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THE GOALS OF COMPETITION LAW

Edited by
DANIEL ZIMMER

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ASCOLA COMPETITION LAW
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Preface

The Academic Society for Competition Law (ASCOLA) has to date held five international conferences. The first conference, organised in 2004 in Florence, was devoted to the 'Evolution of European Competition Law'. The second conference in Paris in 2006 addressed the relationship of 'Economic Theory and Competition Law'. A third conference, organised in Zurich in 2008, dealt with the 'Development of Competition Law'. 'More Common Ground for International Competition Law' was the topic of the fourth conference convened in 2009 in Washington, D.C. These conferences revealed a need for further discussion on the normative foundations of Competition Law: What are the goals of Competition Law? What is the relationship between the law and economic considerations? Does the law indicate that competition as a process ought to be furthered, and as far as this is the case, how does this goal relate to desired outcomes of competition such as an enhancement of welfare and distributional fairness? The board of ASCOLA deemed it necessary to deepen the discussion on these issues and decided to devote a conference to the 'Goals of Competition Law'. The conference took place in Bonn from 27–29 May 2010. This volume contains the contributions to this fifth international conference.

The conference was hosted by the newly founded Center for Advanced Studies in Law and Economics (CASTLE) at the University of Bonn. A distinguished scholar from the field of Law and Economics and current President of the American Law and Economics Association, Louis Kaplow from Harvard University, gave the inaugural speech to open the Center and the Conference. This contribution on the choice of welfare standards in competition law introduces the present volume.

Conference speakers were invited following a call for papers. The committee selecting the speakers consisted of Eleanor Fox (New York University), Josef Drexl (Max Planck Institute Munich), Wolfgang Kerber (University of Marburg) and the organiser of the conference, Daniel Zimmer (University of Bonn). The conference program was divided in two parts. A first part was devoted to basic issues of the normative foundations of competition law, including definitions of competition in a legal context, the economic content of competition law and its relationship to goals such as efficiency and economic freedom. The second part of the conference addressed specific issues, including the question whether the goals of competition law depend on the state of development or on other particular aspects of the respective economy. The volume concludes with a contribution by the conference organiser that draws conclusions from the discussions and presents an additional thesis regarding the goals of competition law.

The editor expresses his gratitude to those institutions which supported the conference: Studienvereinigung Kartellrecht, a lawyers' association promoting research in the field of competition law, as well as CASTLE made generous contributions without which the conference could not have been realised. Special thanks go to the people who made the conference a success and assisted with the book publication: Timo Angerbauer did a wonderful job preparing and realising the conference in Bonn, and Thilo Wienke took care in the most valuable and sensible way of the process of reviewing the contributions and adapting them – where necessary – to the standards required for publication in this volume.

Daniel Zimmer
Bonn, April 2011

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PART I

Normative foundations of competition law

1. On the choice of welfare standards in competition law

Louis Kaplow*

1 INTRODUCTION

The interpretation and application of competition law to horizontal restraints, mergers, and exclusionary (abusive) practices by dominant firms depends on what the laws' goals are deemed to be. Increasingly, and especially in the United States, a concern for economic welfare is taken to be central. As a result, much attention has been devoted to determining which rules best advance welfare. There nevertheless remains dispute over whether total welfare should be the objective, as is conventional under a welfare economic approach, or only consumer welfare should count.[1]

This chapter examines two sets of issues that bear on this choice. First, supposing that society is concerned with the equality of the distribution of income, does it make sense to employ competition law in pursuit of this aim, in particular by giving primary or exclusive weight to consumer welfare, downgrading or ignoring producer welfare? Second, what are the

* Finn M W Caspersen and Household International Professor of Law and Economics, Harvard University, and Research Associate, National Bureau of Economic Research, United States of America. This chapter derives from a lecture that was the keynote address for the Fifth Annual Conference of the Academic Society for Competition Law, on 'Goals of Competition Law', and the inauguration for the Center for Advanced Studies in Law and Economics at the University of Bonn. The first part of this chapter grows out of suggestions in L Kaplow and C Shapiro (2007), 'Antitrust', in AM Polinsky and S Shavell, *Handbook of Law and Economics*, vol 2, North-Holland, 1073, 1166–69, and in other prior work, cited below, outside the competition law context. The second part develops an idea first identified in my recent work on price fixing: L Kaplow (2011), 'An Economic Approach to Price Fixing', *Antitrust Law Journal*, vol 77, 343. I am grateful to conference participants for their comments and also to the John M. Olin Center for Law, Economics, and Business at Harvard Law School for additional financial support.

[1] *See*, e.g., L Kaplow and C Shapiro (2007), 'Antitrust', in AM Polinsky and S Shavell, *Handbook of Law and Economics*, vol 2, North-Holland, 1073, 1166–69 (discussing the issue and citing contrasting sources in the merger context).

differential implications of the choice between consumer and total welfare for the importance of the existing degree of price elevation?

To begin, some definitions are useful. Here, consumer welfare will be taken to refer to the consumer surplus obtained by final consumers, where consumer surplus refers to the difference between consumers' valuations (the most they would be willing to pay) and the price they actually pay.[2] Producer surplus is the difference between the price producers are paid for what they sell and the cost of production. Total welfare is the sum of consumer surplus (or welfare) and producer surplus. Relatedly, the term deadweight loss refers to the sacrifice in total surplus due to price being elevated above marginal cost – which welfare loss is the excess of consumers' valuations over marginal cost for units not purchased due to price elevation. From this perspective, lost consumer surplus is the sum of deadweight loss and the amount transferred from consumers to producers – the latter being equal to the product of the quantity sold and the magnitude of the price elevation. The latter is not part of deadweight loss (the reduction in total welfare) precisely because it is a transfer, to producers.

It is helpful at the outset also to identify some of the issues not consid-

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[2] Unfortunately, the term consumer welfare, which naturally denotes the welfare of consumers, is often used to refer to total welfare, specifically including producers' surplus, largely as a consequence of Robert Bork's usage in *The Antitrust Paradox: A Policy at War with Itself* (1978). *See*, BY Orbach (2011), 'The Antitrust Consumer Welfare Paradox', *Journal of Competition Law & Economics*, vol 7, 133. Others use the term consumer welfare to denote a general endorsement of some welfare standard without committing either to consumer or total welfare. *See*, e.g., Antitrust Modernization Commission, Report and Recommendations 3 and n. 22 (April 2007) (stating that 'Antitrust law prohibits anticompetitive conduct that harms consumer welfare' and clarifying in the footnote that 'Debate continues about the precise definition of "consumer welfare." . . . The Supreme Court has not ruled specifically on this issue. *The Commission's use of the term "consumer welfare" does not imply a choice of a particular definition.*' (emphasis added)). A possible explanation is that, for external audiences, the term consumer welfare seems both more comprehensible and more appealing than total welfare, even though total welfare may be thought to be a more sensible objective. The latter attitude is reflected by the Commission's endorsement of giving greater weight to efficiencies in horizontal mergers. *See also* at 10 (recommendation 6 is that 'The Federal Trade Commission and the Antitrust Division of the Department of Justice should give substantial weight to evidence demonstrating that a merger will enhance efficiency.' and recommendation 7 is that 'The Federal Trade Commission and the Antitrust Division of the Department of Justice should increase the weight they give to certain types of efficiencies. For example, the agencies and courts should give greater credit for certain fixed-cost efficiencies, such as research and development expenses, in dynamic, innovation-driven industries where marginal costs are low relative to typical prices.').

ered here. The subject of competition law's proper objectives is large.[3] In particular, there has long been a broad debate about whether the law's purpose should be viewed as primarily or solely concerned with economic welfare (in some sense) or also (instead) as addressed to other sorts of purposes, some political or social. This chapter does not partake directly in this controversy and instead simply assumes that some weight is to be given to economic welfare.[4] Even regarding the narrower question of the choice between consumer and total welfare, this chapter is not comprehensive. It does not consider the extent to which fidelity to controlling legal provisions (statutes, treaties, precedents) may dictate an answer. Nor does it address other considerations bearing on the normative choice, including whether one or another standard may be easier to apply or whether one might be a practical proxy for the other, subjects that have received significant attention of late, particularly regarding the review of horizontal mergers.[5]

Section 2 addresses the question of whether distributive objectives may sensibly be advanced by adopting a consumer welfare standard – or, more moderately, giving less weight to producer surplus than to consumer surplus. It suggests a negative answer on the ground that distributive objectives are better achieved through the tax and transfer system, with competition law advancing total welfare and hence giving equal weight to consumer and producer surplus. A traditional argument for relying on taxes and transfers that applies in many contexts is that they are better targeted than indirect means, such as the use of competition law. This point

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[3] Indeed, the conference volume in which this chapter appears is devoted entirely to the subject.

[4] In other work, I have advanced in great detail the position that legal policy generally (thus including competition policy) should be concerned exclusively with welfare, which is to say, the well-being of individuals. *See*, L Kaplow and S Shavell (2002), *Fairness versus Welfare*, Harvard University Press. Among the arguments is that giving weight to non-welfarist considerations entails endorsement of the view that it is sometimes best to make everyone in society worse off. Many proposed competition law objectives on one hand do not appear to be denominated in welfare terms and are often presented as alternatives or supplements to considerations of welfare, yet on the other hand may, on reflection, possibly be understood as proxies for aspects of welfare or suggestions that more subtle welfare consequences – such as through reinforcing a democratic political regime – not be excluded from conventional welfare-based analysis of competition policy. For further discussions of such possibilities (without specific reference to competition law), *see above*, especially ch 8A.

[5] For an excellent discussion of some of the arguments recently advanced, see J Farrell and ML Katz (2006), 'The Economics of Welfare Standards in Antitrust', *Competition Policy International*, vol 2:2, 3, 15–27.

is certainly true here since there is great heterogeneity among consumers and among producers, and the extent and even direction of redistribution is not always the same. (A merger between firms producing luxury goods is commonly mentioned.) Nevertheless, because producers – specifically, their owners and other beneficiaries of increased profits – are, on average, wealthier than consumers, this argument is not in itself decisive.

A second, more convincing argument is that the use of indirect means such as competition law to redistribute income – specifically, adoption of less efficient rules (ones that fail to maximize total welfare) because of their more favorable distributive consequences – is an inefficient means of redistribution. Accomplishing the same degree of redistribution through the tax and transfer system allows the redistribution to be achieved at lower cost, which means that both producers and consumers can be made better off. Thus, if the purpose is to help consumers as a whole, using a means that helps them less hardly makes sense.

Section 3 examines how the degree of pre-existing price elevation bears on the implications of using a consumer welfare versus a total welfare standard. The fundamental point is that the marginal and total cost under these two standards changes differently as prices are elevated above a competitive level. For a one unit increase in price, the loss in consumer surplus is (approximately) one times the current quantity. At the competitive price, this quantity is high compared to when the price is significantly elevated, so the marginal loss in consumer surplus is high. As the price rises, the marginal loss in consumer surplus falls. The total sacrifice in consumer surplus sacrifice, to be sure, is higher, but the total loss in consumer surplus rises at a decreasing rate.

By contrast, the marginal sacrifice in total welfare is negligible starting at a competitive price. The reason is that deadweight loss is determined by the quantity reduction times the degree to which consumers' valuation for that quantity exceeds the competitive price (equal to marginal cost). When price is only slightly elevated, this latter component is very small, so the increment to deadweight loss is correspondingly small. However, starting at a significantly elevated price (and supposing that the decline in quantity due to a similar slight further increase in price is the same), consumers' average valuations for that quantity greatly exceed marginal cost, so the increment to deadweight loss is much greater. In sum, the loss in total welfare also rises with price, but the loss starts out very small and increases at an increasing rate – it accelerates.

This fundamental difference between the relevance of price elevation to consumer welfare and to total welfare means that, in various competition law settings, different priorities might arise. For example, with horizontal mergers, suppose we are considering a proposed combination that is predicted to cause a given elevation in price. If the pre-merger market is fairly competitive, this increment will cause a relatively large loss in consumer welfare but a very small loss in total welfare. Hence, the merger is significantly more problematic under a consumer welfare standard. However, if the pre-merger market is much less competitive, the increment will cause a smaller loss in consumer welfare than in the prior case but a relatively large loss in total welfare. Current merger policy in most regimes is stricter in the latter situation, which would make sense if the objective was total welfare, not consumer welfare. Yet most regimes purport to be designed to advance consumer rather than total welfare, so there is a discrepancy between existing rules and claimed objectives.[6] Section 3 also considers implications for price-fixing enforcement, and the analysis has relevance as well to rules addressed to practices employed by dominant firms.

2 DISTRIBUTIVE OBJECTIVES

2.1 Overview

The notion that government functions should be allocated to different agencies that specialize in different tasks is a familiar one. Perhaps the most well-known statement on the present subject is Richard Musgrave's description in his 1959 treatise that, among other things, distinguishes the allocative function and the distributive function.[7] The former (involving the provision of public goods and control of externalities, for example) should be concerned with allocative efficiency. The latter, with control over such instruments as the income tax and transfer programs, should concentrate on how best to achieve distributive objectives.

The virtues of specialization as applied to government agencies are likewise well known. An environmental protection commission should concern itself with the environment, not the quality of schools. The defense department should advance security and not be diverted by concerns about the safety of pharmaceuticals. And so forth.

Of course, complete specialization is not always optimal. Moreover, and perhaps more important as an explanatory matter in the present setting, the desires of many academics and officials in various agencies are not so readily constrained. It is tempting to address problems that one views as

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6 One possibility is that such statements about consumer welfare do not actually reflect rejection of a total welfare standard, as explained in note 2.

7 RA Musgrave (1959), *The Theory of Public Finance*, McGraw Hill, ch 1.