PROJECT TITLE: *Free from what? Evolving notions of 'market freedom' in the history and contemporary practice of US antitrust law and economics*

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INTRODUCTION. US antitrust is in crisis and needs a change. Evidence of its poor status abound in recent policy events, law and economics (L&E) literature and court decisions.

Consider the so-called *Section 2 Report* by the Department of Justice which aimed at harmonizing the Department's enforcement of anti-monopolization statutes with current legal doctrine and (supposedly) accepted economic theory (Department of Justice 2008). Its flagrant repeal in one of the first acts of the Obama administration revealed to the general public the extent of the fracture between the alleged orthodoxy and what the new government considered proper antitrust policy. Or take the critiques against the last couple of decades of antitrust enforcement, as well as the calls for its drastic redirection, voiced by prominent legal scholars and IO economists in a recent volume edited by Robert Pitofsky (Pitofsky ed. 2008). Or reflect on the surprisingly benign view of monopoly power expressed by the Supreme Court's claim that "[t]he opportunity to charge monopoly prices – at least for the short period – is what attracts 'business acumen' in the first place; it induces risk taking that produces innovation and economic growth" (Justice Scalia's opinion in *Verizon Communications v. Law Office of Curtis V. Trinko*, 540 U.S. 398, 2004) – a statement dispensing with a century of legal worries about the evils of market power.

The crisis may be summarized as "the efficiency paradox" of contemporary US antitrust (Fox 2008). There is indeed an almost unanimous consensus that efficiency-driven antitrust enforcement is more rigorous, more reasonable and more analytically sophisticated today than it used to be in the 1960s or 1970s. However, by excessively trusting dominant firm strategies and vertical relationships to produce efficiency, current enforcement patterns end up protecting monopoly or oligopoly and suppressing innovative challenges, thereby eventually stifling that very efficiency they are supposed to enhance. The paradox is even more serious in high-tech industries and IP markets, where the drift toward single-firm dominance caused by the joint action of patents, copyrights and network effects is furthered by antitrust complacency towards monopoly power.

The culprit for the present misery is easily identified: conservative economic theory and, in particular, the Chicago School of economics. Despite being the main force behind the fore-mentioned analytical progress, the Chicago School does seem to have "overshot the mark" in recent antitrust L&E. By identifying efficiency as the sole legitimate concern of antitrust, placing excessive faith in market forces, distrusting government and judicial intervention in the marketplace and playing too often the virtual trump card of potential competition, Chicago-style antitrust has been widely recognized as unable to protect *real* competitive opportunities by *real* rivals and entrants.

An agenda for change is therefore called forth – and an urgent one as well, given the present dire straits of the US economy. Indeed, it may be surmised that the latter's inability to recover from the 2008 financial crisis may in part be due to a weakening of competitive forces in the marketplace, on account of the excessive power and overtly defensive attitudes of established big business.

MAIN RESEARCH QUESTIONS. The standard story is that Chicago success in US antitrust law has been due the acknowledge superiority of its economics, in terms of both theoretical insights and policy prescriptions, over the loose patterns of economic reasoning underlying antitrust enforcement in the three decades following WWII. Starting from the late 1970s and thanks to works such as Posner 1976 and Bork 1978, the Chicago school has revolutionized antitrust L&E. The approach has eventually been endorsed by US courts, first and foremost the Supreme Court – an endorsement which continues today (see e.g. *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 127 S.Ct. 2705, 2007). However, modern economic literature, especially the game-theoretic, so-called Post-Chicago approach to IO, has showed that several Chicago claims, in both antitrust theory and policy, are at best only partially correct and, sometimes, utterly wrong. In particular, it has been proved that, contrary to their supporters' claim, Chicago solutions are often incapable of warranting the most efficient outcome in the

marketplace. Yet, surprisingly enough, Chicago-style antitrust L&E still dominates law enforcement.

How to explain this persisting supremacy? If Chicago triumph has really been due to its ability to show that "the US antitrust emperor had no proper theoretical clothes" (cf. Schmalensee 2008), why has the demonstration that new theoretical clothes do exist that would better fit the emperor's needs failed to meet the same success? In short, why has Post-Chicago analysis been able to win the day in classrooms, but not in courtrooms? What does this failure teach us about the power of contemporary economic theory to turn its results into effective policy tools capable of truly affecting reality?

Questions of this kind are the starting point of the present research. I claim that only by answering them the crisis of US antitrust may be overcome, new theoretical perspectives on enforcement may be opened and a policy agenda for a return to a truly competitive US economy may emerge.

EXISTING LITERATURE. The previous questions are neither new nor unanswered. A huge literature exists on the rise and persistent success of conservative antitrust L&E in the US.

Several commentators have denied that the conservative revolution in antitrust has really been triggered by the theoretical improvements granted by Chicago economics. Their alternative explanations thus de-emphasize economic ideas and focus on political/sociological factors, ass well as on economic history: from the rise to dominance of conservatives in US politics to the appointment of conservative judges in District Courts and the Supreme Court, from the need to protect US big business against the rising competition of foreign firms to the general pro-conservative atmosphere in 1980s American society (see e.g. Freyer 1992; Peritz 1996; Teles 2008; Mirowski & Plehwe eds. 2009; Rodgers 2011). For the largest part, these explanations are very convincing and the present research will not intend to undermine them. Yet they seem to downplay the sheer force of theoretical ideas in a subject like antitrust enforcement whose troubled history clearly shows the importance of alternative *intellectual* interpretations – by judges, legal scholars, economists and government agencies – of an almost invariant statute law.

Other scholars have looked more closely at case law and qualified the extent of Chicago success. The real driver of current enforcement policy has been identified in a sort of "Harvard-and-Chicago" (Kovacic 2007) or "chastised Harvard" (Hovenkamp 2005) approach. For good and for worse, that policy would therefore testify the resilience and versatility of an approach that captures the best of the two main traditions in US antitrust. These answers are closer in spirit to the present research and will provide a useful benchmark. Yet, with the only significant exception of Herbert Hovenkamp's works, they seem to neglect that the most proper place for answering a question about the evolution of economic ideas is to look at the discipline whose specific professional goal is the investigation of such evolution, namely, the *history of economic thought* (HET).

WHY MY APPROACH DIFFERS AND WHY INET SHOULD FINANCE IT. I claim that HET offers a promising avenue to answer my research questions and set US antitrust on a new path. The project will therefore focus on HET, in particular on the reconstruction of the analytical views about competition, the market and the role of the State in the second half of the 20th century.

The faith in HET methodology is easily explained. Common law naturally leads the interpreter to look backward and consider the historical evolution of legal doctrines and enforcement practices. This is even more inevitable in the case of antitrust law, whose statutes have gone almost unchanged for more than a century, so much so that the ebbs and flows in enforcement have all been due to changing interpretations of the same norms. Yet legal history does not suffice in the case of antitrust and has to be supplemented by HET. Just think of the evolving meaning of key notions such as "market", "technology", "welfare", "efficiency", not to mention the most important of them all, "competition". As William Kovacic and Carl Shapiro put it: "Because the [Sherman Act]'s vital terms directly implicated economic concepts, their interpretation inevitably would invite contributions from economists. […] As economic learning changed, the contours of antitrust doctrine and enforcement eventually would shift , as well" (Kovacic & Shapiro 2000, 43). But if we accept that the history of economic ideas has played an important role in antitrust enforcement, it then comes natural to investigate what kind of

economic "theory" (in the broadest possible sense) antitrust enforcers, be they federal agencies or courts, had in mind when assessing their cases.

Unfortunately, such a HET-based approach would find no room within current mainstream economics, whose prevailing attitude may be called Whiggish or incrementalist – that is to say, the belief that present economic theory is always just the outcome of the accumulation of "correct" ideas, while all the other, forgotten ideas have been abandoned as "incorrect". The emptiness of such a naïve view of scientific progress is demonstrated by the case of antitrust economics itself. Many of the old truths of pre-Chicago antitrust era, which had been demolished by Chicago critiques, have been rediscovered, and put on firmer analytical grounds, by the Post-Chicago game-theoretic literature. Thus, economic ideas may and do resurrect. Economists should therefore reject theoretical foreclosures and remain open to the possibility of such resurrections. That progress in economics may come from unexpected quarters, including some seemingly dead-and-buried one, is in my view the essence of INET's own challenge to the orthodox way of "being an economist", and what would make the Institute the ideal sponsor of the present research.

PUT HET AT WORK ON ANTITRUST HISTORY. The research will show, among other things, that the history of US antitrust L&E may be reconstructed according to three dichotomies and that in order to do so it comes natural to adopt a HET approach.

The first dichotomy is also the main one and gives the project its title (*Free from what?*). Following Peritz 1996, I claim that two meanings may be attributed to the adjective "free" in the expression "free competition": either "freedom from market power" or "freedom from state interference". The first meaning emphasizes the negative welfare consequences of powerful market positions and provides a rationale for aggressive antitrust policies. If monopoly arises out of market power, then law should favor deconcentration and an atomistic market structure. No surprise that this meaning characterized the heydays of vigorous antitrust enforcement from the mid-1930s to the late 1970s. The second meaning mirrors the classical view of competition as a welfare-increasing process, whose smooth functioning just requires the freedom to enter into any kind of contract or perform any kind of business activity without any constraints imposed by the law or the State. If monopoly arises out of interferences with market process, then law's only role should be to warrant the maximum freedom to contract.

Events in the history of US antitrust have been significantly influenced by this dichotomy – more precisely, by the different answers different antitrust enforcers in different periods have given to the same "free from what?" question. HET's role here is to clarify that enforcement has swung between the two answers following the evolution of economic ideas: from classical views of competition as a process, whose natural and beneficial functioning the State should leave unobstructed, to post-1930s views of perfect competition as an idealized market structure, whose benchmark role for desirable efficiency outcomes deeply influenced post-WWII antitrust law, to the dynamic view of competition underlying the Schumpeterian understanding of the market process, which seems especially suited to analyze contemporary high tech industries.

The second dichotomy calls into question two different approaches to competition, a static one, viewing competition as a specific market situation, and a dynamic one, viewing competition as a natural process. Historically speaking, economists endorsed the static notion of competition only relatively late, following the accomplishment of market structure analysis in the 1930s. The notion lies at the foundation of Harvard "structure-conduct-performance" approach, i.e., of the dominant paradigm in post-WWII IO which provided the theoretical backbone to the era of most intense antitrust enforcement, when several judicial decisions aimed exactly at "constructing" a more competitive market structure. Yet, for most of their discipline's history, economists have followed a dynamic view of competition, where "to compete" just meant to undertake normal business activities, such as undercutting prices, entering a market or purchasing another business, with the legitimate goal of increasing one's own efficiency. According to this view, law should limit itself to protecting a firm's freedom to compete; this would require no special antitrust statutes as such protection might well be warranted by standard Common Law. This was for example the approach followed by British courts until the mid-20th century and the rationale behind turn-of-20th-century US economists' opposition against the Sherman Act. Chicago antitrust L&E also partakes of this view of competition, although the efficiency paradox indicates that the approach may end up

sacrificing the very notion of competition as a dynamic process on account of its pro-incumbent prescriptions which legalize existing market power and thus hinder potential competitors.

The third dichotomy is more general as it involves two broad attitudes with respect to State intervention in the economy. On the one side, there are those who believe that policy action can actually enhance the spontaneous outcome of markets in terms of whatever goal it wishes to pursue. Following Chicago, modern antitrust is credited with the sole goal of pursuing efficiency. Hence, this position may be summarized as the idea that antitrust intervention may actually increase market efficiency. On the other side, we have those who distrust government intervention and believe that any kind of policy may only make things worse off, especially as far as efficiency is concerned.

As highlighted by Medema 2009, the "faith vs. skepticism" dichotomy has been a constant in the history of ideas about economic policy. Antitrust L&E made no exception, with pre- and post-Chicago scholars endorsing a pro-interventionist view and Chicagoans (or, at least, those belonging to the "new", post-WWII Chicago School) trusting the self-correcting power of markets. Among other things, my research will try to argue that in the case of antitrust a way out may exist from this perennial dichotomy: rather than looking at the efficiency yardstick alone, antitrust intervention should be evaluated in terms of a broader array of social and economic goals which policy-makers may trade-off.

The bottom line of this sketching of the three dichotomies should be clear. My research will show that, at least as far as its economic-theoretic side is concerned, US antitrust has been ruled throughout its history by little else than a varying combination of these dichotomies, as embodied by the concrete choices made by law-makers, federal agencies and judges. It follows that only a thorough understanding of the dichotomies and their interrelations may highlight the path for a re-addressing of the antitrust enterprise. HET role in casting light on the dichotomies should also be apparent, even more so if compared to the almost complete neglect of these themes in contemporary mainstream IO and antitrust literature.

MAIN WORKING HYPOTHESES. What is then HET answer to my main research questions about the "mysterious" resilience of Chicago antitrust L&E vis-à-vis its theoretical weakness? The working hypotheses that my research will try to corroborate on the basis of the three above-mentioned dichotomies are as follows.

First, I accept the thesis of authors such as Kovacic and Hovenkamp that the present pattern of US antitrust enforcement be more correctly described as "Harvard&Chicago" (H&C) antitrust rather than as a full endorsement of Chicago ideas. However, my second point is that such an intermediate approach testifies an almost complete surrender of Harvard to Chicago, at least as far as the main theoretical categories of contemporary antitrust law (efficiency as the sole goal, competitive harm only from adverse output and price effects, rejection of per se prohibitions, ample room for efficiency defenses, freedom of entry as trump card) are concerned. Indeed, I claim that the Harvard part of the H&C approach should not be found in theoretical principles, but in the enforcers' pragmatic attitude towards them, aptly epitomized by then-Judge and Harvard scholar Justice Stephen Breyer in his classic dictum: "We shall take into account of the institutional fact that antitrust rules are court-administered rules. They must be clear enough for lawyers to explain them to clients. They must be administratively workable and therefore cannot always take account of every complex economic circumstance or qualification" (*Town of Concord v. Boston Edison Co.*, 915 F.2d 17, 1st Circuit, 1990, at 22)

Consider for instance predatory pricing violations. While it is true that both elements of the so-called *Brooke* test (as devised by the Supreme Court in *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 US 209, 1993), i.e., both the price-cost comparison and the recoupment test, had been first suggested by Harvard scholars Arreda & Turner 1975, and that US courts have never pushed their views to the extreme of considering every price cut by a dominant firm as *per se* legal, as suggested by Chicago scholars such as Bork 1978 or Easterbrook 1981, yet the application of the *Brooke* test has led to a *de facto* cancellation of predatory pricing from the list of antitrust violations. That no US firm has been condemned for such behavior since 1993 is an outcome in line with Chicago analysis of the alleged violation, namely, that predatory pricing is "rarely tried and even more rarely successful" (see McGee 1980; *Matsushita Elec. Indus. Co v. Zenith Radio Corp*., 475 US 574, 1986). More than that, the *Brooke* test has since been interpreted as a paradigm to be applied to all kinds of

allegations involving exclusionary behavior, with the inevitable result of making it extremely difficult for plaintiffs to prevail in any exclusionary case.

We know that several of the theoretical principles and policy prescriptions of contemporary antitrust have been proved totally or partially wrong by modern, game-theoretic literature. Yet, these new analytical perspectives may exhibit only a dismal record in terms of their application by US courts. Thus, as my third working hypothesis, I will try to demonstrate that the resilience of the H&C approach may be explained in terms of the perfect matching between Chicago price theory and Harvard emphasis on the administrability of antitrust rules, on the one side, and of the impossibility to apply the categories of game-theoretic analysis in courtrooms, on the other. Following MIT economist Franklin Fisher's distinction between generalizing and exemplifying theories – the former being those which proceed from wide assumptions to inevitable consequences and which speak in terms of what *must* happen under the given circumstances; the latter those which focus on determining what *can* happen under a very specific set of assumptions (Fisher 1989) – it may be argued that, while Chicago price theory has several traits of a generalizing theory, game-theoretic IO has only been able to provide exemplifying theories of firm behavior. Unfortunately, no US antitrust court is willing to condemn a firm on the basis of an exemplifying theory whose concrete applicability to the case under scrutiny may just be impossible to demonstrate.

Again the example of predatory pricing is illuminating. Game-theoretic literature has offered several explanations of why predatory behavior may make good economic sense, despite Chicago claims to the contrary, and thus of why, on purely efficiency grounds, predatory pricing would deserve condemnation (for a survey see Bolton et al. 2000; Motta 2004). Yet, none of these explanations has managed to achieve the status of a generalizing theory, i.e., of the only kind of theory which may find hearing in a US antitrust court (especially after the Supreme Court's 1993 decision in *Daubert v. Merrell Dow Pharm. Inc.*, 509 US 579, established the criteria for admitting expert testimonies in court: see Coate & Fischer 2001). Thus, no game-theoretic proof of the strategy's potential profitability has been able to overturn the courts' denial of predation charges. The combination of Chicago basic price theory and Harvard emphasis on courtroom administrability of antitrust rules, epitomized by the *Brooke* test, has just proved irresistible in case law.

As the predation example reveals, HET may play a key role in demonstrating both the courtroom effectiveness of Chicago price theory and the limited applicability of game-theoretic IO. This on account of the historians' combined expertise in disassembling established theories by analyzing the origin and implications of their underlying assumptions (what I call the insider part of HET methodology) and in debunking the myth of straightforward progress in economics by highlighting its manifold analytical, social and political causes (what I call the outsider part).

AN AGENDA FOR CHANGE. Change in US antitrust may not come from within mainstream industrial economics, but it may well be triggered by the broader perspective of the insider/outsider approach of HET. Thus, the final part of my research will be devoted to showing that HET may suggest an agenda for putting US antitrust on a new path.

I start by acknowledging that no amount of rigorous theorizing of the kind currently endorsed by modern IO may be effective in displacing Chicago economics as the main theoretical reference of contemporary antitrust enforcement. In particular, it seems pretty useless to try to beat Chicago on efficiency grounds by proving that there does exist a "possible world" (in Rubinstein 2006's game-theoretic sense of a given set of beliefs supporting a particular kind of equilibrium) where the defendant in a antitrust case may actually have behaved anti-competitively and thus that efficiency would be enhanced if such conduct be proscribed. No, you can't beat Chicago on these grounds because very few, if any at all, US courts would ever endorse an accusation based on a "possible world" way of reasoning devoid of any concrete applicability (how can a court ever know what the parties beliefs actually were at the time of the alleged violation?). Unfortunately, this happens to be the almost unique kind of reasoning that mainstream IO economists seem to know.

The history of US antitrust – especially the history of the economic ideas underlying it – shows that the most proper strategy for change would be to push for a broadening of antitrust goals, for a replacement of its current, single-purpose approach, based on the sole notion of (almost always static) efficiency, with a multi-purpose approach capable of rescuing the original spirit of antitrust statutes, namely, the fight against market power in terms of the

protection of both free access *to* the market and free competitive play *in* the market. Sophisticated technical arguments, like those of contemporary IO, would prove less useful on these grounds and a broader, more dynamic view of the functioning of the market – closer in spirit to the classical process view of competition and emphasizing the role of, say, network effects in high tech industries and dynamic welfare gains in IPR-violation cases – would be called forth.

Again HET shows that this is no utopia, nor that it would require a return to the old, discredited view of antitrust officials as "creators" of competitive markets via the enforcement of structural remedies. It suffices here to note that the suggested approach has been effectively applied by European competition policy in the half century following the 1957 Treaty of Rome. The research will show that EU antitrust enforcement has never considered static efficiency as its sole legitimate goal, neither in its early stages nor today, despite the current efforts to "Americanize" it. Indeed, broader goals have always guided EU competition authorities and courts, such as the achievement of the single market or the strengthening of European firms.

The foundations of EU antitrust were laid down before WWII by the Ordoliberals of the Freiburg School (see Giocoli 2009). As I will try to show in the final part of the research, the Ordoliberal rationale for competition law as the most potent weapon to disintegrate monopoly power and promote market freedom in its broadest possible sense – a rationale that was closer in spirit to the Sherman Act's original goal – may offer a useful guide for a re-direction of US antitrust enforcement.