Exclusion and Efficiency

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IN THE LAST DECADE the Supreme Court has moved decisively toward an antitrust policy based explicitly on efficiency considerations, abandoning earlier cases that allowed recovery based solely on private injury. Private plaintiffs now usually find themselves out of court unless they show that challenged arrangements injure market competition. It is no longer enough simply to show injury to competitors.

Krattenmaker and Salop claim the pendulum has swung too far. Although they disclaim any intent to return to the plaintiff's paradise of the 1960s and early 1970s, they insist that antitrust policy needs a new approach to deal with competitor complaints that fellow competitors have made life tougher by engaging in exclusionary conduct. Their theory would make conduct illegal if it allowed a firm to "raise prices above the competitive level" by raising rivals' costs. Economic efficiencies associated with the conduct could provide a defense only in "extreme circumstances." Even then, cost reductions could be considered only if they lowered prices directly. Other less direct benefits of increased efficiency, which also increase net social wealth, would be ignored.

Krattenmaker and Salop are mistaken in several respects. Their most basic error is the claim that "antitrust concerns collusion and exclusion." In the modern, or consumer welfare, approach, antitrust's basic concern is private arrangements that increase market power (the power to restrict output) in a way that reduces social wealth. Such arrangements reduce wealth if they do not result in offsetting reductions in costs or other increases in productive efficiency. While this is a mouthful, it has the advantage of being correct.

Many, perhaps most, arrangements involving collusion or exclusion fall outside the scope of antitrust's concern, properly defined. The important operational question is what types of arrangements, including those involving collusion and exclusion, fall within that scope. Current antitrust doctrine deals reasonably well with that question. Even if it did not, however, the Krattenmaker-Salop proposals would not improve things; their "solution" creates more problems than it solves.

Raising Rivals' Costs

Krattenmaker and Salop focus on contracts between one firm (which they call a "purchaser") and other firms that supply inputs both to the purchaser and to its competitors. They worry that the purchaser can somehow create a situation where its suppliers will charge its competitors higher prices for inputs than the suppliers charge the purchaser. Sometimes the purchaser

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itself produces the input and refuses to provide it to competitors on terms as favorable as they might like. An example is the computerized reservation systems (CRS) which favor the airlines that created them. Krattenmaker and Salop argue that such arrangements raise rivals' costs, as indeed they will unless airlines that have not contributed to their creation are allowed to free ride on the investment of those that have. Krattenmaker and Salop would hold such arrangements to be illegal if they enable purchasers to raise prices above "competitive levels." In the CRS example "competitive levels" refers to prices that would prevail if airlines that have not invested in reservation systems were given access to systems created by others, without being required to pay for the privilege.

While the problem on which Krattenmaker and Salop focus has not been common in antitrust history, one instructive example appears in the prehistory of antitrust. In the late 1870s a railroad cartel emerged in the transportation of petroleum products from western Pennsylvania. Although many such cartels had been attempted before, this one worked. The three oil-carrying railroads fixed rates and divided the market. The Standard Oil Company enforced the cartel by shifting oil shipments among the railroads to maintain the agreed market division. Standard Oil was the only firm that shipped sufficient oil from different locations served by the railroads to "even" shipments among cartel members. If one railroad increased its market share by secret price cutting, Standard Oil would simply divert oil from that railroad back to those that had lost market share. Since no railroad could increase its market share for a period longer than it took Standard Oil to make "corrections," there was no incentive to cheat on the fixed rates.

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Standard Oil was well paid for its services. It got a substantial rebate (not available to other shippers) from the fixed rate not only on shipments of its own oil, but also on oil shipped by its competitors. A more striking example of raising rivals' costs could hardly be imagined. Standard Oil's competitors in the refining business had every reason to complain about the exclusionary treatment they received and did so, loudly.

This case shows that the problem that concerns Krattenmaker and Salop is real, but it also shows how well orthodox antitrust analysis handles such cases. Today an arrangement similar to that between the railroads and Standard Oil would immediately be identified as naked horizontal price fixing; it would be illegal *per se*. To see that the applicability of orthodox antitrust analysis is quite general, it is worth examining the current doctrine in greater detail.

Current Antitrust Doctrine

In antitrust lingo, arrangements affecting relationships between suppliers and resellers are called "vertical." Those affecting relationships between direct competitors are called "horizontal." A contract by which a purchaser obtains control of the output of only one of its suppliers would be entirely vertical; it would not increase the share of the suppliers' market under the control of any one firm, and it could not therefore affect relationships between direct competitors. Such contracts between a purchaser and more than one of its suppliers, however, would have horizontal aspects. They *would* increase the share of the suppliers' market under the control of a single firm, the purchaser. These contracts could therefore affect relations between direct competitors in the suppliers' market.

Under existing law and practice, arrangements that eliminate competition without any chance of increasing efficiency are called "naked" restraints; they are illegal *per se*. Such treatment would be accorded the apparently naked contract between Alcoa and the electric utilities mentioned by Krattenmaker and Salop. Unlike that arrangement, however, most contracts between suppliers and resellers involve an integration of productive resources; they are therefore capable of increasing efficiency. Existing law evaluates both the vertical and horizontal aspects of arrangements that might create efficiency with the rule of reason, under which a plaintiff must first prove the existence of the restriction and then show that it has an anticompetitive effect in a specific market. Any such effects are then balanced against any procompetitive effects. A restriction is illegal only if its anticompetitive effects outweigh its procompetitive effects.

There was considerable confusion in earlier cases about when the rule of reason should be applied and when the *per se* rule should be used to render certain restrictions automatically illegal. Similar confusion obscured the precise nature of the pro- and anticompetitive effects to be balanced under the rule of reason. Recent Supreme Court cases have eliminated much of that confusion.

The Court's 1977 decision in *Continental T.V., Inc.* v. *GTE Sylvania, Inc.*, for example, applied the rule of reason to vertical non-price restrictions. *Sylvania* is significant both because it overruled an earlier case that would have applied the *per se* rule to such restrictions, and because it hinged the application of the rule of reason on the capacity to create efficiency. In 1979 the Court relaxed the scope of the *per se* rule where it had been applied most rigidly—in horizontal price fixing. In *Broadcast Music, Inc.* v. *Columbia Broadcasting Systems* it applied the rule of reason to blanket copyright licenses which necessarily fixed horizontal prices while creating efficiencies in the licensing of copyrighted music. The Court said it would apply the *per se* rule when a restriction would "always or almost always tend to restrict competition and decrease output," not when it was "designed to 'increase economic efficiency and render markets more, rather than less, competitive.' "

The Court's 1985 decision in *Northwest Wholesale Stationers, Inc.* v. *Pacific Stationery & Printing Co.* extended the *Broadcast Music* approach to group boycotts, another type of restriction it had long held to be illegal *per se*. The rule of reason now governs those restrictions unless it appears that the boycotting party has market power and the boycott lacks any efficiency-creating potential.

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It seems safe to say that the rule of reason will now be applied to most conduct that may reduce costs or otherwise increase productive efficiency. This includes most vertical arrangements (except direct vertical price fixing, which remains illegal *per se*), the horizontal aspects of such vertical arrangements, and horizontal arrangements generally. The Court's increased emphasis on efficiency also clarifies the nature of the competitive factors to be weighed under the rule of reason once it comes into play. Anticompetitive effects occur when the power to restrict output increases, thereby reducing allocative efficiency. Procompetitive effects arise when costs are cut or productive efficiency is otherwise increased.

"Raising Rivals' Costs" Under Current Law

Krattenmaker and Salop complain that competitors are finding it harder to win antitrust cases against their rivals, particularly cases involving vertical arrangements. But the reason for this is clear. It is practically impossible to show that strictly vertical arrangements have any anticompetitive effect. They do not increase market share beyond the amount already held by one of the parties to the transaction. A restriction on competition among a supplier's resellers does not increase market share above that already held by the supplier or by the reseller.

Ordinarily an increase in the share of a relevant market under common control is a necessary condition for an increase in market power. An increase in market power is, in turn, a necessary condition for an increase in anticompetitive effect. Since strictly vertical arrangements do not increase market share it is ordinarily impossible for them to produce any anticompetitive effect. It should be hard, indeed it should be impossible, to win cases in which no anticompetitive effect can be shown. Any concern that changes in the antitrust law have made such cases harder to win is entirely misplaced.

But Krattenmaker and Salop are not concerned only with strictly vertical transactions. Their principal examples of raising rivals' costs involve a "purchaser" that increases its control (its *horizontal* control) over the suppliers' market. In effect, the "purchaser" creates a situation where output can be restricted in the upstream market. This happened in the Standard Oil case.

It is easier to show anticompetitive effect in these cases than it is in cases involving strictly vertical transactions. However there is no need for a new rule to deal with "exclusionary" conduct in such cases. The real problem is collusion or merger to monopoly on the supplier level, a problem easily handled under the traditional antitrust approach to horizontal restrictions.

Naked restraints which a "purchaser" creates in a supplier's market are illegal *per se*, as are all other naked restraints. Increased control of upstream markets involving a fusion of productive resources would, like similar arrangements elsewhere, be subject to the rule of reason. Such arrangements will be illegal only if their anticompetitive effects outweigh their procompetitive effects.

Proxies for Pro- and Anticompetitive Effects

Although pro- and anticompetitive effects are easy to talk about, they cannot be observed directly. To use these concepts we need proxies accessible to the legal process.

Market share is the most common legal proxy for power to restrict output (market power). A large market share is necessary, though market share is an imperfect proxy, at least it can be used to identify certain arrangements that do not increase market power and therefore should not be matters of antitrust concern. A restriction that does not increase market share beyond levels that would exist without it probably cannot increase market power.

A test based on increases in prices and rivals' costs would subject to antitrust scrutiny many arrangements with no antitrust significance whatever.

The most common proxy for efficiency-creating capacity is the integration of productive resources, as in the typical merger or partnership. Like market share, this proxy is imperfect but helps to classify business transactions. For example, arrangements that increase generic market share without joining productive resources are commonly held illegal *per se*. Arrangements that integrate productive resources without raising market share to "high" levels are usually legal. Integration implies a capacity to cut costs or otherwise increase productive efficiency, while the "low" market share implies a lack of market power.

The Krattenmaker-Salop test differs from current law in two crucial ways, both of which render it ineffective for antitrust analysis. First, while current law uses market share as a proxy for market power, Krattenmaker and Salop equate market power with a price increase prompted by an increase in rivals' costs. Sometimes they qualify their test by saying that prices must rise above competitive levels; sometimes they do not. But the qualification is useless anyway, since no one can tell whether a price is above or below the "competitive" level. Making such a determination would amount to making an inquiry into the reasonableness of prices, which for good reason the law has long banned.

As a proxy for market power, increases in rivals' costs and "purchasers' " prices are much less effective than the traditional test of market share. Prices and rivals' costs can increase for many reasons unrelated to market power. An obvious example is an increase in product or service quality. Another, discussed in the next section, is the creation and enforcement of garden-variety property rights. A test based on increases in prices and rivals' costs would subject to antitrust scrutiny many arrangements with no antitrust significance whatever.

Their test also gives inappropriate treatment to cost reductions or other types of productive efficiency gains which may result from restrictive arrangements. Current law recognizes the potential for efficiency gains in two different ways: it hinges application of the rule of reason on the presence of such potential and, under the balancing process of the rule of reason, it weighs efficiency gains against losses from market power. According to Krattenmaker and Salop, claims of productive efficiency gains are "fairy tales" (unlike claims of anticompetitive effects). They leave no room to weigh costs and benefits, except in "extreme circumstances," defined presumably at the whim of a judge or jury. Even in "extreme circumstances" they would credit only those productive efficiency gains that result in direct price cuts; others would be ignored. This makes it essentially impossible for their test to distinguish between arrangements that increase social wealth and those that decrease it. That failing is particularly troubling because their proxy for market power is far too broad, requiring antitrust scrutiny of many arrangements that are more likely to make us richer than to make us poorer. After requiring scrutiny of such arrangements, their test fails to provide a workable way to resolve them.

Current antitrust doctrine is more than capable of handling cases that arise from claims

that either competitors or competition have been injured from acts that "raise rivals' costs." Those claims will tend to prevail when they challenge acts that raise market share without cutting costs. They will tend to fail when they challenge acts that potentially cut costs without unduly raising market share. Those results will tend to increase our wealth, not reduce it.

Property Rights and Rivals' Costs

To this point I have focused on the Krattenmaker-Salop proposal as it pertains to antitrust law and doctrine, but it has far broader implications. It would create serious problems in the process by which courts decide which competing claims to property rights will be recognized and enforced.

Even the most unregulated market cannot operate without private property rights. The essence of these rights is the power to exclude others from using goods to which property rights attach. Such exclusionary rights take the form of legal barriers to entry; their purpose and effect is to raise others' (including rivals') costs of using goods protected by the barriers. Ford Motor Company, for example, cannot use a General Motors plant without incurring the cost of getting the latter's permission. Holders of property rights can typically charge higher prices than they could absent such rights. GM can charge higher prices if it can exclude others from its plants, just as Borden can charge more for "Realemon" if it is not required to let others use its trademark. Exclusion is the essence of property rights.

How do we decide what to recognize as a property right? My colleague Harold Demsetz, economist at the University of California, Los Angeles, notes that "the problem of defining ownership is precisely that of creating properly scaled legal barriers to entry." A property right is "properly scaled" when it operates to maximize consumer welfare (that is, economic efficiency). We cannot decide which property rights to enforce without choosing between different output mixes and making a rough estimate of the most cost-effective way of achieving the preferred result. We must, for example, choose between responding to the demands of arsonists and to the demand of others to be free of intentional torching. We must choose between the demand for low-priced "Realemon" and the demand for associated goods like product information, quality, and uniformity—all of which a trademark protects. We must then decide how best to implement the choices made.

It is important to recognize that someone's costs will be raised no matter how particular property claims are decided. Ford's costs are raised if GM's claims to property rights in its own plants are recognized; GM's costs are raised if they are not. In one case GM can charge higher prices; in the other Ford can. United Airlines' costs are raised if it must make its reservation system available to smaller airlines without charge. The smaller airlines' costs are raised if United's property rights in its reservation system are recognized and enforced. It is deceptive to think—as Krattenmaker and Salop do—in terms of *whether* rivals' costs are raised. The real question is *which* rivals' costs *should* be raised.

Krattenmaker and Salop do not provide a way to answer that question. Indeed their test seems to make all property rights illegal. It vitiates conduct that gives actors market power by raising rivals' costs. But it holds that market power exists when actors can raise prices above "competitive levels" after raising rivals' costs. The "competitive levels" qualification is operationally unworkable; courts are incapable of determining them and have properly refused to try since the beginning of antitrust jurisprudence. Moreover, as discussed below, competitive prices cannot be known even theoretically unless property rights are specified, and it is this specification that Krattenmaker and Salop wish to have based upon competitive prices.

Absent the competitive price level qualification, their test describes the effect of all property rights. All such rights raise rivals' costs by creating exclusionary barriers to entry, thereby letting protected parties raise prices. Surely they did not intend their test to result in a finding that all property rights violate antitrust laws. But this follows directly from their failure to give productive efficiency gains full credit and from their mistaken association of market power with increased prices prompted by increased rivals' costs.

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Consider their own paradigm, arson. Arson benefits miscellaneous incendiaries, but costs the rest of us in obvious ways. The absence of arson produces benefits reciprocal to those costs. The social costs of arson are so much greater than its benefits that we instinctively see it as a social bad. Perhaps unaware, we have effectively gauged the social costs and benefits of different output mixes—fire, and goods associated with untorched property—and have opted against arson. Once we make that choice we must choose the mix of laws, rewards, and punishments that most effectively suppresses arson. One claim of property rights is preferred to another because of its contribution to social wealth. Someone's costs are raised either way.

There is ordinarily no need to submit decisions like this to antitrust scrutiny. Typically there is nothing antisocial about raising costs in this way. Quite the contrary, an increase in rivals' costs is the inevitable effect, indeed the purpose, of any system of private property rights.

Consider some other cases. Suppose I am an orange grower and I raise my rival's costs by building a fence to keep him from taking my oranges. Suppose I am a refrigerator retailer and I induce my supplier to give me an exclusive territory to protect the information I produce about the product. Suppose I buy a business and obtain a covenant from the seller not to compete with me. Suppose I induce government to adopt and enforce laws prohibiting theft, enforcing contracts and trademarks, or protecting trade secrets. The rights created by those acts provide incentives for both producing and conserving goods by imposing the costs and benefits of various activities on those who engage in them. In economic jargon, those property rights "internalize" the costs and benefits of economic activity. They do this by raising costs so holders of property rights—those protected by "properly scaled legal barriers to entry"—can charge higher prices. The reader is invited to determine which of these examples would violate the antitrust laws under the Krattenmaker-Salop test and which would not.

The Question of Competitive Prices

As noted above, courts cannot decide which property rights to recognize by asking which ones permit prices to be raised above the competitive level. For one thing, courts cannot directly determine when prices are above the competitive level. Krattenmaker and Salop glibly refer to such prices but offer no clue as to how we might discover what they are.

Even if courts could identify the competitive price implicit in a particular specification of property rights, that information would not help us determine the optimal specification of property rights because the competitive price is itself dependent on the specification. The "competitive price" of reconstituted lemon juice, for example, will be different in a property rights system that fully protects trademarks than in one that does not. We cannot choose the appropriate level of trademark protection simply by looking at the prices associated with different levels of product characteristics or even by noting the unremarkable fact that lemon juice with more of

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these qualities is more expensive. That choice must be related to some outside factor, like the effect of the choice on total social wealth. Krattenmaker and Salop provide no other standard, and their refusal to credit productive efficiency precludes the total wealth standard. The relation of price to some imaginary "competitive level" fails to provide a standard for choosing one specification of property rights over another.

The quicksand in which the Krattenmaker-Salop test is mired is even deeper since the property right that maximizes social wealth is sometimes associated with prices that are above competitive levels. Consider rules protecting patents, copyrights, and trade secrets. We enforce these rules because we believe the benefits of increased incentives to inventors and authors exceed the costs of the market power associated with such rights. Those decisions are based on a tradeoff of costs and benefits just as they are in antitrust cases under the rule of reason. The Krattenmaker-Salop analysis fails to provide useful guidance on how to decide these cases.

Courts face some tricky choices in deciding which property rights to enforce and how to make sure the ones they do enforce are "properly scaled." Few individual cases, however, will entail a complicated cost-benefit analysis; most

will be decided under general rules that are themselves based on estimates of costs and benefits. For example, courts need not ramble in the economic wilderness to apply the general rule that contracts will be enforced; but that rule itself is based on a prior reckoning of social advantage.

On its face, the Krattenmaker-Salop test would subject to antitrust scrutiny many, perhaps all, arrangements and court decisions that permit parties to charge higher prices by enforcing property rights claims in their favor. This is hardly cost effective. Most such cases would be utterly insignificant from an antitrust standpoint. Moreover, since their test does not treat costs and benefits equally, it provides no clear guidance to decide the many cases it would apparently raise. Its ability to provide standards to decide cases is further impaired because of the reciprocal nature of property rights: if one claim to property rights is granted its reciprocal must be denied. Someone's costs will be higher no matter how the case is decided. The simple fact is that the Krattenmaker-Salop test provides no means for preferring one claim of property rights over another.

Conclusion

Like other cases, antitrust cases involve choices between competing claims to property rights. The choice is grounded in a tradeoff of costs and benefits. The relevant costs in antitrust cases are the losses in allocative efficiency that result from increased market power. The relevant benefits are cost savings or other increases in productive efficiency. Current antitrust law, using the rule of reason, can identify those costs and benefits and effect a satisfactory balance between them. Krattenmaker and Salop have neither identified a serious problem with current antitrust doctrine nor have they provided a useful solution to the problem they think they have found. □

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Courts now are much more willing to award summary judgment to a defendant if the plaintiff does not provide a plausible theory of consumer harm. Not only does this procedure prevent abuse of the Sherman Act, our theory provides the standards to judge the validity of the allegations of exclusion.

Some might object as a matter of principle to any analysis that serves to revitalize exclusion theories. That view may be more firmly rooted in the market realities and judicial shortcomings of the past than the present. Both the market and legal environments are very different today. In the past a highly restrictive merger policy prevented very significant market share concentration. Therefore it was unlikely that many firms would achieve the power necessary to exclude competitors; those that did were likely to be more efficient. That is no longer true. The current highly permissive merger policy allows significant industry concentration even absent evidence of significant efficiency benefits.

Conclusion

There are valid claims of anticompetitive exclusion and they can be tested against rigorous analysis. The analysis presented here is no more complicated or error-prone than the methods now used to test claims of anticompetitive mergers. Our formulation permits courts to focus upon those exclusionary practices likely to harm consumer welfare, and to structure their inquiries to be both rigorous and manageable. There is more work to be done to refine and clarify aspects of our theory, including the efficiency defense. But we believe we have provided a useful way to structure the analysis in antitrust exclusion cases. While perhaps not perfect, this approach is superior to any other presently available. □

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