which competition policy exists and is enforced, with economies in which cartels and national champions are encouraged, must lead a dispassionate observer to conclude that competition produces superior economic performance. An econometric study by economists at the Federal Reserve Bank of New York concludes, “Greater competition produces large effects on macroeconomic performance.... Lower levels of competition are associated with significantly reduced output and consumption and home and abroad...”; had the EU adopted the more deregulatory and competitive US model, its output would be some 12.4 percent higher.¹⁶

Second, studies comparing the innovation records of dominant firms with those in more competitive industries generally contain an intrinsic bias in favour of the former. These studies are observing the behaviour and performance of the dominant firms operating under the constraints imposed by competition policy. For that reason, these studies provide no basis for conclusions about the effectiveness of competition policy in producing more rapid innovation: remove the constraints, and the dominant firm might well see little reason to maintain its previous pace of

¹⁶ Tamim Bayoumi, Douglas Laxton and Paolo Pesenti, “Benefits and Spillovers of Greater Competition in Europe: A Macroeconomic Assessment,” Federal Reserve Bank of New York Staff Report no. 182, April 2004, abstract and pp. 3 and 30.

innovation, confident that if a competitor rears its head, it will be able to lop it off with tactics not now permitted.

Third, most of these studies fail to capture the role of venture capitalists in financing upstarts. These capitalists, the first port of call for a newcomer after he has exhausted his own and his family's resources, are notably hard-headed realists. If they believe that an entrenched incumbent will be allowed to snuff out incipient competition by inducing manufacturers to boycott the new product, or by using technological legerdemain to tie its own competing product to its monopoly product, or by setting a pricing schedule that in effect results in full-line forcing,¹⁷ venture capitalists will, at the very least, raise the cost of capital to reflect the enhanced risk, and more likely suggest to the newcomer that completion of his doctoral dissertation or a job with the entrenched incumbent is his best option. They must always be satisfied, before opening their wallets, that the incumbent does not have sufficient market power to nip the competition in its incipiency. Potential suppliers cannot be threatened with retaliation if they do business with the newcomer; most distributors cannot be fearful of the consequences of dealing with the new entrant; the dominant incumbent cannot manipulate its price schedules so as to make it uneconomic for its customers to

¹⁷ John Vickers, "Abuse of Market Power," p. 20, notes that a dominant firm can raise rivals' costs—unduly deny scale economies to rivals—by offering price reductions that are "*conditional* on the buyer not dealing with rivals."

divert part of their custom to a new entrant. Only with the assurance that the law protects their investment from being washed away by such tactics that have nothing to do with the relative merits of the competing products, will venture capitalists write the checks the challenger needs.

They know what some academic analysts do not: experience suggests that dominant firms are willing to have recourse to tactics that are related to their market power, rather than their efficiency. The use of these tactics turns the battle into one in which the firm with greater market power wins, rather than the firm with the best mousetrap. It is those tactics that the antitrust laws, applied both by the enforcement agencies and private parties, are uniquely equipped to prevent.

- A firm with substantial market power, even power fairly won in the marketplace, cannot leverage that power by tying other products to the one that it dominates.
- A firm with substantial market power cannot use that power to pressure customers not to deal with its competitors, or impose supply allocations and/or a pricing system that accomplishes that same result.
- A firm with substantial market power over a product, access to which is crucial for firms that compete with it in other product

markets, cannot make access conditional on an agreement by its potential competitors to cede other markets to it.

Surely, nothing in the current economic thinking, or in the nature of high-tech industries, makes such restrictions on the tactics available to dominant firms obsolete. Indeed, such constraints on the use of market power are more compelling in the case of industries in which waves of creatively destructive innovation are to be relied on as the principal engines of progress.

Adaptation To A High-Tech Economy

That's why it would be folly to abandon or seriously weaken the competition policy that has contributed so much to the growth of the American economy and has conferred on us the socially stabilizing consequences of a policy that promises the upwardly mobile a fair field with no favours. Of course, antitrust policy will have to be applied with the economic sense that has enabled it to remain a viable tool for the preservation of competition for over a century. That will require that at least three areas of enforcement be applied with sensitivity.

- If it is indeed the case that high-tech products have short economic lives, that fact will have to be factored into any appraisal and measurement of market power. Antitrust policy has never been aimed at demonstrably transient market power,

and I see nothing in current enforcement policies that gives reason to fear that it will be in the future.

- The question of relief will have to be given even greater consideration in the future than in the past. The notion that the antitrust laws are proscriptive rather than prescriptive is less compelling than it once was: if an enforcement agency doesn't know what remedy to propose, it should stay its hand. And that remedy cannot always rely on ongoing judicial supervision of the practices of a company specializing in the creation of intellectual property, for two reasons. First, we do not want to slow the pace of innovation to accommodate the more leisurely one of the judicial process. Second, it is not at all certain that the courts can cope with firms understandably reluctant to comply promptly with their orders, witness the recent confession of the judge in the Microsoft case that the remedies she had ordered are not working terribly well.¹⁸ This difficulty with behavioural solutions may mean that relief would have to be more radical in the case of high-tech violators of the antitrust laws than in the case of lower-tech ones, with divestiture and structural solutions playing a larger role relative to the prohibition of specific practices.

¹⁸ Judge Colleen Kollar-Kotelly of the US District Court for the District of Columbia expressed dissatisfaction but added after a new approach had been agreed upon, “My only wish is that it had been done earlier, so we wouldn’t be at this point,” that being the point at which “Microsoft still has not provided the documentation to competitors” that the decree demanded, according to Thomas Vinje of Clifford Chance LLP.

- The business practices of dominant firms will have to be more carefully scrutinized to separate legitimate applications of efficiencies from the application of market power. Practices requiring the closest scrutiny include pricing policies that make it uneconomic for customers to divert business to new entrants, that create covert tying of new products to those in which the firm has a dominant market share, and that offer supply assurance only to customers who demonstrate their “loyalty” by taking their full requirements from the dominant firm.

All of these potential barriers to entry must be examined closely, lest “high-tech” be converted to “my-tech” by dominant firms. Application of these principles will not be easy. It never has been. But we know enough about how to measure dominance; how to appraise business practices to determine which have as their intent and effect preservation of market power, and which are genuinely competitive weapons related solely to efficiency; how to include such factors as the presence of international competition; and how to account for the effect of technology on the durability of market dominance, to continue to use the antitrust laws to make certain that consumers get to determine who wins the competitive race.

Private Enforcement

Let me add a quick word about the role of private enforcement, a subject being debated in the EU and here in Britain. If enforcement of competition policy is, indeed, important to continued improvements in consumer welfare—call it our standard of living, to use a more familiar term—it would seem self-evident that supplementing the limited resources available to public-sector¹⁹ authorities with those of the private sector makes sense. As Phillip Areeda put it, provisions for private actions “enlist plaintiffs in the work of detecting, punishing, and thereby deterring wrongdoing.”²⁰ The European Commission agrees. In a recent paper it argued that “facilitating damages claims for breach of antitrust law will not only make it easier for consumers and firms who have suffered damages arising from an infringement of antitrust rules to recover their losses from the infringer but also strengthen the enforcement of antitrust law.”²¹

I have elsewhere laid out the argument in favour of vigorous private enforcement, and the hour is late; so I will confine myself here to urging those of you who fear “ambulance chasers”, greedy attorneys filing frivolous suits, and other horrors, to study the

¹⁹ The UK Office of Fair Trading reckons that it has resources sufficient to allow it to pursue only 20-25 cases per year.

²⁰ Phillip Areeda, *Antitrust Violations Without Damage Recoveries*, 89 Harvard Law Review 1127 (1976).

²¹ Cited in the *Financial Times*, January 19, 2006.

American experience more carefully before coming to final conclusions.

Finally, and at the risk of upsetting those who believe that competition policy should be about efficiency and only efficiency, and should not pursue the social objective of contributing to upward mobility and an open society, I should point out that man does not live by bread alone, that our competitive economy is more than a machine to grind out more and more products at better and better prices, laudable as that objective is. During the debate on the Sherman Act, its sponsor referred to the situation in which “a humble man starts a business in opposition to them [the trusts], solitary and alone” and is forced out of business by a monopolist’s predatory acts:

Why, sir, I know of one case where a man
In good circumstances, a thrifty, strong, healthy
American was ... met in just the way I have
mentioned. If he had the right to sue this
company in the courts of the United States
under this section²² he would have been able
to indemnify himself for the losses he suffered.

²² Section 7 of the original Sherman Act, now Section 4 of the Clayton Act, created a private right of action not present under the common law.

Congress was well aware of the imbalance of power between powerful incumbents and their challengers. “This section opens the door of justice to every man, whenever he may be injured by those who violate the antitrust laws,” noted Congressman Webb of New York in a 1914 debate on the antitrust laws.

So we cannot ignore the fact that underlying the policy of encouraging private enforcement lies a deep sense that equity demands just such a policy, that the preservation of open markets creates upward social and economic mobility and diffuses economic and hence political power, keys not only to the maintenance of competition, and to continued increases in productivity and material well-being, but to the maintenance of an economic system that is fair, and is seen to be fair.

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