FOUR QUESTIONS ABOUT HORIZONTAL MERGER ENFORCEMENT

by

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I must, of course, begin with the usual disclaimer. My comments today are my views. [1] They do not necessarily reflect the views of the Federal Trade Commission or any of the individual commissioners.

I'd like to thank the Economics Committee for arranging this session. If I might inject a personal note, I particularly appreciate that David Scheffman was the instigator, as he was the one who arranged for me to take a leave from my academic post to spend a year at the FTC twenty years ago. In his two stints as Bureau Director, he set a high standard, and I will count my time here a success if I come close to meeting it.

The year David arranged for me to spend at the FTC was fascinating, but it paled in comparison to the last three months. I have been asked frequently what I plan to emphasize. I think it would be a mistake to answer that question before spending a bit more time observing from the inside how things work, so I will resort to the old professor's trick of answering a question with a question or, more accurately, several questions. These are questions I have been asking within the FTC, and I pose them here in part to provide some insight into my thinking and in part to solicit answers from outside the Commission. As I have been asked to keep my comments short, I will limit myself to one topic - the review of horizontal mergers – and I will talk about just four of my questions.

Question Number 1: Why don't efficiencies play a more prominent role in merger enforcement?

Consider, for example, U.S. v. Oracle[2]. Oracle claimed roughly $1 billion in annual savings from the merger. The court rejected them as not having been adequately justified. Based on the decision, the court seems to have been correct. The claimed efficiencies were little more than best guesses; and, frankly, the guesses themselves were implausible. For example, Oracle claimed that it would reduce PeopleSoft's $214 million of general and administrative expenses to $34 million.[3] Claimed reductions in general and administrative expenses are, as I understand it, common. The argument is that these kinds of costs are "fixed" and therefore can be saved by combining two companies. That argument reflects a fundamental confusion between accounting fixed costs and economic fixed costs.[4] An economic fixed cost is one that does not depend even in the long run on the level of output. As an empirical regularity, though, larger companies have larger general and administrative expenses than do smaller companies, so these types of costs are not fixed. I would treat any claim of 85% savings in the target's pre-merger general and administrative expenses as being highly unlikely; and any attempt to assert the claim

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[1] I have particularly benefitted from comments by Mark Frankena, Paul Pautler, and Josh Soven, and Mike Vita, although nothing in the following necessarily reflects their views either.

[2] 331 F. Supp 2d. 1098, N.D. California.

[3] *Ibid* at 1173.

[4] Here, I am relying on the definition of fixed costs given by Baumol, Panzar, and Willig, who are careful to distinguish between "fixed" costs and "sunk" costs. See Baumol, W.J., J.C. Panzar, and R.D. Willig. *Contestable Markets and The Theory of Industrial Structure* (New York, NY: Harcourt Brace Jovanovich) 1982. It makes no sense, of course, to suggest that a merger would save sunk costs which are, after all, sunk.

without substantial documentation would suggest to me that the efficiency claims are not meant to be taken seriously.

This case exemplifies what I understand to be a common phenomenon. The efficiency evidence that parties present to the agencies is less credible than one might expect. I realize there might be a chicken-and-egg problem here. Devoting resources to an efficiency claim would be pointless if the claims are not going to be taken seriously. Indeed, the DOJ/FTC Horizontal Merger Guidelines might be used to support the proposition that we do not treat efficiencies seriously. True, the beginning of the efficiency section sounds inviting. It says, "[T]he primary benefit of mergers to the economy is their potential to generate … efficiencies." The remainder of the section, including but not limited to the choice of the word "cognizable," can be read to have a much more skeptical tone. That is not how I read it. I suspect that the efficiencies section reads as it does because many before me have been asking the same question and are similarly perplexed at why merging parties cannot put forward more credible efficiency claims than they typically do.

Perhaps there is a good answer to the question. To the extent, however, that parties are not putting effort into efficiency claims because of concerns that they will be summarily dismissed, they should know that the Bureau of Economics will evaluate efficiency claims seriously. I also hope that in our research efforts, we will have the opportunity to consider past cases in which mergers generated efficiencies and to review how those efficiencies were treated in merger review. I am, of course, aware of the risk of selection bias in the cases we look at, but I would be interested to hear suggestions about either individual cases or sets of cases involving a single industry that we might look at.

Question Number 2: Why do we seem so reluctant to bring coordinated effects cases?

This question is largely rhetorical. Coordinated effects cases can be hard to win. My primary interest in asking the question is that I wonder what the appropriate legal standard is for a successful coordinated effects case and what, as a matter of economics, it should be. We know that, in a relevant market protected by entry barriers, competitors have a strong incentive to coordinate on prices. We also know that individual firms have an incentive to cut prices from collusive levels. As an empirical matter, we know that firms sometimes collude. Our colleagues in the Antitrust Division have in recent years been quite busy prosecuting price fixing cases. By themselves, those cases represent a small fraction of economic activity, but it would be naïve to suppose that all instances of price fixing come to light. Moreover, the merger provisions of the antitrust laws are not intended to prevent just price fixing but tacit collusion as well. Still, because of the incentive for individual firms to violate collusive agreements, our assessment of whether a merger will in fact lead to coordinated effects is inherently probablistic.

This leads me to question Number 3: Isn't there a disconnect between our treatment of efficiencies and the difficulty of bringing coordinated effects cases?

In merger review, two types of errors are possible. We can allow an anticompetitive merger to go through or we can block one that is procompetitive. As a matter of economics, how to trade off these two risks depends on the cost of each type of error.

The potential cost of preventing a merger that is not anticompetitive is foregone efficiencies. How large are these likely to be? We would, of course, expect them to vary from merger to merger. If, however, we are unable to assess efficiencies on a case-by-case basis, then I see no alternative to treating the cost of a "false block" as being the average improvement in efficiency, an approach I refer to as the "standard deduction" approach to merger efficiencies. One possible basis for an estimate is Lichtenberg and Siegel's study of productivity improvements after changes in ownership. In a very large sample of manufacturing plants, they found an average productivity improvement of 1% in the year after an ownership change, and an additional 1.7% over the next six years. Of course, we should not make too much of a single, 15-year old study,[5] but I am not aware of any systematic evidence that the appropriate number is greater than that.

Against this expected cost from a false block, we must weigh the expected cost of a false clearance. That cost is the expected price increases from anticompetitive effects. Here, I use the word "expected" in its mathematical sense. The expected cost is the probability of an anticompetitive effect multiplied by the size of the effect if it occurs. By the definition of a well-defined antitrust market, a 5% price increase would be profitable. That is just the threshhold, though. In individual cases, based on estimates of the elasticity of demand and the height of entry barriers, we can estimate how high collusive prices could go if collusion were to occur. When demand is inelastic and entry barriers are high, the potential cost to consumers from collusion can be substantial. If the policy objective is to maximize consumer welfare and if there is no systematic evidence to suggest that the average efficiencies from mergers is greater than the 1%-3% suggested by Lichtenberg and Siegel,[6] then, as a matter of economics, some mergers that increase the risk of collusion should be challenged even if the increase is not so great as to make collusion the likely outcome. To state the same point in more explicit quantitative terms, the correct standard from the standpoint of economics should not necessarily require a showing that a merger increases the risk of collusion to more than 50%.

I will conclude with a very brief question No. 4: Who suggested the word "cognizable" in the efficiencies section and why?

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[5] For a related, more recent study, see Vojislav Maksimovic and Gordon Phillips, "The Market for Corporate Assets: Who Engages in Mergers and Asset Sales and are there Efficiency Gains?," *Journal of Finance*, 2001.

[6] A collusive price increase would generally apply to all output in the market. The Lichtenberg-Siegel and Maksimovic-Phillips results concern productivity gains in the acquired firm. They do not address whether there are similar or any productivity gains in the assets of the acquiring firm. Efficiencies from a merger could conceivably spill over to other firms if there is a demonstration effect, although I know of no evidence to suggest that such an effect is large empirically. On the other side, collusion might arise only temporarily, which any estimate of the expected cost of collusion must consider. These factors are just a few of the reasons why there can be considerable disagreement over the costs of the different types of errors in merger review. I will consider these comments a success if they stimulate that debate and lead to better estimates.

Again, my thanks to the Economics Committee for providing this forum. I am happy to answer questions and I look forward to receiving answers to the questions I have posed.