

Paper Trail: Working Papers and Recent Scholarship

Editor's Note: In this edition, Editor John Woodbury reviews Jonathan Baker and Carl Shapiro's recent indictment of the past decade of antitrust merger enforcement policy. And Dan Crane responds to our summary of his forthcoming article, Antitrust Antifederalism, on the American tradition of opposition to federal incorporation and its consequences for antitrust policy. Send comments and suggestions for papers to review to: page@law.ufl.edu or jwoodbury@crai.com.

—WILLIAM H. PAGE AND JOHN R. WOODBURY

Recent Papers

Jonathan B. Baker and Carl Shapiro, **Reinvigorating Horizontal Merger Enforcement (June 2007)**

<http://faculty.haas.berkeley.edu/shapiro/mergerpolicy.pdf>

This recent (as-yet unpublished) paper by Jonathan Baker (American University) and Carl Shapiro (University of California at Berkeley) (both senior consultants for my employer) offer an assessment, or perhaps more accurately, an indictment of antitrust policy over the last ten and particularly the last five or so years. In addition to being respected academics, both authors have held high-level government positions in antitrust. Baker was the Director of the FTC's Bureau of Economics from 1995 to 1998; Shapiro was a Deputy Assistant Attorney General for Economics in the Antitrust Division of the Justice Department from 1995 to 1996. Thus, their views carry some weight.

The authors argue that the antitrust pendulum has swung far too far from appropriate merger enforcement policy, becoming so permissive as to be ineffective. According to the authors, this outcome has been driven by the failure to accord market structure an appropriate weight in the competitive effects analysis.

The paper has three principal prongs: the evidence of the decline of merger enforcement, particularly at the Department of Justice; the faulty "economics reasoning" which has permitted or served as the intellectual basis for this decline; and recommendations for developing a "post-Chicago" antitrust policy. This analysis is conducted against a backdrop of a description of the historical role of market structure and concentration in particular in merger enforcement and recent court decisions where structural evidence has been dismissed out of hand.

The Evidence

The first piece of evidence that the paper presents is the set of enforcement statistics previously compiled by former FTC Commissioner Thomas Leary, statistics that he interpreted as indicating a general stability in merger enforcement activity for various groups of years between 1982 and 2000 and for each of the antitrust agencies, the FTC and the DOJ. The statistic used by Commissioner Leary is the ratio of enforcement actions (court cases, consents, transactions abandoned or restructured after the filing of a complaint) to HSR filings. The grouping of years roughly corresponds to the two Reagan terms, the term of the first President Bush, and the two Clinton terms.

The authors note that there are numerous factors that could influence the enforcement rate other than enforcement policies, such as changes in the distribution of filings across more or less “troublesome” industries or changes in the extent of management buyouts (which would not raise horizontal concerns). But they regard as most important the endogeneity of the statistic itself—a more stringent enforcement policy will result in fewer HSR filings and therefore fewer enforcement actions (as some transactions that may have previously been cleared are now abandoned in light of the more stringent policy). In a “steady state,” one might expect the ratio to be relatively constant over enforcement regimes, other things equal. Thus, Baker and Shapiro suggest looking instead at swings in the statistic that reflect “surprise” changes in enforcement policy to which merging parties have not yet adapted. For example, they note that the fall in the DOJ enforcement ratio from 0.8 percent in the first Reagan term to 0.4 percent in the second reflected a surprise at how merger-permissive the agency had become. Had acquirers anticipated that the standards would have been more permissive during the second Reagan administration, the number of filings would have increased, along with the number of enforcement actions to drive the enforcement ratio back to a “steady-state” level.

For the authors, the period of most interest is the first term of George W. Bush (the most recent data available). However, the authors note that because of the substantial change in HSR reporting thresholds (the reportable transaction threshold rose from \$15 million to \$50 million in early 2001), no comparable ratio is available for the first term of George W. Bush. To generate a comparable ratio, the authors predict what the number of HSR filings would have been during that first term by regressing the historical data on the quarterly number of HSR filings on the number of transactions, the value of transactions, and a variable indicating when the threshold changed. From that analysis, they infer that the number of filings fell to 40 percent of its pre-rule-change level, and they accordingly increase the denominator of the enforcement ratio, the raw number of filings, during the 2002–2005 period. Of course, some of those additional filings would have also resulted in additional enforcement actions, and the authors use historical averages of enforcement actions per 1,000 filings to adjust the numerator of the enforcement statistic as well.

After these adjustments and considering alternative explanations, the authors conclude that enforcement activity plummeted during the first term of George W. Bush, a decline most apparent in the DOJ statistic (falling from 1.1 percent during Clinton’s second term to 0.4 percent during Bush’s first term). The corresponding statistic for the FTC actually rose a bit over this same period, but the authors don’t explain why the FTC behavior didn’t track that of the DOJ.

More generally, the regression that serves as the basis for their adjustment should have enabled the authors to indicate the width of the confidence interval (the error range) for their estimate. The adjustment to the numerator—the number of enforcement actions per 1,000 filings for transactions less than \$50 million—is not unreasonable on its face, but some sensitivity testing (e.g., how would the ratio have changed if this adjustment focused on more recent pre-2001 time periods rather than the eleven years from 1990–2000) would give one more confidence in the precision of these numbers. It is not obvious why an average was used here instead of a more refined statistical analysis (e.g., regression).

In addition, Baker and Shapiro conduct a survey of twenty experienced antitrust practitioners. Among the respondents, they confirm the perception that over the last ten years, merger enforcement has become more permissive, particularly at the DOJ, consistent with the factual analysis of the enforcement ratio. Against the backdrop of the *Oracle* decision that permitted the challenged Oracle-PeopleSoft transaction (a decision the authors believe may have “severely undermined” unilateral effects analysis) and the DOJ clearance of the Whirlpool/Maytag merger, the

authors find this perception unsurprising. The authors conclude that “the merger enforcement data, our survey of experienced practitioners, the fallout from the *Oracle* case, and the treatment of the Whirlpool/Maytag deal combine to paint a picture of overly lenient horizontal merger enforcement, especially at the current Antitrust Division.”

The Stories the Agencies Have Come to Accept

Baker and Shapiro then turn to addressing three stories that merging parties tell the agencies and about which the agencies (particularly the DOJ) have become “overly receptive” during this perceived period of decline in merger enforcement. First, the authors note that any lingering structural presumption of anticompetitive harm seems to have all but disappeared, as the merging parties argue and the agencies accept that three or even two “strong” rivals are sufficient to ensure effective competition. But the authors note that market structure does matter: “in the absence of entry and merger efficiencies, a merger that leads to a substantial increase in market concentration will tend to raise price, harm consumers and lead to a greater deadweight loss.” Because there are so few theories of oligopoly suggesting that two or three is enough for competition, the authors urge that large increases in concentration “be given real weight.”

The second story is that if one observes some entry (or some imports), that is just sufficient to conclude that any post-merger anticompetitive behavior will be deterred. Again, the authors note that there are very few theoretical circumstances where that will be the case and merely pointing to some entry does not mean (in the words of the Merger Guidelines) that entry will be timely, likely, and sufficient to deter post-merger price increases, “especially when the shares of the merging firms are large and those of the entrants are small.” Baker and Shapiro note that “comparing the entrant to the weaker of the merging firms can be useful in structuring the timeliness and sufficiency analysis.”

The third story is that the proposed merger will enable the attainment of substantial efficiencies, which serve to offset any otherwise perceived anticompetitive impact. Baker and Shapiro refer to the literature that suggests that managers are systematically over-optimistic about the merger-related efficiencies, and urge “careful analysis,” but actually offer little in the way of guidance as to how to conduct such an analysis.

Post-Chicago Merger Enforcement

To “reinvigorate horizontal merger enforcement,” the authors propose a framework that relies on “partially restoring the structural presumption,” one that could be overcome only by “strong evidence” offered by the merging parties. With respect to coordinated effects, Baker and Shapiro propose that mergers be assessed with an eye towards the effect of the merger on the maverick’s incentives in an antitrust market defined in the usual way. One might identify the maverick by its conduct, or by natural experiments, or “by inference from the features of market structure that tend to suggest a firm would prefer a lower coordinated price than its rivals.”

Having identified the maverick, the focus is then on whether the merger, by reducing the number of sellers or the asymmetries across sellers (e.g., in costs or product characteristics), will tend to make the maverick more accepting of a higher price.

If the proposed merger involves the maverick, then the authors recommend a presumption that the merger is anticompetitive. The government can also establish that presumption by showing that the post-merger market will be less conducive to maverick behavior than pre-merger.

Baker and Shapiro describe a second route to a presumption of competitive harm even if a maverick firm cannot be explicitly identified. If there were a reduction in the number of “significant

firms [i.e., ones that cannot be ignored by a cartel] from, say, four to three, three to two, or two to one,” that change may be enough to presume harm. If identification of significant sellers is difficult, then the authors suggest that mergers generating an HHI of 2800 or more be presumed anti-competitive. Thus, a merger that resulted in a post-merger market served by three significant firms (each with a 30 percent share) and a fourth firm (with a share just under 10 percent) would just pass muster under this presumption. If there is evidence that the merger would significantly reduce asymmetries in costs or product attributes, then the presumptive threshold could be weaker. For example, a merger that reduces the number of significant firms from six to five or an HHI-equivalent threshold could be presumed to generate anticompetitive harm.

The rebuttal of the merging parties could take the form of challenging the market definition, the identification of the maverick or significant firms, the characterization of product attributes, or entry, using the more complete analysis sketched in the paper. Efficiencies too can be a rebuttal, but it must be shown within a coordinated effects framework that the efficiencies will lead to lower prices, i.e., why they effectively create a maverick.

With respect to unilateral effects, Baker and Shapiro also trace two routes to presumptive harm. Both focus on the diversion of sales from one merger partner to the other (i.e., the fraction of total sales lost when one firm increases price that is recaptured by the merging partner), and the gross margin earned on the recaptured sales. The greater the diversion and the higher the margin, the more likely is a post-merger price increase.

Route one defines antitrust markets in the usual way and then effectively assumes that diversion is proportional to pre-merger market shares. Route two looks explicitly at estimates of diversion between the two firms (e.g., estimated own-and cross-price elasticities, “natural experiments” of price increases that reveal substitution patterns). If the data from either of these two routes, along with the pre-merger gross margins, suggest that prices of the merged firms could increase by 5 percent or more post-merger, then there would be a presumption of harm.

Rebuttals with respect to the first route to a presumption of harm include a failure to define the market correctly or to calculate shares correctly. Rebuttals with respect to the second include an incorrect estimate of diversion. In both routes, the parties could rebut the presumption by showing the margins were not calculated correctly or that entry, repositioning, and efficiencies will counteract the effects of the merger.

Postscript

The Baker/Shapiro paper is at its best when it describes the basis for the perception that merger enforcement has been weakened, in terms of both court opinions and agency decisions, and the survey evidence that that perception is widespread (at least among leading antitrust counsel). I am surprised that the paper does not consider changes in merger enforcement as part of a larger tapestry of “revolt” against antitrust, as suggested by the *Microsoft* settlement and the *Trinko* decision.

The paper is a bit less persuasive on the factual case that, recently, merger enforcement has all but disappeared. While it would not make for exciting reading for the non-economist, Baker and Shapiro could have devoted considerably more space to their estimation of their crucial data point—the enforcement ratio during George W. Bush’s first term. That estimate, after all, provides their factual basis for the perception of weakened merger enforcement. Most of that discussion now appears in lengthy but still detail-short footnotes and in an unattached appendix, so it’s difficult to evaluate how sensitive their result is to alternative specification changes or to the use of different time periods for estimating the number of enforcement actions for proposed transactions under \$50 million that would have occurred but for the change in the filing threshold. And the

authors never explain why FTC enforcement behavior appears so different from DOJ enforcement behavior.

While I find the critique of two of the stories credible—the “two firms are sufficient for competition” story and the “any evidence of entry is enough” story—the authors’ response to the efficiencies story is largely uninformative, perhaps because the agencies really don’t count efficiencies even in the so-called tie-breakers (although the survey would disagree).

Finally, the sketch of a more rational antitrust policy offers a number of interesting insights and alternative enforcement guidelines so as to attach a greater weight to structural conditions but, in the end, it is just a sketch. I am a bit surprised by the 5 percent price-increase threshold for unilateral effects, given how sensitive simulated price increases are to the specification of the demand assumption. The authors may be suggesting that the efficiencies must be substantial enough to result in post-merger price increases of less than 5 percent.¹

In any event, perhaps Baker and Shapiro can use this paper as a platform for a more detailed discussion of a post-Chicago approach to merger enforcement.

Notwithstanding my quibbles, this is an important, controversial, but potentially influential, policy critique of current merger enforcement by two prominent antitrust economists. Consequently, this paper should surely be on the antitrust practitioner’s summer reading list.

—JRW

Author’s Response

Many thanks to Bill Page for his thoughtful review of my paper, *Antitrust Antifederalism*, in the last edition of *The Paper Trail*, <http://www.abanet.org/antitrust/at-source/07/06/Jun07-PTrail6-20f.pdf>. Bill rightly notes that the article’s critique of what I call the “crime-tort” model of antitrust fails to propose a better model, other than hinting that there might be advantages in the competing “corporate regulatory model” that was largely rejected as a basis for antitrust enforcement during antitrust’s formative era. Bill also notes that I anticipate some critiques of the corporate regulatory model (such as agency capture and aggrandizement) without presenting an argument as to why those pathologies are less severe than those of the crime-tort model. Bill also notes, again quite fairly, that I fail to compare the features of the U.S. system to those of the European Union, which has followed something more like the corporate regulatory model.

The reason for these gaps (and others) is that this article is the first installment of a much larger project (which I expect will eventually become a book) on the institutional structure of antitrust enforcement. My goal is to rethink the way U.S. antitrust law is enforced not only from abstract first principles but also from the perspective of economic history and legal culture.

In *Antitrust Antifederalism* I describe five “pathologies” of the crime-tort model—suboptimal features of the antitrust enforcement system that took shape as antitrust law interacted with the more general features of the U.S. civil and criminal litigation system. While the article may leave the impression that I favor a larger and more interventionist federal regulatory role, as I explore dif-

¹ Earlier, the authors cite a paper by Greg Werden that offers a solution to this demand sensitivity by focusing on the cost-savings. See Gregory Werden, *A Robust Test for Consumer Welfare Enhancing Mergers Among Differentiated Products*, 44 J. INDUS. ECON. 409 (1996).

ferent models of antitrust enforcement I will not be coming down uniformly on the side of an expanded federal regulatory model. Toward the end of *Antitrust Antifederalism* I argue that the crime-tort model may be perfectly suited for hard-core cartel cases. Perhaps the hard-core cartel should be kept as a separate antitrust regime with damages multipliers, lay juries, severe criminal penalties, and other features of ordinary criminal conspiracy adjudication (like RICO).

That would not have to mean that all other antitrust would be shifted toward a pure corporate regulatory model. For example, as I move forward with this project, I will explore the feasibility of expanding the domain of private or semi-public administrative regimes. Current examples include RAND commitments for patent pools and standard-setting bodies and the rate-setting mechanism under the *BMI* and *ASCAP* consent decrees. Such semi-contractual antitrust remedies may be able to minimize some of the pathologies of the crime-tort model without losing the benefits of incremental common law adjudication and private enforcement. Perhaps the private creation of such administrative regimes should be considered either mandatory or optional with statutory inducements (such as immunity from damages liability) for a broader range of antitrust activities, including certain kinds of mergers, joint ventures, and other competitor collaborations.

One of the aims of this project is to understand antitrust's enforcement mechanisms as social and political institutions. I am currently working on a paper entitled *Technocracy and Antitrust* that analyzes antitrust's shift from democratic to technocratic. I argue that antitrust has lost its broad political saliency even while it has maintained its level of engagement largely because antitrust has come to be seen as technocratic—a field for administration by experts, not politicians. This is a good thing, I argue. If Herbert Hovenkamp is right that antitrust “has no moral content,”¹ then administration of the antitrust laws should proceed in a scientific, expert manner. But what then to do with democratic institutions—like the jury and the Tunney Act—that still infuse antitrust adjudication? Perhaps more of antitrust needs to be shifted away from an adjudicatory model toward an administrative model, which, as I discuss in *Antitrust Antifederalism*, is largely what has happened to merger review in the wake of Hart-Scott-Rodino. The administrative model I describe is similar in many ways to the corporate regulatory model, but the two do not cover exactly the same territory. I will suggest that some mixing and matching of various models may be optimal.

Crime-tort vs. corporate regulatory; democratic vs. technocratic; adjudicatory vs. administrative. Thinking through these and many other conceptual pairings should keep me busy for a few years. As I move forward with this project, I hope to provoke further discussion on the institutional structure of antitrust enforcement. And, of course, I would highly value and welcome any comments on these specific papers or the larger project. ●

—DANIEL CRANE

² HERBERT HOVENKAMP, *THE ANTITRUST ENTERPRISE: PRINCIPLE AND EXECUTION* 10, 54 (2005).