THE ECONOMICS OF LEGAL RELATIONSHIPS

Predatory Pricing in Antitrust Law and Economics

A historical perspective

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Predatory Pricing in Antitrust Law and Economics

Can a price ever be too low? Can competition ever be ruinous? Questions like these have always accompanied American antitrust law. They testify to the difficulty of antitrust enforcement, of protecting competition without protecting competitors.

As the business practice that most directly raises these kinds of questions, predatory pricing is at the core of antitrust debates. The history of its law and economics offers a privileged standpoint for assessing the broader development of antitrust, its past, present and future. In contrast to existing literature, this book adopts the perspective of the history of economic thought to tell this history, covering a period from the late 1880s to present times.

The image of a big firm, such as Rockefeller's Standard Oil or Duke's American Tobacco, crushing its small rivals by underselling them is iconic in American antitrust culture. It is no surprise that the most brilliant legal and economic minds of the last 130 years have been engaged in solving the predatory pricing puzzle. The book shows economic theories that build rigorous stories explaining when predatory pricing may be rational, what welfare harm it may cause and how the law may fight it. Among these narratives, a special place belongs to the Chicago story, according to which predatory pricing is never profitable and every low price is always a good price.

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To Ninetta and the four cousins Enzo, Maria, Rita and Vincenzo

In our worship of the survival of the fit under free natural selection we are sometimes in danger of forgetting that the conditions of the struggle fix the kind of fitness that shall come out of it; that survival in the prize ring means fitness for pugilism; not for bricklaying nor philanthropy; that survival in predatory competition is likely to mean something else than fitness for good and efficient production; and that only from a strife with the right kind of rules can the right kind of fitness emerge. Competition and its purpose are not individual but social. It is a game played under rules fixed by the state to the end that, so far as possible, the prize of victory shall be earned, not by trickery or mere self-seeking adroitness, but by value rendered. It is not the mere play of unrestrained self-interest; it is a method of harnessing the wild beast of self-interest to serve the common good – a thing of ideals and not of sordidness. It is not a natural state, but like any other form of liberty, it is a social achievement, and eternal vigilance is the price of it.

(Clark and Clark [1912] 1914, 200–1)

Highly speculative belief about behavior or its consequences does not satisfy [the legal] standard, even when endorsed by expert economic witnesses.

(Demsetz 1992, 209–10)

It would be indeed an extraordinary thing to strike at competition in the name of competition.

(Macrosty 1907, 345)

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The book is dedicated to the loving memory of my parents, Benedetta and Vincenzo, my aunts, Maria and Rita, and my uncle Enzo, for what they taught and gave me.

Contents

Introduction

1 Three basic dichotomies

Antitrust law is about competition. It aims at guaranteeing economic agents' freedom to compete as the best way to promote maximum social welfare. Simple as they may seem, these statements are far from undisputed or self-explanatory. Controversy about the meaning and goal of antitrust law is as old as the law itself – and even older, as it dates back to mid-nineteenth-century debates over the British common law restraints of trade.

One may legitimately ask what "competition," "freedom to compete" and "social welfare" exactly mean. Recognizing them as technical terms does not help, because two technical and only partially overlapping jargons apply in the field of antitrust: the language of law and the language of economics. The economic point of view has been on the rise during the last three decades of antitrust law, but still the subject belongs to the legal realm. Antitrust enforcement is part of the legal (and administrative) system; acquainted as they may be with economics, judges and agencies adjudicate cases following legal rules.

Even within the boundaries of economics, unsettled issues exist. For example, economists have different ideas of what "competition" actually means. What is competition? Two main characterizations prevail.[1] In the first, competition is viewed as a *process*, the product of the actions and reactions of sellers and buyers bargaining in the marketplace. It is a force operating in the market that does not coincide with any given market structure. Alternatively, competition may be characterized as a *state*; that is, as a specific market structure, endowed with certain desirable properties relating to equilibrium output and price. Historically speaking, the former view was typical of nineteenth-century classical economists, the latter of twentieth-century neoclassical ones. However, in the world of antitrust both views have always co-existed.

The same can be said of the notion of "freedom to compete." When is competition free? Once again, two interpretations exist.[2] According to the first, competition is free when market participants may exercise the utmost *freedom of contract* – that is to say, when they have unlimited access to every possible exchange opportunity and the full management of their property rights. In the second characterization, free competition means *freedom from market power*, or *freedom to trade*. Loosely speaking, market power may be defined as a market participant's capability of increasing her own surplus by constraining or coercing other agents' exchange opportunities or trade. In a freely competitive market this power is kept at an insignificant level by the force of competition itself; all agents are therefore on equal footing with respect to the possibility of exploiting trade opportunities (though some agents may still have more opportunities than others).

The two interpretations are obviously related, but do not coincide. The key difference resides in the dichotomy between market and non-market coercion. The government and the law are the main non-market sources of constraints on freedom of contract, in that they set boundaries to what an economic agent may do with her own property rights. For example, the law may prohibit a merger – that is, the free exchange of property – between two businesses. Hence, freedom of contract may also be characterized as freedom from government or legal coercion. Together with the right to enjoy the fruits of one's own work, this was the basic kind of economic freedom for classical liberals at the time the first antitrust statutes were enacted. Freedom to trade is on the contrary constrained first and foremost by other agents' market power. This may take the form of, say, supra-competitive prices, denial of access to essential inputs or territorial limitations. Apart from the idealized situation of perfect competition, where no such power exists by definition, what causes problems is not market power per se (as it may be the legitimate fruit of superior talent and ability), but rather the way it is employed to constrain or coerce other agents' trade.

The ideal of freedom from market power is intimately related to neoclassical economics and its idea of competition as a state. Market power itself is a technical notion that economists measure in terms of price/cost margins and market shares. However, it also one that easily lends itself to a non-analytical extension. In the history of antitrust law, freedom from *market* power has often been interpreted as freedom from *economic* power. By the latter term is meant a kind of power that trespasses upon the market and spreads its negative influence over the whole society. A powerful business in this sense is one capable of affecting not only a country's economy, but also its politics and social life; a threat to democracy in its most basic nature of a system based on equal rights and duties. Antitrust law has a long tradition of looking suspiciously at large concentrations of economic power, usually summarized in terms of sheer business size. Simplistic as it may be, the idea that big is bad has been a driving force for much of the subject's history.

Economic power, as distinguished from market power, is also the reason why even the notion of "social welfare" is problematic. Analytically speaking, the notion may be interpreted in purely economic terms, such as allocative efficiency or total surplus. Even broadening the analysis to encompass a dynamic setting so as to accommodate the long-run efficiencies generated by, say, product innovation leaves the basic theoretical framework unchanged. Setting social welfare as the goal of antitrust law thus makes antitrust itself a branch of economic policy that must be governed by economic analysis. All other concerns, such as fairness, the plight of small businesses or, crucially, the socio-political consequences of unbalanced economic power, become irrelevant. This is how modern antitrust usually proceeds. However, when and if economic power is viewed as the main foe, as it has often been throughout history, then the goal of antitrust changes. It becomes, broadly speaking, the pursuit of marketplace egalitarianism, of a Jeffersonian ideal of an economy of "small dealers and worthy men,"[3] none of whom are capable of coercing anyone else and, therefore, of negatively affecting a country's socio-political life. Social welfare then takes a broader, less rigorous meaning that transcends economics and even the law, in that neither discipline may properly account for loose notions such as marketplace fairness or the protection of small businesses.

These considerations should suffice to reveal how difficult – and fascinating – a topic the law and economics of antitrust may actually be. Even the simplest of statements, such as "antitrust law is about competition" or "antitrust promotes free competition," conceal a universe of interpretive problems. The present book is an effort to analyze the above-mentioned dichotomic views of "competition," "freedom to compete" and "social welfare" from the vantage point of the history of the economic analysis of antitrust. Three general results will emerge: first, that these dichotomies have characterized the entire history of antitrust law; second, that the courts' evolving attitude towards them has largely determined the way antitrust law has been enforced over the years; third, that the influence of theoretical economics upon this attitude has been anything but steady, as antitrust courts have oscillated between a total neglect and a partial or full endorsement of basic economic principles.

My analysis will focus on a single antitrust issue and a single country. I will deal with the history of the law and economics of predatory pricing in American antitrust. The geographical focus hardly requires explanation. In every respect, the United States is the cradle of antitrust, the country where the discipline first became a serious matter and where the relationship between the legal and the economic sides of competition has been most intensively studied. But why predatory pricing? Why should the history of the law and economics of this specific violation of antitrust statutes merit a book of its own? Is there anything special about predatory behavior? And, in any case, why adopt a history of economic thought viewpoint? Are there any lessons the historical method may teach current antitrust enforcers? The remainder of the Introduction tries to answer these legitimate questions.

2 The trickiest antitrust problem

Predatory pricing (PP hereafter) is an unlawful business behavior within the broader category of unlawful exclusionary practices. A practice is exclusionary when it is

> reasonably capable of creating, enlarging, or prolonging monopoly power by limiting the opportunities of rivals [and] either does not benefit consumers at

> all, or is unnecessary for the particular consumer benefits produced, or produces harms seriously disproportionate to the resulting benefits.
>
> (Hovenkamp 2005, 152)

A predatory price is then "a price that is profit-maximizing only because of its exclusionary or other anti-competitive effects" (Bolton *et al.* 2000, 2242–3). In other words, PP takes place when a firm sets such a low price that its only rationale is to damage competitors, current or potential. The predator's eventual goal is to increase its market power and charge a higher price in the future, after competition has been either disciplined or destroyed.

Historically speaking, PP surely ranks high in the catalogue of antitrust violations – at least as high as cartelization. And as with cartels, predatory behavior has always symbolized what antitrust law is supposed to fight against. The iconic picture of a big business preying upon its smaller rivals by setting the price so low that none of them could survive is second to none in the history of antitrust law, the only possible exception being the image of smoke-filled backrooms in which businessmen secretly agree to fix prices. Opposition to predatory behavior was the primary motivating force of the American public opinion's hostility towards trusts and, therefore, one of the key impulses that led Congress to pass the 1890 Sherman Act.

There is more to PP than mere history, though. The antitrust problem with cartels is easy to apprehend. Cartels are clearly anti-competitive – indeed, their very goal is to avoid competition. While even joining a cartel may be seen as an expression of a member's own freedom of contract as much as the negation of nonmembers' freedom to trade, the fact remains that the harmful welfare effects of cartelization are well established and largely undisputed. Nobody doubts that fighting cartels means fostering competition. This is not so in the case of PP. Predatory behavior is the paradigmatic example of using competition to destroy competition – what several American economists at the turn of the twentieth century called *destructive competition*. We know that defending the utmost freedom to compete is supposed to be the core of antitrust. Mind-boggling questions thus arise. Whose freedom to compete deserves antitrust protection – the predator's or the prey's? Can a firm ever be condemned for competing *too much*? Can a price ever be *too low*? In short, can competition really be destructive? Questions like these make anti-PP enforcement one of the trickiest, if not *the* trickiest part of antitrust law.

Enforcing law against PP means prohibiting competition to foster competition. The danger is clear. The law risks discouraging actual competition as freedom of contract for the sake of protecting an abstract ideal of competition as freedom from market power. The age-old proscription of predatory behavior indeed reflects a specific policy choice, namely, the idea that using the law to curb a firm's freedom to set its own price (i.e., to constrain that firm's contractual freedom) may nonetheless foster freedom to trade, i.e., avoid undue concentrations of market or economic power. This policy choice is, however, far from undisputed.