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Should Economists Like Predation or Not?

(A Note on „Economic Principles of Predatory (Exclusionary) Pricing in the US and in the EU – Their (mis) Application in Some Recent Competition Law Cases of the European Community Commission and the Court of First Instance” by Zoltán Bara¹)

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Economics has a string of bordering (although not necessarily *interdisciplinary*) fields where quantification may have a limited scope only, and analytical tools may have to be borrowed from sciences making qualitative judgments in the first place². Law is a science with a somewhat limited quantitative toolkit. As to its cooperation with economics, the theory of competition policy (or antitrust) is an outstanding example, quite easy to delineate by the way, of what is currently often called *Law and Economics*³.

Law and economics seems to have more economics than law at least if really important contributions to its theory are regarded⁴, and it has a couple of quite interesting features. For instance, the theory of antitrust includes some issues still open to research after decades of in-depth exploratory work. Such an issue is predation where the lack of generally accepted analytical techniques leaves quite much leeway to substantial differences between authors⁵. If such differences are not necessarily based on divergences in likings or professional taste, then at least on judgments built on norms of influential schools of professional thinking, often in conflict with each other on some key issues of a certain field of research.

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¹ Bara (2009).

² Regarding the recent methodological debates on modern quantitative economics and the limits to their ability to reflect reality see Móczár (2008) and Csaba (2009).

³ See on this: Posner (1987).

⁴ To name a few, preferably not recent ones with relevance to the topic of this note: Sosnick (1958), Telser (1966), Areeda and Turner (1975), McGee (1980), Ordover-Willig (1981), Scherer and Ross (1990), Bork (1993), Scherer (1994, 1996), Baumol (1996).

⁵ For a recent and thorough survey of the literature on predation see (Kobayashi, 2009).

Chicago and Harvard

It is rather shared as an oral tradition than put in writing by antitrust economists that this field of economic research harbors two, if it can be said, opposite schools of thinking on both policy and theoretical issues. The Chicago school has produced a huge number of publications explaining the limits of antitrust policy and the necessity for it to be self-constrained⁶. The most intellectually influential findings of this school include results from its in-depth analysis of activism in U.S. antitrust. Activism in the U. S. started with the trustbusters of the early 20th century and ended *de facto* with the “GTE Sylvania vs. Continental” ruling in 1977 (see ABA 1999). Bork’s Antitrust Paradox (Bork, 1993) is closely related to this line of research. The book named after the Paradox is a very clear and condensed treatise on why antitrust policy often acts against its own purposes and policy objectives, and causes therefore unnecessary increase of government power and superfluous spending of taxpayers’ money.

The so-called Harvard school is regarded by many as the “anti-Chicago” line of antitrust thinking. The most influential exponents of this school could be presented along the “Mason-Bain-Caves-Scherer” chain. The cornerstone of their analysis is the Structure-Conduct-Performance (SCP) model. The main message of SCP is that each of 1. concentrated market structure and therefore market power, 2. abusive market behavior of firms and 3. appropriate incentives to firms to deviate from antitrust rules is a *condition sine qua non* of such an anticompetitive practice which can be suspected to generate loss of consumer welfare, the ultimate benchmark of illegal damage to competition according to the Sherman Act of 1890. The Harvard school had, first of all in its earlier times, a quite purist view of competition (see the so-called Sosnick criteria of “workable competition” [Sosnick, 1958]). “Workable”, i. e. close to perfect competition has to be maintained with a tight monitoring of markets by antitrust authorities according to this approach, because the Sosnick set of criteria is very exhaustive and shows a long list of possible deviations from “workable” competition.

The Chicago school basically has such an understanding of markets and competitive structures in which most abuses of dominance will be dealt with by the market itself, in many cases without making any antitrust policy action necessary. The Harvard approach is different, corrections of anti-competitive situations, structures and practices by the authorities are an integral part of this approach.

Bara’s article relates a second chapter of the story, the introduction of which has been outlined in the above. The problem of predation has served as good teaching material for making students acquainted with something we could probably consider the “San Andreas Fault” within antitrust theory and policy. The decades-long efforts by authorities on both sides of the Atlantic to first understand and then solve predatory behavior regularly come up with new insights into its genesis and workings. Still, the core of the problem remains: is policy action usually *not* required to finish off with predation (the Chicago approach), or should authorities take steps against it?

Predatory behavior as such has a quite great variety of forms which is not outlined by Bara in detail, but is signaled by him (Bara, 2009. 27). Predation may take price and non-price forms. The latter include non-ethical but often legally acceptable forms of behavior

⁶ As one of the monumental examples to this, see Bork (1993) and also several works by Richard Posner.

such as “abuse of government regulations”⁷. In addition to traditional patterns of predation, a new high-tech form of predatory behavior was first observed in the late nineties with the apparition of “vaporware”⁸. It is a far cry from predatory pricing although the harm caused by it could potentially be translated into financial losses measured on the basis of market shares and pricing differences.

Multi-faceted predation

Predation is often treated in literature from the consumer’s point of view without respect to supply side interest. This bias is probably linked to the Sherman Act’s emphasis on consumer welfare as the ultimate benchmark of harm to competition. This approach may be somewhat one-sided because it neglects possible long-term welfare gains by the consumer in case predation proves successful for the supply side.

If producers/sellers are asked, they often try to convey a different impression of what others call “predation”. They frequently use the efficiency argument pointing out that the disappearance of small, inefficient producers from the market may increase economies of scale and accelerate processes of innovation.

An additional argument using a similar logic came up in the case “Microsoft vs. United States” (the Internet Explorer case, US v. Microsoft, 2001). The government considered Microsoft’s behavior as predatory based on four arguments⁹. Each of these was refuted by Klein as not being in line with the widely accepted (we can add, Chicago School inspired) definition of predation¹⁰ (see Klein, 2001, 47-60 for details).

In its defense, Microsoft referred to the exorbitant costs of developing browser software. The firm’s lawyers argued that only Microsoft’s dominant position on the browser market would enable it to continue developing this software (Klein, 2001, 46).

This Chicago-inspired defensive argument was partly accepted by the Supreme Court of the United States. This meant the firm was not split up in an operating systems and a software applications company as suggested by Judge Thomas Penfield Jackson in his first ruling of 2000¹¹. However, the Supreme Court of the United States as the Court of Appeal ruled in 2001 that only “behavioral” measures should be taken against Microsoft as opposed to the “structural” action recommended by Judge Thomas P. Jackson. This not obviously dramatic difference between the two terms has a great significance regarding content. “Behavioral measures” means a fine, but taking “structural measures” would have been the equivalent of splitting up the company in the activist spirit of the standard-setting “Standard Oil” ruling of 1911 (see on the latter also Bara, 2009, 30).

To give an unexpected conclusion to the story, the browser market underwent a “sea change” in a few years after the case “Microsoft vs. United States”, apparently to the triumph

⁷ This means certain competitors attacked by others are harmed in such a way that they have to face costly and time-consuming legal procedures to defend themselves even if they are innocent.

⁸ The term Predatory Product Pre-Announcement (PPP) was used first instead of “vaporware”; see (Fleischer, 1997). The idea is, to some extent, Stackelbergian: a leader of a high-tech market announces a new product in order to foreclose its possible competitors, but the development of the new product is lagging much behind the versions developed by the weaker competitors. “Vaporware” can also be understood as a special kind of “credible threat”.

⁹ 1. Microsoft’s massive investment in browser technology; 2. Microsoft’s zero pricing of Internet Explorer (in the late 1990s, Explorer was sold as a part of any MS Windows package by the firm, even to such clients who did not want any kind of browser software. A.T.), 3. Microsoft’s exclusive distribution contracts with Internet access providers, and 4. Microsoft’s tying of Internet Explorer to Windows (Klein, 2001, 46).

¹⁰ See (Ordover-Willig, 1981).

¹¹ <http://www.usdoj.gov/atr/cases/f3800/msjudgex.htm>. Downloaded on July 25, 2009.

of the Chicago school of antitrust analysis. The massive appearance of free browser software (Mozilla Firefox, Opera and others) on the market proved that dominance created by the assumedly predatory behavior by Microsoft was destroyed by new entrants, a case of “hit-and-run entry” often observable in contestable markets (Baumol, 1982). These new entries to the market seemed to provide the ultimate proof of the high level of contestability of the browser market. On the other hand, this was also a case of a very special market with extremely high speed of innovation, and the relationship between the speed of innovation and the degree of contestability is still an issue open to research.

The “Microsoft vs. United States” case from 1997-2001 is a good example of the differences in judging an allegedly “predation” case depending on the time horizon of changes in consumer welfare. A short-term approach to consumer welfare seems to corroborate that Microsoft’s behavior against its main competitor at that time (Netscape) had a predatory character since it caused obvious welfare loss by creating dominance. The plaintiff’s economic expert on the case, Professor Franklin Fisher, came up with the argument that Microsoft’s pricing of Internet Explorer was in fact long-run monopoly pricing corresponding to its strategy combining such objectives as gaining further market shares, discouraging software piracy and raising demand for its own complementary products (Gilbert-Katz, 2001, 29).

Interestingly, this list of alleged strategic objectives seems to be speaking of the government side’s conviction that any short-term regulatory leniency¹² *vis-à-vis* Microsoft would have unleashed unfavorable long-term processes in the browser market. These processes would include cementing Microsoft’s dominance or even exclusive dominance and also a significant decrease of the degree of contestability of the browser market.

We already know that neither of these two possible concerns of the government side became reality. However, this determinate effort to contain potentially dangerous trends of market concentration in their early phase may remind the reader of one of the cornerstones of activism in American antitrust, the concept of “incipiency”¹³. Any professional survey of the relevant literature shows that “incipiency” was strongly criticized by most Chicago School antitrust economists, while many of their Harvard affiliated colleagues were more reserved on this issue (see e. g. Scherer-Ross, 1990; Bork, 1993).

A genuinely long-term approach to consumer welfare, though, would underpin the argument that some sacrifice in terms of current consumer welfare in order to achieve its considerable increase in a not too remote future would have an overall positive impact on it¹⁴. This argument is similar to the logic of recoupment which is considered by part of the literature on predation as an investment in future market shares (cf. Bara, 2009, 32). Interestingly, the recoupment argument has been used mostly by economists defending

¹² Caveat: this term is used here in order to describe a potentially flexible regulatory attitude towards the defendant, but is in no way related to leniency programs applied by antitrust authorities towards firms involved in cartels.

¹³ Our own explanation of this old-style English term as used in antitrust literature: „kill the beast as long as it is still a cub”. See the analysis of „incipiency” based on the „Brown Shoe” case in (Bork, 1993, Ch. 9.).

¹⁴ One source (Fleischer-Doege, 2000) even pointed out that Microsoft’s team of economists used an apparently well received reference to Walter Eucken, the father of German *ordo-liberal* economics. They cited Eucken’s distinction between “destructive/disruptive” and “creative” patterns of competitive behavior. In the Microsoft expert team’s view their firm was accused of the first, but it produced wide-ranging evidence of the second.

or at least explaining predation¹⁵. Such an explanatory work was performed, of course, by Microsoft's expert team on the case headed by Professor Richard Schmalensee of MIT.

Their set of arguments consisted of a mainly technology-related element¹⁶ and two very much economic ones (Gilbert-Katz, 2001. 28-29). Their first argument was that the degree of competition is not necessarily adequately measured by market shares if high-tech markets are considered. This is a very important point, since the ownership of technological standards or representative products setting norms for consumers and competitors may really prove key to future patterns of dominance regardless market shares¹⁷.

Their second argument stressed that Microsoft's actual prices were several times below prices calculated based on retrospective time series of demand elasticity, therefore much below any conceivable level of monopoly pricing. Although there seems to be no evidence of it, this argument could potentially have backfired if confronted during the court hearings with the Areeda-Turner test/technique on estimating predatory pricing levels (cited by Bara, 2009. 29)¹⁸.

It can be retained from the "Explorer case" that predation may have several aspects, instead of just being a pattern of aggressive competitive behavior doing harm to competitors. The usual Chicago view of predation may be summarized as this is a phenomenon with a quite low level of likelihood on markets in practice¹⁹ and therefore it does not call for regular monitoring or action by authorities. Other authors (Steven Salop, for example) proposed that attempted monopolization in general should be put to scrutiny, and not just strategies using aggressive pricing as a tool of gaining market shares. They pointed at the predatory character of "raising rivals' costs" (see Scherer-Ross, 1990. 479). The negative attitude of some authors regarding predation might potentially be replaced with a "more mixed and contextual" approach to it (cf. Whinston, 2001. 63), based on findings from high-tech industry related cases such as the "Explorer" one.

Predatory pricing may take unusual forms in such price wars whose real character is not recognized by authorities in due time. A classic example of this was the US Steel – Bethlehem Steel conflict from the late sixties on a certain steel product (cf. Scherer-Ross, 1990. 292; Scherer, 1996. 161, 167). Predatory pricing is a non-cooperative game between two players on the market and the same goes for price wars. However, in the case mentioned the apparent price war yielded a surprising outcome typical of cooperative rather than non-cooperative games: the post price war price level was above the "pre-war" one (Scherer, 1996. 167). Therefore this "war game" could have been considered a very special form of cartel intended to strengthen the duopolistic character of the product market in question, a cooperative game instead of a non-cooperative (predatory) one.

¹⁵ The frequent use of this argument probably goes back to a U. S. Supreme Court decision from 1993 in „Brooke Group v. Brown and Williamson Tobacco" („Brooke case"). It was suggested there that predatory pricing should be judged in a two-tier approach (1. prices vs. costs; 2. the „reasonable possibility" of recoupment [Viscusi-Harrington-Vernon, 2005. 320-321]).

¹⁶ Competition takes place between platforms rather than operating systems in the software industry (Gilbert-Katz, 2001. 28).

¹⁷ In our somewhat different wording: „apparent market power"

¹⁸ Prices are predatory according to the Areeda-Turner test if below marginal cost or, if marginal cost cannot be measured, below average variable cost. The Schmalensee team's calculations showed that several software prices quoted by Microsoft were less than 10 per cent of supposed demand-based market prices. Although the team was cautious enough not to come up with calculations related to cost factors this difference is still very, very telling.

¹⁹ Bara quotes Areeda-Turner (1975) in this regard (Bara, 2009. 31).

Predation and its treatment in Europe

The competition policy of the European Union recognized with a considerable delay the need to deal with predation. Bara's article gives a very clear impression of a certain "technology gap" between the U.S. and the EU in dealing with issues of predatory pricing. The modern pilot case of predatory pricing in the European Union seems to be the France Télécom (Wanadoo) case concluded in 2007²⁰ after such important, standard-setting precedent cases as the AKZO case from 1991. The solution of the case by the European Court of First Instance (CFI) is to some extent reminiscent of the former American activist approach to predation in that it did not consider the high-tech character of this market and also did not sufficiently reckon with its overall, long-term trend of price decrease.

Advocate General Mazák stressed other inadequate elements of the CFI ruling, and he proposed changes in the EU law on below cost pricing, with greater emphasis on consumer welfare implications and less attention to changes in competitive structures on the markets involved (Bara, 2009. 41-42). Based on Mazák's conclusions as well as on OECD recommendations from 2008 on applying a "more economic approach" to dominance, especially predation related cases, Bara argues for a novel, more "customer-friendly"²¹ technology of predation analysis (Bara, 2009. 42-43).

This would make it possible to firms to take quick decisions on price cuts based on sufficient prior knowledge to adequately assess the authorities' opinion on such price cuts. In other words, arguing simply for a "more economic approach" in assessing cases of predation could potentially open the road for the application of such extremely sophisticated analytical techniques which would make it practically impossible to firms to forecast the reaction of authorities on their planned price cuts.

Predation and economic methodology

There may be room here for two further conclusions completing Bara's argument outlined above, a policy one and also another one linked to recent debates on some methodological issues of economics.

EU competition policy should move away from its current position which seems to be based on a more or less outright rejection of predation, quite much in the spirit of the American antitrust activism of the sixties and seventies. Our analysis of the Explorer case tried to pinpoint the potential conflict between the short-term negative and long-term positive effects of *alleged* predation, first of all in high-tech industries where *alleged* predation may be kind of a competitiveness enhancing strategy and also a strategy for facilitating innovation. Therefore the question „Should Economists Like Predation or Not?" can be reasonably answered only in a balanced way, without any *a priori* judgments based on ethical considerations excluding objective measurement.

²⁰ For its detailed analysis see (Bara, 2009. 38-41).

²¹ Our own term, not used by Bara in the article cited.

Predation is not anticompetitive *per se*, in spite of its quite strange sounding name, because driving out less efficient competitors from the market is not necessarily illegal²². On the other hand, some predatory strategies could be deemed illegal if, and only if there are adequate benchmarks to measure short term and long term losses of consumer welfare as a result of predation. The use of increasingly sophisticated tests of predatory pricing such as the two-tier test first applied in the “Brooke case” opens up new horizons in identifying cases of predation with negative welfare implications both in a short-term and a long-term approach. It is important to stress that the assessment of long-term implications should go much beyond assessing only recoupment, with a great deal of attention paid to consumer surplus generated by technological development.

The second comment draws upon Bara’s remark on the use of such quantitative techniques for assessing predatory pricing which would have the necessary degree of transparency to firms. To be clear, transparency should be understood in this very case not only in the legal, but also the methodological sense of the term. This point takes us to the ongoing debate on the methodology of economics discussed in, for example, Móczár (2008) and Csaba (2009).

The increasing specialization within economics and the growing level of sophistication of mathematical models used in economics makes many results of economics research accessible to an ever narrower audience. This trend may take place irrespective of an overall improvement of the quality of research in economics. The problem is not scientific quality as such, but the applicability of results. The trend of increasing professional segmentation of economics research may be called “the sanskritization of economics”²³ to the extent that the term “analytical background in economics” increasingly means, as a matter of fact, an in-depth knowledge of modern mathematics at least as well as of applied economic issues.

The example of the “more economic approach” to analyzing predatory pricing seems to be speaking of a similar trend towards segmentation and “sanskritization”. The development of methods of economic analysis should serve not only the further development of methods of economic analysis itself, but also decision making at the level of economic actors. If the analytical methods to identify predatory pricing become kind of a collective toy²⁴ for only an exclusive group of experts, this may be conducive to a considerable information asymmetry between not only experts and firms but, with substantially more severe risks for the implementation of EU level competition policy, also between the authorities and the firms. Current legislation on, for example, the abuse of dominance will become less and

²² Kobayashi suggests that the theory of predation should definitely react to the U. S. Supreme Court’s ruling in the „Brooke” case which „...stresses the costs of erroneous condemnations of price competition as well as the benefits of having an administrable predation rule...” (Kobayashi, 2009. 4). As a matter of fact, this remark is very critical of the current condition of the theory of predation. The author namely suggests that an appropriate technique for distinguishing predatory pricing from price competition is still missing, and the existing rules on predation do not offer themselves for easy interpretation by the courts.

²³ Sanskrit was the ancestor of Hindi language. It is not spoken anymore, but is present in many religious texts on the Indian subcontinent in spite of the fact that it is not understood by speakers of Hindi. So it is used without being widely understood.

²⁴ Cf. „playometrics” by Ragnar Frisch („Frisch believed that econometrics would help establish economics as a science, but toward the end of his life he had doubts about how econometrics was being used. ‘I have insisted that econometrics must have relevance to concrete realities,’ he wrote, ‘otherwise it degenerates into something which is not worthy of the name econometrics, but ought rather to be called playometrics.’” (The Concise Encyclopedia of Economics. 2008. Library of Economics and Liberty. 29 July 2009. <<http://www.econlib.org/library/Enc/bios/Frisch.html>>)).

less able to serve as a guidance for firms in their pricing policy, since it will be increasingly conditional upon an in-depth understanding of new analytical techniques of predatory pricing how firms will try to pre-empt accusations of predation.

As another possible consequence of “sanskritization” in this field, theoretical debates on the real scope and relevance of predation may simply disappear. The reason seems to be that any theoretical argument on this issue could be answered, rather than using theoretical arguments, simply with “let us see the case and solve it with our most up-to-date methods”. This could mean, however, that a focus on case-by-case approach would replace any theory, or any attempt to elaborate a theory of predation.

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