CONSUMER WELFARE, EFFICIENCIES, AND MERGERS

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"Treatment of Efficiencies in Merger Enforcement"
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It is a pleasure to appear before the Commission once again, this time to address the treatment of efficiencies in merger enforcement. As the Supreme Court has noted (quoting, of course, Robert Bork), the antitrust laws are a "consumer welfare prescription."[1] While it appears that advocates of a highly interventionist (bordering on anti-capitalist) antitrust enforcement policy have attempted, with some success, to confuse the meaning of the term, the fact is that antitrust enforcement policy cannot truly serve the objective of maximizing the welfare of consumers as a whole if that policy is focused on price effects alone (*i.e.,* the likelihood that the transaction will raise price and reduce consumer surplus) and is oblivious to its impact on productive or technical efficiency (*i.e.,* the prospect that the transaction will lower or eliminate costs).

At least for the last quarter century (and in many ways, since the enactment of the Sherman Act), antitrust enforcement policy has reflected some sensitivity to its impact on productive efficiency. However, even though it is clear (at least to those who believe in the superiority of competitive-market capitalism) that antitrust policy should be sensitive to productive efficiency, it is less clear how antitrust policy, in particular merger enforcement policy, should treat efficiencies. As I will explain, merger enforcement that purports to balance a merger's impact on allocative efficiency and its impact on productive efficiency with mathematical precision is doomed to fail and is likely to be counterproductive. Rather, merger enforcement should only condemn mergers that have a *clear* potential for resulting in *significant* price increases (as a proxy for output reductions); then and only then, the parties should be required to establish that their transaction will generate substantial efficiencies that cannot be achieved without the merger and that, as an order of magnitude, will outweigh the merger's threat to allocative efficiency.

In order to explain this conclusion, I want to make three points. First, I address the Commission's question whether antitrust policy generally and merger policy specifically should be based on "consumer welfare" or "total welfare" and explain why these are just two different labels for the same concept. At least as articulated by Judge Bork and understood by antitrust enforcers in the 1980s (when efficiencies first began to be reflected in merger enforcement), the welfare of consumers as a whole can only be maximized when total suplus (or welfare) is

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1 *Reiter* v. *Sonotone Corp.*, 442 U.S. 330, 343 (1979).

maximized. Second, I describe how explicit consideration of productive efficiency was first introduced into merger enforcement in the 1980s and how merger enforcement's treatment of efficiencies has evolved since then. Although one should not overstate the problems caused by this evolution, at least at the margin, current merger enforcement probably blocks some transactions that would enhance consumer welfare, properly defined. Finally, I will briefly opine whether and, if so how, merger enforcement should take account of a particular merger's potential to generate efficiencies.

The Goal of Antitrust – Consumer Welfare versus Consumer Surplus

After I last testified before the Commission, I felt a little like Rip van Winkle. Throughout my testimony, I premised my recommendations on what was best for "consumer welfare." Sitting next to me that day, Steve Salop, a well-known and well-regarded liberal economist who is a proponent of interventionist antitrust policies, advocated a very different set of recommendations, also ostensibly relying on "consumer welfare" principles. I assumed Dr. Salop was just confused about the concept. However, I subsequently learned that over the last twenty years, the concept of consumer welfare has become garbled and, at least in the minds of some, has taken on a very different meaning from the one that Judge Bork originally attributed to that term. Based on its question to this panel, even the experts on the Antitrust Modernization Commission seem confused, apparently thinking that "consumer welfare" means something different from "total welfare." That the two are different is certainly news to me (and to Judge Bork, I presume)!

The Traditional Concept of "Consumer Welfare"

Twenty years ago, during the Reagan Administration, "consumer welfare" was commonly understood to be synonymous with "total welfare." Back then we took the Supreme Court's declaration that antitrust is a "consumer welfare prescription" to mean that antitrust policy and rules should seek to support and facilitate (as opposed to replace) competitive-market capitalism's tendency to maximize wealth without regard for its distribution. As Assistant Attorney General in charge of the Antitrust Division in the late 1980s, together with David Meyers (at the time my special assistant), I wrote two articles explaining that this broad concept of consumer welfare was the proper touchstone for antitrust policy and had in fact been the basis of antitrust policy generally and merger enforcement policy specifically during the 1980s. (For the convenience of the Commission, the two articles are attached.)

Inherent in the concept of consumer welfare, as articulated by Judge Bork and embraced by antitrust enforcers twenty years ago, is a very specific view of the optimal relationship between the antitrust law and the competitive process. Competition, which is the hallmark of free-market capitalism, has consistently proven itself to be a very effective (frankly the most effective) means of maximizing a society's wealth in the face of scarcity (that is, limited resources). Competition accomplishes this invaluable economic feat by facilitating the creation of two types of efficiency.

First, competitive free markets tend to maximize "allocative efficiency." That is, competition serves to allocate scarce resources to their highest and best use by creating incentives for producers to compete to expand output in a market until the cost of last unit of output ("marginal" cost) is equal to the market-clearing price. At that point, the market is allocating the optimal amount of society's total resources to production of that market's good or service – any less and some consumers who value the good or service at or above its marginal cost are deprived of the output, any more and the cost of the resources to produce the marginal unit of output will be greater than the value of that unit.

By proscribing private agreements and tactics that restrain competition, the antitrust laws facilitate the tendency of free markets to maximize allocative efficiency. When producers agree directly or indirectly to raise price (or restrict output), or when a producer with monopoly power creates an artificial scarcity in order to keep price above competitive levels, in order to shift surplus from the market's consumers to themselves, allocative efficiency is harmed. While, as explained below, producers engaging in such conduct expect to obtain more surplus from consumers than would be possible if competition prevailed, the real concern to society is that as a result of a reduction in output in that market surplus literally disappears and is enjoyed by no one. The familiar "dead weight loss" triangle is the economist's way of depicting this allocative inefficiency. No matter what definition of consumer welfare one subscribes to, everyone agrees – at least conceptually – that the antitrust laws should seek to proscribe agreements and tactics by producers that carry the threat of reducing allocative efficiency. Accordingly, in the case of mergers, it is generally agreed that enforcement policy should block mergers that will alter market structure in a way that is likely to lead to higher price, lower output, and reduced allocative efficiency.

It is, of course, also the case that private restraints that reduce allocative efficiency by raising price also transfer to the market's producers surplus that consumers would have enjoyed in the absence of the restraint. Indeed, it is the hope of gaining such surplus that motivates the restraint in the first place. However, unlike the lost surplus (*i.e.,* the "deadweight loss") that represents the diminution of allocative efficiency, society still enjoys the transferred surplus. The offending producers are, at the end of the day, also consumers (albeit in some other market) and their "consumption" of the transferred surplus also counts toward society's aggregate utility or welfare. As explained below, there is no coherent *a priori* basis for believing that consumers in any given market are inherently more deserving of surplus than the producers in that market. The social value of the surplus is the same. Nevertheless, as a practical matter, under the 1980s concept of consumer welfare, the antitrust laws do seek to deprive antitrust offenders of the transferred surplus in order to deter illicit agreements or tactics.

Second, the welfare of consumers as a whole (that is, the 1980s concept of consumer welfare) is improved by increases in productive (or technical) efficiency. Productive efficiency is generated when production is improved to produce the same level of output using fewer resources (inputs) or to produce more valuable (*i.e.,* higher quality) output using the same resources. Unlike allocative efficiency which is a static concept that is maximized when price equals marginal cost and cannot be improved beyond that point, productive efficiency is a more dynamic concept that can literally always be improved and never maximized. Productive efficiency is the fuel of technical progress, freeing up resources to expand the economy's output and providing the means for deriving more value from the existing deployment of resources.

Property rights are the mechanism for inducing producers to make improvements in productive efficiency. That is, to the extent a competitor creates an "asset" (anything from an acre of farmland to a factory to a management team running a company) that produces the same or greater (or more valuable) output using fewer resources, property rights enable the competitor to earn rents (or surplus) from the asset. The prospect of earning such surplus creates the incentive to increase an asset's productivity (that is, lower the costs or increase the efficiency of the asset).

Society (*i.e.*, consumers as a whole) benefits from improvements in productive efficiency because output in the market where the asset is deployed increases *and/or* because, even if output in that market does not increase, resources are "freed up" to be used to increase output in other markets. So even if an improvement in efficiency leaves price unchanged (or indeed results in a price increase) and consumers in that particular market are not benefited, consumers as a whole (that is consumers in *all* markets) benefit because they are able to consume incremental goods and services produced in other markets from the freed-up resources.

Even though improvements in productive efficiency increase consumer welfare, that observation does not mean that the antitrust laws ought to regulate the creation of productive efficiencies or condemn private conduct that lowers productive efficiency.[2] Because of the relative competency of government (*e.g.,* the courts, antitrust enforcement agencies, etc.) as compared to market forces, it is better to leave it to the market to reward and punish producers for their creation or destruction of productive efficiency. Just as competition tends to create incentives to lower costs, it also tends to punish those who fail to lower their costs. Moreover, history and common sense teach that government bureaucrats and judges do a lousy job of second-guessing the judgments of business people concerning how best to achieve efficiencies.

Just because antitrust law does not, and should not be designed to, regulate the creation *vel non* of productive efficiencies, it does not follow that the courts and antitrust enforcers should ignore the impact of antitrust enforcement policy on the incentive and ability of producers to generate productive efficiencies. Rather, for those adhering to the 1980s meaning of consumer welfare, in order for antitrust policy truly to function as a consumer welfare prescription, that policy must be sensitive to its impact on productive efficiency. In addition, it is necessary for enforcement policy to be sensitive to the fact that agreements and tactics that threaten allocative efficiency may simultaneously generate productive efficiency. For example, a merger may threaten a small price increase and a reduction in allocative efficiency of, say, \$100, yet promise to yield productive efficiencies of, say, \$1000 – resource savings that are going to expand output elsewhere in the economy. Conceptually, it is easy to see that condemning such a merger would not serve the interests of consumers as a whole. Ideally, then, enforcement rules should seek to proscribe only conduct that on balance threatens overall efficiency (*i.e.*, conduct that reduces

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2 Apparently, Dr. Salop believes that the antitrust laws must not be a "consumer welfare prescription" of the sort championed by Judge Bork and the 1980s antitrust enforcers because antitrust does not seek to intervene to deter conduct (including mergers) that, while no threat to allocative efficiency, threatens to reduce productive efficiency. This belief flows, however, from a fundamental misunderstanding of what is meant by "consumer welfare" and how it translates into enforcement policy.

allocative efficiency more than it increases productive efficiency). As explained below, even if one agrees with this ideal, it is not entirely clear how best to make this ideal operational.

The "New" Consumer Welfare – Just Old Fashioned Consumer Surplus

Twenty years ago, the advocates of this traditional meaning of consumer welfare thought that they had won the debate concerning the proper goal of antitrust, namely maximizing consumer (or total) welfare. The only interesting remaining issues seemed to relate to how best (*e.g.,* what form the enforcement rules should take) to achieve that goal. Back then, the only ones who refused to recognize this consensus were cranks and fuzzy thinkers on the fringe who were hostile to the cold efficiency of the market and who yearned for some political or social content to antitrust in order to ameliorate the harshness of capitalism and to justify the use of the law to redistribute wealth from the big and powerful to the small but worthy. Apparently, in the intervening twenty years, the cranks and fuzzy thinkers decided it is easier to co-opt the label "consumer welfare" and proclaim it to mean something very different.

To this crowd, "true consumer welfare" apparently has become synonymous with the static and much narrower concept of consumer surplus. This "stripped down" version of consumer welfare focuses myopically only on the price effects of an agreement or tactic in the particular market in which it is employed. Productive efficiencies are irrelevant unless they translate into lower prices and are converted into consumer surplus. Put differently, productive efficiencies do not count if the only ones who profit (*i.e.,* earn surplus) from those efficiencies are the "producers" who generate them. Embedded within this new concept of consumer welfare, there is an unspoken – perhaps even unconscious – hostility to property rights. The only innovations and improvements in productive efficiencies that are worthy of respect are those that are immediately "free-ridden" away or that are shared with that particular market's consumers in the form of lower prices.

Under this new-fangled view of consumer welfare, there is also an implicit assumption that in any given market, the consumers are more worthy than the producers. Rather than viewing antitrust laws as a mechanism to support free-market capitalism's tendency to maximize society's wealth (and the welfare of consumers as a whole), this new concept of "consumer welfare" sees antitrust as a weapon to be wielded market by market to help the consumers in each particular market garner as much of the available existing surplus with scant regard for the impact on consumers in other markets or on the long-term prospects for efficiency and productivity.

Obviously, I am no fan of this cramped and distorted reinterpretation of consumer welfare. Regardless of the label, the 1980s concept of consumer welfare (or total surplus) seems clearly to be the better animator of antitrust policy than today's "wolf-in-sheep's-clothing" version (which is really consumer surplus). It is impossible for me to discern any plausible benefit to interpreting the antitrust laws in a way that ignores productive efficiency whenever it serves to increase producer (as opposed to consumer) surplus.[3]

Moreover, while it is hard to quarrel with the notion of maximizing the wealth of consumers as a whole – since everyone at the end of the day is a consumer – there is no coherent economic, political, or social theory for assuming that in every discrete market "consumers" are more worthy than "producers." It is certainly not obvious why, *a priori*, enforcement policy should assume that, for example, consumers of luxury automobiles are more deserving than the shareholders (a group which almost certainly will include the proverbial pensioners, widows, and orphans) of luxury automobile manufacturers. Similarly, one must question the coherence of a policy that seeks to maximize the surplus of, for example, oil companies in markets where they are "consumers" (*e.g.,* buying oil field services and tanker trucks) but ignores (or worse) their ability to generate surplus in those markets where they are "producers" (*e.g.,* selling gasoline).

Lastly, the advocates of the new meaning of consumer welfare have a difficult time applying it to the problem of monopsony. If one were truly concerned only with the impact of an agreement or tactic on consumer surplus in discrete markets, the exercise of monopsony power by buyers to extract surplus from sellers presumably should be tolerated, if not encouraged. However, exercises of monopsony power like exercises of monopoly power typically reduce output in the market and cause allocative inefficiency, and even the proponents of a consumer surplus standard recognize that no sensible antitrust policy would ignore agreements that have that effect. Dr. Salop, for example, tries to wave away the problem with the cryptic statement that "monopsony by a buyer cartel of intermediate re-sellers would reduce both true consumer welfare [*i.e.,* consumer surplus] and aggregate welfare" without much explanation.[4] While such a cartel would certainly reduce "aggregate welfare" (the traditional concept of consumer welfare), it would not reduce (in fact, it would increase) consumer surplus in that market. Rather, the only conceivable threat to consumer welfare would appear in other (according to him downstream) markets. If consideration of impacts on consumer surplus in other markets is appropriate in monopsony cases, then why not consider the increased output (and increased consumer surplus) in other markets resulting from resources freed up by an agreement that

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3 Of course, there was a time, before the Supreme Court explicitly recognized that the antitrust laws are a "consumer welfare prescription," that conduct including mergers were condemned strictly because the conduct made the parties more efficient (and therefore a greater threat to their rivals). In fairness, I doubt even the advocates of this narrower concept of consumer welfare would defend those decisions.

4 On the other hand, Dr. Salop believes that monopsony cartels by final consumers are just fine, citing the decision in *Kartell*. *Kartell* v. *Blue Shield of Massachusetts, Inc.,* 749 F.2d 922 (1st Cir. 1984). Dr. Salop misreads that decision. First, the "monopsony cartel" was actually Blue Shield, which one might reasonably think of as an "intermediate re-seller." He doesn't tell us why a provider of healthcare insurance, unlike producers of any other service, is not just another producer but instead is an "agent" for the consumers. Second, in *Kartell*, the actions of Blue Shield appear to have been undertaken to offset a market failure created by an information asymmetry that favored healthcare providers. The tactics of Blue Shield were designed to overcome that market failure and ensure that the price and output of medical services approximated those that would pertain in a competitive market. In other words, the practice may have increased aggregate efficiency (or what traditionalists mean when they use the term "consumer welfare").

generates productive efficiencies and increases producer surplus? More fundamentally, it is not necessarily the case that a monopsony cartel will reduce consumer surplus in downstream markets. If competition exists in the downstream market (*e.g.,* because the cartel members are infra-marginal producers in the downstream market), then the monopsony cartel will not necessarily affect price or output (or *consumer* surplus) in that market.

Bork Was Correct – Antitrust Is <u>That</u> Kind of Consumer Welfare Prescription

An antitrust policy that seeks to support the tendency of competitive markets to drive participants to maximize productive as well as allocative efficiency (and so total surplus) seems inherently superior to a policy that ignores half of the welfare equation and seeks to maximize the surplus to consumers in discrete markets. Nevertheless, if Congress designed the law to concern itself only with maximizing static consumer surplus in discrete markets and to ignore the impact of its application on productive efficiency, then it is irrelevant what may or may not be a superior policy.

The argument that Congress intended to enact a narrow, anti-producer concept of consumer welfare is very weak. True, the debates surrounding enactment of the Sherman Act are replete with references to protecting consumers from rapacious monopolists. Not surprisingly, however, the legislative history does not reveal any clear, nuanced view on the economic policy underlying the law. In fact, most of the economic analysis that forms the basis of the debate as to whether the antitrust should take account of productive efficiencies has developed in the 115 years since the Sherman Act was enacted. Nonetheless, it is unimaginable that Congress passed the law simply to ensure that the maximum amount of surplus available in 1890's economy was received by consumers without regard for the impact of the law on technical progress and productive efficiency.

Certainly, the courts that first interpreted the antitrust laws did not view the law so narrowly. The rule of reason – the bedrock of interpreting and applying the Sherman Act – is a testament to the courts' sensitivity to the impact of the law on efficiency. If the law were indifferent to productive efficiency and condemned any conduct that threatened to "restrain trade" regardless of whether it carried the promise of promoting productive efficiency, then there would have been no need to impose the gloss of "reasonableness" on the Sherman Act. Judge Taft's landmark decision in *Addyston Pipe*[5] with its articulation of the doctrine of ancillary restraints would make no sense – according to the advocates of a narrower reading of consumer welfare, no one should care whether a restraint is ancillary to some productive efficiency. If a restraint threatens to increase price and so could result in a surplus transfer from a market's consumers to its producers, then the restraint should be illegal, regardless of whether it is reasonably necessary to achieve some productive integration.

The subsequent development of per se rules does not provide support for the narrower concept of consumer welfare. To the contrary, it supports the broader view. Remember the per

5 *United States* v. *Addyston Pipe & Steel Co.,* 85 Fed. 271 (1898).

se rule applies only to restraints that represent a threat to allocative efficiency *without any hope of redeeming features* (*i.e.*, without any prospect of offsetting productive efficiencies). In other words, per se rules are intended to be applied only to restraints that, experience teaches, carry no prospect of enhancing productive efficiency.

Perhaps the most authoritative source for the proposition that the antitrust laws incorporate the broader concept of consumer welfare is the Supreme Court itself. It was the Supreme Court that recognized "Congress designed the Sherman Act as a 'consumer welfare prescription.'" *Reiter* v. *Sonotone Corp.,* 442 U.S. 330, 343 (1979), *quoting* R. Bork, The Antitrust Paradox 66 (1978). Since the Court was quoting Judge Bork for the proposition, presumably the Court read and understood how he defined the term.[6] Moreover, over the last thirty years, the Supreme Court has consistently shown sensitivity to the impact of its interpretations of the antitrust laws on productive efficiency.[7]

A Brief History of the Relevance of Productive Efficiencies in Merger Enforcement

It is reasonably clear that the concept of consumer welfare, as described by Judge Bork and embraced by the Supreme Court, is indistinguishable from total welfare and that merger enforcement policy therefore should not ignore its impact on productive efficiency. It is less clear, however, whether (and, if so, to what extent) merger enforcement should explicitly recognize a merger's potential for generating productive efficiencies and seek to quantify and balance that potential against the merger's threat to allocative efficiency. On the one hand, as Professor Oliver Williamson showed long ago, a relatively small increase in productive efficiency typically will offset the allocative inefficiency from a relatively significant price increase.[8] On the other hand, calculating and comparing those efficiencies is a daunting task to say the least.

Due to these measurement problems, no less an advocate of traditional consumer welfare than Judge Bork argued against merger enforcement that explicitly seeks to balance, on a case-by-case basis, a merger's threat to allocative efficiency against its potential for generating productive efficiencies.[9] Though recognizing that "[t]here can be no rational antitrust policy that does not recognize and give weight to productive efficiency," Judge Bork believed that it was beyond the kin of mortal judges to reach accurate conclusions concerning whether the allocative

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6 It has been suggested by those who disagree with Judge Bork's definition of "consumer welfare" that the Court really did not understand what Judge Bork meant by the term. As result, they apparently feel free to replace Judge Bork's definition with any definition they see fit. This contention is quite astounding and, if correct, it would undermine the whole system of legal precedents.

7 *See, e.g., Continental T.V., Inc.* v. *GTE Sylvania Inc.,* 433 U.S. 36 (1977) (vertical non-price restraints); *Broadcast Music, Inc.* v. *CBS*, 441 U.S. 1 (1979) (characterization of horizontal price fixing).

8 Williamson, *Economies as an Antitrust Defense: The Welfare Tradeoffs*, 58 Am. Econ. Rev. 18, 27-28 (1968).

9 R. Bork, The Antitrust Paradox 124-29 (2d ed. 1993).

inefficiencies of a particular merger will be outweighed by potential productive efficiencies.[10] Instead, Judge Bork advocated proscribing only mergers that threaten to impose significant allocative inefficiencies (because the merged firm would command so much of the market that it unilaterally could raise price significantly above competitive levels). Such a general rule would result in a more discriminating, less frequent use of antitrust to condemn mergers and would give firms greater freedom to use mergers to generate productive efficiencies.[11]

The Evolution of the Explicit Consideration of Efficiencies in the 1980s

At the beginning of the Reagan Administration, the Justice Department essentially followed Judge Bork's advice and recognized productive efficiency only implicitly in its merger enforcement policies. The landmark 1982 Merger Guidelines rejected the idea of an efficiencies defense, indicating that the Department would explicitly consider productive efficiencies in exceptional circumstances and then only as a matter of prosecutorial discretion. Notwithstanding that the Guidelines were written fourteen years after Professor Williamson's paper was published, it was considered quite daring for the Department even to acknowledge that it might take a merger's potential efficiencies into account in exceptional cases.[12]

As it turned out, this slight acknowledgement of the possibility of explicitly accounting for productive efficiencies was the "camel's nose under the tent." The confluence of three factors ultimately pushed the Department to acknowledge that, as a matter of law, explicit consideration of countervailing efficiencies was a relevant part of merger enforcement. First, while the Department remained leery of its ability to perform a mathematically precise calculation and balancing of allocative inefficiencies against productive efficiencies, among the non-career leadership there was a recognition that at least in some cases a gross (or "orders of magnitude") comparison of a merger's threat to allocative efficiency against its promise of productive efficiencies was conceivable, particularly where the threat was borderline and the promise manifest. Moreover, the leadership recognized that the very high thresholds for identifying anticompetitive mergers advocated by Judge Bork were neither legally nor politically feasible. Instead, at least in the early 1980s, merger enforcement policy called for the condemnation of rather marginal (and in some cases fanciful) threats to allocative efficiency.

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10 *Id.* at 125.

11 *Id.* at 220-22.

12 At the time (and in fact to this day), the most recent Supreme Court pronouncement on merger-generated efficiencies was found in the Court's *Clorox* decision. *FTC* v. *Procter & Gamble Co.*, 386 U.S. 568, 580 (1967). In that decision, which was issued at the nadir of the Supreme Court's appreciation and understanding of consumer welfare, the Court in an opinion written by Justice Douglas held not only that efficiencies were no defense to an illegal merger but that the generation of efficiencies were the antithesis of competition. 386 U.S. at 580. In his concurring opinion, Justice Harlan disagreed with the majority's treatment of efficiencies, noting "[i]f . . . Congress had reasons for favoring competition, then more efficient operation must have been among them" and when a merger threatens to yield anticompetitive consequences, antitrust enforcement agencies "should then move on to examine and weigh possible efficiencies arising from the merger in order to determine whether, on balance, competition has been substantially lessened." 386 U.S. at 598.

Given that reality, it appeared that the interests of consumer welfare could be better served by an explicit recognition of productive efficiencies at least where the potential efficiencies were clear and very substantial as compared with the threatened loss of allocative efficiency.

Second, the early to mid 1980s were a period of great trepidation concerning the competitive threat posed by foreign competition. Advances in transportation and communication technologies, combined with the rapid growth and increased sophistication of foreign rivals particularly those from Japan, began to worry policymakers. There was a concern that U.S. antitrust policy hindered the ability of U.S. companies to restructure themselves, in particular through mergers, in order effectively to compete with these emerging rivals. As a general matter, the leaders of the federal antitrust agencies thought those fears were grossly overblown. Nevertheless, the fears did create pressure on the agencies to demonstrate that there merger enforcement was not oblivious to the potential for particular mergers to lower the costs of the merging parties.

Third, private parties understandably began to cite the 1982 Guidelines' grudging acknowledgement of productive efficiencies in defending mergers that the Department challenged in court. At that point, particularly given the other two factors mentioned above, as well as the numerous speeches of Department leaders extolling the virtues of general antitrust policies designed not to inhibit agreements and conduct that improve productive efficiency, it was simply not tenable for the Department to respond to these defenses by arguing that the law required the courts to turn a blind eye to a merger's potential for generating productive efficiencies. On the other hand, even the Reagan-era antitrust officials were concerned about endorsing an approach that, at least potentially, could make it exceedingly difficult for the government to prevail in a litigated challenge to a merger. Accordingly, the Department was loath fully to embrace Professor Williamson's tradeoff analysis because of its implication that relatively small increases in efficiency can offset the decline in allocative efficiency attributable to a rather large price increase resulting from a merger.

Reacting to the combined impact of these three factors, the Department in the mid 1980s embraced the proposition that productive efficiencies could be a defense to a merger that otherwise threatened to increase price (and decrease allocative efficiency), but it did so with a catch. Productive efficiencies should only be cognizable, the Department argued, if they were likely to be passed on to consumers *in the market in which the merger posed a threat to allocative efficiency.* In effect, this meant that the parties had to show that the efficiencies were of a type and magnitude that would so lower the merged firm's production costs that the equilibrium price in that market after the merger would be lower than the prevailing price prior to the merger. Although it was not made sufficiently clear to the world at the time, the reason for imposing this burden on merging parties was not a belief that only efficiencies that increase consumer surplus are worthy of recognition. Rather, the Department advocated the burden as a means of ensuring that otherwise anticompetitive mergers would be allowed to proceed only if the promised productive efficiencies were so large that they clearly swamped any threat to allocative efficiency. In other words, the conditions placed on merging parties urging efficiencies as a defense were designed to implement an "orders of magnitude" approach to balancing potential productive efficiencies against threatened allocative efficiency losses.

The Reagan Administration understood that limiting the explicit recognition of efficiencies would likely generate "false positives" – *i.e.,* potentially resulting in condemnation of some mergers that were likely to generate allocative inefficiencies that were outweighed by the merger's promise of productive efficiencies. Nevertheless, the Department made this compromise believing it to be ultimately a more efficient enforcement rule than either ignoring productive efficiencies altogether or trying to perform a precise Williamsonian analysis of a merger's likely net impact on overall efficiency.[13] Moreover, the Reagan Administration considered the recognition of extraordinary efficiencies to be an additive defense. That is, it did not anticipate that the explicit recognition of a merger's potential for increasing efficiency would serve as an excuse to lower the threshold for identifying threats to allocative efficiency that trigger a merger challenge. The antitrust agencies were gradually moving that threshold up to a theoretically sounder and more reasonable level through the evolution of the Merger Guidelines and the application of those Guidelines. It was hoped that the higher threshold would provide producers with significant leeway to explore efficiency-generating mergers without the prospect of a governmental challenge. Rather, as originally conceived, this explicit (but gross) consideration of off-setting productive efficiencies only applied to mergers that otherwise appeared to cross the higher threshold.

No Good Deed Goes Unpunished – The Consequences of Considering Efficiencies

In retrospect, that compromise set merger enforcement policy down a confusing and potentially counterproductive path. First, it appears that many observers (including the succeeding leadership of the Department of Justice) failed to appreciate that the rule represented a compromise and that its design reflected an attempt to minimize enforcement costs. Rather, over time apparently, it came to be seen as validation that the Department's merger enforcement should focus exclusively on consumer surplus. Ironically, then, a rule that was intended to make merger enforcement more sensitive to traditional consumer welfare (total surplus) concerns provided the opponents of traditional consumer welfare with a justification for claiming that productive efficiencies are *conceptually* irrelevant unless they increase consumer surplus.

Second, in the years after the Department embraced this compromise, it became increasingly institutionalized (albeit with a decreasing awareness of the reasons it was embraced in the first place). In 1997, the compromise was formally incorporated into the Merger Guidelines. In the course of adopting the compromise, the Department fleshed out the policy in ways that further circumscribed the efficiencies that were recognized and that made it more difficult for merging parties to satisfy its conditions. As with the original compromise, efficiencies were not relevant unless passed on to consumers in the form of lower prices; however, by this time, the original reason for that limitation had been lost from institutional memory, and the limitation seemed to be a reflection of policy (*i.e.,* a focus on consumer surplus) rather than an effort to minimize the economic cost of merger enforcement (*i.e.,* to minimize the negative impact of merger enforcement on consumer welfare).

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13 As I explained the last time I appeared before this Commission, every enforcement policy has costs – *e.g.*, false positives, false negatives, administrative costs, and *in terrorem* effects. Any policy that seeks to maximize consumer welfare must account for those costs.

Even more troubling, by formally incorporating an explicit recognition of efficiencies (though doing so rather narrowly and skeptically), the traditional notion of *implicitly* accounting for productive efficiencies by challenging only clear and substantial threats to allocative efficiency took a hit, at least at the margin. As explained above, the alternative to a case-by-case recognition of a merger's potential productive efficiencies and a weighing of those efficiencies against the merger's threat to allocative efficiency is to avoid challenging a merger unless it represents a clear, present and substantial threat to allocative efficiency. Setting the threshold for challenges at an appropriately high level provides companies with the opportunity to explore a range of efficiency-generating mergers free from the threat of government challenge. While such an enforcement policy may result in "false negatives" (*i.e.,* allowing mergers that on balance harm consumer welfare to close without challenge), so long as the thresholds at set at reasonable levels, this cost is likely outweighed by minimizing "false positives" (*i.e.,* condemning mergers that on balance have a positive, or at least neutral, effect on consumer welfare) and reducing administrative costs. Moreover, it does all this without the false pretence that the antitrust agencies are capable of refined, precise calculations of efficiency gains and losses.

Once the agencies formally (though somewhat superficially) incorporated recognition of efficiencies into merger enforcement, the threshold for deeming a merger to be a competitive threat began to erode. If merger enforcement explicitly considers efficiencies, the thinking goes, there is no need to tolerate any threat of higher prices in the name of protecting the ability of producers to generate efficiencies. If the merging parties cannot show that their merger is likely to generate efficiencies, then the risk of false positives is low (or so it may seem). Moreover, the original reason for considering efficiencies was forgotten – now it seemed that the only reason for considering productive efficiencies was to determine whether expected lower costs would prevent the merger from having any adverse affect on price (as opposed to considering whether the prospect of increased productive efficiencies outweighed the potential loss of allocative efficiency). This further reinforced the false premise that the only relevant concern of merger enforcement is a merger's impact on price (and implicitly consumer surplus). As a result, at least in theory, even the threat of a trivial price increase became sufficient to shift the burden to the merging parties to prove up cognizable efficiencies.

In this game, the deck is stacked against the merging parties. This is particularly true when the agencies defer to econometric tools to detect the risk of a price increase because those tools are literally programmed to predict price increases when concentration increases. In contrast to their willingness to accept even the most theoretical threat of a price increase, the antitrust agencies are the ultimate skeptics when it comes to considering efficiencies.[14] Moreover, despite the fact that literally none of the lawyers and economists in the antitrust agencies have any first-hand knowledge of how a company runs or experience running a company, they never hesitate to second-guess the business people's judgment concerning likely

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14 As the Commission may recall, I discussed the sorry history of unwarranted skepticism and lack of deference that the courts and antitrust enforcers have displayed when asked to evaluate claimed efficiencies.

efficiencies. In short, the agencies are always much more willing to believe in the unseen boogeyman of theoretical price increases than in the pedestrian promise of concrete productive efficiencies.

So What Now – Stay the Course, Mid-Course Correction, Or Back to the Future?

Given this history, one is tempted to say Judge Bork was right. Perhaps the best way to ensure that merger enforcement serves to maximize consumer welfare (or total surplus) is simply to ignore whether and to what extent a particular merger holds any potential for generating productive efficiencies. Rather, by proscribing only mergers that truly threaten to result in significant price increases and output reductions, the law arguably might do more to promote consumer welfare.

On the other hand, it is probably too late in the day to turn our backs on over twenty years of considering merger-specific efficiencies. Moreover, the problem is arguably not that merger enforcement has explicitly considered the potential of mergers to generate productive efficiencies. Instead, the problem may be that the recognition in recent merger enforcement policy of the relevance of productive efficiencies has been too grudging and has suffered from confusion over what the Supreme Court really means by "consumer welfare." To the extent that merger enforcement continues to focus exclusively on price effects (and reductions in consumer surplus) and ignores the way in which increases in productive efficiency benefit consumers as whole even when such increases generate producer surplus, the thresholds for identifying anticompetitive mergers are likely to be too low and the explicit *and* implicit treatment of productive efficiencies is likely to be too limited.

If the correct lesson is that merger enforcement has failed fully to reflect the significance of productive efficiency to the welfare of consumers as a whole, then there should be at least three mid-course corrections to the treatment of efficiencies in merger enforcement. First, merger enforcement should only block a merger when the threat of higher prices (as a proxy for reduced output) from that merger is clear and significant. Seeking to block mergers based on econometric models that appear to predict price increases of a percent or two will almost certainly stifle the generation of far more productive efficiencies than the allocative inefficiencies such enforcement efforts will prevent. The enforcement agencies should be required to identify, in light of all the relevant circumstances, a clear and logical causal connection between the merger and the likelihood of significantly higher prices and lower output before those agencies block a merger.

Second, when they do consider productive efficiencies, the antitrust agencies should consider all cost savings – both fixed and variable – that a merger is likely to generate. Consumer welfare benefits from fixed cost savings just as much as variable savings. Moreover, to the extent that a merger is reasonably necessary to achieve efficiencies in one market, those efficiencies should be deemed relevant even though the merger may threaten competition in another market. Of course, it may be possible to "have your cake and eat it too" by allowing the merger to go forward with some divestiture in the adversely affected market. However, if substantial efficiencies in one market cannot be realized without some clearly smaller threat to competition in another market, then merger enforcement policy should recognize those offsetting cost savings as a justification for the merger.

Third, while the agencies should not fool themselves or the world by pretending to calculate either the potential cost savings or "deadweight loss triangle" with precision, the agencies are capable of conducting an "orders of magnitude" comparison of the expected productive efficiency gain against the threatened allocative efficiency loss. Nevertheless, assuming the thresholds for identifying potentially anticompetitive mergers are appropriately high, then it is reasonable to require the merging parties to carry the burden of showing that the balance clearly tips in their favor when (but only when) their merger creates a clear, present, and substantial threat of higher prices.

Conclusion

In antitrust, the beginning of all wisdom is understanding the true nature of consumer welfare. Once it is understood that the antitrust laws seek to support and facilitate the invisible hand of the market as it drives the participants to maximize surplus, it is clear that merger enforcement policy cannot ignore a merger's potential for generating productive efficiencies. How precisely the policy should account for that potential is less obvious. Nonetheless, I hope my observations and suggestions will be of some help as this Commission considers how merger enforcement policy should treat efficiencies.