

**CHALLENGES in IDENTIFYING ANTICOMPETITIVE  
DOMINANT FIRM BEHAVIOR**

**by**

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**before**

**THE NATIONAL ECONOMIC RESEARCH ASSOCIATES 2005 ANTITRUST  
AND TRADE REGULATION SEMINAR**

**Santa Fe, New Mexico  
July 7, 2005**

## **Challenges in Identifying Anticompetitive Dominant Firm Behavior**

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It is a real thrill for me to be obligated to begin this talk by saying that the views I express today are mine alone. They do not reflect the views or positions of the Federal Trade Commission, of any of the individual commissioners, or of the Bureau of Economics. I trust you will understand, though, my reluctance to give great offense to any of the aforementioned in my first week on the job. So brevity seems like a good strategy.

Given the title of this session, you might expect me to talk about what sort of behavior by a dominant firm is or should be deemed anticompetitive even if similar behavior by a firm operating in a more competitive environment would not be. That is not what I am going to do. Instead, I will address the challenges in identifying economically justifiable restrictions on dominant firm behavior. Before we condemn dominant firm practices, we should check whether firms operating in competitive markets behave similarly; and – this is essential -- we need to understand why. Obviously, dominant firm behavior cannot be deemed competitive just because firms without market power behave similarly. Firms without market power sometimes give away their products. That does not make predatory pricing legal. But competitive behavior is often more subtle than we expect, and a careful examination of it can reveal valid business justifications for practices that might be misinterpreted as abusive, predatory, or exclusionary.

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Tying is, in my mind, the poster child for the principle that competitive behavior is more subtle than is generally acknowledged. This is an area where we might well see a change in the legal standard in the near future. The Supreme Court recently granted *cert* in *Independent Ink*.<sup>1</sup> Perhaps it will use the case to rule on the narrow issue of whether a patent creates a presumption of market power in the tying good, but it might also take the opportunity to address tying doctrine more broadly. If it does, simply switching from per se treatment to a rule of reason will not do much good if we do not know how to do the rule of reason analysis appropriately.

In *Jefferson Parish*,<sup>2</sup> the Court said that an illegal tie is one in which consumers are “forced” to buy a good they do not want or would prefer to buy from another firm.<sup>3</sup> Even if the Court moves to a rule of reason, this broad conceptual approach could well stand. But does that broad principle really distinguish anticompetitive from competitive behavior? If you look at the tying we observe, it does not.

Here is one of my favorite examples. It is a package of four plug adapters that Radio Shack sells.<sup>4</sup> Each allows you to take electrical equipment with a United States plug and plug it into some other kind of outlet. For example, this one with the round prongs is the one you need in Europe. At Radio Shack and as well as at other retail outlets, you cannot buy the European adapter separately. You must buy other adapters with it. Interestingly, Radio Shack does sell one type of adapter separately. This is the adapter you need in Santa Fe. Now, you are saying to yourself, you do not need an

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<sup>1</sup> *Independent Ink v. Illinois Tool Works*, 396 F. 3<sup>rd</sup> 1342 (2005).

<sup>2</sup> *Jefferson Parish v. Hyde*, 466 U.S. 2 (1984).

<sup>3</sup> *Ibid.*, at 12.

<sup>4</sup> For an extended discussion of this example, see David S. Evans & Michael Salinger, “Why Do Firms Bundle and Tie? Evidence from Competitive Markets and Implications for Tying Law,” 22 *YALE JOURNAL ON REGULATION* 37 (2005).

adapter in Santa Fe. Precisely. This adapter that you do not need in Santa Fe and, indeed, that you probably do not need at all is one of the four adapters included in the package that contains the European adapter. A telling feature of this example is that the price on what I will call the Santa Fe adapter was, when I purchased it, \$3.49. The price for the package was \$10.99 - substantially more than the price of a single adapter. There is a real sense in which customers who want to buy just one adapter are “forced” to purchase an item they do not want in order to get one that they do.

Is this monopolistic behavior? I doubt it. Radio Shack is not the only place to buy this item, and there are many other places that sell adapters only in a package of several. So we observe tying in a competitive market. As I said, though, simply observing competitive tying should not necessarily make it legal when practiced by a firm with market power. What we want to do is understand why the behavior occurs under competition. As simple as the example is, it illustrates a general type of tying efficiency. Companies can find it efficient to design a single good that meets the needs of a diverse group of customers. In this class of cases, the good that is offered might not be precisely what any particular customer would ideally want. Everyone might be forced to take some unwanted component. As sensible as it might initially seem, therefore, the Court’s conceptual standard that a tie is illegal if consumers are forced to take a good they do not want does not distinguish competitive from anticompetitive tying.

Let me give you another example. Magazine subscriptions are basically tied products. One that I find particularly intriguing is *Sports Illustrated* because it includes, depending on your perspective, the notorious or the much-anticipated swimsuit issue. A year’s subscription gets you 52 regular issues with sports coverage and several special

issues, one of which is the swimsuit issue. I hope you do not find the example to be in poor taste; but if you do, that reinforces my point. Some subscribers find the issue offensive. How do we know? Read the letters to the editor two weeks later. They invariably include complaining customers. This year, *Sports Illustrated* added a note to one of the letters that subscribers have the option of foregoing the swimsuit issue and getting a one-week extension on their subscription instead. Reportedly, 1% of *Sports Illustrated* subscribers took the option.<sup>5</sup> Probably, more than the 1% who go to the effort to forego the issue would prefer to do without it. I bet, though, that a far greater fraction of subscribers prefer to get the issue. This class of ties is different from the plug adapters because the tied offering might be precisely what many or even most subscribers want. Still, some customers end up purchasing a component they do not want.

As in the plug adapter case, what is important is not the fact that we observe the tie; rather, the observation causes us to ask why does it happen? Why doesn't *Sports Illustrated* make the no swimsuit issue option as prominently available as the "with swimsuit issue" option. One could imagine that all of its subscription forms would display the option prominently. I can only speculate about exactly how this would complicate *Sports Illustrated's* business and increase its costs, but I doubt the effect would be trivial.

If the Supreme Court moves to a rule of reason on tying and if the rule is to be implemented sensibly, we will need a more sophisticated understanding of tying efficiencies than we currently have. These efficiencies are not well understood. A common misperception is that tying efficiencies and bundling efficiencies are one and the same. They are not. Here is an example of economies of bundling. This is a package

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<sup>5</sup> See Editors Note to letter of Jack Saltzman, "Letters," *SPORTS ILLUSTRATED*, March 14, 2005, pg. 14.

of sinus headache medicine. Each package contains 24 tablets, and each tablet contains some decongestant and some pain reliever. This is a package of 24 tablets with just pain reliever. This is a package of 24 tablets with just decongestant. If you have a sinus headache and want both a pain reliever and a decongestant, you could buy the two separate packages, but you would find it much less expensive to buy the combination product. Why? The active ingredients represent a small portion of the total cost of the package. The combination product is one package instead of two, there are 24 tablets rather than 48, buying it requires one transaction rather than two. These are all economies of bundling. They can explain the large bundle discount we observe. By themselves, though, they do not explain tying; and, in fact, tying does not happen here. The individual component products are available.

Tying cannot arise simply because it is cheaper or more convenient to offer a bundled product to those who want all the components. There has to be a reason why the seller is unwilling to supply the individual components to those who do not want all the parts of the bundle. That is a more subtle issue. If the answer is not adequately understood, enforcement agencies and courts might take the apparently reasonable position that the dominant firm is free to sell the bundled product but must also make the components available separately. In the Radio Shack example, that would mean saying that Radio Shack is free to sell the package of four adaptors, but it also must sell the individual adaptors. In the *Sports Illustrated* example, a court might deem it reasonable to require *Sports Illustrated* to offer the no swimsuit issue option on all its subscription forms. To a court, such a requirement might not seem burdensome, but such a conclusion would reflect what I think is a systematic bias of viewing, on the one hand, production

costs as real and large and, on the other, transactions costs as being abstract and small. That might have reflected economic thinking at one time, but it no longer does.

The economic factors that give rise to the *Sports Illustrated* subscription and the package of plug adapters are different from the economics of the sinus headache medicine, and they are different from each other.<sup>6</sup> The distinction among these types of efficiencies is largely absent from the legal and economics literature, but we are going to have to come to grips with these distinctions for our analysis of tying cases to be economically sound.

My comments today have focused on tying doctrine, and my theme has been that devising an economically defensible limitation on dominant firm behavior is harder than one might expect. Would I make the same point about other types of dominant firm behavior? To prove that I am a card-carrying economist, I'll give you a two-handed answer. On the one hand, a notable feature of tying is that it is so prevalent in competitive markets.<sup>7</sup> That may not be true of all suspect practices by dominant firms. On the other hand, in evaluating other suspect practices, I would urge the same discipline I have suggested for tying. See whether we observe the same practice by firms without market power. By themselves, such examples should not absolve a dominant firm, but it is worth understanding the practice when extending or preserving dominance is not a candidate explanation. Competitive behavior is often more subtle than economic

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<sup>6</sup> For a formal discussion of the economic distinction among these cases, see David S. Evans and Michael Salinger, "The Role of Costs in Determining When Firms Offer Bundles and Ties," (working paper), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=555818](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=555818), as well as David S. Evans and Michael Salinger, *supra* note 4.

<sup>7</sup> The implication of the prevalence of tying as a competitive practice is discussed in Keith N. Hylton and Michael Salinger, "Tying Law and Policy: A Decision Theoretic Approach" 69 ANTITRUST LAW JOURNAL 469. For a contrasting view, see "The Antitrust Tying Law Schism: A Critique of *Microsoft III* and a Response to Hylton and Salinger," 70 ANTITRUST LAW JOURNAL

textbooks suggest, and sound policy is going to be based on distinguishing dominant firm behavior from real competitive behavior, not the textbook version.

Thank you.