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Microsoft (EC) and Duty to Deal: Exceptionality and the Transatlantic Divide

Eleanor M. Fox

This article examines Microsoft's offense in withholding full information to its workgroup server operating systems rivals so that they could not interoperate with Microsoft's systems as seamlessly as Microsoft could. This article agrees with John Vickers' observation that the Court stretched each of the *Magill/IMS* criteria defining circumstances so exceptional that they warrant a duty to deal, and thus created confusion as to the limits of exceptionality. It argues that the Court should have resorted to concept rather than factors (principles rather than rules) to define exceptionality, and that, doing so, it might have reached the same outcome, but in a more principled way. The article concludes, however, that the duty-to-deal outcome in *Microsoft* is not the only logical one; indeed, where a court ends is a function of where it begins.

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I. Introduction

This article examines Microsoft's offense in refusing to give full information to its workgroup server operating systems (WGSOS) rivals so that they could interoperate as seamlessly with Microsoft's PC and WG server operating systems as Microsoft could.[1] It follows John Vickers' excellent paper[2] comparing the1980's *IBM* case with the EC *Microsoft* case, and it responds to his call for greater clarity in the duty-to-deal standard in EC law.

It is well-known that firms, even monopolies, have no general duty to deal, and this is especially true when a claim is made that the firm must share its intellectual property (IP). A dominant firm has a duty to deal only in the event of exceptional circumstances. The question is: Did the *Microsoft* facts involve "exceptional circumstances"?

DID THE *MICROSOFT* FACTS INVOLVE "EXCEPTIONAL CIRCUMSTANCES"?

Microsoft was preceded by two important IP precedents on duty to deal: *Magill*[3] and *IMS*.[4] This essay agrees with John Vickers that the Court of First Instance (CFI) in *Microsoft* purported to apply the criteria laid down in *Magill* and *IMS*, but pushed the round peg of the *Microsoft* facts into the square boxes of *Magill* and *IMS*, thus leaving one to ponder whether those square boxes are any constraint at all. This article proposes abandoning the square boxes and resorting to concept rather than rules to determine when circumstances are so exceptionally important to consumers and the market that a duty should arise. Resorting to concept, and given the general perspective of EC competition law, an EC court would probably find a duty. But is there a transatlantic divide?

II. The Precedents and Their Limits

The European Court of Justice (ECJ) attempted to chart the territory in two important cases: *IMS* and *Magill*. In *Magill*, the Court found that owners of copyright in their TV schedules had a duty to license the schedules to a consolidated TV guide because consumers wanted a consolidated TV guide and the refusals blocked its emergence. In *IMS*, the Court found that the owners of copyright in a grid system demarking geographic boundaries for the collection of pharmaceutical sales data would have a duty to license the grid system if (reciting the *Magill* factors):

1 Case T-201/04, Microsoft v. Commission (not yet reported) (judgment of Sep. 17, 2007) [hereinafter CFI judgment].

2 John Vickers, *A Tale of Two EC Cases:* IBM *and* Microsoft, 4(1) COMPETITION POL'Y INT'L 3 (Spring 2008).

3 RTE, ITP & BBC v. Commission, 1995 E.C.R. II-485 [hereinafter *Magill*].

4 Case C-418/01, IMS Health v. NDC Health, 2004 E.C.R. I-5039 [hereinafter *IMS*].

1) the access was indispensible to enable an undertaking to carry on business on a market;

2) the refusal prevented the emergence of a product for which there is a potential consumer demand; and

3) the refusal excluded any competition on a secondary market.

The three criteria were, said the Court, "sufficient" to trigger the exceptional circumstances exception from the principle of no duty to deal, absent an objective justification.

IMS and *Magill* are formalistic judgments. The *Magill* case was special because people wanted a consolidated TV guide and could not get it unless the broadcasters provided the necessary inputs. The refusal blocked the market. The controlling factors set forth in *Magill* simply describe the facts of the case. In *IMS*, the Court simply held that it was for the national court to apply the *Magill* factors.

The CFI concluded that the *Microsoft* facts qualified as "exceptional circumstances" and, finding no justification, it ordered a duty to deal.

Then along came *Microsoft*. The problem was whether, under the circumstances, Microsoft was obliged to give seamless interoperability information to the WGSOS providers. The CFI examined the question under the *IMS* and *Magill* criteria and gave an expansive construction to each of the three factors:

1) The CFI found (or rather upheld the Commission finding) that rivals' access was indispensable. But access to the information not already provided by Microsoft was not really indispensible to enable the undertakings to carry on business; rather, denial of full information "just" handicapped them.

2) The CFI found that the refusal prevented the emergence of a new product that consumers demanded. But Microsoft's withholding of some protocols did not prevent the emergence of a new product in the sense that BBC's and ITP's refusals precluded the emergence of a TV guide; rather, it "just" significantly undermined the rivals' incentives to innovate (and sounded the death knell to a few of their products).

3) The CFI found that the refusal excluded any competition on a secondary market. But the refusal did not exclude all workgroup server operating system competition; rather, it "just" created a risk that competition would be excluded in the future. More accurately, it seriously undermined competition on the merits.

The CFI concluded that the *Microsoft* facts qualified as "exceptional circumstances" and, finding no justification, it ordered a duty to deal.

II. The *Microsoft* Facts

In *Microsoft*, the Commission's story was simple (even while factually complex). It began some years before the investigation was initiated. Microsoft controlled the PC operating system, occupying more than 95 percent of the market. It had great power; it was the world standard. Its operating system hosted many applications, and some were potential platforms for challenging Microsoft's operating system power.

Microsoft developed strategies to use its leverage to protect its power. For example:

- Netscape pioneered the browser. Before Microsoft had a browser of its own, it welcomed Netscape on its desktop. Microsoft then made its own browser and took actions to "cut[ ] off Netscape's air supply."[5]
- RealNetworks pioneered the media player. Before Microsoft had a media player of its own, Microsoft shared the desktop with RealNetworks. Microsoft then made a media player of its own and bundled its media player with its operating system.
- Novell and Sun Microsystems pioneered workgroup server operating systems. Microsoft facilitated the flow of information to them to interoperate seamlessly with Microsoft's Windows. Microsoft then made its own workgroup server operating software and turned the spigot to cut back the interoperability information flow to the (now) rivals.

In its investigation, the Commission conducted a survey. The survey results showed that, over a wide range of products, users rated the rivals' workgroup systems more favorably than they rated Microsoft's on reliability, availability, security, ease of use, and speed; but, Microsoft (of course) surpassed all others on interoperability because it held the knob to the faucet and, seamless interoperability was the one quality that many users could not do without. As a result, products of rivals that users liked dropped from the market.[6]

DID MICROSOFT HAVE A DUTY NOT TO TURN OFF THE FAUCET?

The Commission's ammunition also included the Computer Software Directive.[7] In this directive, the Community legislature attached high importance to the interoperability of computer software. By the Commission's account, the directive regarded interoperability as of the essence for effective computer use.

5 *See* Mike France, *Decoding the Trial: Microsoft Misses its First Shot*, BUSINESSWEEK ONLINE, Jan. 29, 1998, *available at* http://www.businessweek.com/microsoft/updates/up90129a.htm.

6 CFI judgment, *supra* note 1, at paras. 572 & 573.

7 Council Directive on the Legal Protection of Computer Programs 91/250/EEC of 14 May 1991, 1991 O.J. (L 122) 42.

This means, in the context of Community policy, that computer interoperability may be valued more than exclusive proprietary rights in interface protocols.

Did Microsoft have a duty not to turn off the faucet?

III. The Safe Approach, the Irony, and the Other Path

Applying the *IMS* and *Magill* factors was undoubtedly a safe approach for the CFI if the *Microsoft* facts fit the factors; it could simply apply the rules. I argue that the *Microsoft* facts did not fit the factors; however, they did fit the concept of essentiality much better than the facts of either *IMS* or *Magill*. *Magill* was only about a consolidated TV guide in Ireland. *IMS* was only about boundaries of territories in Germany for assembling sales data. What great power over the lives of people did BBC or IMS wield by keeping their proprietary information to themselves? *Microsoft*, on the other hand, is about people's access, worldwide, to the best computing systems possible. The irony is that a literal applier of the rules of *IMS* and *Magill* would have held that Microsoft did not abuse its dominance, even though the benefits to consumers from a duty to deal was (according to the fact-finding) exponentially greater in *Microsoft* than in the paradigm cases decreeing a duty to deal.[8]

How much more satisfying it would have been for the Court to have asked the important questions:

1. Are consumers and the market seriously disadvantaged by denial of full access to interoperability information?

   No access would be ordered unless the disadvantage to consumers and the market is qualitatively of a very serious order, in view of the general principle that there is no duty to share one's property.

If the answer is "yes":

2. Would the respondent and the market be seriously disadvantaged by a duty to grant access?

If the undertaking has engaged in anticompetitive acts and strategies rather than just saying "no", the case is not simply an essential facilities case and the case for the plaintiff is strengthened.

In *Microsoft*, was the computer user disadvantaged by Microsoft's refusal and acts? According to the Commission's fact-finding, the computer user was serious-

8 *See* E. Fox, *Monopolization, Abuse of Dominance, and Refusal to License Intellectual Property to Competitors—Do Antitrust Duties Help or Hurt Competition and Innovation? How Do We Know?*, in EUROPEAN COMPETITION LAW ANNUAL 2005: WHAT IS AN ABUSE OF A DOMINANT POSITION? (C.-D. Ehlermann & I. Atanasiu, eds., 2006).

ly disadvantaged by lack of full interoperability. Microsoft was the standard in a network market. Rival providers were subject to the power and incentive of Microsoft to "throw noise" into their interconnection. The Commission's evidence that users preferred certain rivals' products on all qualities except interoperability, and had to forego first choices because interoperability problems were serious, was powerful testimony. Moreover, Microsoft engaged in affirmative strategies to handicap rivals that threatened its power.

> WOULD MICROSOFT AND THE MARKET BE DISADVANTAGED BY A DUTY OF MICROSOFT TO PROVIDE SEAMLESS INTEROPERABILITY INFORMATION? ACCORDING TO THE FACTS, THEY WOULD NOT BE.

Would Microsoft and the market be disadvantaged by a duty of Microsoft to provide seamless interoperability information? According to the facts, they would not be. Recall that Microsoft provided the complete information under conditions of competition and changed its path only after it integrated. This is a telling indication that Microsoft was happy to provide the information before it developed a conflict of interest, and that the flow of information was optimal for the market.[9] Would a duty to provide full interoperability information undermine Microsoft's incentives to invent? Under EC law, Microsoft had the burden to prove it would, and Microsoft did not carry its burden. The interface was a by-product that Microsoft had to create for its own internal operability.

IV. Across the Ocean

The structure of analysis proposed above aligns with the values and perspectives of EC law; but, it is not the only approach. U.S. law takes a different tack. The U.S. perspective may be derived from the U.S. Supreme Court's opinion in *Verizon v. Trinko*.[10]

In *Trinko*, Bell Atlantic, the incumbent telephone service provider in the northeast United States (later succeeded by Verizon), owned the elements of the local loop—bottleneck elements connecting long distance service to the local market. It did so under conditions of legal monopoly of local service areas. Technology changed, making local service competition feasible. The U.S. Congress passed the 1996 Telecommunications Act, easing the way for new entry into local service and requiring incumbents to give their rivals nondiscriminatory access to the local loop. Bell Atlantic—wanting to keep its customers to

9 The importance of this circumstance has been highlighted by Judge Robert Bork in THE ANTITRUST PARADOX (1978), and by Justice Antonin Scalia in *Trinko* (*see* note 10 *infra*).

10 Verizon Communications v. Law Offices of Curtis V. Trinko, 540 U.S. 398 (2004) [hereinafter *Trinko*]. *Trinko* is not an IP case. Recent IP case law underscores the principle of IP exclusivity. *See, e.g.,* In re: Independent Service Organizations Antitrust Litigation (CSU et al. v. Xerox Corporation), 203 F.3d 1322 (Fed. Cir. 2000), cert. denied, 531 U.S. 1143 (2001).

itself—gave its new rivals access to the local loop but disrupted their service. The rivals complained to the Federal Communications Commission, which agreed with their claims, penalized Bell Atlantic, and gave the rivals recompense. In an ensuing private suit, the question was whether Bell Atlantic's conduct was also an antitrust violation, which it might have been because the 1996 Act declared that it did not preempt the antitrust laws. The Court held that there was no antitrust violation. In doing so it set forth principles for analysis in Sherman Act duty-to-deal cases.

According to the U.S. Supreme Court, the first strong principle is: no duty to deal. The Court expressed antipathy to sharing duties, stating that they undermine investment and inventiveness. The Court treated the "exceptional circumstances" exception as very rare. It stated that the Supreme Court has never decreed that there is an essential facility doctrine, which would require the sharing of facilities even in the absence of anticompetitive conduct. It ruled that even if the doctrine exists it cannot be invoked where either the defendant has engaged in some dealing, as opposed to a total refusal, or where a regulatory agency (not antitrust) has the power to order dealing. Plaintiffs had relied on the *Aspen Skiing* case,[11] and the Court acknowledged this case as the exception to the no-duty rule. In *Aspen Skiing*, the dominant three-mountain ski resort had joined with the plaintiff in offering a four-mountain ski ticket, but then changed its course and refused to cooperate, sacrificing ticket revenues for supracompetitive profits later. The Court found a violation. The *Trinko* Court called *Aspen* the outer limits of the exception from the no-duty rule, and in fact implicitly overruled the approach and perspective of *Aspen*.[12] Indeed, extolling the principle of freedom to choose not to deal, the *Trinko* Court stated that antitrust does not impose affirmative duties just because it can be argued that consumers would be better off.[13]

Analysis would start with quite a different question: Why should Microsoft be ordered to share its property with anyone, let alone rivals?

Any analyst taking *Trinko* seriously would not start with the question: Are consumers seriously disadvantaged by lack of providers' seamless access to the standard operating system network? Analysis would start with quite a different question: Why should Microsoft be ordered to share its property with anyone, let alone rivals? U.S. courts generally presume that a duty to deal would seriously impair even a monopoly firm's incentives—to the harm of the market and inno-

11 Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585 (1985) [hereinafter *Aspen*].

12 *See* E. Fox, *Is There Life in* Aspen *After* Trinko*? The Silent Revolution of Section 2 of the Sherman Act*, 73 Antitrust L.J. 153 (2005).

13 *Aspen*, *supra* note 11, at 414.

vation.[14] Microsoft would not have the burden to prove that a duty to deal would impair its incentives. The presumption in favor of Microsoft would be difficult to overcome.

This, then, is the great transatlantic divide, even if and when a European court rises above rules to principles and asks the important question: What is the effect of the challenged behavior on consumers and the market?

14 *See* Massachusetts v. Microsoft Corp., 373 F.3d 1199 (D.C. Cir. 2004), at 1215-25.

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"We require from buildings, as from men, two kinds of goodness: first, the doing their practical duty well: then that they be graceful and pleasing in doing it; which last is itself another form of duty."

—John Ruskin, *The Stones of Venice* (1880)

The *Microsoft* judgment was a big decision in the sense that it is long and concerns an important company. If it can be called a landmark decision, what sort of landmark is it? This article considers whether—at least on the interoperability side of the case—the *Microsoft* judgment can really be seen as important and, in doing so, makes certain observations about the tests applied and problems remaining in relation to refusal to supply cases. The article concludes that, at least on the interoperability side of the case, the decision does not break new ground and leaves unresolved various problems in relation to the relevant legal tests.

The author is a Barrister at Monckton Chambers in London. He acted in the appeal against the Commission's Decision on behalf of interveners in support of Microsoft.

I. Introduction

Never in the history of European competition law has so much been written by so many about just one case. The *Microsoft* litigation in the Court of First Instance (CFI), which followed the Commission's infringement decision and record fine, turned into a grand battle. Certain of the protagonists seemed to see it as the moment when the soul of European antitrust was at stake. Not just the Battle of Britain but Stalingrad.

Now, as the dust has settled a little, the battalions of lawyers have tucked away their files and the squadrons of economists have flown away for skirmishes elsewhere, it is worth considering the significance of this judgment.

Cases can, broadly speaking, be seen as important for one of two reasons:

(i) they are high profile;

(ii) they are breaking new ground.

Really important cases are often both. Undoubtedly, the European *Microsoft* competition litigation is important for the first reason; that is, it is high profile. It concerns a company which produces things which affect the way the world works; in other words, Microsoft matters. In relation to the second reason, the answer is far less clear.

This article considers whether—at least on the interoperability side of the case—the *Microsoft* judgment can really be seen as "important" for the second reason and, in doing so, makes certain observations about the tests applied and problems remaining in relation to refusal to supply cases.

II. Background

In its decision of March 24, 2004 (the "Decision"),[1] the Commission found that Microsoft had infringed Article 82 EC in two ways. The first was that Microsoft had abused its dominant position in the personal computer (PC) operating systems (OS) market and the workgroup server (WGS) OS market (encompassing file, print, group, and user administration services) by refusing to supply indispensable interoperability information to Microsoft's competitors. The interoperability information consisted of protocols necessary for communications among servers and between servers and PCs. The Commission found that Microsoft's refusal to supply this information foreclosed competitors from the WGS OS market. The second concerned the tying or bundling of Windows Media Player with Windows OS and is not the subject of this article.

1 Case T-201/04, Microsoft v. Commission (not yet reported) (judgment of Sep. 17, 2007) [hereinafter Judgment] [hereinafter Judgment].

The CFI found no manifest error in the Commission's decision on the interoperability issue. It considered that the refusal to supply the relevant interoperability information was an abuse of a dominant position. Microsoft had failed to substantiate its claim that an obligation to provide interoperability information would undermine its incentives to innovate.

III. The Key Legal Issue: The Refusal to Supply Test

The interoperability case is viewed as having raised a key issue regarding the appropriate boundary between, on the one hand, the proper protection of intellectual property rights (IPRs) and the access to proprietary information and, on the other, the enforcement of competition rules. In particular, it considers the circumstances in which a dominant supplier of software should be required to provide to competitors information that is either secret or protected by IPRs.

In *IMS*[2] (and taking into account previous case law such as *Magill*,[3] *Volvo*,[4] and *Bronner*[5]), the Court restated the cumulative four-part test which had been developed in previous case law for identifying an abusive refusal to supply. The supply refused must:

- **(i)** relate to a product or service indispensable to undertaking a particular activity in a neighboring market;
- **(ii)** exclude any effective competition in that neighboring market;
- **(iii)** prevent the emergence of a new product for which there is potential consumer demand; and
- **(iv)** have no objective justification.

As to part **(i)**, the indispensable nature of the interoperability information at issue, the CFI emphasized that the Commission had a broad discretion in making this complex economic assessment. It then went on to examine in some detail the evidence on which the Commission had relied. This included surveys of information technology (IT) executives apparently revealing that full interoperability with Microsoft's server OS was a key purchasing criterion for server operating systems.

In relation to **(ii)**, the exclusion of any competition in the WGS OS market, the CFI noted that it was not the elimination of a particular competitor which

2 Case C-418/01, IMS Health v. NDC Health, 2004 E.C.R. I-5039 [hereinafter *IMS*].

3 RTE, ITP & BBC v. Commission, 1995 E.C.R. II-485 [hereinafter *Magill*].

4 Case 238/87, AB Volvo v. Erik Veng (U.K.) Ltd., 1988 E.C.R. 6211 [hereinafter *Volvo*].

5 It is noted that this case did not, of course, concern IPRs or trade secrets; rather, it merely the question of access to an existing national delivery service. Case C-7/97, Oscar Bronner GmbH & Co KG v. Mediaprint Zeitungs-und Zeitschriftenverlag GmbH & Co KG, 1998 E.C.R. I-7791.

was important, but the elimination of competition. It stated that the Commission need not, however, wait for the actual elimination of competitors before taking action; rather, the risk of elimination was sufficient. Furthermore, it held that the continuing marginal presence of competitors in certain market niches did not preclude a finding that competition was being excluded.

On **(iii)**, the new product requirement, the CFI took Article 82(b) ("limitation of technical development") to mean that the "new product" concept extends to innovative new product features that consumers want. The CFI highlighted the specific factual context, in particular: the nature of interoperation; surveys perceived to show that but for interoperability problems customers believed that rivals' server OS products were better than Microsoft's; rivals having introduced innovative and popular features at a time when interoperability information had been available; and rivals having incentive to develop products that were differentiated and innovative beyond the design of interface specifications.

Finally on **(iv)**, objective justification, the CFI gave fairly short shrift to Microsoft's arguments. It found that Microsoft did not meet its burden to prove specifically how its incentives might be affected, particularly given that disclosure of interoperability information is common in the software industry. The CFI did not engage in a broader analysis of whether the disincentives placed on companies to develop valuable secret information if they can be later ordered to disclose it, more generally outweigh the industry-wide innovation benefits of a compulsory license.

Thus, the CFI analysis might be seen as a straightforward application of the *IMS* principles. In its Decision, the Commission went out of its way to state that the "exceptional circumstances" in which mandatory provision of sensitive information should be made were not exhausted by the four *IMS* principles and that, furthermore, in the case of Microsoft, additional features meant that the circumstances were exceptional. The Court did not consider it necessary to consider these matters as explicit components in the legal test. The legal test applied was that derived directly from a well-known line of case law without further analysis, criticism, or material qualification. On this key issue of the relevant legal test, therefore, *Microsoft* does not appear to be an "important" judgment: it does not break new ground.

ON THIS KEY ISSUE OF THE RELEVANT LEGAL TEST, THEREFORE, *MICROSOFT* DOES NOT APPEAR TO BE AN "IMPORTANT" JUDGMENT: IT DOES NOT BREAK NEW GROUND.

Furthermore, as pointed out by Frederic Jenny,[6] the approach of the CFI in stressing the "manifest error of assessment" test in its analysis might reinforce the suggestion that the Court is going to be particularly slow to overturn Commission assess-

6 Frederic Jenny, *The CFI Decision in* Microsoft*: Why the European Commission's guidelines on abuse of dominance are necessary and possible*, 1(2) GCP MAGAZINE (Jan-08).

ments in complex economic or technical cases. This should not, however, come as any great surprise and may have some important lessons for those bringing such appeals in the future—less is more. Appeals need a clear and simple "narrative" to be able to succeed otherwise they become bogged down in complexity and make then easier to reject.

A. BREAKING NEW GROUND: THE APPLICATION OF THE "NEW PRODUCT" TEST?

It has been suggested that, in fact, contrary to appearances of merely following *IMS*, in at least one respect, the CFI did break new ground in *Microsoft*: limb (iii) of the *IMS* test—the new product test—has been liberalized or expanded. In other words, post-*Microsoft*, it will be easier to argue that a product a competitor offers or intends to offer is "new" and thus requires provision of the relevant necessary input held by the dominant rival.

Undoubtedly, the Court's approach is somewhat general in form.[7] It sees the test met by the potential existence of new products if interoperability were available rather than needing to point to specific novelties which are being held back. To that extent, the analysis might be seen as more liberal. But a better reading is that, in fact, nothing novel is happening to the new product test.

First, it must be remembered that we are talking about interoperability information for sophisticated computer systems. It does not take an enormous leap of the imagination to consider that third parties might develop products which work differently from Microsoft's but which need to interoperate with the core Windows OS. The fact that the Court does not specifically identify such products does not mean it is reaching an implausible or indeed especially tendentious conclusion. Perhaps, at most, the analysis might have been clearer.

Second, it is important to remember how little novelty was assumed to be required in relation to the pharmaceutical data collection system referred to as the "brick structure" in *IMS* itself. It was never suggested in any judgment that the rival product was some sort of quantum leap forward in terms of pharmaceutical data collection and analysis. Indeed, it might be more difficult to see quite why novelty (or potential novelty) was identified in that case rather than in *Microsoft*.

B. (SADLY) NOT BREAKING NEW GROUND: INDISPENSABILITY/ELIMINATION OF COMPETITION TESTS

In *Philosophical Investigations*,[8] Wittgenstein points out that in order to verify the truth of a headline you do not go out and buy multiple copies of the same newspaper. It is an obvious fallacy that simple repetition strengthens the reasons for

7 *See, e.g.*, Judgment, *supra* note 1, at §656.

8 L. Wittgenstein, Philosophical Investigations (1972).

accepting the truth of a proposition. The application of the *IMS* test by the Court shows signs of this problem.

Indispensability (*IMS* limb (i)) and elimination of competition (limb (ii)) really amount to the same thing. The question raised in the case law about whether competition will be eliminated in the secondary market will invariably involve the consideration of the same issues as arise in relation to the assessment of the indispensability condition. In other words, if a product or service is indispensable for competing in a market, then the refusal to supply that product or service results in the exclusion of competition in that market. As then-Advocate General Maduro in *KPN* stated: "At the outset, in order for a refusal to supply to be caught by Article 82 EC, the existence of a dominant position that enables the dominant undertaking to prevent competition on a secondary market must be established."[9] AG Maduro recognized that it is difficult to see what the "elimination of competition" requirement adds to the indispensability condition.

Although this analysis may seem obvious, it is material in assessing the approach of the Court (and the Commission) in the *Microsoft* case for two reasons. First, in any legal test, asking the same question twice is dangerous—it is confusing and it can mean that evidence is not properly or coherently tested in the round and that the relevant tests can be fudged. Indeed, in this case, the question effectively gets asked three times. The initial "factual and technical assessment" by the Court considers precisely the same issues in testing what constitutes viable competition. Thus, by its factual outline which sets out what it considers the Commission rightly found to amount to a threshold of "viable competition", the Court effectively reaches its conclusions on the key elements of the legal tests before it comes to consider them explicitly. Of course, the application of a legal test to a particular case depends on findings of fact. But it might be said that, in practice, the interoperability case was settled by the section of the judgment where the assessment of what was required in order to be part of the "blue bubble" of interoperating servers (and the need to be in the "blue bubble") was made.[10]

Second, while repeating the question is bad enough, getting it wrong is worse. Here we do have a problem and it relates to the question about whether there needs to be a risk or a likelihood of elimination of competition. The Court focuses on the question of the "risk" of elimination of competition. In doing so, it may be seen as unjustifiably diluting the impact of the indispensability condition.

Obviously the Court was aware of concerns of this sort and considered that there was too much unnecessary semantic discussion about the relevant legal tests in the submissions it has received. It made clear that when referring to "risk", the Court meant that competition need not have been actually eliminated at the time

9 Opinion of Advocate General Poiares Maduro, Case C-109/03, KPN Telecom BV v. OPTA, 2004 E.C.R. I-11273 (Jul. 14, 2004), at para. 50.

10 Judgment, *supra* note 1, at 25.

of the decision. That is fine so far as it goes; but, it is no answer to the problem. Even if it is the case that the elimination of competition can, as a matter of law, occur gradually in order to discharge the indispensability condition, the refusal to supply in question must still be the cause of the exit from the market. When the decision maker or the appeals court talk about beliefs or expectations about the future, there can be no absolute certainty and thus "a high likelihood" of the elimination of competition might be sufficient proof of indispensability.

However, the Commission and, in turn, the Court do not reach a conclusion that there is such a high likelihood that competition will end because instead they uses the notion of "risk of elimination of competition". The indispensability condition is not merely that there is a "risk" of elimination of competition, but that it must at least involve sufficient proof of likelihood. As one sharp Microsoft lawyer put it: there is a world of difference in being told that there is a risk you could catch bird flu and a high likelihood you could catch bird flu. This is not merely a semantic distinction.

More generally it reflects a flaw—or, at least a lack of clarity—in the way the *IMS* test itself is framed and it is perhaps unfortunate that in the course of this grand litigation some further light could not be shone on the issue.

The approach adopted could be criticized as a straightforward legal error; specifically, that the wrong test was applied. Certainly it will be difficult in future cases to judge precisely what indispensability really means when the threshold is effectively qualified by reason of the operation of the second limb of the *IMS* test. More generally it reflects a flaw—or, at least a lack of clarity—in the way the *IMS* test itself is framed and it is perhaps unfortunate that in the course of this grand litigation some further light could not be shone on the issue.

IV. Burden and Standard of Proof

Arguments about burden and standard of proof are often seen as merely the modern legal equivalent of medieval theologians arguing about the number of angels that might fit on the head of pin. They are generally abstruse arguments with little practical impact in civil litigation. However, in the circumstances of the *Microsoft* case, the analysis may deserve a little more attention.

The Community Courts have made it clear that the burden of proof rests on the Commission to establish to the "requisite legal standard" the facts and matters that it relies on to establish a breach of Article 81 or 82.[11] The requirements

11 Case C-185/95, P Baustahlgewebe GmbH v. Commission, 1998 E.C.R. 1-8417, at para. 58:

> where there is a dispute as to the existence of an infringement of the competition rules, it is incumbent on the Commission to prove the infringements found by it and to

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of that standard have been variously expressed to encompass an obligation on the part of the Commission to produce "sufficiently precise and coherent proof"[12] or "a firm, precise and consistent body of evidence,"[13] and to show that it was "in possession of sufficient evidence to establish that the information on which it based itself was correct and that its assessments were well founded."[14]

Although the *Microsoft* case did not involve the application of Article 81, it concerned Article 82 which manifests a similar character of a quasi-criminal provision[15] (as the size of the fine in the case confirmed). Accordingly, a defendant merits the same protection that the Community Courts have accorded to the defendant in Article 81 cases. In that context, it is notable that then-Advocate General Vesterdorf stated that: "Considerable importance must be attached to the fact that competition cases of this kind [cartels] are in reality of a penal nature, which naturally suggests that a high standard of proof is required."[16]

Furthermore, as a matter of general principle, it should not be open to dispute that the more remote or speculative the proposition to be established, the more convincing the evidence that is required to establish it. This point was elegantly made by Lord Hoffman in the English case of *SSHD v. Rehman*,[17] a case cited by then-CFI President Vesterdorf in an article discussing the standard of proof in

footnote 11 cont'd

> adduce evidence capable of demonstrating to the requisite legal standard the existence of the circumstances constituting an infringement.

See also Case T-41/96, Bayer AG v. Commission, 2000 E.C.R. II-3383, at para. 77.

12 Cases 29/83 & 30/83, Compagnie Royale Asturienne des Mines SA and Rheinzink GmbH v. Commission, 1984 E.C.R. 1679, at paras. 16-20. The ECJ applied the same "requisite legal standard" in Rheinzink to the application of Article 82 in Case C-53/92 P, Hilti AG v. Commission, 1994 E.C.R. I-667.

13 Joined Cases C-89/85, C-104/85, C-114/85, C-116/85, C-117/85 & C-125/85 to C-129/85, Ahlström et al. v. Commission, 1993 E.C.R. I-1307, at paras. 70-127.

14 Case T-30/89, Hilti AG v. Commission, 1991 E.C.R. II-1439, at para. 44.

15 President Vesterdorf drew no distinction between Articles 81 and 82 in a recent article discussing the standard of proof in merger cases and characterised them both as provisions that involved severe penalties of a quasi-criminal nature. *See* B. Vesterdorf, *Standard of proof in merger cases: reflections in the light of recent case law of the Community Courts*, 1 EURO. COMPETITION J. (Mar. 2005), at 27.

16 Case T-1/89, Rhone Poulenc v. Commission, 1991 E.C.R. II-86. It is also noted that in the ECJ's ruling in *Montecatini*, there was a presumption of innocence in antitrust proceedings given "the nature of the infringements [of Article 81(1)] in question and the nature and degree of severity of the ensuing penalties." *See* Case C-235/92 P, Montecatini v. Commission, 1999 E.C.R. 1-4539, at para. 176. In Case C-199/92 P, Hüls v. Commission, 1999 E.C.R. I-4287, at para. 149, the Court specifically stated that the presumption of innocence is a "fundamental right" under Community law. The Court went on to say that the presumption of innocence applies in particular to competition law proceedings where fines or periodic penalty payments can be imposed (*id.* at para. 150).

17 Secretary of State of Home Department v. Rehman, 2003 1 A.C. 153, 194 [hereinafter *Rehman*].

merger cases.[18] Lord Hoffman stated that, although the applicable standard of proof would be the same (the balance of probability), "it would need more convincing evidence to satisfy one that the creature seen walking in Regent's Park was more likely than not to have been a lioness than to be satisfied to the same standard of probability that it was an Alsatian."[19]

The Community Courts' jurisprudence in the application of the competition rules generally, and Article 82 specifically, recognizes this requirement. It is established that the quality and strength of evidence that the Commission needs to adduce to establish an infringement of Article 82 depends on both the nature of the alleged abuse and the particular circumstances of the case. Specifically, the burden on the Commission is particularly high where (as in both aspects of the *Microsoft* case) the Commission must prove the abuse and, in seeking to do so, relies on predicted future developments rather than past or present actions or events.

First, regarding the nature of the abuse, particularly careful analysis is required in cases where it cannot be assumed that the conduct complained of results in anticompetitive effects. Thus, then-Advocate General Jacobs stated in *Bronner*[20] that:

> "[T]he justification in terms of competition policy for interfering with a dominant undertaking's freedom to contract often requires a careful balancing of conflicting considerations. In the long term it is generally pro-competitive and in the interest of consumers to allow a company to retain for its own use facilities which it has developed for the purpose of its business. For example, if access to a production, purchasing or distribution facility were allowed too easily there would be no incentive for a competitor to develop competing facilities. Thus while competition was increased in the short term it would be reduced in the long term. Moreover, the incentive for a dominant undertaking to invest in efficient facilities would be reduced if its competitors were, upon request, able to share the benefits. **Thus the mere fact that by retaining a facility for its own use a dominant undertaking retains an advantage over a competitor cannot justify requiring access to it** . . ."
> (emphasis added)[21]

18 *See* Vesterdorf (2005), *supra* note 15, at 23.

19 For those not familiar with the parks of London, the proposition that a lioness had been seen in Regents Park is not completely outlandish; London zoo sits inside the northern perimeter of the park.

20 Opinion of Advocate General Jacobs, *Bronner*, *supra* note 5 (May 28, 1998), at para. 58.

21 *Id.* at paras. 57-62.

In this respect, the relevant test to be applied in the *Microsoft* case must be clearly distinguished from the evidential test formulated in *British Airways plc v. Commission*,[22] where the CFI ruled that it was not necessary to demonstrate that the abuse had a "concrete effect on the markets concerned"; but, that it was sufficient to show that it "tends to restrict competition … or is capable of having, or likely to have, such an effect." These observations related to consideration of the effect of an abuse after the elements of the abuse had been found.[23]

Second, it is important to distinguish between those cases that are concerned with a present distortion of competition and those that are concerned with a future loss of competition. Article 82 cases typically fall into the first category since the prohibition addresses an undertaking's past behavior. In such cases, therefore, the loss of competition can normally be assessed by reference to observed trends on the market. The *Microsoft* case, however, was different. The Commission's Decision relied not on proof of past or present foreclosure of competition, but on an assertion that Microsoft's conduct would at some unascertained point in the future result in the foreclosure of its competitors.[24] As such, it was a case where the finding of competitive harm required an appraisal of the likelihood that the market would evolve in the way predicted by the Commission.

This type of analysis is most commonly found in the context of merger control. It is in that context, therefore, that the evidential issues have been most extensively considered by the Community Courts, which have provided detailed guidance on what is required for the Commission to be able to prohibit a merger (e.g., *Airtours*,[25] *Schneider*,[26] and *Tetra Laval*[27]). That guidance might seem applicable to cases under Article 82 that rely on a forward-looking assessment of competitive impact. Indeed, given the quasi-criminal nature of the penalties imposed for breach of Article 82, the need to adhere to strict evidential standards

22 Case T-219/99, British Airways plc v. Commission, 2003 E.C.R. II-nyr (judgment of Dec. 17, 2003), at para. 293.

23 The ingredients of the abuse, in particular that rival undertakings were unable to attain a level of revenue sufficient to overcome any exclusionary effect of BA's scheme and whether the scheme was economically justified, were found at paragraphs 270 to 292 of the judgment (*id.*).

24 Commission Decision 2007/53/EC of 24 May 2004, Case COMP/C-3/37.792 — Microsoft, 2007 O.J. (L 32) 23 [hereinafter Decision]. *See, e.g.*, paragraphs 589 (and n. 712), 692 & 992.

25 Case T-342/99, Airtours plc v. Commission, 2002 E.C.R. II-2585 [hereinafter *Airtours*].

26 Regarding the Commission's Article 8(3) prohibition, *see* Case T-310/01, Schneider Electric SA v. Commission, 2002 E.C.R. II-4071; regarding the Commission's Article 8(4) divestiture decision, *see* Case T-77/02 Schneider Electric SA v. Commission, 2002 E.C.R. II-4519.

27 Case T-5/02, Tetra Laval BV v. Commission, 2002 E.C.R. II-4381 [hereinafter *Tetra Laval* (CFI)] and Case C-12/03P, Tetra Laval BV v. Commission, 2005 E.C.R. I-987 [hereinafter *Tetra Laval* (ECJ)].

is even stronger. The test applied in that series of cases was summarized by then-President Vesterdorf in an article:

> "The Commission, under the judicial control of the Courts, would have to decide that it was **satisfied at a high degree** whether the concentration would be **likely to result in significant anti competitive effects** and would have to prove that its conclusion was based on a body of **solid, cogent and convincing evidence** and not vitiated by any errors of fact, law or manifest errors of appreciation . . .
>
> . . .
>
> [The standard required] would appear to be something more than a pure balance of probabilities standard, but most certainly something less than a criminal standard . . . " (emphasis added)[28]

There are cogent reasons for doubting whether the notion of a standard of proof is especially relevant in cases assessing future likelihoods.[29] However, the Community Courts have also made it clear that, in certain situations, there will be a particularly strong requirement on the Commission as to the level of evidence necessary to satisfy the "requisite legal standard", and the Community Courts' review of the Commission will be correspondingly thorough. In particular, these situations have been identified where:

- an analysis particularly involves speculation as to future outcomes;[30]
- the relevant type of merger would not usually be considered problematic;[31] or

28 *See* Vesterdorf (2005), *supra* note 15, at 31.

29 Quoting Lord Hoffmann in *Rehman, supra* note 17, at 194:

> I agree with the Court of Appeal that the whole concept of a standard of proof is not particularly helpful in a case such as the present. In an criminal or civil trial in which the issue is whether a given event happened, it is sensible to say that one is sure that it did, or that one thinks it more likely than not that it did. But the question in the present case is not whether a given event happened but the extent of future risk. This depends upon an evaluation of the evidence of the appellant's conduct against a broad range of facts with which they may interact. The question of whether the risk to national security is sufficient to justify the appellant's deportation cannot be answered by taking each allegation seriatim and deciding whether it has been established to some standard of proof.

30 *Tetra Laval* (ECJ), *supra* note 27, at paras. 39 (last sentence) & 42.

31 *Tetra Laval* (ECJ), *supra* note 27, at para. 44 & *Tetra Laval* (CFI), *supra* note 27, at para. 155.

- the case involves novel economic theories.

Thus, the CFI in *Tetra Laval* stated that in light of the fact that "the anticipated dominant position would emerge only after a certain lapse of time", the Commission analysis needed to be "particularly plausible".[32] This was upheld by the ECJ which commented:

> "[N]ot only must the Community Courts, inter alia, establish whether the evidence relied on is factually accurate, reliable and consistent but also whether that evidence contains all the information which must be taken into account in order to assess a complex situation and whether it is capable of substantiating the conclusion drawn from it. Such a review is all the more necessary in the case of a prospective analysis required when examining a planned merger with conglomerate effect."[33]

Similarly, the CFI in *Airtours* noted that:

> "[T]he prospective analysis which the Commission has to carry out in its review of concentrations involving collective dominance calls for close examination in particular of the circumstances which, in each individual case, are relevant for assessing the effects of the concentration on competition in the reference market ... where the Commission takes the view that a merger should be prohibited because it will create a situation of collective dominance, it is incumbent upon them to produce **convincing evidence** thereof." (emphasis added)[34]

Notwithstanding these lines of authority and the good reasons why a high level of scrutiny might be appropriate with regards to the interoperability part, the Commission's Decision alleged that the interoperability information was indispensable for competing in the market for workgroup servers, but did not allege that as a result there is no competition in the market. After having found

32 *Tetra Laval* (CFI), *supra* note 27, at para. 162.

33 *Tetra Laval* (ECJ), *supra* note 27.

34 *Airtours*, *supra* note 25, at para. 63.

that up to 40 percent of the market is provided for by competitors, the Commission speculated that without access to this information there would be a gradual elimination of this competitive fringe.

The Court was content with this analysis. It was happy with the manner in which the Commission had dealt with the various pieces of evidence and that the relevant burden had been discharged to the relevant standard. There was no manifest error of assessment even after the Court had considered the evidential foundation at some length. There is, however, an absence of recognition as to why particularly compelling evidence might be required to meet the relevant thresholds and, moreover, why the evidence provided was in fact particularly compelling.

THE DETAILED ANALYSIS, AT LEAST ON OCCASION, CASTS DOUBT ON WHETHER THE HIGH STANDARD OF PROOF IS REALLY MET.

Indeed, the detailed analysis, at least on occasion, casts doubt on whether the high standard of proof is really met. For example, can it be right to say that in a WGS OS market, as defined by the Commission, if Linux is taking market share from Novell but less from Microsoft, then it is likely to be eliminated from the market even though Linux's share is shown to be growing?[35] If seventy managers who use mixed systems are surveyed, and 53 say they want to use more Linux, can it really be dismissed as being irrelevant to the question of whether Linux will inevitably exit the market?[36]

The analysis of the evidence by the Court is of some concern here both for the lack of clarity about the standard of proof being applied and the actual treatment of some parts of the evidence. The matter is of greater importance, however, given the overlapping concern between the relevant burden and standard and the nature of the substantive test being applied. As discussed earlier, at the very least, limbs **(i)** and **(ii)** of the *IMS* test lack clarity or, more exactly, it is unclear what each adds to the other. That lack of clarity can further affect the approach that the Court may bring to bear in analyzing the evidence before it and exercising its review function. As is evident from the earlier analysis, it was important for the Court to apply a rigorous approach to its assessment of whether the Commission had adduced sufficient evidence to support its decision.

V. Post-Decision Evidence

It does not appear that the Court relied on any post-Decision evidence submitted to it (although not entirely clear from the manner in which the CFI frames its judgment that it entirely ignored post-Decision evidence). However, one

35 Judgment, *supra* note 1, at §603.

36 *Id.* at §§597-600.

point which may arise for further consideration in future cases—particularly in refusal to supply cases where abuse is identified as having already occurred on the basis of a prediction as to the future effect on competition—is the extent to which post-decision evidence might be admitted for consideration. The principal barrier to such material being admitted and considered by the Court is the general rule repeatedly stated by the Community Courts that the legality of a Commission's Decision falls to be assessed on the basis of the elements of fact and law existing at the time when the measure was adopted.

The cases in which the Community Courts have referred to the general principle that where a measure (whether a decision or legislative provision) is under challenge, it must be assessed on the basis of the facts and information available at the time of its adoption, are distinguishable from the *Microsoft*-type situation. In the *Microsoft* decision, the finding of abuse of dominance which has occurred depends on predictions as to future events (i.e., foreclosure or elimination of competition). Certain cases have involved discussion of what the Commission expected would happen after the measure under challenge was introduced, but these have primarily been cases concerning legislative provisions (e.g., *Schroeder*[37] and *Crispoltoni*[38]). There is clearly a material difference between, on the one hand, adopting a set of rules based on past experience and expectations as to the future and, on the other, reaching a specific infringement decision which is predicated on certain matters coming to pass. Many of the other cases concern attempts to adduce new material in circumstances where it had been previously requested (e.g., *GAARM*[39]) or there was a notification procedure under which such material should have been provided (e.g., the state aid cases such as *Belgium v. Commission*,[40] *British Airways and British Midland v. Commission*,[41] and *ESF Elbe v. Commission*[42]). It is clear that where a notification process is in existence, allowing post-decision evidence would wholly undermine that process.

It is notable, however, that even in some of these cases certain consideration of post-decision evidence appears to have been permitted. It appears that post-decision evidence has been admitted and referred to as corroboration in annulment applications even in cases not involving predictive findings (e.g., *Schroeder*,

37 Case 40/72, Schroeder v. Germany, 1973 E.C.R. 125.

38 Cases C-133, 300 & 362/93, Crispoltoni v. FAT, 1994 E.C.R. I-4863.

39 Case 289/83, GAARM v. Commission, 1984 E.C.R. 4295.

40 Case 234/84, Belgium v. Commission, 1986 E.C.R. 2263.

41 Cases T-371 & 394/94, British Airways et al. and British Midland v. Commission, 1998 E.C.R. II-2405 [hereinafter *BA and British Midland*].

42 Case T-6/99, ESF Elbe-Stahlwerke v. Commission, 2001 E.C.R. II-1523.

Crispoltoni, and *BA and British Midland*). In particular, it is noted that in *British Midland*, the CFI stated: "As the Court of Justice accepted in *Bremer Vulkan* ... such factors occurring after the date on which the contested decision was adopted may be taken into consideration as illustrating the obligation to state reasons devolving on the Commission."[43] There is no reason why the *Bremer Vulkan* principle should not extend more generally to other heads of challenge apart from reasons challenges. In fact, in *BP v. Commission*,[44] the Commission itself submitted "developments subsequent to the contested decision may be taken into account, at least in order to show that the Commission did not commit a manifest error of assessment..." In addition, there has been at least one instance where the Court itself has asked for expert evidence which considered post-decision facts and market developments because it was considered it might be helpful in analyzing the decision in question (e.g., *Ahlstrom v. Commission*[45]).

Why should this be of importance here? Given the length of time it takes for the judicial process to grind through, a natural experiment is occurring which may assess the veracity of the initial assumptions made. Was it really the case that at the time of the oral hearing, the best available evidence would suggest that an elimination of competition on the WGS OS market really was occurring as predicted?

It must be recognized, of course, that given the review function of the CFI in appeal cases, there must be care to not impugn the Commission for lacking the benefit of hindsight. It must also be recognized that the admissibility of post-decision evidence can pose a difficult problem in relation to the proper application of review test since there is no decision in respect of that material which can be subject to challenge and review. Nonetheless, to pretend that the real-world outcome must not impinge on the assessment of whether the Commission could (or should) have reached its conclusions as it did when it took its decisions risks maintaining a legal fiction at the expense of an economically rational assessment within the structure of competition law. If competition law is there to ensure that markets operate more effectively, then refusing to consider the real outcome means that courts have to be blind to the best information indicating whether (or not) markets are working. Furthermore, the range of circumstances for which such evidence might be

IF COMPETITION LAW IS THERE TO ENSURE THAT MARKETS OPERATE MORE EFFECTIVELY, THEN REFUSING TO CONSIDER THE REAL OUTCOME MEANS THAT COURTS HAVE TO BE BLIND TO THE BEST INFORMATION INDICATING WHETHER (OR NOT) MARKETS ARE WORKING.

43 *BA and British Midland*, *supra* note 41, at §275.

44 Case T-11/95, BP Chemicals Limited v. Commission of the European Communities, 1998 E.C.R. II-03235.

45 Case C-98/85 et al., Ahlstrom v. Commission, 1993 E.C.R. I-01307.

admitted need not be unduly wide. After all, this was a case where a finding of previous abuse was based on predictions, not actual events that had occurred.

VI. Did the Commission "Over-Prove" Its Case?

As noted in the previous section, the Court did not find it necessary to go beyond *IMS* to consider the additional factors which the Commission maintained rendered the non-supply an abuse. As at least one person has observed, the consequence of the CFI judgment is that the Commission, in effect, "over-proved" its case. That is perhaps true; however, it may be that the factors to which the Commission referred—factors which pertained to the circumstances of *Microsoft* and, in particular, the history of dealing with inoperability information—fed into the Court's approach more generally.

In its Decision, the Commission referred to the fact that the refusal to supply did not relate simply to questions of the supply or licensing or IPRs, but to a specific type of valuable information: interoperability information. Interoperability information is specifically designed to enable interoperability (hence the name). Preventing interoperation with other products is generally not economically desirable unless you are trying to leverage market power. It also stressed that Microsoft had an exceptionally high market share and cited the term "superdominance", a term that has been bandied around in competition knitting-circle discussions particularly since *CEWAL*.[46] No one quite knows what it means; but, it sounds really bad. In addition, the Commission was keen to emphasize what it considered the tenuous nature of the IPRs relied on by Microsoft. Finally, it emphasized that in the past Microsoft had given access to interoperability information, and now had ceased to do so.

None of these points were explicitly relied on by the Court. There was, for example, no reference to "superdominance". The distinction between IPRs and other valuable secret commercial information was specifically stated not to be important to the assessment. It is doubtful, however, that these factual issues were really as insignificant as has been suggested. At the very least they provide color and background. They provide the court with a greater degree of confidence in applying precedent (i.e., the prior case law in *IMS*, *Magill*, *Volvo*, and *Bronner*) which, almost all recognize, has flaws.

It is a perennial danger to assume that competition cases can be won simply by sufficiently coherent economic analysis being provided. While good economists (and lawyers), of course, structure their analysis around the available facts, there

46 Advocate General Fennelly talked of a concept of "superdominance" and highlighted the particularly onerous special obligation affecting an undertaking which enjoys a position of overwhelming dominance verging on monopoly. *See* Opinion of Advocate General Fennelly, Joined Cases C-395/96 P & C-396/96 P, Compagnie Maritime Belge and others ("CEWAL") v. Commission, 2000 E.C.R. I-1365, at para. 137 (citing the Commission's Decision, *supra* note 24, at §435, n. 560).

is a temptation to undervalue the impact that a bit of forensic dirt can still have. As one experienced practitioner put it after an extensive discussion of the nature of consumer welfare and its importance in Article 82 analysis, sometimes the "Sniff" test is as important as the SSNIP test.

VII. Consequences

If it is the case that the judgment is driven by particular facts more than it explicitly recognizes and the legal analysis is far from groundbreaking—and indeed, it may be criticized, then are there any significant consequences that result from the CFI's *Microsoft* judgment? The answer is "yes".

While the Commission may seek to explicate its application with revised guidelines on Article 82, the *IMS* structure remains the basis for analysis. With that comes an inevitable uncertainty as to when dominant undertakings will be required to supply IPRs and other sensitive information.

First, the case law is stuck with the *IMS* test for the moment. While the Commission may seek to explicate its application with revised guidelines on Article 82, the *IMS* structure remains the basis for analysis. With that comes an inevitable uncertainty as to when dominant undertakings will be required to supply IPRs and other sensitive information.

Second, the judgment is talismanic. Its impact is likely to be political in the sense that it is likely to inform the Commission's approach to enforcing Article 82. While there may be claims that, post-judgment, the exercise of its operational discretion is simply "business as usual", it is only necessary to contemplate for a moment the counterfactual of the Commission having lost to see that such an account would ring hollow. The case took on a significance for the Commission that far outweighed the value of the legal precedent; in essence, it enforced competition law against one of the world's largest undertakings—however deep your pockets, you are not out of reach of EC competition law. It also gave it some confidence to act in non-commodity markets.

It is doubtful that we would have seen the range of computing, software, and Internet-related inquiries being pursued with such vigor if *Microsoft* had gone the other way. Nonetheless, if, despite its size and public profile, the *Microsoft* decision does not develop or clarify the case law to any significant degree, it leaves much scope to fight any other infringement decisions.

VIII. Conclusions

The Commission's *Microsoft* Decision and the CFI judgment upholding it have been said to be a landmark in EC competition law. If so, what sort of landmark is it? Certainly, it exhibits less of the clean-lined functionality and elegance of the London Eye and more of the ill conceived grandness of the Millennium Dome.[47] Whether the architectural blueprint is sketched in the Commission's guidelines or in future case law, the refusal to supply edifice still needs work.

47 Both the London Eye and the Dome were constructed to celebrate the Millennium. The London Eye is the large Ferris wheel on the South Bank of the Thames which enables visitors to get spectacular views over London. The Millennium Dome was constructed in Greenwich in East London and was widely perceived as an extravagant white elephant whose exhibits were ill thought out. After lying empty for some time it has been turned into a large private arena and exhibition space. It recently hosted an extended run of the Spice Girls reunion tour.

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The Thirteenth Chime of the Clock

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The Thirteenth Chime of the Clock

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Few judgments of the European Court of First Instance (CFI) have attracted as much attention or controversy as the decision in *Microsoft Corporation v. European Commission*. One aspect of the case dealt with Microsoft's practice of "bundling" its own Windows Media Player application with its ubiquitous Windows operating system. The Court upheld a Commission decision that found Microsoft liable under Article 82 and, as a remedy, required Microsoft to produce and market an unbundled version of its operating system called "Windows N". But Windows N has failed to sell in the marketplace, and the market position of competing media players has nonetheless grown.

The ineffective remedy calls into question the liability analysis that came before it. This article examines possible alternative remedies for "technological tying" and concludes that no satisfactory remedy was open to the Commission or the Court. A more realistic liability analysis would have been appropriate, and the doctrine of objective justification could have provided a better analytical vehicle for resolving the case. By recognizing that, in the context of the software industry, technological bundling is the paradigm of progress, the Commission and the CFI might have avoided an ineffective and potentially dangerous foray into regulation of software design.

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I. Introduction

In *Microsoft Corporation v. European Commission* (EC *Microsoft*),[1] the Court of First Instance (CFI) upheld the Commission's remedy for Microsoft's unlawful bundling of Windows Media Player (WMP) into its operating system—a requirement that Microsoft develop and sell a new product called "Windows N". This "unbundled" edition is identical to regular Windows products except that, until the user installs additional software, the operating system is unable to display video, play most audio files, handle streaming media from the Internet, or even play an audio CD. Using Windows N, an OEM or perhaps a consumer could download and install a media program to enable functionality of this kind, either from Microsoft or a competitor. This was the remedy devised by the Commission for a tying violation of Article 82 EC (the European prohibition of abuse of dominance) which consisted in Microsoft bundling its WMP application with each copy of its Windows operating system at no additional charge.[2]

Windows N has been available for purchase since July 2005.[3] Although it insisted that such a product be developed, the Commission made no stipulation concerning its price.[4] Unsurprisingly, Microsoft chose to price the two versions identically. As a result, Edition N (so-named after the Commission rejected all of Microsoft's own naming proposals[5]) has failed to sell. Having been on the market for more than two years, it accounts for less than five thousandths of one percent of Microsoft's sales of Windows, with few stores or computer manufacturers choosing to carry the product in the first place, let alone sell it to consumers.[6] Windows N appears destined to serve a competitive purpose only in the narrowest of product markets—that for antitrust collectibles.

1 Case T-201/04, Microsoft v. Commission (not yet reported) (judgment of Sep. 17, 2007) [hereinafter Judgment].

2 Windows Media Player is Microsoft's own application for handling digital video and audio content.

3 Microsoft began marketing Windows Edition N while EC *Microsoft* was pending before the CFI.

4 The Commission, in its original decision, prohibited Microsoft from offering a discount to customers taking the bundled product, but did not prohibit charging the same price for bundled and unbundled versions. Commission Decision 2007/53/EC of 24 May 2004, Case COMP/C-3/37.792 - Microsoft, 2007 O.J. (L 32) 23, at recital 1013. In its submissions before the Court, the Commission expressly reserved its position on equal pricing (Judgment, *supra* note 1, at 908), but has raised no objections to an even-handed pricing policy since Edition N went on sale in 2005.

5 *See* Press Release, Microsoft Corporation, Microsoft Statement on European Commission Process (Mar. 28, 2005), *available at* http://www.microsoft.com/presspass/press/2005/mar05/03-28EUName StatementPR.mspx.

6 *See* Microsoft Corporation, FACT SHEET: Windows XP N Sales [hereinafter Windows N Fact Sheet], *at* http://www.microsoft.com/presspass/legal/european/04-24-06windowsxpnsalesfs.mspx (last visited Apr. 1, 2008).

Examination of the Windows N remedy provides a valuable perspective for evaluating the entire technological tying aspect of the EC *Microsoft* case. Indeed, the choice of remedy was inextricably tied to the European Commission's definition of the violation it found, so problems with the remedy immediately call into question the liability analysis that preceded it. What benefits can the remedy be said to have achieved, particularly balanced against the cost of such a sharp transatlantic divergence? If the Windows N remedy lacked merit, were better ones realistically available without sacrificing other important considerations? If not, what does this say about the likely public benefits of an aggressive enforcement program against allegedly anticompetitive product design, particularly in fast-moving technology markets?

Examination of the EC *Microsoft* bundling remedy and its potential alternatives leads to the conclusion that technological bundling cases (as opposed to cases against the more overt forms of exclusion forbidden by the U.S. consent decree[7]) stand little chance of accomplishing any public good or of avoiding unintended harm to competition and innovation. This is primarily because of the ambiguous nature of the conduct being condemned, which is at once harmful to rivals and the embodiment of personal computing progress. Global antitrust enforcement, under attack from all corners of the political arena[8], has important work to do for the benefit of consumers. Its capital would be better spent elsewhere than on a remedy that invites itself to be mocked.

Perhaps we can take comfort from the idea—pressed by supporters of the decision[9]—that the EC *Microsoft* case is just about Microsoft, and will not be applied beyond its facts. But the opinion converted a sui generis legal and political battle into a CFI precedent that purports to state general principles of law. The

7 Microsoft entered into a consent decree with the U.S. Department of Justice (DOJ) that received final judicial approval on November 12, 2002 from district court Judge Colleen Kollar-Kotelly. The decree provides in part that Microsoft shall not require OEM customers (who install Microsoft software onto computers for sale on to end users) to refrain from distributing, installing or using competing software, nor shall Microsoft "entrench" default settings in favor of its own software.

8 *See, e.g.,* Edwin S. Rockefeller, The Antitrust Religion 99 (2007); Dominick T. Armentano, Antitrust: The Case for Repeal (2007); *Antitrust Concerns Draw Fire*, Wall St. J., Feb. 8, 2008; *The Future of Futures*, Wall St. J., Apr. 11, 2007; and *Unity in the European Market, Except When It Comes to Takeovers*, N.Y. Times, Mar. 14, 2006.

9 *See, e.g.,* the comments of prominent European lawyer Thomas Vinje, who represented the European Committee on Interoperable Systems in the EC *Microsoft* case, *quoted in Comments about the EU Court Ruling on Microsoft's Appeal of Antitrust Case*, Associated Press, Sep. 18, 2007 ("No other companies have anything to fear from this decision. [. . .] I don't think you'll see the Commission going on a rampage here, certainly not against Microsoft or any others.") and *in Armageddon For IT Firms?*, Guardian Unlimited, Feb. 29, 2008, *available at* http://www.guardian.co.uk/business/2007/sep/19/davidgowoneurope.europe ("I've been practising in this area for 20 years and I would be very happy to have discussions with anyone who thinks this affects a broad range of companies and isn't limited to Microsoft but I frankly can't see how they can say this. . . If I'm wrong you can have my holiday home and we can discuss dividing it up.").

Commission appears poised to expand the application of product design bundling claims to Microsoft itself.[10] If such claims are applied generally to all market participants that meet the test of dominance, the CFI's bundling opinion may insert regulators into a wide range of technological decisions. This potential is magnified by the possible increase in private European enforcement mechanisms that allow self-interested parties to invoke the opinion in national courts.[11]

Unless there are judicially administrable remedies for technological tying or anticompetitive product design that serve a realistic chance of benefiting consumers and innovation, this path cannot be in the public interest. No such remedies seem apparent, and EC competition law should not be read to require a liability finding that leads to no beneficial remedy. If this is the state of current law, the Commission should work to fix the law, especially now that it seeks to supplement the enforcement authority of its own public-minded officials by encouraging the pursuit of damage claims by commercial parties.

UNLESS THERE ARE JUDICIALLY ADMINISTRABLE REMEDIES FOR TECHNOLOGICAL TYING OR ANTICOMPETITIVE PRODUCT DESIGN THAT SERVE A REALISTIC CHANCE OF BENEFITING CONSUMERS AND INNOVATION, THIS PATH CANNOT BE IN THE PUBLIC INTEREST.

II. The Windows N Remedy Examined

Did Windows N benefit consumers? Sales figures indicate that Windows N was not what consumers wanted. It is hard to see how it has advanced their interests. Just as before the decision, consumers consistently choose to install the fully functional version of Microsoft Windows. WMP is present on practically every (non-Apple) PC sold, and consumers retain the option to purchase or download—often for free—alternative media players from other providers. The CFI in fact recognized that the use of multiple competing media players was becoming increasingly common among consumers throughout the period in question.[12]

10 Charles Forelle, *EU Regulators Begin New Microsoft Probes*, WALL ST. J., Jan. 15, 2008.

11 In *Courage v. Crehan*, the European Court of Justice held that individuals who have suffered loss as a result of an infringement of Article 81 or 82 EC Treaty have a private right of action against the infringing party (Case C-453/99, Courage Ltd. v. Bernhard Crehan, 2001 E.C.R. I-6297). However, the procedural context of this right (i.e., the detailed rules for bringing the claim) are a matter for the Member States. By no means have the Member States enacted comprehensive or consistent systems for private enforcement of competition law. The Commission has recently adopted a White Paper, accompanied by a more detailed Staff Working Paper, on the facilitation of private damages claims. *See* European Commission, Actions for Damages > Documents, *at* http://ec.europa.eu/comm/competition/antitrust/actionsdamages/documents.html (last visited Apr. 3, 2008).

12 *See* Judgment, *supra* note 1, at 1083. Indeed, since the time of the CFI's judgment, Apple's iTunes program has become the fastest-growing media playback application, and Adobe's Flash Player is the leading Internet-streaming software. That is, the whole prediction about market evolution on which

The only difference is that now consumers (including computer manufacturers acting on their behalf) actively choose to take the bundled version. No rational consumer would decide to purchase a less functional product at the same price.[13] So consumers have ignored Windows N.

What about competitors? If the remedy was intended to restore free competition to the market for media player software, it is hard to see how competitors are better off because Microsoft has been forced to make a minor additional product that no one buys. Consumers still buy Windows with WMP bundled in, and they retain the option of changing or adding to that player if they prefer another. To the extent that competitors were abused by Microsoft before the judgment, they are still abused, and to the extent that they can compete now, they could compete before. Nothing has changed from the point of view of Microsoft's competitors in the market for media players.

What of the intermediaries between Microsoft and consumers? OEMs buy operating systems in the course of assembling a complete product that they then sell to end users. They now have the option of buying Edition N without WMP installed, and may instead install software from one or more of Microsoft's competitors. But OEMs have also made their lack of interest in the Edition N product clear. Just as before the decision, they can, and do, add additional media functionality to the bundled Windows package; but, they have not taken such functionality away.[14]

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footnote 12 cont'd

the Commission's decision was based has turned out to be wrong. For one stark illustration of iTunes' astonishing market share growth, *see* WebsiteOptimization.com, iTunes Player Hits a High Note, Passes RealPlayer - US Broadband Penetration Increases to 86.79% Among Active Internet Users - January 2008 Bandwidth Report, *at* http://www.websiteoptimization.com/bw/0801/ (last visited Apr. 4, 2008). The ubiquity of the Flash Player is charted in a Millward Brown study, commissioned by Adobe, that reported in December 2007 a 98.8 percent penetration rate. *See* Adobe Systems Incorporated, Macromedia - Flash and Shockwave Players: NPD Methodology, *at* http://www.adobe.com/products/player_census/npd/ (last visited Apr. 4, 2008).

13 The loss of functionality is in fact two-fold. Windows Edition N not only lacks a media player application that can be run as a standalone application to enjoy DVDs, music, and video, but it also lacks the platform functionality that integrates the WMP code into other applications and Internet resources. The operation of these other programs, designed to utilize the media resources of a "fully-functional" Windows environment, is accordingly impaired until the user downloads the media player and restores the missing code. Microsoft raised this argument before the Court (Judgment, *supra* note 1, at 1109-22). The Court rejected it, stating that the functionality offered to software developers and Internet site creators "cannot suffice to offset" the anticompetitive harm caused (Judgment, *supra* note 1, at 1151-52, 1158).

14 *See, e.g.*, Windows N Fact Sheet, *supra* note 6 ("virtually no demand from PC manufacturers. . . Original equipment manufacturers (OEMs) stated clearly that they were not interested in installing and selling computers with a less than fully functional version of Windows XP"). *See also* Ingrid Marson, *Still 'no demand' for media-player-free Windows*, CNET News, Nov. 18, 2005, *at*

footnote 14 cont'd on next page

The Windows N remedy does not look much better in theory than it does in practice. In order to prove a violation of Article 82, the Commission is required to show:

(a) market dominance;

(b) an exclusionary or an exploitative abuse by the dominant firm; and

(c) that the behavior is not objectively justified as a proportionate measure toward a legitimate purpose.[15]

The Commission applied its own four-factor test—a test now approved by the Court—for product tying, as if product tying were a special and unique type of antitrust violation with its own independent rationale. The Commission's test required that, for a violation to be found, there be:

(a) two separate products;

(b) an undertaking dominant in the market for one product;

(c) no choice for the consumer to obtain that product without also obtaining something else; and

(d) foreclosure of competition.

Finally, an objective-justification test would be applied.

Under EC law, tying can be a violation of Article 82 due to either an exploitative or an exclusionary abuse.[16] The Commission's test creates a hybrid inquiry that is partly about exploitation and partly about exclusion. This mix and match analysis is reflected in the remedy. An exploitative abuse could result from requiring consumers to purchase a tied product (or to assume "supplementary obligations" as described in Article 82(d)[17]). An exclusionary abuse could be

footnote 14 cont'd

http://www.news.com/Still-no-demand-for-media-player-free-Windows/2100-1016_3-5960750.html (last visited Apr. 1, 2008) (noting the "continuing reluctance of PC vendors to sell Windows XP N"); and Paul Meller, *Microsoft Opens Appeal In Europe*, N.Y. Times, Apr. 25, 2006 ("To date, not one order for XP edition N has been placed by PC manufacturers, Mr. [Jean-François] Bellis [of Van Bael and Bellis and Microsoft's lead lawyer] said, and 1,787 have been ordered by computer stores across Europe in the nine months since it went on sale.").

15 *See* Case C-85/76, Hoffman-LaRoche & Co. AG v. Commission, 1979 E.C.R. 461, at 91; Case C-27/76, United Brands Company & United Brands Continental BV v. Commission, 1978 E.C.R. 207, at 249-50 (exploitative abuses); and Case T-30/89, Hilti AG v. European Commission, 1991 E.C.R. II-1439 ("[The defendant corporation's] behaviour cannot therefore be described as being motivated solely by a concern to ensure the safety and reliability of its [products]"). *See generally* I. Van Bael & J.-F. Bellis, Competition Law of the European Community 903-05 & 907-08 (2005).

16 Van Bael & Bellis (2005), *id*. at 904.

17 *See*, *e.g.*, Napier Brown/British Sugar, 1988 O.J. (L 284) 41, at recital 71.

shown if competitors are foreclosed because abuse of dominance ensures that the purchase or use of competitors' products does not occur.[18] The third prong of the Commission's test requires that the consumer be given "no choice" in obtaining the tying product without the tied one. This is a test for exploitation, used to protect a consumer from being stuck with a "supplementary obligation" that he does not want.

The competitive harm alleged by the Commission, however, was exclusionary, not exploitative. The theory was that Microsoft had ensured that each consumer was already equipped with WMP, reducing consumers' need to look at the range of players and decide which best suited their needs.[19] This was said to have resulted in the exclusion of other media player manufacturers.[20] Having applied a hybrid test that sits between the two types of Article 82 abuse in finding a violation, the Commission concluded that the introduction of "customer choice" would address the violation found.

A mismatched liability inquiry thus produced an ineffective remedy. The Commission's remedy—giving customers a choice about whether or not to accept WMP by marketing a version without it—was meaningless as far as Microsoft's alleged exclusion was concerned. The issue was that customers could (and did) get WMP so much more easily than competing products, not that they had to use the program. The CFI ended up endorsing a remedy aimed at a nonexistent harm.[21]

So what can be said for Windows N? To be sure, it did not impose price regulation or otherwise intrude on Microsoft's business model, which the CFI rightly celebrated.[22] The condemnation of Microsoft's bundling may be pleasing to those who simply dislike Microsoft and enjoy seeing it condemned and put to expense. The result may likewise please observers of a populist or anti-American bent. Conversely and perversely, the seeming futility of the remedy will bring glee to the hearts of those who do not believe in the value of antitrust enforcement generally, or Article 82 enforcement in particular. But none of these observations is a worthy reaction to the CFI decision. It is wrong to say that the Court's or Commission's decisions were based on nationality or politics (indeed,

18 *See*, *e.g.*, Case C-53/92P, Hilti AG v. European Commission, 1994 E.C.R. I-667.

19 *See* Judgment, *supra* note 1, at 1041-42.

20 *Id.* at 1090.

21 The CFI completes the circle of confusion by stating that "the Commission's sole intention is to make it possible for consumers to obtain Windows without Windows Media Player" (*id.* at 1225). Its earlier findings about harm to competing media player companies have, by this stage of the long judgment, apparently fallen by the wayside altogether.

22 *Id.* at 1223.

many of the complainants were U.S. companies). Rather, the decision reflects a good-faith conviction that Article 82 technology tying enforcement can work as a practical matter to protect competition and promote innovation in markets adjacent to that in which an undertaking has lawfully achieved a dominant position. That is the proposition that merits discussion.

THE DECISION REFLECTS A GOOD-FAITH CONVICTION THAT ARTICLE 82 TECHNOLOGY TYING ENFORCEMENT CAN WORK AS A PRACTICAL MATTER TO PROTECT COMPETITION AND PROMOTE INNOVATION IN MARKETS ADJACENT TO THAT IN WHICH AN UNDERTAKING HAS LAWFULLY ACHIEVED A DOMINANT POSITION. THAT IS THE PROPOSITION THAT MERITS DISCUSSION.

III. Possible Alternative Remedies

Can the enterprise of technological tying enforcement be defended on the ground that, although this particular remedy was flawed, better ones might be available? That does not appear to be the case. Assuming that the bundling of WMP with Windows constituted an unlawful product tie (on the ground that Microsoft's dominance on the market for operating systems enabled it to bundle its own media software with each copy of Windows, and so obtain an unfair advantage in the media-player market), three alternative remedies might have been pursued.

A. HARD UNBUNDLING

One remedy could have required that Microsoft stop selling WMP as a bundle with Windows altogether, on the ground that offering the bundle at all constituted unfair leverage of its unquestioned dominance in the operating system market and so automatically excluded other media player competitors. A strong variant of this remedy might include a breakup of Microsoft into operating system and application companies.[23]

Imposing a remedy like this, however, would have defied the logic of many of the most significant developments in the computer industry since its inception. Advances in computing have always been, in great measure, about making one thing—one device, one operating system, one application—perform several different functions. The path from abacus to handheld is a story of increasingly integrated functionality: convenience and efficiency remain the goals of innovation.

The computer and technology trade press makes a conspicuous virtue of technological integration. As one analyst puts it: "[T]he endgame is that users should

23 As many know, district court Judge Thomas Penfield Jackson imposed a breakup remedy in the DOJ case. EC Competition Commissioner Neelie Kroes also hinted at such a remedy at the 2007 Spring ABA Antitrust Section meetings.

end up with more integrated functionality at a lower price."[24] Whether companies are building multiple functions into email management software,[25] integrating baseband and radio frequency capacity into a single chip in cellular telephone manufacture,[26] or designing competitive wireless network technology,[27] integration is a key ambition and a driving objective.

Accessibility is also a priority. Graphical user interfaces become cleaner, simpler, and more helpful with time, and the effort and understanding that machines demand of the average user diminishes with each step. To task consumers of an operating system with finding and downloading separate applications in order to access central functions is counter to both innovation trends and common sense.

To promote such a remedy as applicable outside the unique circumstances of *Microsoft* would chill activity that has been seen previously as laudable technological innovation. As soon as any dominant company added an additional level of functionality to its product, that function would have to be "spun-off" (i.e., unbundled and set up as a separate program) to avoid allegations of leveraging its dominant position to the unlawful disadvantage of competitors in the market for the new function. Customers would be required to purchase, and companies required to package and market, an array of separate, narrowly functional individual programs in order to assemble anything as useful as a standard PC.[28] No one really wants a world in which this happens except owners of companies producing unbundled accessories.[29]

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24 Matt Hines, *IT Security and Management on Collision Course,* InfoWorld Daily News, Oct. 18, 2007 (*quoting* Neil McDonald, technology analyst).

25 *See, generally*, Robert F. Smallwood, *The Fast-Moving Email Management Market*, KM World, May 2007, at 12.

26 *See, generally*, Gregory Quirk, *IC Keeps Phone Costs Ultralow*, Electronic Engineering Times, Dec. 4, 2006, at S72.

27 Joni Morse, *Wi-Fi Deployments Stretch Across Cities, Countries, Corporations*, RCR Wireless News, Feb. 27, 2006, at 12 ("In order to be successful, branch and retail WLAN solution must deliver … wide-ranging integrated functionality for security and voice…").

28 This is particularly true given the Court's loose, demand-based definition of what constitutes a "separate product". *See* Judgment, *supra* note 1, at 917-44.

29 As the U.S. Court of Appeals for the DC Circuit noted in United States v. Microsoft Corporation, 253 F.3d 34, 88 (D.C. Cir. 2001) [hereinafter *Microsoft III*]:

> [I]f there were no efficiencies from a tie (including economizing on consumer transaction costs such as the time and effort involved in choice), we would expect distinct consumer demand for each individual component of every good. In a competitive market with zero transaction costs, the computers on which this opinion was written would only be sold piecemeal-keyboard, monitor, mouse, central processing unit, disk drive, and memory all sold in separate transactions and likely by different manufacturers.

B. MUST-CARRY

The Court might have required that Microsoft bundle its competitors' products into the Windows operating system along with its own. Just as WMP received a free ride onto new computers, so could the applications made by everyone else. What if, as part of the Windows installation process, customers could select which media player they want to install from a menu of options?

The problem with this remedy lies in its administration. Every media player would clamor to be included in the menu on the Windows installation CD. There would be no obvious way for Microsoft or a court to decide whose claim should be granted and whose should be denied. At a minimum, this remedy would generate ongoing controversy and burden. Microsoft could justly complain that its own product would suffer damage to its reputation from the inevitable consumer complaints generated by this more cumbersome installation procedure, or by the potentially inferior products customers might choose to install.

The must-carry approach was in fact one of the options discussed for settlement of the case, but rejected by the Commission.[30] As a settlement on agreed terms between Microsoft and the Commission, this might have been a workable compromise. But as a precedent for all dominant technology firms, it would be alarming. As a judicially imposed remedy, it would be unworkable. Judicially imposed forced dealing on this scale seems unlikely to succeed.[31]

C. PRICE REGULATION

A third option would be to do with conviction what the actual remedy did half-heartedly:

(i) require the marketing of the unbundled product;

(ii) permit the marketing of the bundle; and

(iii) ensure that there is a meaningful price gap between the two.

Consumers could choose a more expensive product with WMP included, or a cheaper one without. The difficulty with such an arrangement is that it runs counter to the whole notion of competition law as principled enforcement rather than price regulation. Setting prices is not a task that either the Commission or CFI is well-suited to perform. And, it seems bizarrely artificial given that WMP is also available to download for free, as are competing media playback or Internet-streaming products like the Apple iTunes store and Adobe Flash Player.

30 *Europe Takes On Windows*, N.Y. Times, Mar. 20, 2004.

31 Forced dealing may in fact be a practical result of the decisions, that is developers of successful secondary products may find it easier to demand that dominant companies buy them rather than compete with them and risk antitrust complaints.

Moreover, even if this solution could work for a single accessory, a serious attempt to apply it over time would lead to an impractical array of mixed or mismatched options that consumers are unlikely to desire. [32]

This review of the options suggests that there is no serious bundling remedy that would be workable on the facts of EC *Microsoft* without doing violence to other important values or creating an administrative nightmare. Certainly the remedy imposed by the Commission fixed nothing and did not help consumers, though it no doubt did a little harm to Microsoft. Yet the CFI concluded that Microsoft acted unlawfully. Was this finding of a violation with no apparently workable remedy correct as a legal or policy result? As a matter of policy, at least, it would be desirable to "begin with the end in mind".[33] That is, without good confidence that an available remedy will work in practice, government intervention should not be undertaken in the first place.

IV. A More Modest Proposal

How should the facts in EC *Microsoft* be reviewed for abuse of dominance? It is clear that WMP was competing with other media players. It is also clear that WMP had an advantage with respect to its competitors in that market because it came ready-installed as part of every copy of Windows. As a result, consumers were more likely to use WMP in place of a competing product simply because they already had the Microsoft product, rather than because it was better or more efficient. This is true even though it would have been relatively easy to download or purchase any number of competing media players.

The problem with holding this to be abusive is that Microsoft, in bundling its media player, was doing exactly what software companies are supposed to do: develop their products to do more things. It cannot make sense to assign antitrust authorities the task of weighing the merits of competing technologies to determine whether product development is "abusive" if the best remedy that can result looks like Windows N or its alternatives.

Why go down this path? Article 82 recognizes the possibility that a prima facie abuse of dominance may be objectively justified by reference to a pro-competitive purpose. There can be few pro-competitive purposes clearer or more compelling than the legitimate development and innovation of software products in line with industrial practice. This objective-justification test provides an appro-

32 From this point, Microsoft might fairly argue that more serious imposition of the vision underlying Windows N would lead to a hodgepodge of different versions of Windows, destroying Microsoft's business model of providing a uniform Windows product as a platform for other applications. That is, perhaps only Windows N's market failure allowed the court fairly to say Windows N was minimally intrusive on Microsoft's business model.

33 *See* Stephen R. Covey, Seven Habits of Highly Effective People 95 (1989).

priate ground on which the CFI might have recognized the special nature of the software industry and declined to interfere with Microsoft's product development.[34] Instead, the CFI found itself approving a remedy without a clear objective in sight, leading it to demand that Microsoft market a product it did not want to sell to consumers who did not want to buy it. Predictably, this was all to no discernible effect on competition.

Microsoft made this argument before the Court, although it is not prominently treated in the judgment and the Court does not address it distinctly. The judgment records Microsoft's submissions that "[c]onsumers expect that Windows will be continually improved" and that:

> "[T]he main justification for its conduct is that the integration of new functionality into operating systems in response to technological advances and changes in consumer demand is a core element of competition in the operating system business and has served the industry well for more than 20 years."[35]

That is exactly the point. Integrated functionality is the central feature of the industry in which Microsoft operates. If this feature of the market is not capable of constituting an objective justification for its integration of a media player, it is hard to see what might be.[36]

A better approach in the face of the remedial problem in this area would be for the CFI to recognize the objective justification unless it is clear that *no* inno-

34 In doing so, they would have aligned the EC treatment of this issue with that of the U.S. courts in the American counterpart of this case. In *Microsoft III*, the DC Circuit replaced a rule of per se illegality in software bundling cases with a more flexible and fact-sensitive "rule of reason" analysis that weighed competitive harm against gained efficiencies. *See* United States v. Microsoft Corp., 87 F.Supp.2d 30 (D.D.C. 2000, *rev'd in part*, 253 F.3d 34 (D.C. Cir. 2001)). The clarity with which the DC Circuit indicated the difficulty of showing that adding product features would constitute an antitrust "tying" violation led the DOJ to drop its tying claim.

35 Judgment, *supra* note 1, at paras. 1106 & 1108.

36 There was a complicating factor in the analysis—evidence that senior executives at Microsoft had their eye on more than just improving Windows. In particular, the Court refers to an email between Microsoft executives indicating a plan to attack the position of the media company, RealNetworks, on the media player market by harnessing the power of the entire Windows brand (*id.* at paras. 911 & 937). That looks like an *intentional* exclusionary abuse of dominance. Still, in every case of healthy software development, there will be an awareness and hope that competitors will suffer from the success of the integrated product. Intent evidence of this type would appear to preclude the requisite showing of legitimate purpose required to make out an objective justification defense in EC law. *See, e.g.*, *supra* note 15.

vation or improvement was accomplished by the product design under attack.[37] Only in the rare case where this is clear will a competition agency have much confidence that its intervention will produce positive effects. Otherwise, the decision will inevitably be made on the basis of competing expert technical testimony, consumer satisfaction surveys, and the like. An ex post analysis based on such amorphous criteria cannot provide useful guidance for businesses engaged in real-world competition. As an academic matter, this less-ambitious approach to technology product design claims would leave the possibility that the value of the innovation might be outweighed by the harm of exclusion. The problem is that answering this question in the real world is not a task for which competition law officials and judges are well-suited.[38] Assigning them this task cannot make sense if practical remedies are lacking.

A better approach in the face of the remedial problem in this area would be for the CFI to recognize the objective justification unless it is clear that no innovation or improvement was accomplished by the product design under attack.

V. Conclusion

Is the EC *Microsoft* bundling decision really so bad? Certainly the Commission and the opinion should be celebrated for avoiding hands-on price regulation. Perhaps the case will be limited to Microsoft Corporation alone as its proponents have suggested. For all the controversy, we are unlikely to see—for several years at least—another undertaking in Microsoft's unique position, let alone one subject to the same kind of transatlantic litigation. In retrospect, the story of Edition N will speak for itself. In that way, Edition N may still contribute to the debate and sound development of competition law, if not to the welfare of software users. It can best do so by telling the Commission and the CFI that the potentially mischievous doctrine of technological tying by product design should be carefully circumscribed.

37 Employing a test such as this would be consistent with the test for exclusionary conduct advocated by the DOJ in a number of cases including *Microsoft III*-asking whether the practice at issue makes economic sense but for the exclusion of competition. While the application of such a test is not without difficulty, it would put the analysis of exclusionary conduct on a more predictable, realistic, and objective footing than the open-ended evaluation of technical merits and consumer preference risked by the analysis in EC *Microsoft*.

38 *See*, *e.g.*, Judgment, *supra* note 1, at paras. 1050, 1078, 1080, 1084, *et seq.*, where the Court finds itself choosing among, and drawing legal distinctions from, competing consumer surveys and market statistics.

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Tying after *Microsoft*: One Step Forward and Two Steps Back?

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Tying after *Microsoft*: One Step Forward and Two Steps Back?

Kelyn Bacon

In the tying part of the *Microsoft* case, as in the interoperability part of the case, the CFI upheld the Commission's Decision. But it did so on grounds that were confused and inconsistent. For all of the central elements of the case, the CFI appears to have been unable or unwilling to set out a clear statement of principle and apply it properly to the facts. The judgment also sets the CFI in direct conflict with the more economic approach being developed by the Commission in its assessment of Article 82 cases. The only clear signal provided by the CFI in this case is that it will not engage in a reform of Article 82 policy. Fortunately, this does not prevent the Commission from doing so; indeed, the legal uncertainty resulting from this judgment makes clear guidance from the Commission all the more imperative.

The author is a barrister at Brick Court Chambers, London, and in the CFI proceedings represented the Association for Competitive Technology, intervening in support of Microsoft. She is grateful for the helpful comments of Christian Ahlborn (Linklaters) on an earlier draft.

I. Introduction

The second part of the *Microsoft* judgment addresses the integration of Microsoft's media player ("Windows Media Player" or "WMP") with the Windows operating system. WMP had been integrated into Windows since the early 1990s; then in 1999, when Windows 98 Second Edition was released, Microsoft added streaming functionality to WMP, enabling the playback of an audio or video file while it is being downloaded. Microsoft continued to distribute all successive versions of Windows with WMP installed as an integral component of Windows. In its Decision,[1] the Commission considered that the integration of a streaming media player into the Windows operating system constituted an abuse of Microsoft's dominant position in the supply of PC operating systems, by tying two separate products contrary to Article 82 of the EC Treaty. This abuse contributed to the EUR 497 million fine imposed on Microsoft. In addition, the Commission required Microsoft to offer a WMP-less version of Windows, which the Commission later agreed should be called "Windows XP N".

In its appeal to the Court of First Instance (CFI), Microsoft argued that the integration of WMP into Windows simply was not, either conceptually or legally, a tie. Moreover, even if there was (quod non) a tie, the Commission had not sufficiently demonstrated that it had produced any anticompetitive effects by foreclosing competitors. The CFI rejected those arguments and upheld the decision.[2] Microsoft has decided not to appeal the judgment.

This article will discuss the central parts of the Commission's Decision and the CFI's judgment, before analyzing the implications of the judgment from a Community competition policy perspective.

II. The Commission's Decision

Unlike the interoperability part of the Decision, in relation to which the Commission's investigation was initiated following a complaint by Sun Microsystems, the Commission's investigation into WMP was launched on its own initiative.[3] The Commission admitted, however, that the situation did not fit within the model of a "classical tying case".[4] This led to some uncertainty as to the precise legal basis for the Commission's claims. Thus, in its second

1 Commission Decision 2007/53/EC of 24 May 2004, Case COMP/C-3/37.792 — Microsoft, 2007 O.J. (L 32) 23 [hereinafter Decision].

2 Case T-201/04, Microsoft v. Commission (not yet reported) (judgment of Sep. 17, 2007) [hereinafter Judgment].

3 Judgment, *supra* note 2, at para. 10.

4 Decision, *supra* note 1, at para. 841.

Statement of Objections (SO), the Commission had relied on claims that the integration of WMP infringed Article 82(b) and (d). But in the Decision, the Article 82(b) claim was dropped, and the Commission only nominally pursued a claim based on Article 82(d).[5] Rather, its case was primarily based on a general application of Article 82 and the case law (in particular, the *Hilti* and *Tetra Pak II* cases[6]), from which the Commission derived the following test:

> "Tying prohibited under Article 82 of the Treaty requires the presence of the following elements: (i) the tying and tied goods are two separate products; (ii) the undertaking concerned is dominant in the tying product market; (iii) the undertaking concerned does not give customers a choice to obtain the tying product without the tied product; and (iv) tying forecloses competition."[7]

That test was, the Commission considered, satisfied by the integration of WMP into Windows.

First, according to the Commission, WMP was a separate product from the Windows operating system itself, since media players are available separately on the market. Consumers can and do obtain other media players such as RealPlayer and QuickTime, as well as WMP itself and WMP upgrades, by downloading them from the Internet. The fact that many consumers expect their PC to include a streaming media player does not, the Commission held, make the two an integrated product for the purpose of the tying test.[8]

Since Microsoft had admitted that it was dominant in the supply of PC operating systems, the second condition was also satisfied.[9]

The third condition was also considered to be satisfied since Windows was distributed with WMP pre-installed. Inevitably, therefore, customers did not have a choice to obtain Windows without WMP. The Commission noted that con-

5 The Decision (*id.* at para. 792) articulates this as a basis; but, there was no claim in the decision that the integration of WMP forced Windows customers to accept "supplementary obligations", nor any suggestion that such obligations would have been inconsistent with "commercial usage".

6 Case C-53/92 P, Hilti v. Commission, 1994 E.C.R. I-667 and Case C-333/94 P, Tetra Pak v. Commission, 1996 E.C.R. I-5951.

7 Decision, *supra* note 1, at para. 794.

8 *Id.* at paras. 800-13.

9 *Id.* at 429 & 799.

sumers were not forced either to "purchase" or to "use" WMP, but regarded this as irrelevant.[10]

Finally, the Commission set out a detailed theory of foreclosure, based on the ubiquity of WMP on PCs worldwide as a result of its integration with the Windows operating system.[11] It claimed that distributors of other media players could not replicate this ubiquity by concluding installation agreements with original equipment manufacturers (OEMs), by offering their media players for download on the internet, or by bundling media players with other software. That in turn would be likely to encourage software developers and content providers to give priority to WMP over other media players, which would create network effects leading to the foreclosure of Microsoft's competitors and the creation of barriers to entry for new products.

On that basis, the Commission concluded that Microsoft had infringed Article 82 by the integration of WMP with Windows.

III. The CFI's Judgment

The Court upheld the Commission's case on the tying of WMP. Starting with the tying test itself, the judgment endorsed the four-stage test proposed by the Commission, with two qualifications. The first was the addition of the condition that there must be no objective justification for the conduct in question.[12] The second was a reformulation of the Commission's customer choice test (no choice to obtain the tying product without the tied product) as an orthodox test requiring the imposition of "supplementary obligations" or coercion within Article 82(d),[13] a claim that the Commission had conspicuously eschewed in its Decision.

Applying that test to the facts of the case, the Court confirmed that WMP was to be regarded as a separate product from the Windows operating system, essentially for the reasons given by the Commission in its Decision.[14] The judgment went on to find that the pre-installation of WMP could be regarded as both coercion and the imposition of "supplementary obligations", on the basis that consumers were unable to acquire the Windows operating system without simultaneously acquiring WMP, and that it was not technically possible to uninstall WMP.[15]

10 *Id.* at paras. 826-34.

11 *Id.* at paras. 835 *et seq.*

12 Judgment, *supra* note 2, at para. 869.

13 *Id.* at paras. 864-65.

14 *Id.* at paras. 912-44.

15 *Id.* at paras. 960-75.

On the issue of foreclosure, the Court confirmed that while neither Article 82 as a whole nor Article 82(d) specifically made any reference to a requirement to demonstrate the anticompetitive effect of bundling, "the fact remains that, in principle, conduct will be regarded as abusive only if it is capable of restricting competition."[16] The Commission was therefore correct to examine in detail the extent to which the integration of WMP did foreclose competitors. In its application of that test, however, the Court again went considerably further than the Decision. It was sufficient, the Court concluded, that the Commission demonstrated that the ubiquity of WMP resulting from its distribution with Windows could not be counterbalanced by other methods of distributing media players. That allowed Microsoft to obtain "an unparalleled advantage with respect to the distribution of its product and to ensure the ubiquity of Windows Media Player on client PCs throughout the world."[17] In turn, that provided a disincentive for users to make use of third-party media players and for OEMs to pre-install such players on client PCs. This, the Court said, "inevitably had significant consequences for the structure of competition."[18] Nevertheless, the judgment went on to endorse the other elements of the Commission's analysis of foreclosure in any event, concluding that the Commission had sufficient grounds to state that there was a "reasonable likelihood that tying Windows and Windows Media Player would lead to a lessening of competition so that the maintenance of an effective competitive structure would not be ensured in the foreseeable future."[19] This conclusion was not, according to the CFI, invalidated by the fact that, several years after the beginning of the abuse, a number of third-party media players were still present on the market.[20] Nor were the anticompetitive effects of the tying objectively justified by the beneficial effects of the uniform presence of media functionality in Windows, such as the provision of a stable platform for software developers and web designers.[21]

IV. Analysis

The analysis that follows considers in turn each of the central planks of the Court's judgment on tying: the separate products test, the coercion test, and the foreclosure requirement. It will show that, on each of these issues, the approach

16 *Id.* at para. 867.

17 *Id.* at para. 1054.

18 *Id.*

19 *Id.* at para. 1089.

20 *Id.*

21 *Id.* at para. 1151.

adopted by the Court is problematic and calls into question the rigor of its review of controversial decisions of the Commission.

A. THE SEPARATE PRODUCTS TEST

At a semantic level it is clear that unless products are separate, they cannot be "tied" to one another. This in itself, however, does not give any guidance as to when products should be regarded as "separate" for the purposes of assessing tying under Article 82. This question was one on which Microsoft and the Commission were fundamentally divided. It is disappointing that the Court addressed at length the factual matters in favor of the Commission's conclusion, without giving any principled answer to the prior question of why the Commission was, as a matter of law, correct in its test.

IT IS DISAPPOINTING THAT THE COURT ADDRESSED AT LENGTH THE FACTUAL MATTERS IN FAVOR OF THE COMMISSION'S CONCLUSION, WITHOUT GIVING ANY PRINCIPLED ANSWER TO THE PRIOR QUESTION OF WHY THE COMMISSION WAS, AS A MATTER OF LAW, CORRECT IN ITS TEST.

Both Microsoft and the Commission were in agreement that the distinctness of products for the purpose of a tying analysis under Article 82 EC had to be assessed by reference to customer demand. The parties disagreed, however, as to what was the relevant customer demand. The Commission took the position that the relevant question was the existence of independent demand for the tied product, in this case WMP or media players in general. By contrast, Microsoft argued that the relevant question in this case was rather whether there was demand for operating systems to be offered without media functionality. Put another way, Microsoft's proposed test was whether there was demand for the products to be "untied".

In order to determine which of the two interpretations is correct, it is necessary to consider the underlying rationale of the separate products test. That rationale has never been discussed in the tying cases which have come before the European Court. It has however, been considered by the U.S. courts, most pertinently in the *Microsoft III* judgment of the U.S. Court of Appeals for the DC Circuit.[22] There, the Court recognized that not all ties are detrimental, and that customers could benefit from tying (e.g., through lower distribution and transaction costs). The Court cited the integration of mathematical co-processors and memory into micro-processors chips, and the inclusion of spell checkers in word processors as examples from the computer industry.

Given that tying may have potentially positive as well as negative effects, the consumer demand test, in the judgment of the DC Circuit Court, is a "rough proxy for whether a tying arrangement may, on balance, be welfare enhancing" (i.e., whether the customer benefits from tying outweigh the customer restrictions):

22 United States v. Microsoft Corp., 253 F.3d 34, 346 (D.C. Cir 2001) [hereinafter *Microsoft III*].

> "In the abstract, of course, there is always direct separate demand for products: assuming choice is available at zero cost, consumers will prefer it to no choice. Only when the efficiencies from bundling are dominated by the benefits to choice for enough consumers, however, will we actually observe consumers making independent purchases. In other words, perceptible separate demand is inversely proportional to net efficiencies."[23]

This proxy is intuitively convincing. If, due to efficiencies, two components can be offered either at a lower price (e.g., as a result of economies of scale) or at better quality (e.g., due to integration), and the restrictions on customer choice are not severe (e.g., because bundling does not prevent the use of alternative components), then one would expect all, or almost all, consumers to buy the components as a bundle rather than separately. By contrast, if the efficiencies from bundling are limited and choice is valued highly, then a significant number of consumers can be expected to buy the components individually. This rationale indicates that the critical question is whether consumers only demand the alleged tying product as a bundle, or whether there is material separate demand for the components.

> THE CRITICAL QUESTION IS WHETHER CONSUMERS ONLY DEMAND THE ALLEGED TYING PRODUCT AS A BUNDLE, OR WHETHER THERE IS MATERIAL SEPARATE DEMAND FOR THE COMPONENTS.

In some circumstances, it is irrelevant whether the separate demand test is phrased in terms of the demand for the two products to be "untied", or simply framed in terms of the demand for the alleged tied product, since both questions lead to the same outcome. This is the case in a tie between consumables and primary products, and explains why the CFI in *Hilti* identified nail guns and nails as separate products on the basis that "there have been independent producers ... making nails intended for use in nail guns"[24]; hence, that there was an independent demand for the tied product, nails. If there is demand for nails produced by independent producers, it follows inexorably that there is also demand more generally for the two products to be "untied".

But the facts of the present case demonstrate that, in some cases, the two questions may have different answers. The particular characteristics of media players are that:

23 *Id*. at 383-84.

24 Case T-30/89, Hilti v. Commission, 1991 E.C.R. II-1439, at para. 67.

(a) they are typically made available for free;

(b) they are relatively easy to download;

(c) they require a minimal amount of memory on a PC; and

(d) they are imperfect substitutes both in terms of features as well as formats.

As a result of these features, many customers have installed and use more than one media player. This in turn means that while there is undoubtedly separate demand for media players themselves, that demand would still exist even if most or all customers wanted WMP to be bundled with Windows. In such a case, the separate products test only corresponds with its economic rationale (as a proxy for the net welfare effect of the arrangement) only if it is asked whether there is customer demand for the "untied" product. The Commission's version of the test, focusing only on the demand for the tied product, carries the risk of producing what scientists call a "false positive".

The CFI's analysis of the separate products test did not, in this author's view, deal adequately with these problems. The Court's starting point was the assertion that the Commission's test was supported by the *Tetra Pak* and *Hilti* cases.[25] But that begs the question, since the CFI did not address the central issue of whether those cases (which both involved ties of consumables) had comparable features to the present case.

The CFI's second argument was that Microsoft's argument "amounts to contending that complementary products cannot constitute separate products for the purposes of Article 82 EC, which is contrary to the Community case-law on bundling." In support, the Court commented that in *Hilti* it could be assumed that there was no demand for a nail gun magazine without nails, since a magazine without nails is useless, but that this did not prevent the European Court there from concluding that the two products belonged to separate markets.[26]

THE QUESTION OF WHETHER THERE IS DEMAND FOR A SPECIFIC PRODUCT TO BE MADE AVAILABLE IN "UNTIED" FORM DOES *NOT* LEAD TO THE RESULT THAT TWO COMPLEMENTARY PRODUCTS ARE INEVITABLY TO BE REGARDED AS A SINGLE PRODUCT.

Unfortunately this too misses the point. The question of whether there is demand for a specific product to be made available in "untied" form does *not* lead to the result that two complementary products are inevitably to be regarded as a single product. That is illustrated by the *Hilti* example given by the CFI itself; in that case, while users obviously

25 Judgment, *supra* note 2, at para. 920.

26 *Id.* at para. 921.

needed to obtain both cartridge strips and nails to use together in their nail guns, there was a demand for cartridge strips to be sold without the corresponding nails (i.e., for the two products to be "untied"). Thus, although the products were complementary, they were clearly separate products.[27] It cannot, however, be assumed that the same is true of Windows and WMP. Ultimately, it should have been a matter of evidence demonstrating the demand for Windows and WMP to be distributed separately rather than together. No such evidence was provided, since the Commission did not regard this as a relevant question.[28]

The Court's third and final argument on the test was a claim that in any event there was demand for client PC operating systems to be provided without streaming media players, for example by companies afraid that their staff might use them for non-work-related purposes, which the Court claimed was not disputed by Microsoft.[29] This is a surprisingly uncritical acceptance of a single-sentence assertion by the Commission in the Decision,[30] which Microsoft did *not* accept; on the contrary, it pointed out in its pleadings that the claim was simply conjecture on the part of the Commission, unsupported by any evidence whatsoever.

The comments of the Court represent little more than a recitation of the arguments of the Commission, with little or no critical analysis. They suggest that the Court was unable or unwilling to articulate a coherent rationale for its approach. That is unfortunate, and Microsoft (and other undertakings in a similar position) would be justified in expecting better. In an industry where product integration is the norm, and where there is increasing consumer demand for multifunctional equipment, the Court's judgment sets an uncertain precedent for undertakings seeking to satisfy that demand.

B. THE COERCION TEST

Having established that two products are properly to be regarded as separate, the central objection to a tie is that customers are coerced into purchasing the sec-

27 One can think of many similar examples: wine and wineglasses or a chocolate fountain and chocolate, to cite a few close to the heart of this author.

28 It follows that the CFI's comments that customers might wish to obtain the products together, but from different sources, were also pure speculation (Judgment, *supra* note 2, at paras. 922-23). Had the Commission asked the right question, it might conceivably have found that end users and OEMs wish to obtain Windows unbundled from WMP, in order that a different media player can be pre-installed (though this seems unlikely, given the negligible sales of Windows XP N). On the other hand, it might have found that the preponderant demand was for the products to be bundled, since it saves everyone the bother of installing WMP, which most users would end up downloading anyway. The point is, however, that the decision simply did not reach a conclusion on this issue one way or the other.

29 Judgment, *supra* note 2, at para. 924.

30 *See* Decision, *supra* note 1, at para. 807 & n. 936 which simply cites in support the fact that "Organisations routinely choose the applications they want installed on their desktops."

ond product from the dominant supplier of the first product, when they would prefer to obtain the second product elsewhere (or in some cases not at all). In the *Hilti* case, the producers of nail guns attempted to force users to purchase only their own branded nails and cartridges for use in the guns. In *Tetra Pak II*, the purchases of filling machines were not able to obtain supplies of packaging from any source other than Tetra Pak. In both cases, therefore, the tie was prohibited because of the coercion of the customers, forcing them to buy from Hilti and Tetra Pak certain consumables that they would or might have wanted to source from a competing supplier.

That objection is reflected in the U.S. tying standard applied in *Microsoft III*, referred to previously, which requires that "the defendant affords consumers no choice but to purchase the tied product from it."[31] This test is thus explicitly based on the notion of a forced purchase, and is central to the U.S. interpretation of the tying test. As the U.S. Supreme Court said in the seminal case of *Jefferson Parish*:

> "[T]he essential characteristic of an invalid tying arrangement lies in the seller's exploitation of its control over the tying product to force the buyer into the purchase of a tied product that the buyer did not want at all, or might have preferred to purchase elsewhere on different terms."[32]

In a similar vein, the U.S. Supreme Court in the earlier case of *Northern Pacific Railway* had defined a tying arrangement as:

> "an agreement by a party to sell one product but only on the condition that the buyer also purchases a different (or tied) product, or at least agrees that he will not purchase that product from any other supplier."[33]

According to the Court, such arrangements:

31 *Microsoft III*, *supra* note 22, at 381.

32 Jefferson Parish Hosp. Dist. v. Hyde, 466 U.S. 2 (1984).

33 Northern Pac. R. Co. v. United States, 356 U.S. 1, 518 (1958)

> "deny competitors free access to the market for the tied product, not because the party imposing the tying requirements has a better product or a lower price but because of his power or leverage in another market. At the same time buyers are forced to forego their free choice between competing products."[34]

The reasoning of the U.S. Court in these cases is consistent with the judgments in *Hilti* and *Tetra Pak*, the key feature being that the forced purchase of the product from the dominant undertaking deprives the customer of the choice to purchase elsewhere from a competing supplier.

By contrast, the Commission's different test of whether the dominant undertaking "does not give customers a choice to obtain the tying product without the tied product" (a definition subsequently repeated in the Commission's Article 82 discussion paper[35]) was entirely anodyne, containing no requirement of either a forced purchase or coercion of any sort. This test would be satisfied, for example, if WMP did not come pre-installed as part of Windows, but was simply provided with Windows in every case for the customer to install if desired.[36]

The CFI evidently recognized the problems with this approach, and noticeably did not apply the Commission's test. Instead, in its view, the test was indeed one of coercion or the imposition of supplementary obligations within the meaning of Article 82(d).[37] Therefore prima facie, its judgment realigns the tying test with the U.S. jurisprudence and the European Court's earlier case law and is consistent with the basic rationale of a tying prohibition.

The Court's application of this test to the facts of the case is, however, more questionable. As noted above, the CFI's ruling was that the test was satisfied by the fact that consumers buying a Windows operating system automatically obtained WMP, taken together with the fact that WMP could not technically be

34 *Id.*

35 The Commission's Article 82 discussion paper asserts: "Typically tying involves the dominant undertaking by contract depriving its customers of the choice to obtain the tying product without the tied product." *See* European Commission, DG Competition discussion paper on the application of Article 82 of the Treaty to exclusionary abuses (Dec. 2005) [hereinafter Article 82 discussion paper], at para. 182, *available at* http://ec.europa.eu/comm/competition/antitrust/art82/discpaper2005.pdf.

36 To take another example familiar to readers of British weekend newspapers, the inclusion with the newspaper of a free CD or DVD would also, on this definition, be regarded conceptually as a "tie".

37 *See,* in particular, Judgment, *supra* note 2, at paras. 961-63 & 975.

uninstalled. Both of these points are correct as a matter of fact. But for the CFI to draw from those facts the conclusion that customers were in some way coerced or required to accept supplementary obligations, in circumstances where the pre-installation of WMP constituted neither a forced purchase,[38] nor a forced use of the product, and did not prevent OEMs or end users from installing and using other media players in preference, is a triumph of form over substance. The Court's true assessment of the situation is betrayed by its comment, in the same part of the judgment, that "OEMs are deterred from pre-installing a second streaming media player on client PCs and ... consumers have an incentive to use Windows Media Player at the expense of competing media players."[39] The integration of WMP might well have acted as an OEM "deterrent" or a consumer "incentive", but neither effect should be regarded as coercion or the imposition of supplementary obligations.

> THE INTEGRATION OF WMP MIGHT WELL HAVE ACTED AS AN OEM "DETERRENT" OR A CONSUMER "INCENTIVE", BUT NEITHER EFFECT SHOULD BE REGARDED AS COERCION OR THE IMPOSITION OF SUPPLEMENTARY OBLIGATIONS.

It is difficult to avoid the conclusion that on this issue at least the CFI was (to invert the usual idiom) "willing to strike, but afraid to wound." The Court apparently wished to set a precedent underlining that the tie of two products is only to be regarded as abusive where the "supplementary obligations" condition of Article 82(d) is satisfied; at the same time, however, it seems to have been very careful not to overturn the decision on this point.

C. FORECLOSURE

In light of the increasing discussion, including within the Commission itself, as to the application of a more rigorous economic approach to the interpretation of Article 82,[40] it is encouraging that the Court has reiterated that conduct will only be regarded as abusive where it is capable of restricting competition, and appears to have endorsed the Commission's application of a foreclosure test which takes account of the "actual effects" that the conduct has had on the market.[41]

As with the coercion test, however, the difficulties lie in the Court's application of the test on the facts, for which the Court appears to have relied very heavily on a structural standard. It was sufficient, the CFI thought, that the

38 The suggestion (*id.* at para 968) that the price of WMP is included in the total price of the Windows operating system ignores the fact that the competitive price of WMP is zero, since both WMP and competing media players are widely available to download for free.

39 Judgment, *supra* note 2, at para. 971.

40 In particular in the context of the Article 82 discussion paper, *supra* note 35.

41 Judgment, *supra* note 2, at paras. 867-68.

Commission demonstrated that the integration of WMP "inevitably had significant consequences for the structure of competition," by allowing WMP to benefit from the ubiquity of Windows on PCs throughout the world.[42] According to the CFI, it was not necessary to go further and show that this did in fact result in the elimination or restriction of competition, as the Commission had done in its examination of the network effects said to result from Microsoft's conduct.

The CFI thus seems to be saying that the use by Microsoft of a particularly effective distribution system for its media player in itself constituted foreclosure, whether or not the evidence showed an overall reduction of competition on the media player market (e.g., by a reduction in the number of media players available or a trend towards exclusive use of WMP). Indeed, the Court expressly commented that it was common ground that the number of media players and the extent of the use of multiple players are continually increasing. But this did not, in the Court's view, demonstrate the absence of foreclosure.[43]

The Court's judgment on this issue gives rise to a number of questions. First, the ruling is at odds not only with the methodology of the Commission in its original decision, but also the approach adopted by the Commission in its Article 82 discussion paper. In the latter, the Commission emphasizes that the *Hoffmann-La Roche* definition of exclusionary abuse within Article 82 requires a "likely market distorting foreclosure effect" to be established. It goes on to say that:

> "By foreclosure is meant that actual or potential competitors are completely or partially denied profitable access to a market. ... Foreclosure is said to be market distorting if it likely hinders the maintenance of the degree of competition still existing in the market or the growth of that competition and thus have as a likely effect that prices will increase or remain at a supra-competitive level."[44]

Whatever Microsoft's criticisms of the Commission's own foreclosure assessment, it is clear that that assessment was designed to satisfy a test of foreclosure akin to the test articulated in the discussion paper. The judgment of the CFI, however, does not even purport to follow this approach. It is unclear where this leaves the Commission's Article 82 policy reform proposals, for which the eco-

42 *Id.* at para. 1054.

43 *Id.* at para. 1055.

44 Article 82 discussion paper, *supra* note 35, at para. 58.

nomic analysis of foreclosure proposed in the discussion paper was a central tenet. The legal formalism of the CFI's approach in this case in respect of Article 82 is also inconsistent with the European Court's own emphasis on a more economic approach to the assessment of anticompetitive effects in the fields of Article 81 and merger control,[45] prompting the question of why Article 82 should be treated differently.

From a purely practical perspective, the CFI's judgment is also likely to create real problems for dominant undertakings. Many such undertakings will benefit from particular advantages which may make their products or services particularly attractive to, or more likely to be used by, consumers. That in itself should not imply foreclosure. Rather, the real question should be whether the use (or abuse) of those advantages leads in concrete terms to a lessening of competition on the market. For those advising undertakings in this situation following *Microsoft*, there is no longer merely the (already difficult) question of considering whether their competitive conduct falls the right side of the line; rather, there is a real question of what the line even looks like.

V. Concluding Remarks

Some critics of the *Microsoft* judgment have pointed in mitigation to the unusual facts of the case and the constitution of the Court delivering the judgment. Not many dominant undertakings, it is said, enjoy the ubiquity of the Windows operating system and the competitive advantages that entails. Moreover, it is pointed out, one cannot expect ground-breaking judgments from a Grand Chamber of 13 judges from very different legal traditions. In this author's view, neither of these factors is a good excuse. The size, strength, and market power of an undertaking are all relevant factors in the economic assessment of an alleged infringement of Article 82; however, they should not lead to the adoption of a different or lower threshold for the establishment of such an infringement. And if the Grand Chamber of the CFI is unable to deliver a coherent and principled judgment in an important case, serious doubts must be raised as to the usefulness of such a constitution.

THE *MICROSOFT* RULING SHOULD BE SEEN FOR WHAT IT IS: A CLEAR SIGNAL THAT THE CFI IS ITSELF UNWILLING TO ACT AS A CATALYST FOR THE REFORM OF ARTICLE 82 POLICY.

The *Microsoft* ruling should therefore be seen, unexcused, for what it is: a clear signal that the CFI is itself unwilling to act as a catalyst for the reform of Article 82 policy. But that does not prevent reform from taking place, as it is doing,

45 *See, e.g.,* Case T-342/99, Airtours plc v. Commission, 2002 E.C.R. II-2585; Case C-12/03 P, Commission v. Tetra Laval, 2005 E.C.R. I-987; Case T-210/01, General Electric Company v. Commission, 2005 E.C.R. II-5575; Case T-328/03, O2 (Germany) v. Commission, 2006 E.C.R. II-1231; Case T-168/01, GlaxoSmithKline v. Commission (not yet reported) (judgment of Sep. 27, 2006).

through the Commission's own development of its policy in the prosecution of Article 82 cases. In that respect, there is as yet no sign that this judgment (or the equally controversial judgment of the ECJ in *British Airways* earlier last year[46]) has dissuaded the Commission from an economic analysis in its investigation of ongoing Article 82 cases. In fact, if anything, the *Microsoft* judgment demonstrates the need for an ongoing debate as to the direction of the Commission's enforcement policy in this area. It is to be hoped that the legal uncertainty resulting from the ruling will at least serve to reinvigorate that reform process.

46 Case C-95/04 P, British Airways v. Commission (not yet reported) (judgment of Mar. 15, 2007).

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Consumer Protection Policies, Economics, and Interactions with Competition Policy

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Consumer Protection Policies, Economics, and Interactions with Competition Policy

Paul A. Pautler

The Spring 2008 issue of *Competition Policy International* features four papers focusing on consumer protection policy.[1] The papers by Armstrong, Beales, Rubin, and Tesauro & Russo present a tour of the logical basis for consumer protection policy and a review of the recent legal rules in the European Union and Italy. There is no book (yet) on consumer protection economics, but this collection of papers would make a nice start for such a text, particularly with regard to the advertising regulation component of consumer protection. There are some topics that cut across the various papers. I will discuss three of those topics:

1) market-based incentives for firms to disclose information in markets;

2) the application of behavioral economics in consumer policy; and

3) the connections between consumer protection and competition policies at a practical level and at the more important conceptual level.

Before discussing these common elements, I provide a description of the papers.

1 *See A Symposium on Consumer Protection*, 4(1) COMPETITION POL'Y INT'L 83-222 (Spring 2008).

The author is Deputy Director for Consumer Protection in the Federal Trade Commission's Bureau of Economics. The views expressed are those of the author and do not necessarily represent the views of the Commission or any individual Commissioner. The author would like to thank Mike Baye and Pauline Ippolito for comments on a prior version of this paper.

I. The Four Papers

A. ARMSTRONG[2]

Armstrong's paper defies brief description. It is centered on fairly standard consumer protection issues, but it is packed with thought-provoking topics ranging from economic models of firm and consumer behavior (e.g., consumer search), to price distributions in markets for price information, to recent behavioral economics models of consumer and firm behavior. Armstrong diligently works to find connections between his main subject, consumer policy, and competition policy. As one can tell by reading his paper, the task is formidable. It can be done, but many of the linkages are at a conceptual level rather than at a practical enforcement level.

Armstrong provides food for thought about new avenues for consumer policy intervention. The most ingenious arguments flow from ideas about economic models of price searching and competition. There are instances where competition does not lead to good outcomes for all consumers. This includes environments where consumers are passive, where entry by new sellers does not reduce search costs, where consumers cannot handle quality variation, and so forth. Armstrong sprinkles behavioral economics literature throughout his tour of consumer policy issues. That literature relates to exercise gym memberships and credit card fees (e.g., do consumers systematically have overly optimistic beliefs?), shrouding of various characteristics, and small print disclosures (e.g., are consumers misled?). On the policy front, Armstrong discusses various mandated disclosures of pricing information and terms and conditions of sale in instances where sellers fail to disclose various aspects of the transaction. While Armstrong sees more room for policy intervention than either Rubin or Beales, he is not an ardent proponent of regulation in general, and he concludes with an admonition for more study and rigorous cost-benefit analysis prior to undertaking such interventions.

B. BEALES[3]

Beales presents a remarkably tight paper on consumer protection economics. He discusses the advent of the economics of information and much of the intellectual basis for current U.S. policy toward consumer protection in general and advertising regulation in particular. The main thrust of the paper, however, is to examine whether the blossoming behavioral economics literature provides substantial new ideas for applying consumer policy. Beales argues that at this point it does

2 Mark Armstrong, Interactions between Competition and Consumer Policies, 4(1) COMPETITION POL'Y INT'L 97-147 (Spring 2008) [hereinafter Armstrong].

3 Howard J. Beales, III, *Consumer Protection and Behavioral Economics: To BE or not to BE?*, 4(1) COMPETITION POL'Y INT'L 149-67 (Spring 2008) [hereinafter Beales].

not, and further, that many of the valuable innovations in that literature are already incorporated in consumer protection practice at the U.S. Federal Trade Commission (FTC) under the traditional economics of information paradigm. Beales provides at least five reasons for his skepticism regarding behavioral results:

1) in real markets money and time are at stake, while little is at stake in laboratory experiments;

2) the positive findings (at least with respect to endowment theory) may be artifacts of the experimental settings;

3) the biases are not found in many circumstances, in large part because it is the marginal consumer who drives market equilibria and such marginal consumers are not likely to be subject to the decision-making foibles;

4) consumers in real markets will learn; and

5) firms will respond to missing information and fill in gaps left by rivals.

C. RUBIN[4]

Rubin presents a discussion of advertising regulation and some history of that activity since the 1950s. He asks and answers the question: what is the best way to regulate commercial speech? Rubin's paper makes it clear that one must be very careful to consider the regulated firms' reactions to restrictions on their ability to converse with consumers, since they are the consumer's main source of information regarding products. If regulation causes them to provide less useful information, then consumers will be less well-informed. Policies designed to induce truth-telling can actually result in less truth being told. Clearly, if enough costs are imposed on an advertiser, at some point he will quit advertising. Much of Rubin's analysis focuses on the historical actions of the U.S. Food and Drug Administration (FDA) and compares them to that of the FTC. His view is that a generalist agency with an expertise in advertising (e.g., the FTC) does a better job of regulation than does the safety-focused, industry-specific agency with much less background in advertising regulation. One of the key reasons for the difference is the FTC's focus on both Type-I and Type-II decision errors in regulating advertising claims. The FTC knows that one can over-regulate and that over-regulation is not free to consumers. In addition, the FTC has learned from its previous mistakes (which Rubin makes an effort to point out). Rubin's analysis will surely not be well-received by those with a pro-regulatory bent, but he forces one to consider the costs of policies that might have seemed innocuous, but are not.

4 Paul H. Rubin, *Regulation of Information and Advertising*, 4(1) Competition Pol'y Int'l 169-92 (Spring 2008) [hereinafter Rubin].

D. TESAURO & RUSSO[5]

Tesauro & Russo describe the May 2005 EU Directive on unfair business-to-consumer commercial practices and its relationship to Italian consumer protection law and enforcement.[6] The Directive was intended to make EU markets more effective by fully harmonizing the rules and regulations affecting traders and consumers so they know and follow a common set of rules.[7] The authors discuss the Italian implementation of the rules; and some of the implementation receives criticism. Presumably all the Member States had some existing consumer protection laws that may have been more or less restrictive on traders than are the current rules.

The goal of the Directive is protection of the "average consumer", who is reasonably observant and circumspect in the circumstances of the transaction. This notion seems similar to the U.S. construct of a "consumer acting reasonably in the circumstances."[8] The EU law defines unfair practices broadly and then goes on to specifically discuss protection of the average consumer in any definable vulnerable group. The law discusses misleading advertising, misleading comparative advertising, aggressive practices (intimidation and coercion of various types that alters decisions or significantly restricts consumer choice), and 31 banned practices (23 of which are misleading and eight of which are aggressive). The banned practices include lying about price, product origin, and other product characteristics, claiming a product is free if it is not, bait and switch marketing, pyramid marketing schemes, switching languages from the one used to make the sales pitch, statements in adverts aimed directly at children, inducing false urgency by saying that offers are good for only a very limited time, claiming brand uniqueness that is false, requiring payment for unordered merchandise, and so forth.[9] Aggressive practices include threats, intimidation, persistence that coerces, exploiting known misfortunes of the consumer, etc. In each case to be actionable, the EU law requires that the practice alter consumers' decision-making.[10] The authors do not analyze each of the specific provisions in the lists, but they worry that the increase in legal certainty that derives from the lists may come at a cost. For exam-

5 Claudio Tesauro and Francesco Russo, *Unfair Commercial Practices and Misleading Comparative Advertising: An Analysis of the Harmonization of EU Legislation in View of the Italian Implementation of the Rules*, 4(1) Competition Pol'y Int'l 193-222 (Spring 2008) [hereinafter Tesauro & Russo].

6 Directive 2005/29/EC of the European Parliament and of the Council of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market, 2005 O.J. (L 149) 22.

7 Tesauro & Russo, *supra* note 5, at 211.

8 *See* M. Salinger, P. Ippolito & J. Schrag, *Economics at the FTC: Pharmaceutical Patent Dispute Settlements and Behavioral Economics*, 31 Rev. Indus. Org. 85-105, 97-104 (Sep. 2007) for an economist's view of a similar FTC unfairness law and how it works.

9 Tesauro & Russo, *supra* note 5, at 209-11.

10 This is similar to the notion of "materiality" in U.S. consumer law. If a claim is material, then it presumably can alter the consumer's decision.

ple, they worry that the specificity of the law may make enforcement less flexible in the future.[11] In addition, they worry about potential under-deterrence in the Italian application of the law by the Autorità. They are particularly concerned that firms may be able to violate the rules and obtain absolution simply by promising not to do it again.[12] Although that is a weak penalty, for minor, harmless infractions where the line of illegality is unclear, it is not obviously silly, so long as it does not devolve to lawlessness (no harm, no foul).

II. Issues Cutting Across the Various Papers

A. THE UNFOLDING PRINCIPLE

There are several issues that cut across many of the papers and one of the key arguments involves the ability of markets to reveal information. If unregulated markets do not provide information, then there is a better argument for aggressive consumer protection. Beales and Rubin rely fairly heavily on the principle that almost all information, including adverse information, about products and services will be revealed to consumers through the competitive process.[13] This idea has been dubbed the unfolding principle. The argument first put forward by Grossman (1981) is that in a world with homogeneous and skeptical consumers and competitor firms, rivalry will force firms to reveal even the bad aspects of their products.[14] All but the very worst will disclose, so long as consumers want the information and its provision is not too expensive. This is a great story, and it clearly works often, but it is not clear whether it works well all the time.

> THE ARGUMENT IS THAT IN A WORLD WITH HOMOGENEOUS AND SKEPTICAL CONSUMERS AND COMPETITOR FIRMS, RIVALRY WILL FORCE FIRMS TO REVEAL EVEN THE WORST ABOUT THEIR PRODUCTS. THIS IS A GREAT STORY, AND IT CLEARLY WORKS OFTEN, BUT IT IS NOT CLEAR WHETHER IT WORKS WELL ALL THE TIME.

Armstrong is less of a believer in the unfolding principle. He discusses Jin and Leslie's 2003 work where forced revelation of a credence characteristic (Los Angeles restaurant kitchen cleanliness ratings) resulted in benefits to consumers in the form of reduced illness.[15] Similarly, Mathios (2000) reviews some of the more recent refinements on the theory of unfolding and pro-

11 Tesauro & Russo, *supra* note 5, at 198, 211.

12 *Id.* at 219.

13 Beales, *supra* note 3, at 151-52 and Rubin, *supra* note 4, at 187-88.

14 S. Grossman, *The Informational Role of Warranties and Private Disclosure About Product Quality*, 24 J.L. & ECON. 461-83 (Dec. 1981).

15 G. Jin & P. Leslie, *The Effects of Information on Product Quality: Evidence from Restaurant Hygiene Grade Cards*, 118(2) Q.J. ECON. 409-51 (May 2003).

vides evidence on unfolding in the labeling for salad dressings before and after such labeling was mandated in the early 1990s.[16] Prior to the mandate, all low-fat salad dressings disclosed fat content, while the higher-fat dressings did not, even though there was substantial variation across the higher-fat dressings and disclosure was not costly. Market incentives were insufficient to induce disclosure of the information. As a result, gains were available from mandating information in markets for Los Angeles restaurants and salad dressings.[17]

B. APPLICATIONS OF BEHAVIORAL ECONOMICS TO POLICY

A second issue that cuts across the various papers is the relevance of behavioral economics for consumer policy. Beales and Armstrong devote substantial segments of their papers to describing the blossoming behavioral findings and discussing policy based on them. Behavioral economics alters the standard consumer optimization assumptions of traditional economic theory in various ways. The list of human decision-making foibles seen in economic psychology labs is vast.[18] Surely human consumers are not calculating machines, but it is easy enough to think that market incentives of rival sellers and the self-interested actions of imperfect humans in a market setting might combine to produce outcomes that would look remarkably like those that would be produced if consumers were calculators. Good outcomes occur mainly because profit-seeking suppliers try to outdo each other in providing what the marginal consumers in a market want. Beales makes this point well.

The question is whether these foibles uncovered in the lab are important in real-world markets. Furthermore, if not, why not, and if so, will learning solve the problem? That appears to be the current question regarding the application of behavioral theory to policy. What persistent problems do we see in market equilibrium following an opportunity to learn? Some studies find that learning occurs, and then forgetting occurs. Some studies find that lab outcomes do not appear in markets, while other results do seem robust to leaving the lab. Some

16 A. Mathios, *The Impact of Mandatory Disclosure Laws on Product Choices: An Analysis of the Salad Dressing Market*, 43(2) J.L. & Econ. 651-78 (Oct. 2000).

17 For additional examples, *see* P. Ippolito & A. Mathios, *The Regulation of Science-Based Claims in Advertising*, 13 J. Consumer Pol'y 413-45 (1990). They discuss research showing nearly complete unfolding for ready-to-eat cereals and butter and margarine, but substantially incomplete unfolding in frozen pizzas and cigarettes.

18 The list of factors that cause consumers to fail systematically to optimize includes emotional states, inattention, disinterest, inability to solve complex problems, myopia (present bias caused by imperfect discounting in time dimension), framing effects, anchors, over-optimism, overconfidence, endowment effects, lack of self-control, status quo bias, excessive risk aversion (overestimation of some risks—choosing too low an insurance deductible, and underestimation of others—ignoring small, distant risks that have a high cost if they occur), and projection bias (what happened to my friend will happen to me), to name a few. D. Kahneman, *Maps of Bounded Rationality: Psychology for Behavioral Economics*, 93(5) Am. Econ. Rev. 1449-75 (2003) describes human tendencies to revert to inexact intuition when problems are hard or decisions must be made quickly.

studies find that the lab techniques themselves likely drive many of the results. While the area is producing a wealth of new and interesting insights, much of it is still untested and it is not clear whether consumer experience and learning allows for reasonable outcomes in the unregulated markets where human behavioral foibles are most evident.[19]

Armstrong sees more room for useful application of behavioral results than does Beales. Armstrong focuses on one of the most interesting recent developments in the behavioral literature: models indicating that firms will not necessarily have individual incentives to disclose hidden attribute prices (add-ons) in equilibrium, even when doing so would be cheap and easy. One of those models does not appear to rely on any particular consumer decision-making foible for its result (where as many behavioral models do), but rather relies simply on firms' individual profit incentives in a setting where some consumers are sophisticated and some are naive.[20] If such results can be shown to apply generally to important markets, then perhaps more economists will convert to behavioralism.

MUCH OF BEHAVIORAL ECONOMICS THUS FAR HAS DEFINED MARKET FAILURES BASED ON THE INABILITY OF HUMAN CONSUMERS TO MAKE TIME-CONSISTENT, MAXIMIZING DECISIONS. THAT IS A USEFUL FIRST STEP IN THE PROCESS OF RATIONAL REGULATION. MORE WORK REMAINS.

The difference of opinion regarding application of behavioral insights to consumer policy may be a matter of the burden of proof. We all know that markets do not always work. If you think a market is failing to deliver a good outcome, you want to define the failure, obtain evidence that it is systematic and persistent, identify the lowest cost remedy for the failure, gather information indicating that the remedy will provide benefits in excess of its costs, and then pursue the remedy.[21] Much of behavioral economics thus far has defined market failures based on the inability of human consumers to make time-consistent, maximizing decisions. That is a useful first step in the process of rational regulation. More work remains.

19 The need to examine consumer behavior and market outcomes following a period of learning was the most obvious lesson from the FTC's April 20, 2007 Behavioral Economics Conference. For the agenda, some of the presentations, and a summary of the conference authored by Joe Mulholland, *see* Federal Trade Commission, Bureau of Economics, *at* http://www.ftc.gov/be/consumerbehavior/index.shtml. *See also* M. Salinger, P. Ippolito & J. Schrag, *Economics at the FTC: Pharmaceutical Patent Dispute Settlements and Behavioral Economics*, 31 REV. INDUS. ORG. 85-105, 97-104 (Sep. 2007).

20 *See* X. Gabaix & D. Laibson. *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets*, 121(2) Q.J. ECON. 505-40 (2006).

21 This list ignores the teachings of the economic theory of regulation that one cannot treat the regulator as a benign social planner. One would need to evaluate the outcome of the policy change to be sure that the results were welfare enhancing.

C. THE INTERACTION OF CONSUMER PROTECTION AND COMPETITION

Armstrong discusses various models that might have implications for both consumer protection and competition, but the interactions are difficult to characterize. A more concrete way to think about the interactions is to consider that there are two levels at which one can consider overlaps between competition and consumer protection: the practical day-to-day enforcement level, and the underlying conceptual level. The interaction differs at each level. At the enforcement level, there is interaction in a fairly narrow set of areas related to specific professions and regulated markets. At the underlying concepts level, there is substantial interaction, but it occurs slowly as new ideas and evidence drive case selection and enforcement. This latter interaction tends to affect policy design in the long run.

Although both consumer policy and competition policy have welfare maximization as a goal and both are based on an understanding of how markets operate, the conceptual basis for the policies (in economics) developed independently. Economics had a significant impact on the development of competition policies over the last century (the supply side of microeconomics), but until 1961 there was no economic basis for consumer policy beyond very simple notions of aggregate consumer reactions to prices (the demand side of microeconomics). Starting about that time, economists began to investigate the incentives of firms to provide information and respond to consumers and to regulators.

The two sides of any market almost always have some connection. For example, suppose the government initially banned health claims for foods. Firms' reaction to that state of affairs is to care little about health aspects of their products. Now suppose a change in regulatory strategy allows such truthful claims. Firms now have an incentive to tout their current brand's differences on health dimensions and to alter their products to be better on differentiable health dimensions. So the information environment affects both the supply of information and the supply of product characteristics to consumers. This happened in food production in the United States when the FDA altered its rules to allow more competition on health dimensions.[22] When the production of truthful health claims in a market was hindered, firms reacted in ways that made consumers worse off. This episode showed that the demand side and supply side of markets are clearly connected, but notice that this is not a competition-consumer connection; rather it is an information-supplier connection. Bad consumer policy can indeed adversely impact markets. Mark Armstrong's contribution recognizes more such areas of interaction between the demand side and the supply side of markets.

22 Firms altered their behavior to market healthier ready-to-eat cereals and better versions of fats and oils. A policy reversion at one point caused certain heart health claims to virtually disappear. Paul Rubin's paper in this issue recounts part of that story and more of the history of the health claims debate is provided in L. Froeb, D. Hosken & J. Pappalardo, *Economics Research at the FTC: Information, Retrospectives, and Retailing,* 25 REV. INDUS. ORG. 353-74, 355-60 (2004).

Competition policy typically focuses on the prices consumers pay, so in that sense it has always been about consumer protection; competition policy has centered on the ways that firm interactions in pricing and output affect consumers. The consumer protection "side" is less about prices and more about consumer information sets, specific marketing strategies of firms, legal rules and liability, firm's reactions to the legal rules, search behavior, and instances where the incentives of firms and the goals of consumers do not seem to align. The competition and consumer sides are not completely separable, but the overlap in the research has not been large.[23]

THE COMPETITION AND CONSUMER SIDES ARE NOT COMPLETELY SEPARABLE, BUT THE OVERLAP IN THE RESEARCH HAS NOT BEEN LARGE.

By way of analogy, consider the connection between vertical restraints issues in competition policy and horizontal competition issues. Are they related? Yes, but it is possible to specialize in one and see relatively little connection. A theorist who is currently working on vertical issues need not revisit her knowledge of horizontal market power issues very often to be sure she has not missed some important insights. They are, however, related. Vertical restraints could lead to horizontal market power in certain well-defined situations. That, in fact, may be about the only completely settled issue in the theories and policy on vertical control. (And in situations where horizontal markets are unconcentrated, vertical restraints are unlikely to have any deleterious impact.)

1. Interaction at the Enforcement Level: Occupational Regulation, Self-Regulation, and More

The situation is similar with competition and consumer protection policies. The clear overlap occurs in the analysis of issues in occupational regulation, self-regulation, standard-setting, and in some regulated industries. In the first two areas, there is an obvious tension between protecting consumers from hard-to-observe quality variation (e.g., via minimum quality standards) and a potential reduction in competition caused by such protection policies. The relevant literature here has to do with lemons markets, credible signals of quality, implicit collusion, restraints by licensing boards and similar bodies, and the theory of regulation.[24]

23 For a brief description of consumer protection as seen through the eyes of two economists, *see* L. Froeb & P. Pautler, *Consumer Protection*, *in* INTERNATIONAL ENCYCLOPEDIA FOR THE SOCIAL SCIENCES 102-03 (2nd ed. 2008). One FTC Commissioner has analogized the legal overlap of consumer protection and competition to the wings of a house. *See* T. Leary, *Competition Law and Consumer Protection Law: Two Wings of the Same House*, 72 ANTITRUST L.J. 1147-51 (2005). Other than being inanimate, the winged house is not a bad analogy. The wings are largely separate, but they meet in a central area that often involves some form of regulation or legal complication (e.g., occupational regulation, standard-setting organizations, regulated industries, etc). At a conceptual level, an understanding of markets is the foundation for the entire house, including each wing.

24 Armstrong discusses occupational regulation and restraints on advertising (*supra* note 2, at 117-18, 133-36 and n. 95, 96), as does Rubin (*supra* note 4, at 176-78).

Such trade-offs of additional consumer protections versus loss of competition and variety come up fairly frequently in enforcement and competition advocacy work at the FTC in connection with occupational regulation, real estate settlement services, real estate listing systems and brokerage services, mortgage disclosures, out-of-state wine distribution, and advertising restrictions by various professions. In many instances, incumbent supplier groups argue that restrictions on entry or marketing are needed to avoid various harms to consumers, such as avoiding alcohol sales to youths or protecting home buyers from exploitation. Surely some of the consumer protection arguments made in support of various restrictions on entry and marketing of products are legitimate, but just as surely many of the restrictions are overly broad and provide no net gains for consumers.[25]

In addition to entry restrictions, the FTC has undertaken a large number of related advocacy efforts aimed at reducing unnecessary restraints on truthful advertising by professional groups including optometrists and attorneys.[26] Unfortunately, despite at least 25 years of FTC efforts, some states still tightly constrain advertising and marketing efforts by attorneys and other professionals.[27]

Although the FTC often scrutinizes entry restrictions and overly broad restrictions on advertising, the agency also has a history of encouraging various forms of self-regulation by industry. This can occasionally raise competition tensions similar to those in the licensed professions, but typically the restraints imposed by the collective are narrowly tailored to address a particular legitimate concern and the restraints therefore are not likely to have a significant effect on competition within the collective. The self-regulatory approach is often fostered because it can be more flexible and adaptable than the likely alternative of direct regulation. The goals of such self-regulatory activity include reducing misleading advertising, minimizing the reach of advertising of alcoholic beverages to those less than 21 years of age; limiting advertising of violent material in movies, video games, and music to youths; encouraging compliance with marketing rules for funeral goods and services; and enhancing product compatibility in various stan-

25 M. Ohlhausen, *Identifying, Challenging, and Assigning Political Responsibility for State Regulation Restricting Competition,* 2(2) Competition Pol'y Int'l 151-60 (Autumn 2006) describes challenges to entry restraints in wine distribution and real estate. A recent U.S. submission to the OECD describes efforts by the FTC and U.S. Department of Justice (DOJ) to alter agent activities that deter innovative service offerings in real estate service provision. *See* Federal Trade Commission, The Interface between Consumer Protection and Competition Policies, U.S. submission to OECD discussing U.S. Real Estate Markets, Mortgage Financing, and Real Estate Settlement Services, OECD Global Forum on Competition (Feb. 21-22, 2008), January 2008 DAF/COMP/GF/WD (2008)19, *available at* http://www.oecd.org/dataoecd/18/4/39915760.pdf.

26 On optometry, *see* R. Bond, J. Kwoka, J. Phelan, & I. Whitten, Effects of Restrictions on Advertising and Commercial Practice in the Professions: The Case of Optometry, Bureau of Economics Staff Report, Federal Trade Commission, Washington, DC (Sep. 1980). For a recent attorney advertising comment, *see* Federal Trade Commission, Comments to the Louisiana State Bar Association regarding attorney advertising and solicitation (Aug. 14, 2007).

27 N. Koppel, *Objection! Funny Legal Ads Draw Censure*, Wall St. J., Feb. 7, 2008, at A-1, A-10.

dard-setting organizations, among others. In each case, the right balance between allowing useful self-regulation while avoiding adverse effects on competition in the self-regulating industry must be assessed.[28]

Appropriate consumer protection efforts to deter fraud and deception may benefit consumers by reducing noise in the information environment and increasing confidence in markets, but not all well-intended consumer protection efforts benefit competition. Such a case presented itself in connection with potential reform of real estate settlements in the United States. One piece of that reform was a requirement that mortgage brokers should disclose any compensation they received from lenders. The proposed disclosure would alert consumers (home buyers) to the fact that the brokers might not be acting solely in their interest. There are, however, two offsetting concerns. First, disclosing the broker's compensation might distract consumers from focusing on the bottom-line price that they would actually pay for the loan, which is the issue of ultimate concern. Second, this compensation disclosure would be required only for broker loans, the growing part of the market, but the same issues exist in loans provided directly by banks. Would the added, asymmetric, information improve or interfere with consumers' ability to make an informed decision in choosing mortgage loans? A consumer experiment to test the issue found that the compensation disclosure misdirected consumers' attention and led consumers to systematically choose loans that were more costly.[29] So the proposed mandated disclosure of compensation would likely mislead consumers (a consumer protection effect), but it could also reduce competition between the segments of the market for loan generation (a competition effect). Armstrong discusses a similar problem with "headline pricing" that could distract consumers from focusing on the more relevant totality of a transaction.[30]

A unique instance of consumer protection and competition interaction occurred in connection with a case of deception by a "copy-cat" seller of abdominal belts. The original hucksters claimed that you could achieve "six-pack abs"

28 For a description of the FTC's efforts to support many activities in the self-regulatory area, *see* FTC Chairman Deborah P. Majoras, Self-regulatory Organizations and the FTC, Speech before the Council of Better Business Bureaus (Apr. 11, 2005), *available at* http://www.ftc.gov/speeches/majoras/050411 selfregorgs.pdf. *See also* FTC General Counsel D. Valentine, Industry Self Regulation and Antitrust Enforcement: An Evolving Relationship, Speech at the Seminar on New Developments in Antitrust Policy, Herzlia, Israel (May 24, 1998), *available at* http://www.ftc.gov/speeches/other/dvisrael speech.shtm.

29 J. Lacko & J. Pappalardo, The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment, Bureau of Economics Staff Report, Federal Trade Commission, Washington, DC (Feb. 2004).

30 Armstrong, *supra* note 2, 110-12, 119-21, 141. One significant difference is that if consumers are misled via "headline pricing", that problem could be offset by rivals who choose to disclose more or run counter-advertising. In the mandated disclosure case, private firm incentives cannot readily fix the regulation-induced problem. In any event, the correct policy to solve the problem would have been a disclosure about broker incentives (and lender incentives), not a disclosure about their compensation level.

simply by wearing an electrified belt that stimulated your abdominal muscles. The claims were ubiquitous for a short time on TV, radio, and the Internet. The firms sold such devices for about $40. Not very surprisingly (to me, but apparently not to the buyers), the belts did not work. A new firm entered the market, made no explicit claims in its advertising (but showed pictures of people with nice tight stomachs similar to those shown in the ads by the original marketers), and cut the price to $10. Sales by the original hucksters plummeted as the entrant stole much of the business and forced price reductions by rivals. Competition works. Now consumers lost only $10 on each belt rather than $40, and the profit from running the fraud declined. In this case, competition affected the outcome for the better, albeit without really removing the fraud from the market. That task was left to the FTC, which ultimately sued all the marketers and the marketing of miracle-producing abdominal belts faded away.

Having discussed a few areas of competition and consumer protection overlap at the enforcement level, it should be noted that this is not the tip of a large iceberg; rather, it is almost all of the ice flow. In practice at the FTC, the two areas seldom meet outside of the competition advocacy areas discussed above.[31] One could easily be a consumer protection attorney and never interact with a competition attorney during a 30-year career. That is somewhat less true for the economists who work on the different missions of the agency (but the difference may be more due to the fact that all the economists are housed in the same organization than due to inherent interaction between the two areas at the law enforcement level).

2. Interaction at the Conceptual Level

The narrow range of interaction between consumer protection and competition at the enforcement level hides the fact that there are substantial undercurrents that affect both areas at the conceptual level and in the long run. These undercurrents ultimately alter case choices in both consumer protection and competition by altering the conceptual bases of enforcement activity. It is surely true that an understanding of how competition works and how markets behave will temper the instincts of consumer protectors to regulate almost all aspects of consumer dealings. The market can do a good bit of the work, if it is allowed to do so.[32] Such an understanding of the

> SUCH AN UNDERSTANDING OF THE PROCESS OF MARKET COMPETITION IS ONE REASON THAT THE FTC REGULATES IN A MANNER THAT IS LESS RIGID THAN MANY OTHER REGULATORY AGENCIES.

31 Muris provides some additional examples of competition and consumer protection connections during the past 25 years. The importation of remedies from consumer protection to antitrust may be the most significant. T. Muris, The Interface of Competition and Consumer Protection, Presentation at the Fordham Corporate Law Institute's 29th Annual Conference on International Antitrust Law and Policy, New York (Oct. 31, 2002), *available at* http://www.ftc.gov/speeches/muris/021031fordham.pdf.

32 Armstrong, Beales, and Rubin all appear to agree that the market can provide much of the needed consumer protection.

process of market competition is one reason that the FTC regulates in a manner that is less rigid than many other regulatory agencies.[33]

At a conceptual level, the economic analysis that undergirds consumer protection has affected the way competition is analyzed. Beginning in the 1960s, the economics of information forced antitrust economists to come to grips with the value of advertising and the value of branding. No longer would the world of homogenous consumers and products be sufficient. Economists also had to consider the solution to a "consumer issue" involving the sustained production and distribution of high-quality consumer products, when judging quality was both subjective and uncertain. That led to increased thinking about reputation, quality-assuring premiums, and agency issues. We had to study why distribution chains mattered as much as they do. The heterogeneity of consumers and matching those consumers to products had to be understood. Retailing and marketing had to become more than "black boxes". These conceptual changes in economics were very significant and they almost surely influenced what economists later considered a "good" antitrust or competition case, but the changes occurred sufficiently slowly and at a high enough level of abstraction that the connection is hard to observe in short-run enforcement decisions. It is clear, however, that advertising and branding are no longer reflexively thought of as entry barriers, positive product margins are no longer evidence of poorly performing markets, and vertical distribution restraints are no longer considered suspicious, as was true in an earlier era.[34]

III. Conclusion

This set of papers provides a smorgasbord of views on the basis for consumer policy and the correct application of that policy. Readers have the option of embracing the minimalist approaches of Rubin and Beales, the more interventionist approach of Armstrong, or the Italian legal approach described by Tesauro & Russo. While readers are likely to have various reasons for choosing among these alternatives, which approach is best for consumers should be determined by empirical evidence regarding the strength or weaknesses of market forces in correcting market imperfections.

On the issue of interaction between competition and consumer protection, there is a clear connection based on the analysis of markets. Markets matter and

33 This is a theme in Paul Rubin's paper in this issue.

34 Saying that policy is affected by the underlying crosscurrents is not to say that everything is affected. For example, the authors of the DOJ and FTC's *Horizontal Merger Guidelines* in 1982, 1992, or 1997 were not actively using their knowledge of consumer protection principles. Similarly, the FTC's key consumer policy documents—the deception statement, unfairness statement, and advertising substantiation statement—were not likely impacted by "antitrust thinking," although all these documents were clearly affected by consideration of the process of market competition.

an understanding of how both sides of a market work is a key to formulating rational policy, whether it is competition policy or consumer policy. The narrow range of interaction at the day-to-day enforcement level should not misdirect us from the need to get the concepts correct by thinking about the process of competition so that competition and consumer policy can be as useful as possible.

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Interactions between Competition and Consumer Policy

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Interactions between Competition and Consumer Policy

Mark Armstrong

This paper discusses complementarities and tensions between competition policies and consumer protection policies. The paper argues that markets will often supply adequate customer protection without the need for extra public intervention. Special areas where intervention might be needed are discussed, including the need to combat deceptive marketing and the need to provide additional market transparency (about both headline prices and shrouded product attributes). A few instances are presented of how more intense competition can worsen the outcomes for some consumers. Situations in which poorly designed consumer policies can harm consumers are discussed, including how they can be used to protect incumbent suppliers, how they can relax competition between oligopolists, how they can reduce consumer choice, how they can focus on one aspect of market performance at the expense of others, and how they can lead consumers to take insufficient care in the market.

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I. Introduction

The objective of both consumer and competition policy is to deliver well-functioning markets, something which requires both a strong supply side (competition) and a strong demand side (consumers). For many products, vigorous competition is the single best protection for consumers, and only minimal consumer protection (general contract law, forbidding deceptive marketing, the ability to return faulty goods, and so forth) is needed. As a former Chairman of the Federal Trade Commission (FTC) writes: "[R]obust competition is the best single means for protecting consumer interests."[1] However, in some markets some consumers do not always obtain a good deal, even when substantial competition is present, and in such cases additional policies to aid consumers have a role to play.

What prevents markets from delivering good outcomes to consumers? Familiar reasons include abuse of dominance and collusion between suppliers, and these fall broadly within the domain of competition policy. However, there are several other reasons why competition need not work well (e.g., imperfect information about product attributes, imperfect information about market prices, consumer costs of obtaining market information, supplier costs of advertising, or consumers possessing imperfect information about their own needs). These features, which are explored in Section III below, fall broadly under the heading of consumer policy.

It seems hard to define precisely "competition policy" versus "consumer policy". One could say that competition policy comprises "the set of policies and laws which ensure that competition in the marketplace is not restricted in such a way as to reduce economic welfare."[2] Whereas consumer policy "consists of preventing sellers from increasing sales by lying about their products or by engaging in unfair practices such as unilateral breach of contract or unauthorized billing."[3] Alternatively, one can define consumer policy in terms of the fundamental problems it seeks to prevent, cure, or remedy, which are:

- **(i)** duress and undue sales pressure;
- **(ii)** information problems pre-purchase; and
- **(iii)** undue surprises post-purchase.[4]

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1 Timothy Muris, The Interface of Competition and Consumer Protection, Paper presented at Fordham Corporate Law Institute's 29th Annual Conference on International Antitrust Law and Policy, New York (Oct. 31, 2002).

2 MASSIMO MOTTA, COMPETITION POLICY: THEORY & PRACTICE 30 (2004).

3 Muris, *supra* note 1.

4 J. Vickers, *Economics for Consumer Policy*, 125 PROC. BRIT. ACAD. 287-310, 289 (2004).

Nevertheless, many policies (such as policies which act to reduce consumer search costs or switching costs, or which reduce industry advertising costs) could be said to fall under both headings.

In the past, consumer policy and competition policy ran along quite separate lines, with little interaction between the two. For better or worse, there was a lot more economics informing competition policy than consumer policy. However, in recent years economists have shown a greater interest in consumer policy. This stems from at least two, probably related, causes. First, the modern consumer arguably faces more difficult decisions, involving more choices, than in the past. Second, the economics profession has recently seen the dramatic rise of "behavioral economics", a branch of the discipline which takes into account imperfect consumer decision making—consumers can be less "rational", more prone to various "biases"—more so than in earlier analysis. As leading behavioral economists put it in a 2003 paper: "Recent research in behavioral economics has identified a variety of decision-making errors that may expand the scope of paternalistic regulation."[5]

Over recent decades, competition policy has tended to be implemented in a more similar fashion across countries than in the past. As the Internet enables more products to be marketed globally, this same trend of convergence is now starting to affect consumer policy too. As Muris (2002) puts it:

> "If different arbiters apply different standards in these areas, then marketers who wish to apply identical techniques across borders may have to design a strategy that complies with the standards of the most restrictive jurisdiction in most countries, a result that might not maximize consumer welfare."[6]

This is another reason why there is currently more interest in consumer policy than before.[7]

5 C. Camerer, S. Issacharoff, G. Loewenstein, T. O'Donoghue & M. Rabin, *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism"*, 151(3) U. Penn. L. Rev. 1211-54 (2003).

6 For a discussion of recent convergence in the area of consumer fraud, *see* Muris (2002), *supra* note 1.

7 The current European Union *Unfair Commercial Practices Directive* is an important step towards harmonizing consumer policy within Europe. *See* Directive 2005/29/EC of the European Parliament and of the Council of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market, 2005 O.J. (L 149) 22 [hereinafter UCPD].

In this paper, I describe some of the interactions between competition and consumer policies: when are they substitutes or complements, and when does one approach actively interfere in the implementation of the other? In Section II, I give a very brief outline of how competitive markets often offer sufficient protection to consumers without the need for extra publicly provided protection. In Section III, I point out some ways in which competitive markets may fail some consumers, and how consumer policy might then be needed. Some scenarios in which more competition might actually make some consumers worse off are outlined in Section IV, while situations in which poorly designed consumer policies could harm consumers are presented in Section V. Section VI concludes and offers some suggestions for where future research might be most usefully targeted.

II. Competition on Its Own Can Often Protect Consumers

The aim of this section is not to present the various benefits of competitive markets in general; rather, I wish to discuss the ways in which markets can provide consumer protection measures without additional government intervention. In well-functioning markets, supported by general contract law, competitive pressure means that only those firms which give consumers what they want can prosper. There is little role for consumer policy when all product attributes and prices are easily observed and evaluated at the time of sale, when search costs are not significant, when consumers sample offers from multiple suppliers, and when most consumers are capable of making reasonably good decisions concerning the product in question. These stringent conditions probably apply when someone buys a new diary for the start of the year, for instance.

It is rare that all product attributes and prices are known when a choice is made. The more important insight is that even in markets for experience goods, the competitive mechanism can often still work well unaided.

But many, perhaps most, products do not satisfy these restrictive requirements. In particular, it is rare that all product attributes and prices are known when a choice is made. The more important insight is that even in markets for experience goods, the competitive mechanism can often still work well unaided.[8] Consider novels, for instance, which are a clear-cut experience good since consumers do not know how much they will enjoy a particular book until they read it.[9] Here, many signals of a book's likely quality are available:

8 It is conventional to divide products into three classes, depending on the extent of the information problem. "Search goods" are products whose attributes are fully observable at the time of purchase; "experience goods" have attributes which are only revealed after purchase; and "credence goods" have attributes which are not fully revealed even after purchase.

9 *See* Vickers (2004), *supra* note 4, at 297.

- **(i)** the consumer enjoyed previous books by the same author (a "brand" effect);
- **(ii)** there are useful blurbs on the back (which most readers know are not always to be trusted);
- **(iii)** the bookseller provides informative comments;
- **(iv)** word-of-mouth from friends may be valuable; and
- **(v)** electronic versions of word-of-mouth, such as "reader comments" on retailer websites such as Amazon.com, provide useful information.[10]

There is no obvious consumer protection policy which could improve on the laissez-faire outcome in this market.

Even credence goods, the most challenging type of good, can sometimes be supplied effectively in a laissez-faire competitive market. Consider repairing a particular kind of machine (which could be the human body). The consumer does not know the cause, which may be trivial or may require a major repair. An expert can repair the fault to the satisfaction of the consumer, but the consumer might never know if the expert exaggerated what was needed in order to increase the bill. But if the search or diagnosis cost is relatively small, many consumers will shop around for several quotes for repair, and competitive pressure may force the cost of repair close to the minimum cost.[11] Nevertheless, consumer search costs for credence goods may be extremely high (as is plausible for car repair, for instance), and experts may presume that most consumers are captive and the severity of the fault can be exaggerated safely.[12] Moreover, if consumers cannot tell if the repair has been successful ex post (say, the medical treatment only cures the patient some of the time, even when the treatment is appropriate),

10 On this last point, *see* J. Chevalier & D. Mayzlin, *The Effect of Word of Mouth on Sales: Online Book Reviews*, 43(3) J. Marketing Res. 345-54 (2006).

11 U. Dulleck & R. Kerschbamer, *On Doctors, Mechanics, and Computer Specialists: The Economics of Credence Goods*, 44(2) J. Econ. Lit. 5-42 (2006). The result referred to is Lemma 7 in that survey. In addition, in situations where consumers commit to get treatment when they get diagnosis from an expert, and where experts post prices for treatment, competition can, under stringent conditions (such as all consumers having the same probability of needing a serious repair), deliver the ideal outcome (*see* Proposition 1).

12 Illustrative anecdotes are provided in W. Emons, *Credence Goods and Fraudulent Experts*, 28(1) RAND J. Econ. 107-19 (1997). For instance, in a region in Switzerland the general population had significantly more medical operations than medical doctors and their families, consistent with a degree of over-treatment among the uninformed. Likewise, *see* H. Schneider, Agency Problems and Reputation in Expert Services: Evidence from Auto Repair (2007) (mimeo, Cornell University) reports results from a field experiment where the same faulty car was taken to 40 garages for diagnosis and quotes for repair. He found that 27 percent of garages suggested unnecessary repairs, while real faults were missed in 77 percent of cases.

then under-treatment as well as over-treatment presents a danger, and the market may break down altogether without intervention.[13]

A seller's concern with its reputation is another means by which opaque markets can work relatively well. Reputation can be established through two main channels: via repeat purchases from the same consumer, or via publicity, including word-of-mouth from one consumer to another. The reputation literature is concerned with how and when an appropriate level of product quality is supplied in the market. The term "quality" can be interpreted very broadly and encompasses hidden charges in the small print, unexpected exclusions in insurance contracts, and so forth. For instance, it is quite unrealistic to suppose that consumers are aware of the prices of all products inside a supermarket before they visit, and so many of the store's prices are only observed at the point of sale. The store could set high prices in order to exploit the fact that the consumers are "locked in" once they enter the store. If this were the end of the story, this market would perform very badly, and there would be scope for beneficial consumer policies, such as publicizing price indices for supermarkets.[14] But a supermarket is a leading example of a seller that relies on repeat purchases, and this hold-up strategy is unlikely to be profitable for a store since many consumers will experiment with a rival store if they are exploited by their current choice.

A more serious information problem is that many consumers may not be aware even of the prices of the products they put into their baskets. Therefore, if a supermarket marks up its price for, say, butter by 500 percent, many of its customers will mistakenly buy it, yielding the store a short-run profit. But at least some people will notice the trick, either in the store or once they get home, and there will quickly be substantial negative publicity which will wipe out any short-run gains to the shop. (Note that reputational effects are greatly enhanced when there is a vigorous free media operating in the jurisdiction.) Here, a supermarket's concern to maintain its reputation is a more powerful constraint than any externally-imposed informational remedy could be. Similar issues arise with financial products, where the product often requires signing a lengthy contract involving many clauses and potential hidden charges. Indeed, when a consumer does not realize the importance of a small-print clause or price until after the product is purchased, the effect is very much like an experience good. For instance, a firm concerned with its reputation selling a life insurance policy would not put in exploitative clauses (such as "We will not pay out if death occurs on Tuesday"), even if they were legal, since the negative publicity would be enormous.

Modern technology provides new ways in which the reputation mechanism can be harnessed. For instance, one situation which on the surface seems prob-

13 *See* Dulleck & Kerschbamer (2006), *supra* note 11, at Proposition 4.

14 See the later discussion of the "Diamond paradox" in Section III.C of this paper.

lematic is buying objects on an Internet platform such as eBay, where a consumer hands over money while having to trust that the seller will actually send the object. Since there is little chance that a buyer and seller will interact repeatedly, or even that a friend of the buyer will interact with the seller, there seems to be little scope for direct reputational concerns to play a role. But the use of "seller ratings", a kind of collective reputation mechanism, apparently provides a powerful constraint on the seller's ability to exploit consumer vulnerability (unless the seller has only one item to sell).[15]

All of this suggests that reputation (generally conceived) is a powerful force to constrain firms to behave well, even when they supply highly complicated products. However, in some markets, reputation cannot play a strongly disciplining role, for instance if the product is not purchased repeatedly and if word-of-mouth or other publicity is ineffective.[16] The textbook example is a restaurant in a tourist area, although in reality tourist guidebooks or star rating systems can provide large incentives to provide good food.

Advertising is a prime means by which to get information—price and non-price—to consumers with search costs. Consumers do not always have to visit a retailer physically to find out its prices and other product characteristics. In addition, advertising can provide important information about product characteristics which consumers would otherwise find hard to discover even at the point of sale, thus ameliorating experience or credence good problems. Suppliers of breakfast cereals, for instance, may advertise useful information about the healthiness of their products.[17] While advertisers can be trusted to point out the good aspects of their products, they will not voluntarily advertise the bad product characteristics. However, comparative advertising (when permitted) may step in here, and rivals will often be willing to point out defects in a product to the benefit of all consumers. Even advertising messages which do not contain

15 P. Bajari & A. Hortacsu, *Economic Insights from Internet Auctions*, 42(2) J. Econ. Lit. 457-86, §5 (2004), surveys the empirical work on the effectiveness of the reputation mechanism in online auctions, which is mixed in its conclusions.

16 G. Jin & P. Leslie, *Reputational Incentives for Restaurant Hygiene*, Am. Econ. J.: Microeconomics (forthcoming 2009) provide evidence showing that restaurant hygiene tends to be higher in local markets which have a greater proportion of repeat buyers. Schneider (2007), *supra* note 12, tests for the impact of reputation by informing some (randomly chosen) garages that he has just moved to the area (thus indicating scope for repeat business) and informing others that he is about to leave the area. He finds that while the potential for repeat business appears to lead to a lower charge for diagnosis, it appears to have no significant affect on the quality of the diagnosis.

17 In 1984, Kellogg launched an advertising campaign focusing on the health benefits of one of its cereals, All-Bran. This was in direct violation of the U.S. Food and Drug Administration's then-policy which essentially banned health claims on food products. A subsequent relaxation of this ban acted to facilitate information flows to consumers, which led many consumers to change their consumption behavior. Moreover, it seems that government and general information sources before the ban was lifted had little impact on consumer behavior. *See* P. Ippolito & A. Mathios, *Information, Advertising and Health Choices: A Study of the Cereal Market*, 21(3) RAND J. Econ. 459-80 (1990).

useful information to consumers may indirectly act as a signal of the price or quality of the product. If consumers follow the rule of thumb that a more heavily advertised product is likely to be better or cheaper than its rivals, it may often be in the interests of the better (or lower cost) supplier to advertise most intensively.[18] Finally, advertising—including direct marketing methods—may be the only way to reach those consumers who do not wish to research the market actively themselves.

To aid those consumers who do wish to undertake market research, there is a flourishing market for market information that can help overcome consumer search costs as well as provide information about shrouded product attributes. This market includes commercial magazines and websites offering consumer reports on various items, as well as price comparison websites and the certification intermediaries discussed in the next paragraph. Other commercial websites offer detailed consumer protection advice.[19] The market for market information has several special features which can limit its efficient operation, some of which are discussed later in Section III.B, but it undoubtedly is important in helping active consumers to make better decisions.

Institutions often exist to allow sellers to communicate the quality of their products to consumers. These institutions include advertising (when supported by policy to combat misleading advertising) and "certification intermediaries" who are trusted to convey accurate information about products they test. (An example of the latter is firms seeking to provide "green" certification standards.) When these institutions exists, the opportunity that sellers have to reveal product quality can mean that there is no need for a policy of mandated disclosure, and consumer policy needs merely to facilitate the emergence of these institutions. The basic idea is that a seller with a high-quality product will choose to disclose this information, and (rational) consumers will assume that sellers that choose not to disclose their quality have lower quality. In theoretical models, all sellers can choose to reveal their product quality.[20]

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18 *See* Kyle Bagwell, *The Economic Analysis of Advertising*, *in* 3 THE HANDBOOK OF INDUSTRIAL ORGANIZATION 1701-1844 (M. Armstrong & R. Porter eds., 2007). Likewise, if users of a search engine tend to click on suggested links in the order in which they appear on the page, then websites which are most likely to fit the user's need will often pay the most to be listed first. (And in this case, consumers indeed should click on the links in the suggested order.) *See* S. Athey & G. Ellison, Position Auctions with Consumer Search (2007) (mimeo, MIT and Harvard University).

19 *See, e.g.,* Money Saving Expert: Consumer Revenge (United Kingdom), *at* http://www.moneysavingexpert.com (last visited Jan. 17, 2008).

20 P. Milgrom & J. Roberts, *Relying on the Information of Interested Parties*, 17(1) RAND J. ECON. 18-32 (1986). In fact, this "unraveling" argument works even with a monopoly seller, provided that consumers think strategically and have accurate information about the market environment (see Section 2 in that paper). When there is competition, consumers do not need to reason in such a sophisticated way for this result to hold (see Sections 3 and 4 in that paper).

In markets with switching costs, it is likely that rivals will choose to make it as easy to switch as possible. For instance, an energy company might offer to do all of the work involved in switching supplier. More controversially, a firm may offer new customers a better deal than its existing customers, in order to overcome its new customers' cost of switching.[21] The result then is that there could be too much switching in the market, not too little, which could provide a novel role for policy. Finally, several price comparison websites (e.g., for energy, insurance) provide a "one-stop" switching service too.

A contentious issue when discussing the competition versus consumer policy interface is whether more competition acts to simplify the deals offered to consumers (to the appropriate extent), or whether firms in competitive markets resort to trying to "confuse" consumers in order to relax competition. The evidence on this question is very mixed, and often anecdotal. But it is clear that at least sometimes firms compete by offering simpler deals than their rivals, in order to attract those consumers who find consideration of complex tariffs or products psychologically costly. For instance, a mobile phone entrant might try to differentiate itself from incumbents by offering a tariff with a uniform call charge regardless of the network being called or the time of day. Or a firm might "unshroud" a rival's tariff, for instance by pointing out that the price for its car is "all inclusive" while the rival's advertised price excludes some core features. Situations in which firms do attempt to confuse consumers are discussed in Section III.

Markets can deliver products which help consumers deal with their own imperfect decision making. For instance, many consumers have problems of self-control to do with impatience—say, spending too much on a credit card now, and not thinking enough about high interest charges later—and many of these consumers are aware of their weakness of will (e.g., they have learned this over time). These sophisticated, but weak-willed, consumers have a demand for commitment devices to constrain their subsequent choices[22], which the market will often supply. The most obvious of these are illiquid savings products (e.g., where someone automatically pays in a certain amount of money each month, and it is hard to extract the savings on short notice).[23] Other examples include addiction treatment clinics, where consumers sign up for a period of time and are kept apart from their vice, season tickets to "high-brow" cultural events (where consumers may be tempted to stay in and watch TV if they had to buy a ticket for each performance), and exercise gyms offering lump-sum membership contracts so that

21 Y. Chen, *Paying Customers to Switch*, 6(4) J. ECON. MGMT. STRATEGY 877-97 (1997).

22 For evidence that consumers have demand for commitment devices, *see* N. Ashraf, D. Karlan & W. Yin, *Tying Odysseus to the Mast: Evidence from a Commitment Savings Product in the Philippines*, 121(2) Q.J. ECON. 635-72 (2006).

23 D. Laibson, *Golden Eggs and Hyperbolic Discounting*, 112(2) Q.J. ECON. 443-77 (1997).

consumers are not discouraged from exercise by a per-visit fee.[24] Thus, the presence of time-inconsistent, or otherwise boundedly rational, consumers is not a sufficient reason to intervene in a market.

Finally, many retailers compete by voluntarily offering warranties or "no quibble" return policies that are substantially more protective of their consumers than is required by consumer law. In sum, consumer protection in its various forms is undoubtedly a vital service, but it is usually provided without the need for government intervention. The next section considers those situations in which intervention might still be needed.

THE PRESENCE OF TIME-INCONSISTENT, OR OTHERWISE BOUNDEDLY RATIONAL, CONSUMERS IS NOT A SUFFICIENT REASON TO INTERVENE IN A MARKET.

III. How Consumer Policy Can Sometimes Aid Consumers

A. DECEPTIVE MARKETING

An implicit assumption in the discussion in the previous section was that firms could not engage in deceptive marketing. For instance, without constraint a firm could make false claims for its products, or it could advertise one price while consumers find they must pay a higher price once they arrive at the store (or the advertised product is not available in the store, and only the more expensive versions are—the so-called bait-and-switch technique). If firms could do such things, some of them would do so when the practice enhanced profit. Consequently, consumer faith in the reliability of the advertising mechanism would be eroded, to the detriment of consumers and honest firms. However, it is important to recognize that many firms would not take advantage of the ability to make deceptive claims, since their reputation would quickly be harmed.

Similarly, if firms could freely denigrate their rivals' products, many would choose to do so, and consumers may eventually view advertising as meaningless babble, shutting down this crucial channel of information. (Reputational considerations may have somewhat less force for misleading comparative advertising, since, if the advertising campaign were successful, consumers might not try the rival product and so might not discover that the claims made were deceptive.) Naturally, though, there is a fine line to be drawn between outright deception and adverts which mislead many consumers but which are technically accurate. To cope with this issue, it is common to use "copy tests" to determine how many

24 S. DellaVigna & U. Malmendier, *Contract Design and Self-Control: Theory and Evidence*, 119(2) Q.J. ECON. 353-402 (2004) and K. Eliaz & R. Spiegler, *Contracting with Diversely Naive Agents*, 73(3) REV. ECON. STUD. 689-714 (2006). An alternative and less benign reason why gyms might set low per-visit charges, with respect to exploiting over-optimism on the part of consumers, is discussed in Section III.E of this paper.

people are misled by a particular advert. The consumer body still needs to decide the vexed question of how many consumers need to be misled in order for the advert to be withdrawn.[25] (In Section V.A, it is argued that past policy in the United States set the barrier too low, requiring only a few people to be misled before an advert was withdrawn.) Such policy can never be perfect, since adverts that are useful for sophisticated consumers may mislead others.

Likewise, if a firm has built up a reputation for high-quality products, a rival firm may wish to pretend to be that firm by choosing a similar brand name or packaging (the phenomenon known as "passing off") in order to charge the brand price but offer a product of a lower quality, thus harming both consumers and the original brand. Here, trademark laws and their enforcement will be useful for consumers.

Of course, misleading marketing practices can go beyond advertising false prices, and suppliers can make false claims about their products. Common scams include claims that a particular "natural health cure" is effective, that "Professor X can predict the next winning lottery numbers", or that a stranger genuinely needs to deposit money in my bank account.[26] Sometimes policy towards scams and scam-like products can be hard to formulate. Since people (even policymakers) differ in their beliefs about the efficacy of some products, and objective data can be unavailable, it can be hard to determine whether a product is fulfilling a genuine need or is really a scam. We might agree that Professor X cannot really foresee the winning lottery numbers,[27] but there are many grey areas, including: services which predict the outcome of horse races,[28] clairvoyants, astrology, some

25 For discussion of this point, *see* H. Beales, R. Craswell & S. Salop, *The Efficient Regulation of Consumer Information*, 24(3) J.L. & Econ. 491-539, §1B (1981). The UCPD, *supra* note 7, at para. 18, takes the view that a commercial practice is unfair if the average consumer in that market is misled (among other hurdles which need to be passed). If a product is marketed at a particular sub-group of consumers (e.g., the elderly), then the average consumer should be taken with reference to that subgroup. Specifically, the UCPD states that "[t]he average consumer test is not a statistical test. National courts and authorities will have to exercise their own faculty of judgment [...] to determine the typical reaction of the average consumer in a given case."

26 For a long list of the scams being used in Australia at the time of writing (2008), *see* ScamNet – Complete Listing of Scams, *at* http://www.docep.wa.gov.au/ConsumerProtection/ScamNet/content/pages/full_list.html (last visited Jan. 25, 2008).

27 "Claiming that products are able to facilitate winning in games of chance" is one of the 31 practices which are in all circumstances considered unfair in the UCPD, *supra* note 7.

28 For details of recent intervention against a racing tipster, *see* Press Release, U.K. Office of Fair Trading, OFT obtains injunction against bogus racing tipster (Jan. 22, 2008), *available at* http://www.oft.gov.uk/news/press/2008/12-08. In return for a membership fee of GBP 590, members received tips on likely winners in horse races. Some 3,000 consumers signed up for the service. The marketing materials for the service were judged to be misleading, and falsely claimed for instance that the tipster owned a team of race horses and had ridden regularly for some of the most successful horse trainers. In addition, members were told they would make a "minimum of £47,000 in 30 days."

beauty products, some alternative health remedies, or the health benefits of organic food. The consumer body could publicize warnings about those products it felt confident were indeed scams,[29] but it is perhaps unlikely that those consumers taken in by outlandish claims will be the kind of consumer who browses consumer protection websites. The use of misleading marketing regulations is probably the most effective and proportionate method of controlling exploitative conduct here, and sellers should be prevented from making claims which are false or which cannot be verified. In addition, if there is objective information available about the efficacy or otherwise of these products, then that could usefully be brought to consumers' attention.[30]

Generally, policy to combat fraud and misleading marketing is the least contentious area of consumer policy. (In this regard it is similar to cartel and horizontal merger policy in competition policy.) However, some commentators are skeptical of the need for public intervention even here. For instance, Richard Posner (1969) has written:

> "In the political arena we posit a marketplace of ideas in which good ideas can be expected to prevail in open competition with bad, and one can take the same approach to advertising. Individuals know more about household products than they do about political questions, so if we trust them to evaluate competing and often fraudulent claims by political candidates, we should also trust them to evaluate competing product claims. Since other sellers, like rival candidates, have every incentive to counter the misleading representations of a competitor, false claims should eventually be unmasked."[31]

A situation in which even Posner admits may require public intervention is when no seller has an incentive to provide accurate information and no rival has an incentive to unmask a rival's misleading claims. He suggests that cigarettes are an example of such a market, where no supplier has an incentive to advertise that smoking is unhealthy.[32] Here, there may be a role for carefully designed health warnings on cigarette packets, for instance, as well as other education campaigns.

29 *See supra* note 26.

30 See the discussion of "quacks" in Section III.C.

31 R. Posner, *The Federal Trade Commission*, 37(1) U. Chi. L. Rev. 47-89, 62 (1969).

32 Posner (1969), *id.* at 68.

B. THE MARKET FOR MARKET INFORMATION

Internet-based, price-comparison websites and other information intermediaries mitigate problems of costly consumer search.[33] However, information intermediaries are not a panacea for several reasons. First, while the market may provide market information, it cannot force consumers to undertake market research. For instance, in 2003, only 10 to 12 percent of consumers in a survey who had made price comparisons for energy suppliers that year had used the internet as their source of market information.[34] (Doorstep selling was a much more significant source of information, which at times is indeed a way of forcing consumers to investigate market options.) Of course, though, this does not imply that government intervention to make markets transparent can do any better in this regard.

Second, there is still a good deal of price dispersion on price-comparison websites. A detailed study of one such website over a long period suggests that price dispersion is significant and non-transient: the gap between the lowest and the second-lowest listed prices averaged 23 percent when just two firms listed prices for the product, although this fell to 3.5 percent when 17 suppliers listed prices.[35] Suppliers also change their listed prices frequently over time, so that consumers (and rivals) need to keep on their toes. As discussed in the next section, it is the search cost of the marginal searching consumer which is likely to determine the degree of price dispersion in market, and it could be that the number of consumers who use price-comparison websites is not yet large enough to have a major impact of price dispersion in many markets.

Third, if consumers visit just one such information broker (e.g., because of search costs for using more than one price-comparison website), then a broker will hold a monopoly over providing access by sellers to its exclusive consumers. This will often mean that consumers are treated well by the broker (e.g., they obtain the service for free, as is often observed) while sellers may have to pay inefficiently high charges to list their prices. Moreover, as the broker makes its

33 J. Brown & A. Goolsbee, *Does the Internet Make Markets more Competitive? Evidence from the Life Insurance Industry*, 110(3) J. Pol. Econ. 481-507 (2002) provide evidence that the growth of price-comparison websites for life insurance drove prices down for this product. An interesting study in the pre-Internet era had related findings. In 1974, two districts in Canada were chosen for a market transparency experiment in supermarket pricing. In one district, prices were collected but not publicized; in the other district, average price indices for individual supermarkets in that area were publicized in local newspapers. The result was that price dispersion and price levels fell in the second district relative to the first. *See* G. Devine & B. Marion, *The Influence of Consumer Price Information on Retail Pricing and Consumer Behavior*, 61(2) Am. J. Agric. Econ. 228-37 (1979).

34 Office of Gas & Electricity Markets (OFGEM), Domestic Competitive Market Review 2004: A Review Document Tables 2.14 & 2.16 (Apr. 2004); and U.K. Office of Fair Trading (OFT), Internet Shopping: An OFT Market Study ¶ 9.18 (Jun. 2007), reports that only 47 percent of Internet shoppers had used a price comparison website.

35 M. Baye, J. Morgan & P. Scholten, *Price Dispersion in the Small and the Large: Evidence from an Internet Price Comparison Site*, 52(4) J. Indus. Econ. 463-96 (2004).

revenue mainly from the supplier side, it may have an incentive to restrict competition between sellers so that sellers have a better ability to pay high fees for being listed.[36] The result of this skewed pricing could be that too few suppliers choose to be listed on the broker's website or suppliers may choose to bypass the broker and try to market their services directly to consumers. (For instance, we now see the increased use by airlines of their own websites to sell tickets directly to travelers, and some insurers have forbidden their products to be sold on price-comparison websites.) If such bypass goes too far, many consumers will have to search supplier by supplier once more, and the search efficiency introduced by the brokers in the first place will be eroded.

Fourth, the intermediaries are commercial operations, and must be funded from some source.[37] The funding may come from non-discriminatory listing fees (as described earlier), but alternatively it may come from just one or a few suppliers. In such cases, the broker may be biased and give undue prominence to its funders' products. In extreme cases, a "price-comparison website" might just be a marketing front for one supplier. As such, a consumer body needs to be open to consumer complaints about the accuracy of price comparisons, as well as ensuring that the funding basis for the website is transparent. (These issues are already familiar in the market for financial advice.)

Fifth, many price comparison websites attempt to rank their various products by price (or give consumers the option to rank in this way), and for this they may be forced to use a single-dimensional measure of "price". This gives suppliers an obvious incentive to publicize a low "headline price" in order to be placed near the top of the list, and to load hidden charges onto the item insofar as this is possible. For instance, a seller could set high postage and handling charges. Even worse, the seller's postage and handling charges may not be observable to the consumer until the consumer has gone to the "checkout" page. Similar issues arise in insurance markets. If price-comparison websites focus consumer attention on the headline premium, many consumers may buy the cheapest product, and this could well turn out to be a low-quality product with many small-print exclusions or excesses. The net result of all this subterfuge is that suppliers at the

36 The recent literature on two-sided markets is relevant here, one example of which is M. Armstrong, *Competition in Two-Sided Markets*, 37(3) RAND J. ECON. 668-91, §5 (2006). Similar issues arise with the (typically non-price) market information found in Yellow Pages directories, where most consumers consult just one directory. *See* M. Rysman, *Competition Between Networks: A Study of the Market for Yellow Pages*, 71(2) REV. ECON. STUD. 483-512 (2004). M. Baye & J. Morgan, *Information Gatekeepers on the Internet and the Competitiveness of Homogeneous Product Markets*, 91(3) AM. ECON. REV. 454-74 (2001) present a model with a monopoly intermediary, and show that the intermediary restricts competition among sellers in order to increase the listing fee it can charge them.

37 It is worth noting that consumer-testing organizations often do not permit a good product review to be used in a product's advertising. This is in part because the consumer organization wishes to maintain revenue from consumers buying its magazine or subscribing to its website, but it does act to impede information flows about product quality to the wider consumer population.

top of list may not be the cheapest or best value when the total deal is taken into account.[38] Generally, inefficiency ensues if consumers are misled about the total charge for the product or its quality, or if they have to spend undue effort to understand exactly what is included in the service.

Finally, and related to the previous point, for complicated products, price comparison websites are often opaque and hard to use for many consumers. When consumers differ in their demand for, say, electricity, and suppliers use nonlinear tariffs, to obtain a relevant comparison a consumer must know and key in her typical demand volume.[39] One supplier may well be cheaper for low-demand consumers, but more expensive for higher-demand consumers. In markets with complex products where a consumer's demand volume or tastes are needed to determine the relevant price comparisons, price comparison websites are not always effective since there is no single price or price index to use in ranking the products. With complex products, making the market transparent is difficult both for commercial intermediaries and for public policy.

The "market for market information" has several special features which imply that it does not always work well unaided. As such, with the important caveat that policy cannot force inactive consumers to undertake market research, there may be a role for public policy to provide additional market information.

In sum, the "market for market information" has several special features which imply that it does not always work well unaided. As such, with the important caveat that policy cannot force inactive consumers to undertake market research, there may be a role for public policy to provide additional market information.[40] The impact of these

38 Recent papers present evidence that obfuscation strategies, such as presenting a low headline price together with high small-print charges for postage, can confuse consumers and reduce firm-level demand elasticities. *See* G. Ellison & S. Fisher Ellison, Search, Obfuscation and Price Elasticities on the Internet (2004) (mimeo, MIT) and T. Hossain & J. Morgan, *Plus Shipping and Handling: Revenue (Non)equivalence in Field Experiments on eBay*, 6(2) Advances in Econ. Analysis & Pol'y 1429 (2006). OFT (Jun. 2007), *supra* note 34, at 125-27, documents a survey which revealed that the majority of listed prices do not make clear whether delivery is included, and in a sample of airline ticket bookings the final price was above the original listed price in 47 percent of cases (furthermore, for these cases, the median price increase was 19 percent).

39 Related issues arise with attempts to measure the life-time cost of a product. Such is the case with printers, which may have different per-page costs, or cars, which may have different running costs, where the lifetime cost depends on the usage made of the durable product. Matters are even worse with multi-product markets such as telecommunications and supermarkets, where consumers must key in their estimated demands for many products to get a valid comparison of suppliers.

40 In the United Kingdom, several regulators have accredited price-comparison websites listed on their own websites, and one regulator, the Financial Services Authority, has its own comparison website. *See* FSA: Money made clear, *at* http://www.moneymadeclear.fsa.gov.uk (last visited Jan. 28, 2008). In addition, the introduction of an approved price-comparison website was one of the remedies to market failure in U.K. Competition Commission, Home Credit Market Investigation 10 (2006).

policies is discussed in the next two sections. Section III.C discusses the impact of market transparency policies about headline prices and product attributes; Section III.D discusses further the problems caused by hidden charges and how transparency policies may be helpful in overcoming these problems.

C. THE IMPACT OF MARKET TRANSPARENCY POLICIES

There are a number of plausible situations in which consumers differ in how well-informed they are about products in the market. In part, this may reflect how much effort they have put into market research. Here, situations fall into three broad types:

- **A:** where uninformed consumers exert a negative externality on the informed consumers;
- **B:** where informed consumers benefit from the presence of the uninformed; and
- **C:** where there is no cross-subsidy between the consumer groups.

Much consumer policy aims to improve market transparency in a general sense in order to increase the number of informed consumers. Such a policy is relatively uncontroversial in **A** and **C** situations, but in **B** situations it could harm the informed consumers and can be more contentious. This section considers some examples of **A** situations, where increasing the number of informed consumers benefits all consumers. (The next section provides some examples of **B** situations and Section III.E discusses **C** situations.)

A classic model by Varian (1980) is instructive.[41] Here, a number of symmetric firms offer an identical product to a population of consumers who each wish to consume a single unit of the product. The only way in which consumers differ is that a fraction of them, given by λ, know all of the prices in the market, and the remaining consumers know none of the prices.[42] The informed con-

41 H. Varian, *A Model of Sales*, 70(4) Am. Econ. Rev. 651-59 (1980). A closely related model is S. Salop & J. Stiglitz, *Bargains and Ripoffs: A Model of Monopolistically Competitive Price Dispersion*, 44(3) Rev. Econ. Stud. 493-510 (1977).

42 For instance, as emphasized by Brown & Goolsbee (2002), *supra* note 33, the well-informed consumers could be those who use price-comparison websites on the Internet, while the remainder are those who must painstakingly search supplier by supplier. The discussion in the text assumes that suppliers cannot set different prices for online and offline consumers, as was the case in Brown & Goolsbee's data. If suppliers could set different prices to informed and uninformed consumers (e.g., by making the price depend on whether the sale was online or offline), the model would have a very different prediction: informed consumers would pay competitive prices and uninformed consumers would pay monopoly prices, and the prices in each case would not depend on the number of suppliers or the fraction of informed consumers. Thus, informed consumers would not protect the uninformed at all. Here, a policy which boosts the fraction of informed consumers is good for aggregate consumer welfare, but it has no impact on those consumers who remain uninformed.

sumers will buy their item from the lowest-price supplier, while the uninformed consumers will buy from a random supplier. In this framework, firms have to trade off the benefit of setting a low price which may attract the informed consumer against the benefit of setting a high price which exploits the "vulnerable" uninformed consumers. A firm chooses its price randomly, so that rivals cannot predict its price. One can show that both the average price paid by informed consumers and the (higher) average price paid by the uninformed consumers decreases as the fraction of informed consumers, λ, rises. In particular, informed consumers are harmed by the presence of the uninformed consumers, while uninformed consumers benefit from (or free-ride on) the presence of the informed. Consumer policy that increases market transparency, in the sense of raising λ, will improve the welfare of both groups of consumers. However, price dispersion varies non-monotonically with the fraction of informed consumers. When λ is close to zero, almost all prices are close to the monopoly level, and when λ is close to 1, almost all prices are close to the competitive level. In either case, there is little price dispersion, and so price dispersion is maximal at some intermediate level of λ. In particular, starting from a low level of consumer price awareness (where λ is small), a market transparency policy that increases λ may also increase price dispersion.[43]

Likewise, consumer policy that acts to reduce consumer search costs will tend to benefit all consumers.[44] When consumers have low search costs, both the average level of prices and their dispersion tend to be low. To illustrate, consider this variant of Varian's model.[45] Instead of supposing that consumers fall exogenously into two groups, the informed and the uninformed, suppose a consumer has the option to learn all market prices for a cost s. (This "all or nothing" search

43 Brown & Goolsbee (2002), *supra* note 33, find support for this effect in the early part of their data where the fraction of consumers who used price-comparison websites was small.

44 Markets differ greatly in their consumer search costs. For instance, petrol has a rather low search cost since many consumers are already in their car when buying the product. As a result, prices are reasonably competitive and exhibit little dispersion within a local area. Funerals and condoms, by contrast, are often purchased by consumers with little appetite for market research. Car tires are frequently purchased by consumers who are not very mobile. In one study, 71 percent of consumers wanting to buy tires contact no other outlet apart from the one at which they buy. For details and further discussion, *see* M. Waterson, *The Role of Consumers in Competition and Competition Policy*, 21(2) INT'L J. INDUS. ORG. 129-50 (2003). However, the case of petrol presents an interesting danger: given that the market is understood by consumers to be reasonably competitive, consumers may not even bother checking the prices when they fill up, and this leaves a profit opportunity for unscrupulous (but legal) suppliers. For instance, in 1996, a Mr. Mole in Lancashire (United Kingdom) operated a number of petrol stations where petrol was nearly twice as expensive as his competitors. *See Garage fuels price protest*, LANCASHIRE TELEGRAPH, Jan. 19, 1996.

45 *See* Salop & Stiglitz (1977), *supra* note 41 and K. Burdett & K. Judd, *Equilibrium Price Dispersion*, 51(4) ECONOMETRICA 955-69 (1983). Related insights are obtained in the model with sequential search in S. Anderson & R. Renault, *Pricing, Product Diversity, and Search Costs: a Bertrand-Chamberlin-Diamond Model*, 30(4) RAND J. ECON. 719-35 (1999). In that model, there is no price dispersion and the market price is an increasing function of the search cost.

process simplifies the discussion, but does not alter the qualitative conclusions.) This search cost may vary across consumers. There is a subtle two-way interaction between consumer and firm behavior in such a market. The fraction of consumers who choose to become informed affects the level and dispersion of prices, which in turn determines the incentives for consumers to become informed in the first place. As just discussed, price dispersion is a non-monotonic function of the number of informed consumers. Since the incentive to become informed depends on the dispersion (rather than the level) of prices, we expect that the benefit of becoming informed will depend non-monotonically on the number of other informed consumers, as illustrated in Figure 1.

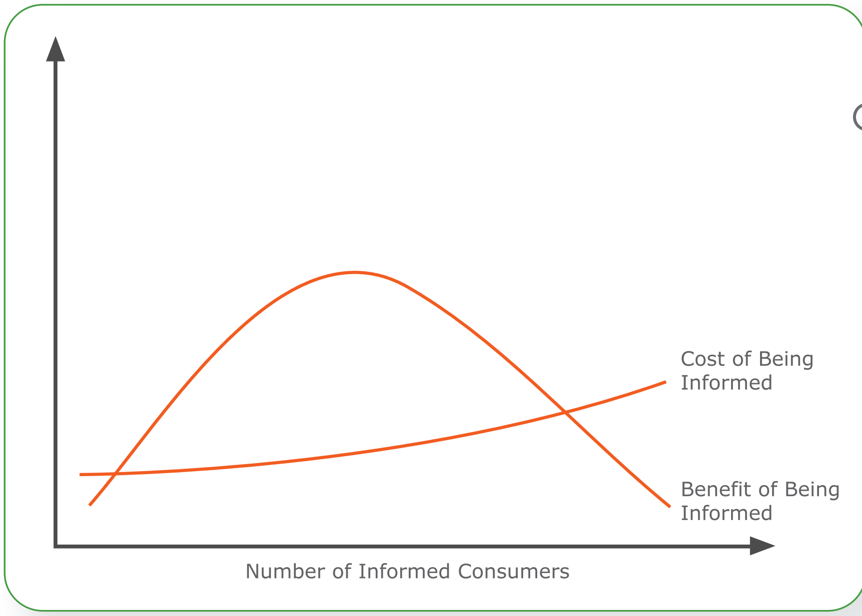

Figure 1

The Cost and Benefit of Being Informed

A consumer will choose to become informed if the private benefit to her exceeds her search cost *s*, and an equilibrium degree of search is when the cost of the search for the marginal searching consumer equals the benefit from searching, as depicted on Figure 1. From the diagram, it is clear that there will probably be two (interior) equilibria, one with relatively few informed consumers and the other with relatively many. On the assumption that it is the latter equilibrium which is observed (this is the stable equilibrium of the two), a reduction in all search costs (in the sense that the search cost schedule in Figure 1 is shifted downwards) will lead to more consumers choosing to become informed, which in turn leads to a more competitive market and lower average prices. However, it is the search cost of the marginal searching consumer who determines price levels and dispersion. If a large number of infra-marginal consumers (whose search cost is anyway below the marginal searcher's cost) experience a fall in their search cost, this may have little impact on market prices. Thus, if the use of price-comparison websites has not yet reached the marginal searching consumer (as discussed in Section III.B), then such websites may not yet have had a major impact on price levels or dispersion.

Notice that, provided that all consumers have positive search costs, in this theoretical framework there is also always a third equilibrium and this involves (i) all firms setting monopoly prices and (ii) no consumers choosing to become informed. The reason is that if all firms set the same price (in this case, the monopoly price), no consumer finds it worthwhile to incur the search cost *s* to find the best deal; and if no consumer is informed, then each firm will set the monopoly price to exploit those consumers who randomly come to it. This is the famous "Diamond paradox".[46] It provides a stark example of how simplistic competition policy, interpreted as a policy to increase the number of suppliers but without decreasing search costs, may have no beneficial impact on consumer welfare.

As well as reducing search costs, another powerful form of consumer protection is to remove restrictions on advertising, as advertising typically intensifies competition between firms. Consider the classical model of informative advertising by Butters (1977).[47] In this model, many firms compete to sell a homogeneous product. The only way consumers can find out about the product is by seeing an advert from one or more firms. Firms send out (non-misleading) adverts to consumers at random with information about the product's existence and its price, with an advertising cost *c* per recipient. One can show that (i) total quantity sold (i.e., the number of consumers who observe at least one advert) decreases with *c*, and (ii) the average price paid for the product increases with *c*. Thus, policy which acts to lower *c* (e.g., a policy which removes restrictions on non-misleading price advertising in the specified market) will intensify competition and benefit consumers.[48] However, sometimes policy towards advertising needs to balance two conflicting kinds of consumer protection. Since many consumers do not like being on the receiving end of direct marketing, one consumer protection policy is to allow consumers to opt out of direct marketing campaigns. (An example of this is the U.S. "Do Not Call" policy launched in 2003 to which some 145 million people have signed up.) But if a significant number of consumers

46 P. Diamond, *A Model of Price Adjustment*, 3(2) J. Econ. Theory 156-58 (1971).

47 G. Butters, *Equilibrium Distributions of Sales and Advertising Prices*, 44(3) Rev. Econ. Stud. 465-91 (1977).

48 For instance, empirical studies of opticians and legal services in the United States have investigated how relaxing a state ban on price advertising typically led to lower prices. *See* L. Benham, *The Effect of Advertising on the Price of Eyeglasses*, 15(2) J.L. & Econ. 337-52 (1972); L. Benham & A. Benham, *Regulating Through the Professions: A Perspective on Information Control*, 18(2) J.L. & Econ. 421-47 (1975); and D. Haas-Wilson, *The Effect of Commercial Practice Restrictions: The Case of Optometry*, 29(1) J.L. & Econ. 165-86 (1986). *See also* the review of related studies on the impact of advertising on prices in Bagwell (2007), *supra* note 18, at 1745-46.

choose to opt out of advertising, it is possible that competition between firms is thereby lessened to the detriment of consumers as a whole.[49]

Further insights into the benefits of market transparency are obtained from a pair of 2006 models by Ran Spiegler. Consider first Spiegler's model of credence goods.[50] Here, word-of-mouth does not necessarily work well when consumers are not sophisticated. There are a number of suppliers of treatment for a given medical condition and each supplier has an associated probability of successful treatment. If no treatment is given, there is also a chance that a consumer gets better anyway. Without policy intervention, consumers do not observe a supplier's probability of success, but instead hear from friends whether they have had success or suffered failure with each supplier (with, for simplicity, one "anecdote" for each supplier, including the no-treatment default). Instead of understanding that treatment success is probabilistic, consumers behave as though each anecdote predicts what will happen to them for sure. In particular, each consumer will choose the supplier who offers the lowest price (or no treatment, which has a zero price) from among the successful treatments she hears about. Spiegler shows that, even when all suppliers offer "treatment" that does not involve higher probability of success than getting no treatment at all (i.e., the suppliers are "quacks"), the market for quacks is active and consumers are worse off relative to the case where quacks are not present. In fact, when the disease is unlikely to be cured (so the no-treatment default and quack success probabilities are both small), the quacks charge a higher price, for the reason that a consumer is unlikely to hear of more than one success story, which weakens competitive pressure. In addition, when suppliers differ in their treatment success rates and have the ability to reveal their success probability to consumers, none of them, including the best one, unilaterally wishes to do so. (Given the anecdotal basis of consumer decision making, they prefer to set high prices to those consumers who hear about their successful treatments than to get a moderate price from consumers who know the real success probability.) Thus, there is a role for consumer policy to publicize the treatment success rates for the various suppliers. Such a policy will induce those consumers who see the public-

THERE IS A ROLE FOR CONSUMER POLICY TO PUBLICIZE THE TREATMENT SUCCESS RATES FOR THE VARIOUS SUPPLIERS. SUCH A POLICY WILL INDUCE THOSE CONSUMERS WHO SEE THE PUBLICITY TO CHOOSE THE BEST VALUE TREATMENT.

49 More generally, while new technologies often facilitate information flows to consumers, they can sometimes also help consumers avoid adverts. For instance, personal video recorders in broadcasting and "pop-up blockers" on the Internet allow consumer to avoid adverts. Since many consumers dislike viewing adverts, but there is a competitive benefit to consumers as a whole when more consumers receive adverts, it is possible that the increased use of ad-avoidance devices may harm aggregate consumer welfare. A simple model of broadcasting in which the ability to opt out of advertising harms viewers can be found in M. Armstrong, *Public Service Broadcasting*, 26(3) FISCAL STUD. 281-99, 295 (2005).

50 R. Spiegler, *The Market for Quacks,* 73(4) REV. ECON. STUD. 1113-31 (2006a).

ity to choose the best value treatment.

Second, consider Spiegler's model of "confusing prices".[51] Here, a number of identical firms compete to sell a homogeneous product to identical consumers. However, instead of revealing their true price, each firm publicizes an unbiased noisy signal of its true price. Each consumer sees a price signal from each supplier, and buys from the supplier with the lowest signal. This could be because consumers mistakenly take the signal they see to be the price they will actually pay, or consumers might be more sophisticated and, in the absence of other information, assume that the firm with the lowest signal is most likely to be the firm with the lowest true price. Spiegler shows that firms do not want to set transparent prices.[52] Instead, firms choose to offer noisy prices in equilibrium, where the amount of noise depends on the number of suppliers. Remarkably, in this model the equilibrium true price does not depend on the number of suppliers, while the noise becomes more pronounced as the number of suppliers increases. Thus, firms respond to "more competition" (in the simplistic sense of there being more suppliers) with "more obfuscation". Firms make positive profits as a result of their obfuscation strategy, even though products are homogeneous. Consumer welfare would be improved if policy either forces firms to publicize their true prices or ensures that some other platform publicizes the true prices. When all consumers base their decision on the true prices, Bertrand competition and zero profits ensue.

Finally, a very different kind of market transparency policy involves the accurate labeling of experience and credence goods. Despite the predictions of theoretical models that mandated disclosure may not be needed (see Section II), history does not make one confident that the market will, on its own, ensure that firms always adequately label their products.[53] For instance, a future Chairman of the FTC wrote:

51 R. Spiegler, *Competition Over Agents with Boundedly Rational Expectations*, 1(2) THEORETICAL ECON. 207-31 (2006b). Spiegler interprets his model in terms of a product with many pricing attributes, where a consumer's inability to process many pieces of information implies that she just looks at a small number of price attributes for the product, while the expected price eventually paid depends on all pricing attributes.

52 Suppose the unit production cost is c. If all firms offer transparent prices, there is Bertrand competition and price is equal to c. Suppose instead that one firm sets a noisy price, where its true price is $2c$ and its (unbiased) signal is either zero or $4c$ with equal probability. This seller will have the lowest signal in the market half the time, and in these cases it will make the sale and make a positive profit while doing so.

53 A. Mathios, *The Impact of Mandatory Disclosure Laws on Product Choices: An Analysis of the Salad Dressing Market*, 43(2) J.L. & ECON. 651-77 (2000) discusses how a change to a mandatory policy for food labeling affected disclosure of fat content in salad dressing. With a voluntary labeling regime there was substantial disclosure by low-fat suppliers, but the dressings with no disclosure had a wide range of fat content. Mandatory labeling thus improved the information available to consumers. Likewise, G. Jin, *Competition and Disclosure Incentives: An Empirical Study of HMOs*, 36(1) RAND J. ECON. 93-112 (2005) shows that only some health suppliers chose to make use of a (costly) accreditation service.

> "Until the government intervened and required or induced disclosure, accurate information was not available in the market concerning the durability of light bulbs, octane ratings for gasoline, tar and nicotine content of cigarettes, mileage per gallon for automobiles, or care labeling of textile wearing apparel."[54]

As already mentioned, credence goods are a particularly challenging type of product, since repeat purchases or word-of-mouth may not adequately discipline the market. In response, it could be valuable for policy to publicize and verify suppliers' professional qualifications. For a novice consumer, the ability or effort of a lawyer is hard to determine. In such cases, one thing which may help to some extent is to mitigate information asymmetries about an expert's ability (even if the effort problem remains), which can be done by publicizing a recognized system of professional qualifications. Thus, if a consumer consults a qualified solicitor, she may be reasonably confident that the expert at least knows how to do the task, even if the under- or over-treatment problems remain. In practice, this transparency policy often goes alongside a policy which sets a minimum qualification barrier to entry, although the two policies are distinct and need not go together. I discuss this second, more interventionist policy in Section V.B.

A second labeling issue involves the accurate listing of ingredients in a product. To illustrate, consider the salt content of a particular kind of snack food. Without access to a chemical laboratory, a consumer cannot determine salt content, even after consumption. Suppose a supplier can make its product tasty in two ways: an expensive way involving high-quality ingredients, or a cheap way which just involves adding salt. Consumers know the tastiness of a snack, but they do not know whether it is due to high-quality ingredients or to too much salt. Suppose that excessive salt consumption in the long term has adverse health effects, and many consumers would prefer to avoid this if possible (despite the higher cost of the alternative). In this situation, a competitive market may not, on its own, deliver a good outcome. Firms cannot attract customers by using the more costly, high-quality method of production, and so they make greater profit by putting too much salt in the snack. This is true even if consumers are smart enough to work out a firm's incentives, and foresee that salt is used. If consumer policy somehow ensures accurate labeling of ingredients, then it is more likely that consumers will at least have the option to consume a healthier snack. Although it will not be perfect, consumer policy might be reasonably effective through the "deceptive-marketing" route: firms have the ability to publicize the

54 R. Pitofsky, *Beyond Nader: Consumer Protection and the Regulation of Advertising*, 90(4) Harv. L. Rev. 661-701, 664 (1977). In fact, Posner (1969), *supra* note 31, at 69, claims that the FTC acted in the early 1960s to prevent the disclosure of tar and nicotine content in cigarette advertising.

salt content of the snack and market the product accordingly, while the consumer body makes periodic laboratory checks on the accuracy of the claims. Similar issues arise with the provenance of a product (e.g., "free-range", "organic", "U.K.-bred", or "fair-trade").

Powerful evidence of the impact of mandatory labeling of credence goods comes from a study of hygiene ratings cards for restaurants in Los Angeles.[55] In 1998, restaurants in parts of Los Angeles were forced to make prominent the results of recent hygiene inspections. The result was that (i) average hygiene scores increased, (ii) consumer demand became sensitive to changes in hygiene, and (iii) hospitalizations due to food poisoning in the local area declined. Moreover, the policy intervention was superior to the laissez-faire situation in which reputational concerns were the main incentive to have clean kitchens, suggesting a significant role for policy in this market.[56]

D. ADD-ON PRICING, HIDDEN CHARGES, AND THE SMALL PRINT

A possible limitation of Spiegler's model of confusing pricing discussed in Section III.C is that firms were somehow forced to advertise an unbiased signal of their true price: some consumers get the impression that the price is higher than it really is; some consumers think it is lower. However, in a wide range of plausible situations, firms systematically give the impression that the price is lower than it will in fact turn out to be. A common reason for this is that part of the service which many consumers will want is not included in the "headline" price used in marketing, as discussed in Section III.B. Although many of these situations are similar to the bait-and-switch method of deceptive marketing discussed in Section III.A, and their impact on consumer behavior can be similar, they do not fall foul of consumer law if the various charges are included in the advert's small print. In this section, I discuss this issue of hidden charges.

Consumers often seem to pay a lot for "add-on" products, such as extended warranties on electrical goods, payment protection insurance on loans, house insurance linked to a new mortgage, hotel phone and minibar charges in the hotel room, printer ink cartridges for a computer printer, or treats at the supermarket checkout line after the main shopping is done. They may be willing to do this in order to eliminate the hassle of buying complementary items from several different suppliers. However, if this was the only story, we would expect to see suppliers compete in terms of the total charge for all items, and consumer choice would not be distorted. But very often the price of the add-on is not voluntarily

55 G. Jin & P. Leslie, *The Effect of Information on Product Quality: Evidence From Restaurant Hygiene Grade Cards*, 118(2) Q.J. Econ. 409-51 (2003).

56 G. Jin & P. Leslie (2009), *supra* note 16, at 1. The authors conclude that "even when there is merit to the argument that reputational incentives operate as a market-based mechanism for mitigating information problems, they may be a poor substitute for full information."

publicized when the main item is marketed (electrical retailers do not tend to post prices for extended warranties on their shop windows, for example), which suggests that other factors are also at work.

Suppose, for whatever reason, the market operates so that the price of the main item is transparent to all consumers, but the price for a secondary product, the add-on, is not revealed until after a consumer has decided to purchase the main item. One example of this might be supermarkets, where a retailer can advertise its prices for a few selected prominent items, but the prices for other items can only be discovered once in the store. In a static context, it is plausible that a retailer will advertise very low prices for the prominent items (perhaps below cost), since that is the only way it can attract shoppers into the store, but the remaining items have something like monopoly prices.[57] Formally, the situation is much like the "bargains then rip-offs" prices seen in markets with switching costs.[58] As such, there will be an undesirable pattern of prices, which could harm consumer welfare whenever the demand for the add-on is not completely inelastic.

Another version of this kind of problem is the following.[59] A contract drawn up between a seller and a consumer includes a clause which comes into effect only in a relatively unlikely event. For instance, this could be the payout from an insurance contract in a particular scenario. The efficient negotiation of this clause would lead to a pay-off to the consumer of v and a pay-off to the seller of π. However, if the seller knows that the consumer does not, for whatever reason, read this clause, it could draft the clause so that it obtains payoff $\pi^* > \pi$ while the consumer then obtains just $v^* < v$. If the consumer has a "reading cost" k to read and understand this clause in the contract, she will not bother to read it when $k > r(v - v^*)$ where r is the small probability that the clause is implemented. That is, if the reading cost is large, or the perceived probability that the clause is relevant is small, the consumer will not bother to check that the clause has been efficiently drafted. In this case, sellers will draft the clause in their own interests, and inefficiency will result. This is true even if consumers are sophisticated and foresee that they will be exploited in the small print. Notice that, although the probability r might be almost negligible for an individual consumer, the fact that a firm deals with many consumers means that the profits it obtains from exploiting consumers in the small print could be significant.

57 R. Lal & C. Matutes, *Retail Pricing and Advertising Strategies*, 67(3) J. Bus. 345-70 (1994).

58 For a survey, *see* Joseph Farrell & Paul Klemperer, *Coordination and Lock-In*: *Competition with Switching Costs and Network Effects*, *in* 3 The Handbook of Industrial Organization 1967-2072 (M. Armstrong & R. Porter eds., 2007).

59 *See* M. Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47(2) Stanford L. Rev. 211-59 (1995), as well as the discussion of that paper and related literature in B. Hermalin, A. Katz & R. Craswell, *Contract Law*, in 1 The Handbook of Law & Economics §2.3.4 (M. Polinsky & S. Shavell eds., 2007).

In the situations described in the previous paragraphs, even if consumers had a very small, but positive, cost of investigating the small print or the add-on prices, it remains an equilibrium for all sellers to set monopoly terms for unobserved prices or clauses: if sellers are predicted to do this, there is no reason for consumers to incur the cost of finding out the hidden terms, and if no consumers look at the hidden terms, there is no reason for any seller to attempt to lure consumers by offering a better deal in the hidden terms. This is essentially the Diamond Paradox discussed in Section III.C, except applied to small print rather than to headline terms. The important difference is that when sellers exploit consumers in the small print, we do not expect industry profits to be excessive in markets with many sellers (unlike the situation with the usual Diamond Paradox): sellers will use the "rip-off" profit obtained from the monopoly small-print terms to fund "bargain" prices for the main item.

As a variant on this situation, suppose that a fraction of consumers (the "sophisticates") either observe or foresee the high price of the add-on product, and can substitute away from it at little cost. For instance, they could bring a mobile phone to a hotel rather than pay the high hotel phone charges. Or they could decide in advance whether or not to buy the extended warranty on their new TV, rather than have to make this decision under pressure from the sales assistant. In these cases, the sophisticates will not buy the add-on when they expect it to have a high price. By contrast, "naive" consumers do not consider that they may want the add-on product until they have purchased the main item. If sellers cannot distinguish sophisticates from naive consumers, and so must charge the same price for the main item, it follows that in competitive markets the main item will be subsidized to some extent, to reflect the fact that a fraction of consumers (the naive consumers) will go on to buy the high-priced add-on. Therefore, electronics retailers may offer a TV at a low price, in the hope of selling profitable warranties to a subset of purchasers. As such, the sophisticates, who obtain the main item at a subsidized rate and do not buy the add-on, will benefit from the presence of naive consumers. This is an example of a **B**-type cross-subsidy, in the terminology from Section III.C. A consumer policy that acts to reduce the price for the add-on (either by improving information about add-on prices, or by direct regulation of these prices) will likely cause harm to sophisticated consumers, and so will be more controversial than the **A**-type situations discussed in Section III.C.[60]

A consumer policy that acts to reduce the price for the add-on will likely cause harm to sophisticated consumers, and so will be more controversial than the A-type situations.

60 This effect is akin to the so-called "waterbed effect" seen in markets such as mobile telephony. There, if one charge is reduced by policy, it does not necessarily have an impact on equilibrium industry profits, but it will cause another price to rise correspondingly.

This discussion applies readily to penalty charges for late payment on credit cards or unauthorized banking overdrafts. If a bank sets a high charge for unauthorized overdrafts, this will generate profit from those consumers who naively get overdrawn. This profit will, in a hypothetical competitive market, be used to subsidize the main item (i.e., the bank account in this example). Therefore, high penalty charges could lead to free banking for those consumers who can avoid getting unexpectedly overdrawn. However, banks and credit card companies differ in one important respect from hotels and electronics retailers. A hotel, for instance, has no obvious way to determine whether a customer will or will not use its in-room add-ons, and so must charge a common room rate to all consumers. But a bank or credit card company has a long-term relationship with its consumers, and can learn about its consumers' behavior. Thus, a bank might be able accurately to identify those customers who do not get unexpectedly overdrawn. Since, according to this model, such consumers are loss-making for the bank, it is plausible that the bank will be tempted to raise charges to its solvent consumers (sometimes under the banner of "premium services" for preferred customers), or even to withdraw service from these consumers if free to do so.

The discussion to this point has taken as given the shrouded nature of add-on and small-print prices. An important point is whether firms in competitive markets do have an incentive to publicize all relevant prices (or other aspects of product quality), even when they could easily do so. It is possible to construct models where firms collectively prefer to keep their add-on prices hidden from consumers, so that industry profits in equilibrium are higher with hidden prices than with transparent prices.[61] But it seems plausible that competitive pressure will give a firm a unilateral incentive to make its prices transparent, and better aligned with consumer interests than the bargain-then-rip-off prices. The reason this is plausible is that the bargain-then-rip-off prices are an inefficient way to deliver utility to consumers, and the firms can extract more profit for a given level of consumer utility by increasing the price of the "bargain" and reducing the "rip-off".[62] This is just the usual argument that deadweight losses are reduced as prices are brought into line with costs.

However, there are also realistic scenarios in which firms do not even have a unilateral incentive to publicize their own, or their rivals', hidden charges.[63]

61 G. Ellison, *A Model of Add-on Pricing*, 120(2) Q.J. ECON. 585-637 (2005).

62 *See* Ellison (2005), *id.* at Proposition 4 and C. Shapiro, *Aftermarkets and Consumer Welfare: Making Sense of Kodak*, 63(2) ANTITRUST L.J. 496 (1995).

63 X. Gabaix & D. Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets*, 121(2) Q.J. ECON. 505-40 (2006). The numerical example which follows is essentially taken from section 1 of their paper. In a very different model Spiegler (2006a), *supra* note 50, also shows that firms do not wish to "de-bias" consumers. These recent results go against the claim in Beales et al. (1981), *supra* note 25, at 502, and many other authors, that "if information dissemination were costless to sellers, theory suggests that disclosure would be complete."

Advertising the add-on price acts as an "eye-opener" for naive consumers, and if it is advertised these consumers are converted into sophisticated consumers who take account of both prices. This can render unprofitable a decision to make charges transparent.

A numerical example serves to illustrate the point. Suppose all hotel rooms cost \$100 to supply and that there is a range of add-ons in the room which, for the sake of simplicity, costs the hotel nothing to supply. All consumers are willing to pay up to \$20 for these add-ons. The sophisticates think about add-ons in advance, and they can buy the add-on items beforehand if they believe the hotel's add-on charges will be excessive. If the add-on price is not advertised, these consumers will naturally assume the worst and expect high prices once in the room. They can buy the add-ons in advance at the competitive rate, which here is zero. Naive consumers do not buy these items in advance, and will buy them from the hotel if the add-on charge is no higher than \$20. Suppose that a fraction λ of consumers are sophisticated. In this case, if hotels do not make transparent their add-on charges, the price P for a room in a competitive market satisfies

$$P + 20(1 - \lambda) = 100$$

since a hotel knows that a fraction $(1 - \lambda)$ of the consumers will end up buying the add-ons in the room, which generates profit of \$20 each time, and this revenue can be used to help cover the cost of the room. In particular, a hotel is willing to set the room rate below cost in order to obtain the profit opportunity to exploit naive consumers. The sophisticates foresee that the in-room charges will be high, and buy their add-ons in advance, and so pay $P = 80 + 20\lambda$ for the whole service. Naive consumers, however, pay $100 + 20\lambda$ for the whole service. Thus, the sophisticates benefit from the presence of the naive consumers (if all consumers were sophisticated, the hotel room rate would be \$100); and, the naive consumers are harmed by the presence of the sophisticates.

What happens if one hotel advertises its add-on charges to potential consumers? By assumption, this makes even the naive consumers think about their consumption of add-ons. As such, the hotel cannot levy a positive price for its add-ons, since otherwise all of its consumers will buy the add-ons in advance. Therefore, to break even the hotel must charge \$100 for its rooms, which will attract no consumers since consumers can get a room for a subsidized rate at rival hotels. Thus, hotels in this example have an incentive to shroud the price of add-ons.

A policy of increased market transparency could have somewhat perverse consequences in this setting. If public policy acted to increase the fraction λ of consumers who were sophisticated, this raises the price for the total service paid by both types of consumer. (However, aggregate consumer welfare does not depend on the fraction λ in this model.) For instance, if policy made almost all consumers pay attention to hotel add-on prices, the result would be that the room rate simply reflected the cost. (A hotel would not anticipate making any significant profit from add-ons.) Those few inattentive consumers remaining would then pay the full room cost, plus the monopoly add-ons.

In a richer model, it is plausible that aggregate consumer welfare is harmed by excessive add-on prices, since the balance of prices is inefficient.[64] This suggests a potential role for consumer policy to correct this market failure. This policy could either make sufficiently prominent the "small-print" clauses and charges or directly regulate the add-on charges.[65] The more interventionist policy is discussed later in Section V, so for now consider market transparency policies. Since firms do not always choose publicize add-on prices, or consumers do not always think hard enough about such prices, there is a potential role for consumer policy to improve information flows to consumers. The effect of such a policy may act to educate the naive consumers to be more aware of the danger of add-on prices, and also to clarify what the add-on charges are (which is useful for sophisticated consumers too). To facilitate information flows, one could, for instance, require electrical retailers to post the price of the relevant extended warranty next to the main price for its televisions, so consumers could consider the two prices jointly.[66] This would be likely to have two effects: (i) consumers would be able to consider whether to buy the add-on without pressure from the sales assistant and (ii) the retailer may react by setting a more efficient balance of prices. In February 2007, the U.K. Office of Fair Trading warned travel providers to include all non-optional costs and taxes in their basic advertised prices, and in May that year it announced its intention to bring enforcement proceedings against airlines failing to comply.[67] Likewise, one could (somehow) force printer manufacturers to publicize the per-page printing costs of using their tied ink cartridges.[68] In a similar spirit, one might, I suppose, require hotels to publicize their

64 In a competitive market, the excess profits made on the add-on will be passed back to consumers in the form of inducements to buy the main item, and industry profits will not be excessive overall. In this case, the consumer harm consists just of the deadweight loss "triangles" rather than the monopoly profit "rectangles" which result from excessive pricing of add-ons. As such, the consumer welfare loss may be relatively small. *See* Shapiro (1995), *supra* note 62, at 497-98.

65 As an example of the latter policy, Gabaix & Laibson (2006), *supra* note 63, report that policy in Singapore required that hotels price their international phone calls at marginal cost plus a maximum of 30 Singaporean cents.

66 This was a remedy in U.K. Competition Commission, Extended Warranties on Domestic Electrical Goods (2003).

67 OFT (Jun. 2007), *supra* note 34, at 127.

68 This assumes the printer controls the retail price of its cartridges, and would also require a standardized "page" to facilitate comparisons. The general issue of establishing standardized scoring systems, and how a public body might act as a useful coordination device for this, is discussed in Beales et al. (1981), *supra* note 25, at 523-27.

in-room telephone charges on their webpages, but one would not wish to force hotels to read out a whole list of possible add-ons whenever a potential consumer calls up asking for the room rate.

This last point reminds us that consumers find information costly to digest. In particular, consumers may simply not take in the information that firms provide about aspects of their service. Thus, banks certainly provide details of their various charges in their contracts to new customers, but many customers do not read the contracts in detail.[69] Of course, one may be able to improve the presentation of the various charges, which will increase the proportion of consumers who are aware of the level of these charges. For instance, the consumer body could decide which of the various bank charges were important, and instruct the bank to present these charges in a prominent "summary box". But with a complex product all charges cannot be fitted into a summary box (without the box losing its function), and a danger is that consumers may react to the summary box by paying even less attention to the remaining small-print charges. In addition, a supplier could respond by inventing new categories of charges. As mentioned in Section III.B, with complex products it is hard for both firms and public policy to make all product attributes salient.

In addition, another reason why consumers do not always pay sufficient attention to some charges, even when they are made prominent, is that they (mistakenly) believe they will not get into a situation where the charges are payable. For instance, they optimistically believe they will always pay their credit card on time and do not look at the associated charge. Simple transparency policies cannot work well then. The next section discusses these situations of mistaken beliefs.

E. MISTAKEN CONSUMER BELIEFS ABOUT FUTURE TASTES OR NEEDS

If some consumers systematically misperceive their future tastes or needs (e.g., the probability that a new TV will break down, or that they will be able to pay their credit card on time each month), then even a competitive market will exploit them. The reason that competition does not help in these cases is that competition is good at giving consumers what they think they want, not what they end up consuming.

To take one example in detail, if exercise gyms have experience that suggests that new consumers will end up visiting the gym less often than the consumers anticipated, the gym may make more money by setting fixed membership fees instead of per-visit charges, as the former will be perceived by members as offer-

69 U.K. Financial Services Authority, Levels of Financial Capability in the UK: Results of a Baseline Survey (2006) reports that when buying a financial product, about half of survey respondents read the terms and conditions "in detail", while 10 percent did not read them at all. *See also* the references in R. Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. Chi. L. Rev. 1203-95, n. 45 (2003) and the references listed in note 38 *supra*.

ing better value for money.[70] To be specific, suppose the gym sets a fixed annual charge for membership F together with a per-visit charge p. Suppose all consumers will visit the gym $Q(p) = 1 - p$ times if the marginal price per visit is p. (Here, the number of visits when each visit is free is normalized to one.) However, suppose all consumers think they will visit twice as often and believe their demand is given by $Q_N(p) = 2(1 - p)$ where N denotes "naive". In this case, a consumer's perceived surplus at the time they consider the contract is

$$v = (1 - p)^2 - F.$$

Here, $(1 - p)^2$ is a consumer's surplus (the area under the demand curve and above the price p) corresponding to his predicted demand $Q_N(p) = 2(1 - p)$. The gym's profit from each consumer will actually be

$$\pi = (1 - p)(p - c) + F,$$

assuming the gym incurs cost $c < 1$ when a consumer visits. In a competitive market, a gym will maximize perceived consumer surplus v subject to profit π being non-negative. If negative prices for visiting the gym are not feasible, one can check that this entails $p = 0$ and $F = c$, so that only a membership fee is levied and each visit is free. Thus, this simple model suggests that the gym will offer a contract with only a fixed membership charge, even though there is a per-visit cost involved in providing gym services. The reason is that the firm and consumer evaluate a contract using a different prediction for the number of visits, and a fixed membership fee contract is mistakenly perceived to be good value by over-optimistic consumers.

An interesting feature of this situation is that the presence of sophisticated consumers need not help, or harm, the naive consumers at all.[71] That is to say, this is a type-**C** situation, using the terminology of Section III.C. To see this, suppose there is a second group of consumers who are more sophisticated and accurately predict they will visit the gym $Q(p) = 1 - p$ times. This group will just be offered marginal-cost prices in a competitive market, so that $F = 0$ and $p = c$. Neither type of consumer wishes to choose the contract targeted at the other type. (The contract targeted at each type of consumer maximizes that consumer's perceived utility subject to a break-even constraint.) Thus, in a competitive market a gym will offer two kinds of contracts: a membership fee contract aimed at the over-optimistic consumers and a per-visit contract aimed at the realistic consumers. The fraction of consumers who are sophisticated does not affect the form of these contracts.

70 DellaVigna & Malmendier (2004), *supra* note 24, and S. DellaVigna & U. Malmendier, *Paying Not to Go to the Gym*, 96(3) AM. ECON. REV. 694-719 (2006). Their 2006 paper provides evidence showing that many consumers choose a gym membership, even though they end up going so rarely they would be better off with pay-per-visit arrangement.

71 A related feature is observed in a monopoly context in Milgrom & Roberts (1986), *supra* note 20, at Proposition 3.

Note also that a gym does not have an incentive to de-bias consumers, even if it could somehow convince the naive consumers that their demand would in fact be lower than they expect. (It is hard to imagine how this de-biasing could be achieved, however.) If a consumer became aware of her true future demand, she would choose the per-visit contract aimed at the sophisticated consumers, which is already available in the market.

Similar issues arise in more important markets, such as medical or motor insurance. There is ample evidence to suggest that many people are over-optimistic about the likelihood that they will not have a serious illness or about their relative driving skills.[72] In such cases, the market may provide inadequate insurance to these over-optimistic consumers, since consumers will underweight the insurance policy's payout in the event of illness or an accident. Similarly, if consumers underestimate their propensity to get into debt, it may be profitable for a credit card company to offer up-front inducements to use the card (e.g., interest-free periods or no joining fee) combined with steep interest charges. Naive consumers will pay too little attention to the interest rate (until it is too late) since they do not believe it will apply to them. Ausubel (1991) emphasizes how even intense competition in the market does not overcome this problem.[73]

An issue related to over-optimism is that some consumers may be over-confident in their prediction of future tastes. For instance, a mobile telephone user has to forecast her future usage in order to choose amongst various calling plans. An over-confident consumer may have something like a point-estimate for her future usage, and neglect the likelihood that she may under- or over-use the service relative to this estimate. In such cases, it may be profitable for a firm to offer her a "three-part" tariff (i.e., a tariff which involves a fixed monthly fee, a number of inclusive minutes of calls, and then a high price for calls beyond the free allowance). This consumer will downplay the high price for making excess calls, and will not mind paying for calls she might not use in her free allowance, since she does not think either situation will apply to her.[74]

It is often hard to see how consumer policy can realistically improve these kinds of market failures, except via informational remedies. A more interventionist policy would involve intervening in the details of contracts, and this is rarely some-

72 *See*, respectively, N. Weinstein, *Unrealistic Optimism About Future Life Events*, 39(5) J. Personality & Soc. Psychol. 806-20 (1980); and O. Svenson, *Are We All Less Risky and More Skillful than our Fellow Drivers?*, 47(2) Acta Psychologica 143-48 (1981).

73 L. Ausubel, *The Failure of Competition in the Credit Card Market*, 81(1) Am. Econ. Rev. 50-81 (1991).

74 M. Grubb, Selling to Overconfident Consumers (2007) (mimeo, MIT). As well as providing the theoretical analysis outlined here, Grubb presents empirical data in support of the hypothesis that consumers are overconfident in their predictions of future usage. *See* Eliaz & Spiegler (2006), *supra* note 24, for closely related theoretical work in the context of time-inconsistent consumers.

thing a consumer body should attempt.[75] Should a regulator control the price for mobile phone calls beyond the monthly allowance? If so, at what level? Section V revisits this issue and discusses some examples of small-print regulation. For some products, though, information remedies may help to de-bias consumers. For instance, informative warnings on cigarette packets may cause smokers to re-think.[76] Driving tests (and advanced driving tests) may serve to reveal a driver's aptitude.[77] And the way statistical information is presented can have a major effect on many consumers' ability accurately to process that information. To take a simple example, many consumers put too much weight on low-probability events, especially if the outcome from such an event is particularly salient (e.g., a national lottery). If a (kill-joy) consumer policy is trying to de-bias consumers to have a better understanding of the likelihood of winning a lottery, the odds might usefully be represented as a metaphor (imagine choosing one ping-pong ball out of a large swimming pool filled with balls) or as a relative-odds comparison (winning the lottery is about as likely as being struck by lightning next week).[78]

> IT IS OFTEN HARD TO SEE HOW CONSUMER POLICY CAN REALISTICALLY IMPROVE THESE KINDS OF MARKET FAILURES, EXCEPT VIA INFORMATIONAL REMEDIES.

Finally, another example of how some consumers mis-forecast their future tastes is what is termed "projection bias", whereby a consumer extrapolates her current preferences too far into the future.[79] For instance, the excitement of test-driving a new car may lead to an impulse purchase, whereas after a few days the desire may end. In such cases, a mandated "cooling-off period", or a required waiting period before purchase is possible, may be a useful policy to counter-act this effect. Historically, the same reasoning applied to mandated notice periods for getting married.[80] Likewise, excessively onerous notice peri-

75 DellaVigna & Malmendier (2004), *supra* note 24, at §II.G, discuss possible regulatory intervention in the contracts offered by, say, gyms. They come to the pessimistic conclusion that "it requires extensive information which the government is unlikely to have [. . .]. A better policy for the government, in general, is to educate partially naive users and make them aware of their naiveté." No specific guidelines for how to do this are given, however.

76 Here, the form of the warning is likely to be very important. *See* C. Jolls & C. Sunstein, *Debiasing Through Law*, 35(1) J. LEGAL STUD. 199-241 (2006).

77 A. Sandroni & F. Squintani, *Overconfidence, Insurance, and Paternalism*, 97(5) AM. ECON. REV. 1994-2004 (2007).

78 Taken from Camerer et al. (2003), *supra* note 5, at 1231.

79 G. Loewenstein, T. O'Donoghue & M. Rabin, *Projection Bias in Predicting Future Utility*, 118(4) Q.J. ECON. 1209-48 (2003).

80 Camerer et al. (2003), *supra* note 5. Of course, another reason for cooling-off periods is when there is a danger that the contract may have been signed under duress. In this case, the cooling-off period will both protect the consumer from being locked into a contract she did not freely sign, and lessen the incentive to engage in aggressive selling practices in the first place.

ods or early contract termination payments seem a fairly clear cut area for intervention, unless the supplier has made specific durable investments which need to be recovered via a long-term contract (such as offering a free mobile handset in return for twelve months guaranteed service). There is no obvious efficiency reason why an exercise gym, for instance, needs several months' notice for a contract to cease. As was the case earlier, projection bias is one reason why many consumers do not pay sufficient attention to contractual arrangements for ceasing service at the time they sign up, since they may not anticipate their tastes changing.[81] (For the same reason, perhaps too few couples consider signing prenuptial contracts when they marry.)

IV. Can Competition Worsen Outcomes?

An important issue is whether competition can sometimes make things worse for consumers. (The previous section discussed several situations in which competition simply did not help.) Athletes sometimes claim that competitive pressure "forces" them to take banned substances, and that when their rivals use banned substances, they must do the same to stand a chance of success. Can the same phenomenon occur in markets too?

While this idea seems plausible, and is often stated casually, it is not straightforward to formalize. For instance, in the "salty snack" example from Section III.C, a monopoly snack provider has a strong profit incentive to use the cheaper, less healthy method. Indeed, one could say that it has a stronger incentive than a firm in a highly competitive market (which makes zero profit no matter which method it uses).[82] One simple attempt to analyze this point is Model 1 in the Technical Appendix at the end of this paper. In this model, when firms face consumers who are more likely to be price-aware (this is what we simplistically take to mean by "more competitive" in this context, since firms face higher own-price elasticity of demand), the product quality chosen by firms falls. In a related model in which all consumers observe market prices but only a fraction observe market qualities, one can show that increasing the number of suppliers (a simplistic form of "increasing competition") will increase the fraction of suppliers which "cheat" (that is, offer the inefficiently low-quality product), unless the fraction of consumers who pay attention to quality is particularly low.[83] Also, recall from Section III.C that Spiegler's model of confusing prices had the feature that, while the actual price chosen by firms was not affected by the number

81 *See* DellaVigna & Malmendier (2004), *supra* note 24, at §IV.

82 When Korobkin (2003), *supra* note 69, at 1235-36, discusses this point, he does not analyze a monopolist's incentive to supply the low-quality product.

83 M. Armstrong & Y. Chen, Inattentive Consumers and Product Quality (2007) (mimeo, University College London and University of Colorado at Boulder).

of suppliers, the "price noise" increased when there were more suppliers. In this sense, competition worsens outcomes. In some situations, moving from unregulated monopoly to duopoly can actually cause market prices to rise.[84]

Intensifying competition can also have a differential impact on different consumer groups. Specifically, a more competitive market may be better at delivering to vigilant consumers what they want, but may end up exploiting more vulnerable consumers even more than before. Consider Varian's model of sales once more. If the number of suppliers is increased—which is one measure of increasing competition in this symmetric oligopoly—one can show that the average price paid by the informed consumers goes down, but the average price paid by the uninformed actually increases (with limit equal to the monopoly price). Thus, in highly competitive (or rather, fragmented) markets the uninformed consumers do not gain any benefit at all from competition.[85] This differential impact of increasing competition on the two groups raises the distributional issue—which consumers are we aiming to protect? We could frame this question as "advantaged versus vulnerable consumers" or "careful versus lazy consumers", for instance, which may lead to different policy conclusions.

Another issue is not so much that firms behave worse when competition is stronger, but that some consumers are less able to make good decisions when faced with more options. There is some evidence that some consumers make worse choices, or do not choose at all, when they have a larger choice set.[86] In a field experiment, for instance, lending offers in a number of different formats were sent to a large number of potential borrowers. One of a number of interesting results from this study was that the take-up of a lending offer went down (all else equal) if more than one option for the loan size and loan maturity was given in the offer letter.[87]

While these and related studies are suggestive, it is not clear at this stage how they should impact consumer or competition policy. For one thing, there is at best a weak link between competition and the number of options which consumers face: a single firm could offer a bewildering number of options, or a number of firms could compete by offering simple deals to consumers. I would guess that very few people seriously advocate limiting the number of suppliers purely in order to

84 Y. Chen & M. Riordan, Price-Increasing Competition (2006) (mimeo, University of Colorado at Boulder and Columbia University).

85 This is discussed in Armstrong & Chen (2007), *supra* note 83, rather than in Varian's article itself.

86 A famous psychology experiment is described in S. Iyengar & M. Lepper, *When Choice is Demotivating: Can One Desire Too Much of a Good Thing?*, 79(6) J. Personality & Soc. Psychol. 995-1006 (2000).

87 M. Bertrand, D. Karlan, S. Mullainathan, E. Shafir & J. Zinman, What's Psychology Worth? A Field Experiment in the Consumer Credit Market (Nat'l Bureau of Econ. Research, Working Paper No. 11892, 2005).

help consumers make easier choices, and few would suggest public policy should intervene directly to reduce the number of options supplied by any given firm.

Nevertheless, it is clear that when some consumers face more choice (or any choice at all), they may make poor choices.[88] In terms of policy, this is most likely to be important when a hitherto monopolized market is opened to competition for the first time. There may be a special role for consumer policy in newly liberalized markets until consumers have found their feet in the new environment (a kind of "infant consumer" argument).

For instance, in 2003, the U.K. market for directory inquiries was opened to competition. Instead of having one familiar telephone number for telephone directory inquiries, consumers had a choice of more than 200 numbers they could call. Moreover, in the interests of maintaining a level playing field for entrants, the old number was withdrawn and consumers were forced to choose a new number. Since most consumers did not use the service more than once a month, it was hard for consumers to remember the new numbers. In addition, different operators offered different pricing schemes (e.g., per minute, per number, and so forth). The result was a good deal of consumer confusion and price dispersion, and many consumers paid more for the service than they did under the previous monopoly regime. Indeed, total demand for the service fell in the immediate aftermath of liberalization. However, after a year had passed, the market consolidated and just two (highly memorable) numbers supplied 80 percent of the market.[89] In fact, it may have been worth keeping the old number in place in the new liberalized regime: consumers who were confused by the plethora of new numbers (or did not want to go to the trouble of finding out) could stay with the familiar service, while more active consumers could take advantage of the lower prices or product innovations of the new services. (The favored number could then be auctioned off, in order to pass the rents from the incumbency advantage back to tax-payers.) This last point suggests a possible tension between consumer protection and competition policies that aggressively assist entrants in newly liberalized markets by means of banning the incumbent from the market.

When a market is newly liberalized, there is extra scope for transparency and consumer education policies. For instance, many consumers may be unaware for some time that they actually have a choice of supplier. Some consumers may initially overestimate how hard it is to change supplier.[90] While it seems likely that

88 For data indicating that many consumers do not choose the best electricity supplier for their needs even when they switch supplier, *see* Chris Wilson & Catherine Waddams Price, Do Consumers Switch to the Best Supplier? (Centre for Competition Policy, Working Paper No. 07-6, 2007).

89 All of this is taken from U.K. National Audit Office, Directory Enquiries: From 192 to 118 (Mar. 2005).

90 Waterson (2003), *supra* note 44, at Table 7, presents a survey in which one-third of consumers thought it would take at least a day to switch electricity supplier, when in fact it would probably take less than an hour.

the new entrants would be in a better position to educate their potential customers than a consumer body, there may also be a role for policy to provide market information at this time. Given consumer unfamiliarity with market conditions, together with the fact that some newly liberalized products are offered with nonlinear tariffs (which, as explained in Section III.B, makes price-comparison websites and adverts less useful), it makes sense to have a permissive attitude to direct marketing of various forms by entrants. Of course, alongside this tolerance of direct marketing, one would want other consumer protection policies in place to combat the danger of aggressive selling on the doorstep.

While it seems likely that the new entrants would be in a better position to educate their potential customers than a consumer body, there may also be a role for policy to provide market information at this time.

V. When Bad Consumer Policies Can Harm Consumers

A. CONSUMER PROTECTION AS INDUSTRY PROTECTION

Although its aims may be honorable, there is a long history of consumer protection being used as an excuse for industry protection, which is a form of protection that consumers do not want. An early example of consumer protection being used to limit competition and consumer choice is the legal monopoly held by the BBC in the 1920s and 1930s. The BBC was felt to broadcast high-quality content, and commercial rivals might tempt listeners to lower their own standards. Lord Reith, the first Director General of the BBC, wrote that a broadcasting monopoly was "essential ethically, in order that one general policy may be maintained throughout the country and definite standards promulgated."[91] Like many forms of consumer protection, the policy seems to have benefited one consumer group more than others:

> "Though the programme policy of the [BBC] gave the lower social classes what they ought to have, it gave the educated classes what they wanted; or, at any rate, more of what they wanted than they thought they would obtain with what was believed to be the only alternative – commercial broadcasting."[92]

91 As quoted in Ronald Coase, British Broadcasting: A Study in Monopoly 186 (1950).

92 *See* Coase (1950), *id.* at 177.

Somewhat more recently, in the 1950s and 1960s, the FTC often took a very expansive view of which adverts were misleading, and this was used to protect incumbent firms from new entrants. The problem was that an advert could be ruled as misleading even when it deceived only the "ignorant, unthinking, and credulous", which in practice could include many adverts.[93] Pitofsky (1977) wrote:

> "When the government acted as a surrogate enforcement arm for competitors, as it often did in ad regulation in the 1950's and early 1960's, it characteristically become entangled in nit-picking, literalistic disputes over the meaning of words in ads. During this period, many enforcement actions against advertisers grew directly out of competitor complaints and appear to have been primarily intended to protect sellers against competition from cheaper substitutes. Moreover, many of these cases involved disputes over relatively inconsequential items of information – e.g., [. . .] the percentage content of fibers in a fabric (90% wool/10% nylon, when wool content actually varied between 89.9% and 94.9%), or the definition of "free". After an analysis of some 200 decisions and orders entered by the [FTC] during the period July 1, 1962 to June 30, 1963, Professor Posner persuasively concluded that the FTC achieved "precious little consumer protection"."[94]

In Section III, I argued that consumer policies should facilitate advertising, since advertising might be a valuable channel through which consumers obtain information about prices and product attributes in the market. Therefore, it is ironic that in the past (as illustrated in the previous quote), consumer policies often acted to restrict advertising. Just one example of this is how the U.S. Food and Drug Administration essentially forbade firms to make health claims for their food in adverts.[95] Many professional bodies—sometimes acting with the blessing of consumer bodies—historically have had codes of conduct that unduly restricted advertising. Opticians and lawyers in some U.S. states were forbidden from advertising their prices. At least until 2006, lawyers in Scotland had tight restrictions on advertising, including comparative advertising.[96] Rules prohibiting comparative advertising are often justified on the basis that they prevent

93 *See* Beales et al. (1981), *supra* note 25, at 497.

94 Pitofsky (1977), *supra* note 54, at 674. The report by Professor Posner alluded to was expanded to become Posner (1969), *supra* note 31.

95 *See* note 17, *supra*.

96 *See* Scottish Executive, Report of the Research Working Group of the Legal Services Market in Scotland ch. 6 (2006).

misleading advertising from occurring. But this objection has no force if there is an effective consumer policy in place to prevent misleading advertising.

As well as taking an inappropriately restrictive line on advertising, there are several historical examples where other restrictive trading practices have been permitted under the banner of consumer protection. For instance, there is the danger that professional bodies may require unduly stringent conditions for new entrants to be licensed. In Section III.C, I argued that making professional qualifications transparent was likely to be a useful policy in credence goods markets such as law or medicine. A distinct policy is to require minimum qualifications to be able to enter the market. Again, this may sometimes be justified if vulnerable consumers do not make good decisions and if a poor decision is very costly. But there is also the danger that the licensing body sets excessively stringent minimum qualifications, with the result that supply and competition is restricted. For instance, "black cab" taxis in London may lobby against unlicensed minicabs being permitted to enter the market, not just because the latter may not know the streets well enough, but because they will cause the market price to fall. Other famous examples include restrictive rules that only licensed pharmacists can sell drugs, or only licensed funeral directors can supply coffins.[97] The website of the Hairdressers' Registration Board in Western Australia states that one goal of licensing is to protect incumbents from competition by preventing "unqualified people from opening a salon next to you and practising as a hairdresser in an attempt to impact on your established clientele."[98] The general point is that self-regulation by professional bodies cannot be relied on to deliver good outcomes for consumers. Moreover, as well as restricting supply, such a policy also restricts the choices available to consumers, as discussed in the following section.

B. CONSUMER POLICIES THAT RESTRICT CONSUMER CHOICE

Other highly contentious consumer policies are those that act to restrict the choices available in the market. The reason for this is that such policies harm those consumers who vigorously defend their interests, even if they sometimes help the more vulnerable consumers.[99] Such policies are usually highly re-distributive between consumer groups, and often have the flavor of putting fences alongside cliff-top paths: they protect careless or vulnerable walkers from falling

97 *See* Muris, *supra* note 1. Muris quotes the FTC as writing in a court statement that "[r]ather than protect[ing] consumers by exposing funeral directors to meaningful competition, the [law] protects funeral directors from facing any competition from third-party casket sellers."

98 Productivity Commission of Australia, Review of Australia's Consumer Policy Framework 9 (2007).

99 However, information remedies which educate naive consumers can also make sophisticated consumers worse off in the **B**-type situations described in Section III.D. But there is a difference between correcting an "unfair" cross-subsidy caused by inattentive consumers, and harming sophisticated consumers in order to support inattentive consumers.

off, but they reduce the utility of everyone else. Such policies are often heavily paternalistic, and involve a danger that they reflect the tastes of policymakers—either their innate tastes, or the tastes of the special interest groups who have captured the policymakers—rather than citizens as a whole (as is Coase's point in the quote in the previous section).[100] A strong expression of distaste for this form of policy opens a 2006 paper by Klick and Mitchell:

> "Several years ago the ethicist Daniel Wikler provocatively asked, "If we claim that relative intellectual superiority justified restricting the liberties of the retarded, could not exceptionally gifted persons make the same claim concerning persons of normal intelligence?" Wikler's question, posed originally to raise doubts about paternalism directed at the developmentally disabled, possesses a new relevance today, as legal elites increasingly claim that "persons of normal intelligence" exhibit numerous irrational tendencies that justify restrictions on market and non-market transactions."[101]

A somewhat related point can be made in a less contentious way: "[I]nformation remedies allow consumers to protect themselves according to personal preference rather than place on regulators the difficult task of compromising diverse preferences with a common standard."[102]

A frequent way in which consumer policies can restrict choice is by imposing stringent minimum quality standards on a market. Of course, if quality is not observed by consumers, if reputational concerns are not effective, and if information remedies are not feasible, then it may be sensible to impose minimum standards. But the situation is rarely that bad. An example of a simplistic consumer policy might be to require all airline flights to offer a full meal service, for instance. This policy bundles together the flight and a full meal, and denies those consumers who prefer not to pay for the meal that option.[103] (It may also act to deter entry by "no frills" carriers.)

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100 Also, in democracies majorities may vote to outlaw choices made by minorities. For instance, in 1998 a California referendum voted to outlaw the sale of horsemeat in restaurants. *See* Alvin Roth, *Repugnance as a Constraint on Markets*, 21(3) J. Econ. Persp. 37-58 (2007).

101 J. Klick & G. Mitchell, *Government Regulation of Irrationality: Moral and Cognitive Hazards*, 90 Minnesota L. Rev. 1620-63 (2006).

102 Beales et al. (1981), *supra* note 25, at 513.

103 Likewise, in 2005 the European Commission required airlines to compensate consumers for cancelled flights, regardless of the cause, thus bundling together the flight and travel insurance.

A model which captures the trade-off between dealing with information problems and giving consumers with diverse tastes what they want is described by Leland (1979).[104] Consider, say, the market for doctors. Because of the credence good nature of the market, consumers can only observe the average skill of doctors active in the market, not the skill of an individual doctor. Without policy intervention, a "lemons" problem may be present, and highly-skilled potential doctors may prefer another profession which better rewards their abilities. Doctors differ in their skill, and consumers differ in their willingness-to-pay for that skill. By setting a minimum skill standard, the lemons problem is alleviated. However, the policy also removes the ability of those consumers who do not value skill highly (say, because their medical problem is routine) to find a low-quality service at a low price. Moreover, Leland shows that self-regulation will lead to excessively high minimum standards, in line with the discussion in Section V.A.

A somewhat similar model is presented as Model 2 in the Technical Appendix at the end of this paper, which analyzes the impact of minimum quality restrictions in a market with three kinds of consumers: consumers who want a low-quality good, consumers who want a high-quality good and think about quality when they purchase the good, and consumers who innately want a high-quality good but do not (for some reason) consider quality when they buy. This last group buys purely on the basis of price. As analyzed in the Appendix, a policy which permits only high-quality products to be sold has two effects:

1. it protects those consumers who do not pay attention to quality but who do care about quality, and
2. it harms those consumers who truly want the lower quality item.

Whether such an interventionist policy is merited depends on the relative numbers of the two groups and their respective gains and losses.[105] Sometimes it is fairly clear that the low-quality item should be forbidden; for instance, if hardly anyone would really want it, if many would not think about this aspect of quality until it is too late, and if the harm to inattentive consumers is great. Some examples might include a contract clause which makes it extremely difficult to cease service, a mortgage contract which doubles all future interest payments if a consumer defaults on just one monthly payment, or perhaps an obscure clause couched in legal jargon which limits forum selection and a consumer's ability to sue. But other cases are much less clear-cut, such as the credit card penalty

104 H. Leland, *Quacks, Lemons and Licensing: A Theory of Minimum Quality Standards*, 87(6) J. Pol. Econ. 1328-46 (1979).

105 As Korobkin (2003), *supra* note 69, at 1251-52, puts it: "ex ante mandatory terms are desirable when a simple rule or an only moderately complicated rule can insure that the mandated content will be efficient for a relatively large proportion of contracts."

charges discussed shortly. In such cases, the information needed to be confident that the benefits of banning a particular product outweigh the losses is hard for a consumer body to find. In these situations, the consumer body should investigate carefully whether there is an information remedy that might do almost as well at protecting the inattentive consumers without restricting choice.

This trade-off for consumer policy—between protecting vulnerable or careless consumers who do not read the small print, and giving sophisticated consumers the finely tuned contract they want—is underemphasized in much research. Many of the simplest behavioral models assume that all consumers have the same tastes, in which case a "one-size-fits-all" policy remedy is usually straightforward. For instance, if all consumers want the same insurance contract but only some consumers look at the small print, then without regulation it is likely that some firms will offer a contract with exploitative small-print terms. The remedy for this is simple: force all firms to set the unanimously desired small-print terms.[106] If all consumers prefer an expensive healthy snack to a cheap salty snack (see Section III.C), one could just enforce maximum salt content rules. Likewise, in the example of gym contracts in Section III.E, a solution to the market failure in that theoretical model would simply be to force gyms to levy charges on a per-visit basis. But this is obviously an absurd policy in reality, since there are several other reasons why gyms might wish to give consumers the option of a fixed monthly contract (such as to offer a commitment device to weak-willed consumers who will be put off by a per-visit charge, or to price discriminate between low-usage and high-usage consumers). In reality, different consumers have different requirements and may want different contractual terms, in which case the simple remedy to ban "inefficient" contract terms no longer works well.

Consider in more detail the case of late payment charges on credit cards. As an alternative (or in addition) to an informational remedy, such as making these charges more prominent when the consumer signs the contract, one could directly control the level of such a charge. Set against the beneficial impact on those consumers who end up paying the charge and did not realize it applied to them, there are at least five drawbacks to such a policy. First, as discussed in Section III.D, the impact will likely be to harm the careful consumers who do always pay on time, and so the benefit in terms of aggregate consumer welfare is unlikely to be great. Second, there may be consumers who actively want to have this particular charging structure. For instance, a consumer who is aware that he suffers from self-control problems might like the extra discipline that high penalty charges bring, so that the high charge acts as a commitment device.

The third problem is that a credit card supplier might legitimately wish to deter adoption of its product by less credit-worthy consumers, and may use a high

106 *See* Armstrong & Chen (2007), *supra* note 83.

charge for late payment as a means of doing so.[107] Fourth, as a practical matter it may be very resource intensive for a consumer body to have to determine permitted price levels in the small print of contracts. Generally, one does not want a consumer or competition body to need to have a detailed knowledge of the many industries it oversees. Unless it is completely arbitrary, in order to calculate the basis for a "fair" small-print charge, the authority will have to investigate detailed costs incurred by many firms on an ongoing basis, which will be resource-intensive for both the authority and the industry.[108]

Finally, the fifth reason for caution is that such a policy may be the thin end of the wedge.[109] If policy to control the level of small-print or add-on charges is deemed appropriate in this instance, why not in other markets such as: hotel phone charges; printer ink cartridges; extended warranties on electrical goods; charges for going beyond one's monthly allowance for mobile phone calls; the hypothetical expensive butter in the supermarket in Section II; and so forth?

As a practical matter, though, it is important to recognize that a consumer body operates in an established legal environment, and its options for intervening in the small print may be rather limited. For instance, realistically the consumer body may only be able to choose between (i) not being pro-active in participating in legal challenges to high small-print charges and leaving matters to the courts and individual actions, or (ii) being pro-active on behalf of consumers and mounting (or threatening to mount) a legal challenge whenever the relevant small-print charge is above some threshold. In the second approach, this

107 Of course, then such a firm would not put the charge in the small print. Alternatively, a credit card company might require its customers to agree to pay a minimum monthly payment (or even the entire balance) by direct debit each month. The supplier may thus hope to attract credit-worthy customers and also to remove the need to run a large "debt collection" office. However, this point conflicts with the discussion in Section III.D of this paper, where I discussed how a credit card company might make more money from its less solvent customers.

108 In 2006, the OFT announced that it regarded penalty charges (for all kinds of default, including spending beyond the agreed credit limit) higher than GBP 12 as being unfair, and that such charges would lead it to intervene. The legal framework for this decision is provided by the 1999 Unfair Terms in Consumer Contracts Regulations. A "core term" (e.g., the headline price, or interest rate in the case of credit cards) in a contract can essentially be set at any level, but other items in a standard contract (to which some consumers will not pay attention when they sign) are subject to a "fairness" constraint. In the case of breach of contract (which is what late payment technically is), the fairness constraint broadly allows the supplier to have its additional administrative costs covered by the penalty charge. The OFT estimated these administrative costs at GBP 12, and gave some broad (but unquantified) indications of how it estimated these costs. It states that "on the basis of our analysis we consider that the threshold is robust and there are unlikely to be grounds to consider any higher threshold for our action over the short or medium term." *See* U.K. OFFICE OF FAIR TRADING, CALCULATING FAIR DEFAULT CHARGES IN CREDIT CARD CONTRACTS: A STATEMENT OF THE OFT'S POSITION (Apr. 2006).

109 In addition to this list, one could point out that in the United Kingdom there has been so much recent publicity about credit card penalty charges that the number of consumers who are now unaware of such charges has shrunk substantially, thus mitigating to some extent the need for further intervention in this area.

threshold is presumably chosen in anticipation of courts judging a charge above this threshold to be unfair. Whether the threshold should be chosen to be the smallest threshold acceptable to the courts is less clear, for the reasons given earlier. A crucial advantage of the second approach is that there are major economies of scale in litigation; that is, while an individual consumer may find it not worthwhile to bring a court case if she receives a single excessive penalty charge, a consumer body may well find it worthwhile to bring a test case on behalf of many affected consumers.

It seems fair to say that current economic understanding of good policy towards small-print terms is limited, and one of the most fruitful avenues for future research at the law and economics interface would be to investigate these issues further. For instance, what should determine a "small-print term"? How many consumers need to take into account the term before it can be considered a "core term"? Could the high charges for making mobile phone calls beyond the monthly allowance be considered a small-print charge, and therefore needing explicit control? Can a supplier make a contract term small print for some consumers but, by making appropriate adjustments, a core term (and so not governed by small-print regulations) for other, perhaps more sophisticated, customers? And, what economic principles govern the appropriate level of charges in those terms deemed to be small print in standard-form contracts? For example, one would not wish to permit mobile phone companies to be able to set arbitrarily high charges for phone calls beyond the monthly allowance, since at least some consumers will mistakenly go over the allowance. On the other hand, there is no reason to think that the company should be forced to sell these extra calls at cost.

IT SEEMS FAIR TO SAY THAT CURRENT ECONOMIC UNDERSTANDING OF GOOD POLICY TOWARDS SMALL-PRINT TERMS IS LIMITED, AND ONE OF THE MOST FRUITFUL AVENUES FOR FUTURE RESEARCH AT THE LAW AND ECONOMICS INTERFACE WOULD BE TO INVESTIGATE THESE ISSUES FURTHER.

C. CONSUMER PROTECTION AND MORAL HAZARD

Related to the previous discussion, a general and powerful point is that, if consumers are over-protected in their market transactions, moral hazard may ensue and they may not pay sufficient attention to making the best choices.[110] If a consumer is fully insured, she will take less care protecting her possessions. An efficient insurance contract will trade off the benefits of insurance to risk-averse consumers with the need to ensure that the consumer takes care. Likewise, in markets with complex products, the consumer needs to invest effort to choose what product is the best for her. For instance, if consumer protection ensures she

110 This view is emphasized in Klick & Mitchell (2006), *supra* note 101. In particular, §1A of that paper surveys the ample, though not unanimous, evidence that subjects in laboratory experiments make better decisions when their stakes are higher.

will face no bad surprises in the small print, she may be less likely to read the contract at all. As Posner (1969) puts it:

> "Just as the cheapest way to reduce the incidence of certain crimes, such as car theft, is by inducing potential victims to take simple precautions (locking car doors), so possibly the incidence of certain frauds could be reduced at least cost to society by insisting that consumers exercise a modicum of care in purchasing, rather than by placing restrictions on sellers' marketing methods."[111]

It seems plausible that consumers learn market skills over time and, moreover, these market skills are often not specific to one market, but spill over to many markets. For instance, the victim of a scam, or an unexpectedly high credit card penalty charge, will usually be more vigilant in future. It does not take many bad experiences with scams to learn the maxim that "if it seems too good to be true, it probably is." Unless a consumer is particularly vulnerable or the product is particularly harmful, it is probably best to let consumers develop their own imperfect rules of thumb to defend themselves in the market. Some consumers will no doubt harm themselves by inexpertly cooking a chicken (say, by not reading the small print of the cooking instructions), but the solution is not to remove raw chicken from the market.[112] The general point is that excessive consumer protection may be inimical to the development of market skills in consumers.[113]

111 Posner (1969), *supra* note 31, at 67.

112 However, just because there is moral hazard does not mean insurance should not be offered at all. One might balk at permitting sales to the general public of Japanese pufferfish, which is fatal if prepared even slightly incorrectly.

Staying with the food theme, another related issue is the widespread use of "use-by" dates on food. Many consumers never use food beyond its use-by date. Given that the use-by date is chosen so that the foodstuff is almost certain to be edible regardless of local conditions (e.g., how often the consumer's fridge is opened), it is plausible that inefficiency arises from this policy. If use-by dates were less widespread (say, in the days when many consumers purchased meat from a butcher rather than a supermarket), consumers would likely have better skills in detecting whether food is edible (e.g., by smell). This is another instance of how arguably excessive protection leads to consumers possessing too few market skills. Of course, though, one cannot sniff a "ready meal".

113 There is a plausible lifecycle effect here. Younger consumers may not yet have learnt their market skills, whereas some of the elderly may have learnt, but forgotten, their skills. In particular, policy might sometimes exempt the latter group from this caution about over-insulating consumers against market risk. *See* S. Agarwal, J. Driscoll, X. Gabaix & D. Laibson, The Age of Reason: Financial Decision-Making over the Lifecycle (MIT Department of Economics, Working Paper No. 07-11, 2007) for some evidence that consumers reach their decision-making peak for financial products at around 53 years of age.

To take a specific example, a consumer policy that acts directly to limit price dispersion in such a market could have somewhat perverse effects. (In some jurisdictions, for instance, usury laws operate so that an interest rate which is more than a specified distance above the market average for the relevant loan cannot be legally enforced. It is plausible that such a policy will reduce interest rate dispersion.) If price dispersion is reduced, this reduces the incentive for a consumer to become informed (i.e., the benefit curve in Figure 1 is shifted down), and so is likely to reduce the number of informed consumers. The net result of reduced consumer search could well be that average prices in the market increase, thus harming consumers. Similar effects might arise with imposing minimum quality standards on a market, which could reduce the number of consumers who monitor quality and hence the average quality supplied.

SOME CONSUMERS WILL NO DOUBT HARM THEMSELVES BY INEXPERTLY COOKING A CHICKEN (SAY, BY NOT READING THE SMALL PRINT OF THE COOKING INSTRUCTIONS), BUT THE SOLUTION IS NOT TO REMOVE RAW CHICKEN FROM THE MARKET.

D. MARKET TRANSPARENCY POLICIES

As discussed in Section III, a consumer policy of price transparency is often valuable. However, market information supplied by government bodies is not a panacea, just as it is not when supplied by commercial bodies. For instance, a policy-induced focus on headline price may lead to worse performance on other attributes (such as product quality or small-print charges). In Model 1 presented in the Technical Appendix at the end of this paper, it is shown that when more consumers become aware of prices in the market, this can result in lower quality products being offered by firms.[114] The reason for this is quite intuitive. With increased consumer focus on price, price competition is intensified and lower price-cost margins result. Therefore, a firm has a reduced incentive to expand its market share by boosting its product quality, and so chooses to offer a lower quality than before.[115] The implication of this is that policies to improve market transparency need to be carefully designed not to give undue emphasis to just one aspect of market performance (such as headline prices), since worse performance on other dimensions could unravel any welfare gains.[116] Empirical evidence for this danger can be found by examining the impact of the publication of

114 The first model presented in the appendix is similar to (but simpler than) D. Dranove & M. Satterthwaite, *Monopolistic Competition when Price and Quality are Imperfectly Observable*, 23(4) RAND J. ECON. 518-34 (1992).

115 S. Huck, G. Lünser & J.-R. Tyran, Pricing and Trust (2008) (mimeo, University of College London), presents experimental evidence which is consistent with this discussion.

116 This insight is similar to that in the principal-agent literature, where when an agent's overall performance depends on several kinds of effort, excessive focus on one kind of effort may lead to poor overall performance. *See* B. Holmstrom & P. Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7(special issue) J.L. ECON & ORG. 24-52 (1991).

patient outcomes for individual hospitals and physicians.[117] The introduction of this transparency measure appears to have induced many health care providers to be more selective in the healthiness of the patients they take on, so as to make their "report card" more impressive. Data on cardiac surgery suggests that, in the short run at least, this effect outweighed the benefits of improved matching of patients to hospitals, and overall patient welfare declined.

When prices are made more transparent to consumers, they are also made more transparent to rival suppliers, and this can relax competition between firms. There are two aspects to this issue. First, there may be an increased danger of collusion. For instance, evidence suggests that a price transparency policy in the Danish ready-mixed concrete market may have relaxed price competition.[118] Effective competition policy should be able to counteract this effect to some extent, but it cannot be perfect (especially if collusion is tacit rather than explicit). The second aspect of this issue is that transparency requirements could have the effect of making suppliers set a standard tariff to all consumers, rather than setting "personalized" prices to individual customers. The impact of this is akin to a ban on price discrimination in the market, which is well-known to have ambiguous effects on consumer welfare. There are several plausible situations in which price discrimination acts to intensify competition to the benefit of consumers.[119]

VI. Conclusions

This paper has explored the interactions between consumer and competition policies. In many respects there was no tension between the two approaches. Indeed, in most competitive markets, firms succeed by giving consumers what consumers want to buy, and there is little need to provide customer protection beyond what firms themselves supply. Specific situations in which consumer policies can help markets function better include a number of information policies: the provision or accreditation of price comparison websites; attempts to increase the number of consumers who are aware of market conditions; attempts to reduce consumer search costs; attempts to "unshroud" (rather than directly control) hidden charges; removing constraints on advertising (including comparative advertising); attempts to provide product information which it is not in the industry's

117 D. Dranove, D. Kessler, M. McClellan & M. Satterthwaite, *Is More Information Better? The Effects of "Report Cards" on Health Care Providers*, 111(3) J. Pol. Econ. 555-88 (2003). *See* Archon Fung, Mary Graham & David Weil, Full DisclosuRE: The Perils & Promise of Transparency (Cambridge University Press, 2007) for a detailed analysis and evaluation of various transparency policies such as this one.

118 S. Albæk, P. Møllgaard & P. Overgaard, *Government-Assisted Oligopoly Coordination? A Concrete Case*, 45(4) J. Indus. Econ. 429-43 (1997).

119 *See, e.g.,* Mark Armstrong, *Recent Developments in the Economics of Price Discrimination* §3.3, *in* II Advances in Economics & Econometrics 97-141 (R. Blundell et al. eds., 2006).

interest to provide itself; and policies to provide accurate labeling of credence goods. Somewhat related to these are policies that prevent misleading or outright fraudulent marketing.

Competition policies can occasionally harm some consumers. For instance, if a fixed fraction of consumers observe market prices while the remainder shop in ignorance, having more suppliers in the market can sometimes cause the prices paid by the uninformed shoppers to rise. A newly liberalized market can be particularly confusing for vulnerable consumers. Policies which protect "infant suppliers" may conflict with policies to protect "infant consumers".

Poorly conceived consumer policies can easily cause tension with competition policies and consumer freedom of choice. Such policies might include unduly strict licensing of professions (or lax monitoring of self-regulation) and unduly strict interpretations of misleading marketing regulations which act to protect market incumbents rather than consumers. In addition, ill-focused information remedies can act to relax competition between suppliers, and also cause other de-emphasized aspects of market performance to falter. Generally, if consumers are overly protected in their market transactions, there is a danger of moral hazard and consumers may not develop the market skills to defend themselves against future exploitative conduct.

Moving beyond information remedies, many remaining consumer policies are paternalistic in flavor. The most palatable of such policies are those that help vulnerable consumers who do not always make good decisions for themselves, without significantly harming more sophisticated consumers.[120] Default rules provide a good example of such a policy. For instance, a motor insurance contract might have as its default that a driver has a full right to sue after an accident, or alternatively the default might be a more limited right to sue. Sophisticated consumers will probably make the same decision in either case (given that the cost of putting a tick in the relevant box is small), but inattentive consumers will be more likely to go along with the default. Therefore, policymakers can choose the default to maximize (their view of) the interests of the inattentive consumers, without unduly impacting the sophisticated consumers.[121] The problem, however, is that there may not be many such "no trade-off" policies available.

More common is the danger with some consumer policies of tensions between different consumers. Several of the more interventionist consumer policies benefit one group of consumers at the expense of another. At the mild end of this spectrum are policies against misleading advertising; a policy that prevents

120 The philosophy behind such policies is sometimes termed "asymmetric paternalism" by Camerer et al. (2003), *supra* note 5, or "libertarian paternalism" (or even "anti-anti-paternalism") by R. Thaler & C. Sunstein, *Libertarian Paternalism*, 93(2) Am. Econ. Rev. 175-79 (2003).

121 *See* Camerer et al. (2003), *supra* note 5, at 1226.

adverts from misleading the "ignorant, unthinking, and credulous" may prevent adverts that are useful or entertaining to more sophisticated consumers. At the more extreme end are policies that forbid certain products—which some consumers may actively want—in order to protect vulnerable or careless consumers. Such policies should only be contemplated if no information or education remedy would work instead. Even so, it would be reassuring if they were accompanied by a rigorous cost-benefit analysis (which is usually sorely lacking in consumer policy). As exemplified by Model 2 in the Appendix, the informational requirements needed to assess the likely benefits of the intervention are formidable in even the simplest situations.

This paper has also highlighted the need for more research, in particular:

- more analysis of when "opt-out policies", in which consumers can choose not to receive marketing from firms, might conflict with the generally pro-competitive benefits of advertising and direct marketing;
- more analysis of the economic basis of controlling both the definition and the content of small-print contract terms; and
- more analysis of when excessive consumer protection leads to moral hazard in consumer decision making.

MORE COMMON IS THE DANGER WITH SOME CONSUMER POLICIES OF TENSIONS BETWEEN DIFFERENT CONSUMERS. SEVERAL OF THE MORE INTERVENTIONIST CONSUMER POLICIES BENEFIT ONE GROUP OF CONSUMERS AT THE EXPENSE OF ANOTHER.

Finally, it is noticeable that redistributive aims are rarely included in competition policy analysis, where the objective is typically to maximize the (possibly weighted) sum of aggregate consumer welfare and industry profit.[122] The idea behind this is that other instruments (such as taxation) are better targeted at income redistribution between consumers. The aim is also more appropriate for elected politicians than unelected bureaucrats to pursue. However, some of the more interventionist consumer policies are explicitly aimed at benefiting vulnerable consumers at the expense of sophisticated consumers. It would be worthwhile to investigate if there is indeed a valid role for redistribution via consumer policy.

122 *See, e.g.*, MOTTA (2004), *supra* note 2, at §1.3.1.

Technical Appendix

MODEL 1: THE "PERVERSE" IMPACT OF MARKET TRANSPARENCY

Suppose that two firms, 1 and 2 say, are located at each end of a Hotelling line of unit length. Consumers are uniformly located along this line, and must pay a transport cost t per unit distance traveled. The two firms potentially differ in the price they offer, p, and the quality of their product, v. If a consumer pays p_i for a product with quality v_i, her surplus (excluding transport costs) is $v_i - p_i$. It makes the algebra easier (but does not significantly affect results) if we suppose that choosing quality only affects a firm's fixed costs, and a firm's marginal cost does not depend on quality and always equals c. If a firm chooses quality v_i, suppose its fixed cost is

$$\frac{kv_i^2}{2} .$$

Suppose that a fraction $1 - \lambda$ of consumers do not observe market prices and a fraction $1 - \mu$ of consumers do not observe market qualities. (It does not matter about the correlation between the two kinds of inattentive consumers.) If a consumer observes neither prices nor qualities, she will simply buy from the nearer firm. (She, correctly, predicts that both firms set the same price and the same quality.) Those consumers who observe prices but not qualities assume both firms offer the same quality and so buy purely on the basis of price. Likewise, those consumers who observe quality but not price buy on the basis of quality. The remaining consumers know all market information, and in particular they can respond to a price cut (or a cut in quality) by a firm.

The market share of firm i can then be shown to be

$$\frac{1}{2} + \mu\,\frac{v_i - v_j}{2t} - \lambda\,\frac{p_i - p_j}{2t} .$$

Therefore, the firm chooses p_i and v_i to maximize

$$\pi_i = \left(\frac{1}{2} + \mu\,\frac{v_i - v_j}{2t} - \lambda\,\frac{p_i - p_j}{2t}\right)(p_i - c) - \frac{1}{2}kv_i^2 .$$

The first-order conditions for this problem are

$$\frac{\partial \pi_i}{\partial p_i} = \left(\frac{1}{2} + \mu\,\frac{v_i - v_j}{2t} - \lambda\,\frac{p_i - p_j}{2t}\right) - \frac{\lambda}{2t}(p_i - c) = 0 \text{ ; and}$$

$$\frac{\partial \pi_i}{\partial v_i} = \frac{\mu}{2t}(p_i - c) - kv_i = 0 .$$

At a symmetric equilibrium, it follows that

$$p = c + \frac{t}{\lambda} \text{ ; and } v = \frac{\mu}{2\lambda k} . \tag{1}$$

The second-order condition requires that

$$0 > \frac{\partial^2 \pi_i}{\partial p_i^2} = -\frac{\lambda}{t} ,$$

which is always the case, and also that

$$0 < \frac{\partial^2 \pi_i}{\partial p_i^2}\frac{\partial^2 \pi_i}{\partial v_i^2} - \left(\frac{\partial^2 \pi_i}{\partial p_i \partial v_i}\right)^2 = \frac{k\lambda}{t} - \left(\frac{\mu}{2t}\right)^2 . \qquad \textbf{(2)}$$

This inequality requires that k is sufficiently large (i.e., that it is not too easy to improve quality since otherwise it would be in a firm's interest to expand quality so as to attract the entire population of consumers). Notice that condition **(2)** ensures that firms at least break even in equilibrium. Therefore, assume that parameters are such that condition **(2)** holds.

Note that equilibrium quality in **(1)** is decreasing in the fraction of price-aware consumers. This is intuitive: increasing the number of price-aware consumers will cause equilibrium prices to fall, and this reduces the firm's return from expanding market share by means of offering higher quality. Thus, a consumer policy (or a commercial price comparison website) which increases market focus on price, boosting λ, will cause quality to fall. In this simple model with unit demand and full coverage, quality is the only variable which affects total welfare, and the socially optimal quality is

$$v^* = \frac{1}{2k} .$$

From **(1)**, quality is too low in equilibrium whenever $\mu < \lambda$ (i.e., when consumers pay less attention to quality than they do to price, as often seems plausible). Thus, whenever $\mu < \lambda$, boosting λ further by making prices more transparent will actually harm overall welfare. Since quality is increasing in μ, though, boosting μ through a market transparency policy which focuses on quality awareness will improve welfare.

MODEL 2: THE PROS AND CONS OF SETTING SMALL-PRINT TERMS AT "EFFICIENT" LEVELS

Suppose a product (e.g., an insurance contract) can be supplied at two levels of quality, q_L and q_H, and the respective unit costs of providing this product are c_L and c_H. There is a competitive market for this product, and each variety is available for a price equal to its cost of provision. In terms of preferences, there are two types of consumers: those who value the high-quality product highly, and those who do not. Specifically, the consumers who value high quality have utility

$$\theta_H q - p$$

if they consume a product with quality q and price p, while the remaining consumers have utility

$$\theta_L q - p, \text{ where } \theta_H > \theta_L \ ,$$

with the same product. Suppose that it is efficient for the type-θ_H consumers to buy the high-quality product and the others to buy the low-quality product, so that

$$\theta_H q_H - c_H > \theta_H q_L - c_L \text{ and } \theta_L q_L - c_L > \theta_L q_H - c_H \ . \quad (3)$$

Suppose that a fraction α of consumers have taste parameter θ_H.

As well as having these taste differences, consumers also differ in how much attention they pay to quality when they choose their product. Specifically, suppose that a fraction $1 - \mu$ of the type-θ_H consumers do not think about quality when they decide on their product, and buy simply on the basis of price. (It does not matter whether the type-θ_L consumers think about quality or not, as they will buy the appropriate product even if they buy only on the basis of price.) Unlike Model 1 in this appendix, assume that all consumers pay attention to prices.

In a laissez-faire market, all type-θ_L consumers buy the low-quality product for a price c_L, as do that fraction of the type-θ_H consumers who do not pay attention to quality. The remaining type-θ_H consumers buy the high-quality product for a price c_H. In sum, welfare without intervention is

$$(1 - \alpha)(\theta_L q_L - c_L) + \alpha[(1 - \mu)(\theta_H q_L - c_L) + \mu(\theta_H q_H - c_H)] \ .$$

On the other hand, suppose that consumer policy forbids the supply of the low-quality product, in order to protect those consumers who mistakenly buy it but who would prefer the high-quality product. In this case, on the assumption that the type-θ_L consumers prefer buying the high-quality product to buying nothing, welfare when choice is restricted is

$$(1 - \alpha)(\theta_L q_H - c_H) + \alpha(\theta_H q_H - c_H) \ .$$

One can check that welfare is increased by the policy intervention whenever

$$(1 - \alpha)[\theta_L(q_H - q_L) - (c_H - c_L)] + \alpha(1 - \mu)[\theta_H(q_H - q_L) - (c_H - c_L)] > 0 \ .$$

From (3), the first term in square brackets is negative while the second term in square brackets is positive. Thus, whether the policy intervention improves welfare depends on the relative sizes of α and μ (keeping other parameters constant). If there are many consumers who value the low-quality product, the policy is harmful; if there are many consumers who do not pay attention to quality, the policy may be beneficial (assuming there is no market transparency policy which acts to improve the attentiveness of these consumers without restricting the choice of the type-θ_L consumers). Except in extreme cases, the informational requirements needed to be confident that the policy is desirable are substantial.

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Assessing the Quality of Competition Policy: The Case of Horizontal Merger Enforcement

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Assessing the Quality of Competition Policy: The Case of Horizontal Merger Enforcement

*William E. Kovacic**

This article suggests how a jurisdiction might best go about evaluating the quality of its competition policy system. It urges that competition agencies and collateral institutions strive to improve the ability to measure the economic effects of merger control and to verify the consequences of different approaches to enforcement. The article uses merger control in the United States as its main illustration, but the article's observations apply to other areas of competition policy oversight, as well. The article seeks to encourage the recent trend within the global competition policy community of accepting a norm that focuses greater attention on the evaluation of the economic effects of enforcement decisions—especially by developing better quantitative measures of actual economic effects—and the assessment of the processes by which competition agencies examine individual transactions.

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I. Introduction

Horizontal merger policy is an important focus of contemporary discussions about the quality of competition policy.[1] It should be. Horizontal merger policy attempts to forestall combinations that otherwise would permit the merged entities to exercise substantial market power, and it tries to curb the creation of market environments that encourage coordination by rival firms through tacit coordination or the formation of express agreements. Because society also has a major stake in allowing business restructurings that improve economic performance, both in individual transactions and in the preservation of a robust market for corporate control, merger policy ought to go about these tasks without blocking combinations that are benign or procompetitive.

The fulfillment of these objectives has important links to other areas of competition law.[2] If merger control misses the dominance issue, mergers can create durable market power with consequent adverse effects on prices, quality, and innovation. If merger control overlooks a transaction's contribution to oligopolistic interdependence, a merger can contribute to a market configuration in which the surviving firms either find it easier to establish effective cartels by a direct exchange of assurances or to use indirect means to realize the results that express agreements yield. Because competition law has not addressed dominance or tacit collusion with great success, it matters that merger policy make proper choices about when to intervene.[3]

In most jurisdictions, the competition agencies evaluate transactions before the parties complete them.[4] This process is unavoidably predictive and, in a number of instances, speculative. In a wide range of matters, no analytical calculus provides a sure way to distinguish transactions that pose anticompetitive dangers from those which promise to be benign or procompetitive. The examination of a proposed transaction often involves difficult, probabilistic assessments of future commercial developments. This is especially true in markets that display high levels of dynamism owing to technological or organizational innovation, or to developments in trade, transport, and communications that link previously isolated geographic regions into unified commercial markets.

Each possible course of action by a competition agency poses risks. Block the deal improvidently, and valuable economic benefits from consolidation are lost. Accept the wrong divestitures or conduct-related undertakings as conditions of allowing the deal to proceed, and the agency creates an illusion of effective intervention that masks future anticompetitive results. Unwisely allow the deal to proceed as proposed, and consumers suffer the costs of diminished economic performance. The public statements of agencies concerning specific decisions to intervene or take no action ordinarily either acknowledge no risks associated with the choice taken or assert that all risks were thoughtfully and correctly weighed. It takes a high and unusual level of institutional self-assurance to state that the chosen course of action could be wrong.

Seen in the aggregate, public enforcement decisions over time reflect more humility about the analytical quandaries and difficult judgments associated with merger control than do the agencies' portrayal of individual episodes of review. The history of merger review has featured what best can be seen as a series of experiments through which the public agencies have used various analytical and procedural measures to improve the accuracy of the predictive process. Modern commentary tends to accept the view that contemporary analytical methods are superior to predecessor techniques, but that may be because many contemporary commentators played some part in creating the modern techniques. The field is still a work in progress, and much remains to be done to improve procedures and substantive analysis, particularly for what might generally be labeled as the hard cases.

So how are we to tell if a competition system is doing a good job of the important, forward-looking exercise of merger control? A popular and seemingly irresistible technique is to measure the worth of a competition agency by studying how often it blocks deals, allows deals, or subjects proposed transactions to elaborate analysis.[5] Commentators lean on this method so often and so heavily that they forget its frailties. To say that an agency is doing a lot of things or only a few things does not tell us whether it is doing the right things. In sport, coaches admonish athletes not to equate activity with accomplishment.[6] So it should be for merger control.

In sport, coaches admonish athletes not to equate activity with accomplishment. So it should be for merger control.

There is a debate worth having, and that is whether antitrust oversight of mergers is improving or retarding economic performance. Answers to questions about actual economic effects will not emerge from the study of activity levels, unless we bravely (and dubiously) assume that specific levels of enforcement activity invariably or typically beget good results. Especially amid larger contemporary debates about the correct form of government intervention in the economy, we cannot rely on these feeble proxies to assess effectiveness. When competition policy agencies ask external audiences to accept the value of antitrust intervention on faith, they are likely to hear variants of the aphorism: In God we trust; all others provide data.[7] The relevant data cannot be found in simple counts of merger reviews and challenges.

This article suggests how a jurisdiction might best go about evaluating the quality of its competition policy system. It urges that competition agencies and collateral institutions strive to improve the ability to measure the economic effects of merger control and to verify the consequences of different approaches to enforcement.[8] The article uses merger control in the United States as its main illustration, but the article's observations apply to other areas of competition policy oversight, as well. The article seeks to encourage the recent trend within the global competition policy community of accepting a norm that focuses greater attention on the evaluation of the economic effects of enforcement decisions—

especially by developing better quantitative measures of actual economic effects[9]—and the assessment of the processes by which competition agencies examine individual transactions.[10]

The article begins the treatment of evaluation with several normative propositions about what is good merger policy. Part III sketches the pendulum narrative of modern U.S. antitrust enforcement. This narrative figures prominently in discussions about the quality of U.S. merger policy since the early 1960s and relies chiefly on activity-based measures of efficacy to identify dramatic changes in policy over time. The pendulum narrative attributes the observed variations in activity to changes in political leadership. Part IV suggests future focal points for evaluation and means for assessing the quality of merger review. Among other sources, it draws upon the results of a recently completed self-study of the U.S. Federal Trade Commission (FTC).[11]

II. What Is "Good" Merger Policy? Three Suggested Criteria

Discussions about competition policy tend in a colloquial way to ask whether public enforcement agencies are doing a "good" job of carrying out their responsibilities. This form of discourse seldom involves a careful specification of what constitutes "good" performance. Expressly or implicitly, levels of enforcement activity are the foundation for judgments.

In the case of merger policy, an appropriate assessment of the quality of merger policy should focus on three criteria. First, has merger policy improved economic performance by reducing the price or improving the quality of goods or services? This is the essential question about the effectiveness of merger policy. It is worth asking and debating regularly. A merger review system accomplishes this result by intervening to correct or preclude transactions that pose serious competitive dangers and by allowing combinations that promise to have benign or procompetitive effects.

The second criterion is whether individual competition systems minimize unnecessary implementation costs within and across jurisdictions. Enforcement agencies should seek to achieve a given level of monitoring and enforcement at the lowest possible cost to society.[12] Among other means, a jurisdiction can eliminate unnecessary burdens associated with its own notification procedures and investigations, promote international standardization based on superior techniques, and raise levels of interoperability across competition systems.

The third criterion is whether a competition system has committed itself to a process of continuous reassessment and improvement.[13] This has two dimensions. The first deals with the testing and improvement of methods to assess (a) the economic consequences of individual decisions to intervene or not to intervene and (b) the aggregate effects of a system of merger review. The second involves an examination of the procedures for merger review and an analysis of whether the jurisdiction can achieve a given level of oversight at lower cost. Improvements in both dimensions require competition authorities to make meaningful disclosures about decisions to prosecute or not prosecute, to maintain and reveal informative data sets about activity levels, and to refine techniques—with the agency's resources and in cooperative ventures with external bodies such as research institutions—for measuring actual economic effects of intervention decisions.

III. Modern U.S. Merger Policy: Alternative Narratives

Discussions about the quality of merger policy ought to dwell upon whether a system of competition law satisfies the criteria sketched above. Such discourse frequently does not. In many instances, assessments of merger policy neither define normative criteria clearly nor apply them systematically. In other cases, problems associated with the measurement of merger enforcement consequences cause commentators to run away from the issue of actual economic effects. The means for determining the economic effects of merger policy are not ideal.[14] In practice, it can be difficult to determine how merger control, in individual cases or across a range of intervention opportunities, affects economic performance.

Owing to problems of measurement, the antitrust community ordinarily succumbs to the temptation to duck the ultimate question of economic effects.[15] Discussions about the quality of merger enforcement instead use a variety of effectiveness proxies. Three stand out. The primary fallback is to trace and analyze levels of activity, such as the total number of government interventions over a period of time or the percentage of all transactions in which the competition agency conducts an elaborate inquiry or takes action to modify or block a deal. By this measure, enforcement quality is inferred from rates of action or inaction.

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A second popular evaluation technique is to seek out the opinions of practitioners about the quality of the competition authority's performance. Is it challenging too many deals, or too few? Are remedies too weak or too strong? Does the agency have sound processes in place for sorting out the good and the bad? Compared to other eras of competition policy, is it easier, or more difficult, today to get a merger approved by the enforcement agency?

In principle, practitioner views can be valuable source of information, and commentators and competition authorities ought to seek them out. As presented in the literature on merger control, practitioner views tend to be qualitative, unsystematic, and unverifiable. As a group, the accounts of practitioner views generally provide a haze of unattributed impressions that no outsider can test rigorously. Some commentary offers the vastness of the narrator's own experience as authority that an asserted proposition captures a broad, important reality.[16] Other articles and press reports quote unidentified individuals with the suggestion that the speakers have revealed universal, fundamental truths.[17] There have been some efforts to conduct surveys of larger numbers of practitioners, but these seldom specify or discuss the transactions that provide the basis for the participants' qualitative views, and the identities of the participants invariably are anonymous. The anonymity may be necessary to avoid retribution by a competition agency that dislikes the speaker's opinion, but anonymity also relaxes the speaker's incentives to portray events fully and accurately.

The third approach is to present specific enforcement episodes as exemplars of the competition agency's philosophy about merger control. By offering an exemplar, the commentator asks the reader to draw broader conclusions about whether the competition agency's analytical methods and ultimate conclusions are sound.[18] Case studies can be informative in what they say about the agency's philosophy, analytical perspectives, and methodology. Yet individual enforcement episodes too often are analyzed in isolation. To be reliable as a way to make larger judgments about the quality of merger enforcement, one needs a sufficiently large number of case study observations to know how the agency is performing in any single period or across periods. For example, comparisons of enforcement choices in specific sectors over time can help illuminate adjustments in policy and technique, and can offer insights about how a collection of consolidation events affected sectoral performance.

Activity levels, practitioner perspectives, and the occasional case study provide the main ingredients for discussions of U.S. merger policy. Below I describe the most popular approach —the pendulum narrative—that commentators use to assess the quality of merger policy. In this narrative, federal merger enforcement swings dramatically from extraordinary intervention to extraordinary permissiveness as a consequence of political appointments to the two U.S. antitrust authorities, the Department of Justice ("DOJ") and FTC. The discussion then presents an alternative interpretation of U.S. experience.

A. THE PENDULUM NARRATIVE OF MODERN MERGER ENFORCEMENT

The leading narrative about modern U.S. antitrust enforcement policy uses the metaphor of a swinging pendulum to describe shifts in the government's approach to intervention.[19] This metaphor is popular among academics, journalists, and practitioners as a way to explain patterns of public antitrust enforcement and to assess the quality of merger control in individual eras. The pendulum narrative posits a fundamental instability in U.S. competition policy. Pendulum narrators attribute this instability largely to changes in the country's political leadership, although streaks of raw enforcement agency irrationality divorced from political forces also receive some credit. Thus, in its attempts "to balance possible threats to competition against merger benefits," modern U.S. merger policy often "has careened from one extreme to another in this balancing process."[20] This is not a flattering characterization of U.S. experience. Reckless drivers careen. Good public policy does not.

As applied to merger policy, the pendulum narrative divides the modern U.S. enforcement experience into four periods. Public enforcement policy toward mergers is said to have been too aggressive in the 1960s and 1970s, too lenient in the 1980s, just right in the 1990s, and too cold again in the first decade of the 21st century. This mimics the classification scheme first introduced in the account of Goldilocks and her encounter with the three bears: U.S. merger policy is first too hot (1960s-1970s), then too cold (1980s), then just right (1990s), and then too cold again (2000s).

Reckless drivers careen.
Good public policy does not.

Scholarly and popular commentary that embraces the pendulum narrative emphasizes what are said to be indefensible lapses in decision making, other than in the just-right era of the 1990s. In the other periods, government enforcement officials and judges appear incapable of well-reasoned, sober-minded thought. Thus, in the 1960s, federal enforcement policy is set by "antitrust witchdoctors,"[21] "trust-busting zealots … who saw evil in every big company or merger,"[22] and "excessively intrusive Populists."[23] With this collection of economic primitives in control, the government agencies "challenged everything."[24]

In the pendulum narrative's depiction of the 1980s, federal enforcement policy swings dramatically away from the mindless interventionism of the 1960s and the "extraordinary activism" of the Carter administration in the 1970s.[25] Thus begins the modern ice age of antitrust policy that is Ronald Reagan's presidency. During the Reagan administration, the federal antitrust agencies "trivialized" the U.S. antitrust laws[26] and produced "the most lenient antitrust enforcement program in fifty years."[27] In this era, federal antitrust "[e]nforcement ceased;"[28] "U.S. Federal merger enforcement ground to a halt;"[29] and the federal agencies achieved the "emasculation of the nation's merger policy."[30] The Reagan appointees responsible for these developments were characterized as "extremists"[31] given to "lawlessness"[32]—a "garbage barge of ideologues."[33] Their influence stemmed from brute political force, not the power of ideas. The Reagan administration's success in altering U.S. antitrust policy was "largely a political victory, not an intellectual or legal one."[34]

In the pendulum narrative, the wild swings in merger policy – from the hyperactive 1960s and 1970s to the indolent 1980s—ceased temporarily in the 1990s. Antitrust policy had a lucid interval during the Clinton administration. Through a series of prosecutions and non-litigation policy adjustments in the 1990s, the federal agencies "restore effective and sensible merger enforcement—avoiding the undue activism of the 1960s and the extreme under-enforcement of the 1980s."[35] Spurring this temporary transformation was the appointment of new leadership to the federal agencies. "Beginning in the 1980s," observes one account, "we entered a period of calm on the merger front. This was particularly true at the Federal Trade Commission, which was seen as a sleepy agency. Then along came the appointment of Bob Pitofsky as Chair of the FTC [and] the appointment of Jon Baker as the Director of the FTC's Bureau of Economics."[36] Through the efforts of these appointees and the guidance of Justice Department officials such as Joel Klein, the enforcement pendulum came to rest at a thoughtful, moderate equilibrium.[37] Many authors who say federal enforcement policy attained a sensible, moderate equilibrium in the 1990s served as high officials in the antitrust agencies during the Clinton administration and helped mold the antitrust policies of the just-right era.[38]

Many authors who say federal enforcement policy attained a sensible, moderate equilibrium in the 1990s served as high officials in the antitrust agencies during the Clinton administration and helped mold the antitrust policies of the just-right era.

In the latest chapter of the pendulum narrative, the presidency of George W. Bush destroys the sensible balance of the 1990s and returns federal merger enforcement to the ice age. Like the experience in the 1980s in the Reagan administration, merger enforcement in the Bush administration features an "extraordinarily low level of government merger enforcement."[39] As the Bush presidency draws to a close in 2008, the merger policy "pendulum has swung too far in the direction of nonintervention."[40] The capacity of merger policy to swing toward excessive permissiveness is "particularly evident in the minimalist enforcement agenda of the Antitrust Division during the second term of the Reagan administration and during the George W. Bush administration."[41] On a good day, the public officials responsible for these developments are merely captives of "the excesses and rigidities of extreme theoretical economic analysis."[42] On a bad day, they are intellectually unprincipled. Not only do they employ "extreme interpretations and misinterpretations of conservative economic theory," they also engage in a "constant disregard of the facts."[43]

The three proxies for effectiveness mentioned earlier in this section serve as the factual foundations for the pendulum narrative's assessment of federal merger enforcement since 2001. First, several commentaries contend that enforcement policy during the George W. Bush administration was significantly more "lenient" than enforcement policy during the Clinton administration.[44] This deviation from past periods of enforcement is taken to show that the quality of merger policy has deteriorated.[45]

Second, Professors Jonathan Baker and Carl Shapiro surveyed twenty practitioners whose responses are said to indicate agreement with the view that DOJ and the FTC were more likely to approve mergers under the Bush administration than they had been in the previous decade.[46] In this survey, DOJ is reported to be more permissive than the FTC.[47] Professors Baker and Shapiro also present quotations from news accounts saying that the Bush administration offers the best opportunity for firms to attempt anticompetitive transactions in the hope that permissive Bush antitrust appointees will not attack them.[48] As with activity rates, the greater permissiveness reported in the survey of practitioners and in the news accounts is said to show that the quality of merger policy has declined.

Third, Professors Baker and Shapiro offer a case study of the Whirlpool-Maytag merger, which DOJ approved in 2006. Professor Shapiro acted as a consultant for the Justice Department and urged DOJ to block the combination of the two producers of washing machines. DOJ did not do so. Professors Baker and Shapiro say DOJ's non-intervention in Whirlpool-Maytag reveals how the DOJ during the Bush administration embraced analytical techniques that improperly biased enforcement decisions toward non-intervention.[49]

In their review of Bush administration merger enforcement policy, Professors Baker and Shapiro expressly embrace the pendulum narrative[50] and conclude that "the pendulum has swung too far in the direction of nonintervention."[51] Criticizing "the too-ready acceptance by some courts and enforcers of unproven non-interventionist economic arguments about concentration, entry, and efficiencies," they propose measures to "reinvigorate horizontal merger enforcement."[52]

B. TOWARD AN IMPROVED INTERPRETATION OF MODERN U.S. MERGER POLICY

The pendulum narrative of modern U.S. merger enforcement policy portrays a system whose instability robs it of legitimacy. As Thomas Leary has observed, "How much credence could be given to merger policy if it really were so susceptible to change, depending on the outcome of Presidential elections?"[53] President Barack Obama may choose, as he promised during his campaign for the presidency, "to reinvigorate antitrust enforcement" and "step up review of merger activity."[54] If the narrative correctly interprets American antitrust experience, the U.S. system is so prone to politically-driven variations in enforcement that future presidential elections could send the merger policy pendulum swinging wildly again. There is no reason to expect that the just-right enforcement approach of the 1990s is the norm rather than an exceptional interlude.

If the narrative correctly interprets American antitrust experience, the U.S. system is so prone to politically-driven variations in enforcement that future presidential elections could send the merger policy pendulum swinging wildly again.

To study the pendulum narrative carefully is to see that, in its struggle to accentuate the swings of the pendulum, it provides an unsupportable, unreliable interpretation of modern U.S. merger control. With repeated telling, the pendulum narrative ignores discordant facts and obliterates troublesome complexities in merger enforcement policy. This is a serious obstacle to effective public administration. Without an interpretation that more faithfully recounts actual events and forswears superficial explanations in favor of deeper exploration of causes, the antitrust community will neither understand why policy evolved as it did, nor will it identify paths for improvement going ahead. This section discusses some of the pendulum narrative's main faults and offers an alternative interpretation of modern U.S. merger policy that suggests important elements of continuity and progressive, cumulative development.

1. Failings of the Pendulum Narrative

The narrative depends crucially on fractured accounts of antitrust history to highlight the asserted reasonableness of merger policy in the just-right 1990s. To accomplish this result, the narrative must frame the just-right era between periods of indefensible extremism—the too-hot era of the 1960s and 1970s, and the too-cold periods of the 1980s and the current decade. There is an evident compulsion in the pendulum narrative to achieve rough symmetry in the swings away from the sensible middle of the 1990s—to show that the too-hot and too-cold periods displayed comparable levels of extremism.

The effort to achieve symmetrical, massive swings away from a sensible mean requires unacceptable distortions in the presentation of antitrust history. The narrative depicts the too-hot era as a time of irrational, fanatical intervention undisciplined by sound analysis of individual mergers or thoughtful reflection upon recent experience. For commentators who endorse the pendulum narrative's account of merger policy and its treatment of the 1990s as a sensible mean between periods of extremism, there appears to be a felt need to single out and disavow the too-hot 1960s as a way of signaling the reasonableness of their views.[55]

> DID MERGER POLICYMAKING IN THE UNITED STATES IN THE 1960S, AS THE PENDULUM NARRATIVE SUGGESTS, SIMPLY AND INEXPLICABLY LOSE ITS MIND?

Did merger policymaking in the United States in the 1960s, as the pendulum narrative suggests, simply and inexplicably lose its mind? To be sure, merger enforcement standards were highly interventionist.[56] The interesting question is why they came to be so. Was merger enforcement policy "careening" because it was driven by what the pendulum narrative calls antitrust witchdoctors, zealots, or populist extremists? To reflect upon who made the policy is to see that the pendulum narrative's fundamental weaknesses. The epithets of irrationality poorly describe FTC Commissioner Philip Elman, who applied his formidable intellect in the 1960s to shape conglomerate merger enforcement doctrine that attracts intense rebuke today.[57] Nor does Donald Turner resemble the enforcer who single-mindedly seeks to expand the government's ability to "challenge everything." In DOJ's 1968 merger guidelines, Turner took critical steps to retrench the existing zone of government merger enforcement. This self-correcting measure, which existing trends in judicial analysis did not compel DOJ to undertake, proved to be an enormously influential exercise in wise self-assessment and prudential self-restraint.[58] Turner and his 1968 guidelines fit awkwardly in a narrative in which enforcement extremists, zealots, or witchdoctors careen out of control. The pendulum narrative seizes up if such complexities are acknowledged and the apparent capacity of public enforcement agencies to reassess policy and make appropriate refinements is taken into account.

The second pillar of the pendulum narrative's effort to highlight the sensibility of the just-right 1990s is to portray merger enforcement policy in the 1980s and in the 2000s as dramatic swings toward non-intervention. To achieve the desired stark contrasts, the pendulum narrative must side-step or flatten out phenomena that suggest continuity across periods or otherwise reduce the degree of variation. This explains demonstrably false observations that federal merger enforcement "ground to a halt" in the 1980s,[59] and that the FTC was a "sleepy agency" when it came to merger control.[60] It also accounts for the perceived imperative to say that enforcement officials from these periods were extremists and ideologues.[61] If their thinking was so cramped, it would have been difficult for these enforcement officials to devise policy measures such as the 1982 DOJ merger guidelines, whose intellectual vision brought about enduring changes in U.S. policy and changed, by way of persuasion, how the world's competition agencies think about merger policy.[62] Few of the world's merger guidelines today do not owe an intellectual debt to William Baxter and his DOJ guidelines team.

The recent Baker & Shapiro paper evaluates horizontal merger enforcement policy since 2001 with the assistance of the pendulum narrative. The paper is more measured than some in its assessment of the enforcement agencies during the administration of George W. Bush, and its claims are more nuanced than much of the pendulum narrative literature. Professors Baker and Shapiro properly draw attention of the antitrust community to issues associated with the future development of judicial doctrine governing horizontal mergers. The Baker/Shapiro paper usefully helps define issues for future debate about the role of structural presumptions. Their discussion of enforcement agency policy could bring more attention to the pursuit of better techniques for measuring the consequences of merger enforcement choices. These are useful contributions to future policy making.

In its discussion of the work of the federal enforcement authorities since 2001, the Baker/Shapiro paper does little to improve our understanding of the quality of modern merger enforcement policy generally or of the merger programs of the DOJ and the FTC. The paper's findings rest heavily upon an examination of levels of federal agency enforcement activity. It detects a decline in enforcement activities, and it treats this trend as a reliable indication that the quality of merger enforcement policy deteriorated during the presidency of George W. Bush.[63]

These conclusions, which use activity levels as proxies for the quality of merger control, place unsupportable faith in the reliability and meaning of data on rates at which the federal agencies engage in enforcement related activities—for example, how often they issue second requests or intervene to block or modify mergers. Assembling an informative data set that permits meaningful comparisons of activity rates between presidential administrations is a difficult undertaking. Calculations based on activity levels require extraordinary care in determining whether observed activity levels across periods are genuinely comparable.[64] Among other steps, this demands close examination and classification of the type of transactions coming before the agencies at any one time. Relatively small adjustments to account for various factors can change the results materially. The effort to amass activity-related data sets with high levels of comparability is worthwhile for the agencies and collateral institutions, such as research institutes, as one part of the effort to assess merger policy. At best, existing data sets permit conclusions about activity levels that require careful, and perhaps debilitating, qualification.

THESE CONCLUSIONS, WHICH USE ACTIVITY LEVELS AS PROXIES FOR THE QUALITY OF MERGER CONTROL, PLACE UNSUPPORTABLE FAITH IN THE RELIABILITY AND MEANING OF DATA ON RATES AT WHICH THE FEDERAL AGENCIES ENGAGE IN ENFORCEMENT RELATED ACTIVITIES.

Let's suppose that we had absolutely precise and meaningful comparisons of activity over time. It is not clear that variations in activity across periods tell us anything about the larger question posed earlier in this article: How has public merger enforcement affected economic performance? Activity levels say nothing about whether an agency's work has positive or negative economic effects. It is one thing to say that enforcement has become "tougher" or "more lenient" in the sense that the agency is intervening more often or less often as a percentage of all matters to come before it. It is another thing to say that a given level of activity begets specific economic results.

Professors Baker and Shapiro supplement their examination of activity levels with a survey of 20 distinguished practitioners with extensive experience in competition law. The authors do not identify the participants by name, but their identities can be reverse engineered from information provided in the paper. Surveys and interviews can provide useful information about merger enforcement—especially about the effectiveness of the processes by which agencies study individual transactions. On the question of economic effects, surveys have nothing to say, unless the participants have specific data to offer about individual transactions. A general statement that is easier or more difficult to get deals through does not improve our understanding of economic effects unless the speaker at least identifies specific transactions to provide a concrete basis for knowing which deals ought to have been modified or stopped.

The participants in the Baker/Shapiro survey presumably knew what hypothesis the authors were testing and knew how the authors were likely to portray the survey result. Are the authors confident that the participants, owing to past service with a specific presidential administration or a preference for a political party in the 2008 elections, would not answer questions in any way strategically to bias the results? The participants provided narrative answers to the survey questions, and the authors coded them on a five-point scale. The aggregate scores are offered as evidence of greater Bush administration permissiveness and, by inference, of weaker enforcement policy quality. Are the authors confident that their own preferences—both worked for the Clinton antitrust agencies in the 1990s—did not affect their scoring of the responses?

The third measurement technique in the Baker/Shapiro paper is a case study of the Whirlpool/Maytag transaction. The authors say they "are deeply concerned that the Whirlpool case is indicative of an overly lax approach to merger enforcement at the current Justice Department."[65] Case studies can be informative tools for understanding what an enforcement agency has done and for making judgments about the soundness of its analytical approach. First-person accounts, such as Professor Shapiro's observations from his perspective as a consultant to DOJ on Whirlpool/Maytag, can be enlightening.

IT TAKES EXTRAORDINARY SELF-DISCIPLINE FOR A FIRST-PERSON NARRATOR TO AVOID THE TEMPTATION TO SKEW THE NARRATION IN WAYS THAT, AT LEAST TO SOME DEGREE, UNDERSCORES THE APPARENT REASONABLENESS OF THE NARRATOR'S VIEWS.

For all of their positive attributes, case studies informed by first person accounts of events also present problems that affect their value. It takes extraordinary self-discipline for a first-person narrator to avoid the temptation to skew the narration in ways that, at least to some degree, underscore the apparent reasonableness of the narrator's views.[66] One such problem is selectivity in singling out a case study as the informing exemplar. An example of this selectivity is to take an individual merger review episode in isolation and attribute great significance to that episode alone. When the narrator presents the single episode as the informing example, is the attitude toward risk exhibited in that episode unique to the incumbent agency leadership, or might their predecessors have made decisions that showed a similar tolerance for risk?

There is a way to avoid misinterpretations of single merger review episodes, and that is to do comparisons over time. A useful way to test whether an agency at any one moment is taking unacceptable risks in allowing mergers to proceed is to use other case studies from other periods to get a rough sense of how the agency in other periods assessed risk and accounted for risk. Did DOJ gamble excessively in allowing Whirlpool and Maytag to combine? We can ask: compared to what? One approach to seeing if Whirlpool/Maytag tells us something important and distinctive about DOJ decision making since 2001 is to look more closely at transactions approved by the Clinton administration in the just-right 1990s.

For example, what does the FTC's decision to allow Boeing to purchase McDonnell Douglas in 1997 tell us about the Clinton administration's treatment of risk in merger analysis? Professor Baker was the FTC's chief economist when Robert Pitofsky and his colleagues reviewed and approved the transaction with no modifications. I consulted for McDonnell Douglas in this merger, and I believe that the FTC properly declined to take any action. Yet the merger involved many defense and commercial aerospace markets that were close calls.[67] In approving the deal, the Commission took risks about the future of competition in commercial aircraft production and military systems (such as fighter aircraft, aerial refueling tankers, and innovation in the design of weapons generally) that are at least as great as those DOJ took in allowing Whirlpool to buy Maytag. A right-minded person reasonably could have voted to block the Boeing/McDonnell Douglas merger on the ground that these risks were unacceptable. If DOJ behaved unreasonably in Whirlpool/Maytag, was the FTC's decision in Boeing/McDonnell Douglas appropriate?

IF DOJ BEHAVED UNREASONABLY IN WHIRLPOOL/MAYTAG, WAS THE FTC'S DECISION IN BOEING/MCDONNELL DOUGLAS APPROPRIATE?

The same question about enforcement agency risk-taking across time periods can be posed in connection with the Clinton administration's review of mergers involving the petroleum industry. No sector of FTC competition policy responsibility has received more intense and critical congressional scrutiny in this decade. Since 2001, FTC officials have made many appearances before congressional committees to answer questions about the agency's review of mergers involving petroleum companies, especially transactions that took place during the Clinton administration in the 1990s. A much-repeated charge by members of Congress is that the FTC oversight of mergers in the 1990s was lax—that the Commission improvidently allowed, albeit with substantial divestitures in some cases, Exxon to buy Mobil, Chevron to buy Texaco, BP to buy Arco and then Amoco, and many others. Imagine that these transactions had taken place during the George W. Bush presidency. What would the pendulum narrative have to say if the FTC in the Bush administration had made exactly the same choices as the Clinton administration made in the 1990s? By further point of comparison, recall also that it was during the too-cold period of the Reagan administration that the FTC sued to bar Mobil from buying Marathon Oil Company, the 16th largest U.S. refiner.[68]

In 2004, the Government Accountability Office ("GAO") published a study that sought to measure the price effects of eight mergers that took place during the Clinton administration. It concluded that six of the eight mergers—including Exxon/Mobil—caused prices to increase.[69] Professors Baker and Shapiro are familiar with a number of the transactions that have received criticism from Congress and from the GAO. Many of the relevant transactions took place during Professor Baker's tenure as the head of the FTC's Bureau of Economics, and

Professor Shapiro advised British Petroleum in support of its acquisition of Amoco.

On the FTC's behalf, I have testified on several occasions since 2001 to defend the Commission's petroleum industry program and to rebut the GAO's criticisms of Clinton administration merger enforcement policy in this sector.[70] On those occasions I have said, and I believe today, that the FTC's choices in these matters were correct. Even if my assessment is right, there remains the question of how the chances the FTC took in those cases compare to the chances taken by DOJ in Whirlpool/Maytag. How should we assess the competitive risks of the FTC's decision to allow some transactions (e.g., Unocal/Tosco) to proceed without modification, or the risks associated with divestitures required as a condition for allowing other transactions to go through (e.g., Exxon/Mobil)? How do those risks—as well as the sector-wide risks associated with the many petroleum transactions that the Clinton FTC approved in whole or in part—compare to the risks taken by the DOJ in Whirlpool/Maytag?

To consider the wisdom of the enforcement agency's decisions about what risks to take and when to intervene, single episodes of merger review—such as Whirlpool/Maytag—should be analyzed in a larger context when the enforcement agency has made judgment calls no less problematic in other periods that are depicted as eras of sound public administration. The potential adverse economic and social consequences of the FTC getting things wrong in the aerospace and defense sector and in the petroleum industry in the 1990s are at least as grave as the hazards of having DOJ improvidently permit two leading producers of washing machines to merge. In the Baker/Shapiro account of Whirlpool/Maytag, one gets no idea that the Clinton antitrust agencies might have taken risks of equal or greater magnitude. Measured by risks taken and risks avoided, Boeing/McDonnell Douglas and the petroleum deals of the 1990s are as damning of FTC enforcement under Bill Clinton as Whirlpool/Maytag is of DOJ's work under George W. Bush. They ought to be part of the story.

2. An Alternative Interpretation: The Role of Continuity

Horizontal merger policy has changed considerably since the early 1960s. The process of change has involved a significantly greater degree of continuity that the pendulum narrative suggests. The first ingredient has been a gradual narrowing of the zone of liability.[71] This narrowing has been largely continuous rather than sharply discontinuous. Using a rough structural measure, the threshold at which the federal agencies could be counted on to apply strict scrutiny and to be most likely to challenge involved a reduction of the number of significant competitors in the following manner: 1960s (12 to 11), 1970s (9 to 8), 1980s (6 to 5), 1990s (4 to 3), 2000s (4 to 3). These thresholds can be derived from parsing the cases which the government agencies chose to litigate. It is reasonable to debate whether a 4 to 3 deal had a better chance of getting through in this decade than it did in the 1990s. The main point is that the perimeter the federal agencies have been defending has shrunken substantially over the decades. This is a function of the agencies' own reassessments of policy and of interpretations of merger law in the lower federal courts.[72]

The second ingredient has been an increased willingness on the part of the agencies to engage in fact-intensive analysis that qualifies the application of structural criteria. This is evident in decisions taken in matters such as Boeing/McDonnell Douglas and in Whirlpool/Maytag. It is entirely appropriate to ask whether the agencies have applied qualifying factors correctly. The key point here is that modern experience, especially since the issuance of the 1982 DOJ merger guidelines, has involved greater consideration of non-structural criteria and more willingness to experiment with enforcement approaches short of outright prohibition to resolve competitive concerns.

> THE MAIN POINT IS THAT THE PERIMETER THE FEDERAL AGENCIES HAVE BEEN DEFENDING HAS SHRUNKEN SUBSTANTIALLY OVER THE DECADES.

Seen this way, modern U.S. enforcement policy toward horizontal mergers has not resembled a wildly swinging pendulum. There instead has been a relatively steady progression toward a narrower zone of enforcement for horizontal transactions. The pendulum narrative and its emphasis on enormous periodic policy swings deflect attention away from the larger question raised above: Is this trend of enforcement policy, combined with reinforcing doctrinal developments in the courts, producing desirable economic effects? That question, rather than an examination of aggregate activity levels or single cases, ought to occupy the attention of the competition policy community.[73]

III. Conclusion: Institutional Arrangements for Evaluation

The development of a performance evaluation methodology for horizontal merger enforcement and other forms of competition policy can take advantage of a growing body of experience and scholarship with the subject.[74] Improvements in existing evaluation programs and extensions of the methodological state of the art might proceed along several paths. One is to engage competition authorities and researchers in more extensive collaborative discussions about existing projects and in explorations about evaluation techniques. This can take place in a variety of multinational and regional forums such as the International Competition Network and the Organization for Economic Cooperation and Development. In recent years, these and other organizations have shown an increased interest in operational issues, including performance management. Another way is for competition agencies to form partnerships with major research institutions.

A second element is for competition authorities to expand resources devoted to performance measurement. Agencies can ensure that, in every budget cycle, there are outlays for evaluation. These performance measure exercises can be carried out by agency insiders, external consultants, or some combination of the two. Competition authorities with common interests and common investigations usefully could cooperate to do relevant research. Focal points for collaboration would include the assessment of economic effects and of the processes for merger control. In making budget outlays, agencies should view performance measurement as an integral element of the policy-making life cycle and not simply as a luxury. Performance measurement investments are part of the policy research and development ("R&D") by which a public competition authority grows smarter.

A third element is to continue and extend the trend of publishing fuller data sets on merger enforcement activity.[75] For the DOJ and the FTC, this means an acceleration of the recent trend to publish accounts of decisions not to prosecute and to issue reports on major variables affecting the decision to prosecute. These transparency measures could be coupled with workshops and seminars that rely on these and other materials to discuss enforcement trends and effects.

Good policy runs on an infrastructure of institutions, and broadband-quality policy cannot be delivered on dial-up-quality institutions.

All of these measures will help to build and reinforce an ethic of self-assessment and continuous improvement. They underscore the importance of institutional improvement as a necessary complement to advances in doctrine or theory. Good policy runs on an infrastructure of institutions, and broadband-quality policy cannot be delivered on dial-up-quality institutions. If one asks whether the U.S. antitrust agencies have got things just right today, the answer yesterday and today is no. If one asks whether there are measures in place to get there, the answer is emphatically yes. Better answers to the question of how to assess actual economic effects of enforcement will be key ingredients of reaching that destination.

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1 For a representative discussion of current issues, *see Roundtable Discussion on Developments—and Divergence—in Merger Enforcement*, 23 Antitrust 9 (Fall 2008).

2 *See* William E. Kovacic et al., *Quantitative Analysis of Coordinated Effects*, Antitrust Law Journal (forthcoming 2009) (discussing connections between merger policy and learning from antitrust enforcement against cartels).

3 In an unpublished lecture at the Federal Trade Commission in the early 1980s, I recall Phillip Areeda borrowing a Cold War metaphor from George Kennan to describe merger control. Areeda said merger policy was antitrust law's program of "containment" because it sought to avoid the expansion of dominance and the growth of oligopolistic market structures which invited tacit coordination that yielded cartel-like results but generally evaded effective intervention by competition bodies.

4 Many competition policy regimes oblige the parties to notify the public enforcement agency of a proposed transaction. In these systems, the parties may not complete the consolidation until the agency has had a period of time to analyze the likely competitive effects. In a number of other systems, premerger notification and review are optional, but many companies choose to report proposed mergers in advance and allow the authority to review them before the integration of assets takes place.

5 In U.S. parlance this is the "second request." In the European Union, it is the second phase inquiry.

6 This advice seems to have primeval, untraceable antecedents.

7 I thank David Hyman for bringing this caution to my attention.

8 For an earlier treatment of this theme, *see* William E. Kovacic, *Evaluating Antitrust Experiments: Using Ex Post Assessments of Government Enforcement Decisions to Inform Competition Policy*, 9 George Mason L. Rev. 843 (2001).

9 The case for increased efforts to conduct quantitative studies of the effects of merger policy is presented in Dennis W. Carlton, *The Need to Measure the Effect of Merger Policy*, 22 Antitrust 39 (Summer 2008).

10 These trends are reviewed in William E. Kovacic, *Using Ex Post Evaluation to Improve the Performance of Competition Policy Authorities*, 31 J. Corp. L. 503 (2006).

11 The Federal Trade Commission at 100: Into Our 2d Century (January 2009), available at http://www.ftc.gov/os/2009/01/ftc100rpt.pdf.

12 For statements of this normative aim and critical assessments of the efforts of the U.S. enforcement agencies to achieve this goal, *see* Joe Sims et al., *Merger Process Reform: A Sisyphean Journey?*, 23 Antitrust 60 (Spring 2009); Joe Sims & Deborah Herman, *The Effect of Twenty Years of Hart-Scott-Rodino on Merger Practice: A Case Study of Unintended Consequences Applied to Antitrust Legislation*, 65 Antitrust L. J.865 (1997).

13 The Federal Trade Commission at 100, *supra* note 11, at 22-23.

14 *See* Carlton, *supra* note 9, at 23 (noting that the dearth of quantitative studies and measures of effectiveness "means that there is no reliable guide for determining whether our antitrust policy is too lax in some areas and too stringent in others").

15 Professor Carlton observes: "Antitrust analysis of proposed mergers has become increasingly sophisticated. Evaluation of antitrust policy has not." *Id*. at 42.

16 *See*, e.g., Thomas G. Krattenmaker & Robert Pitofsky, *Antitrust Merger Policy and the Reagan Administration*, 33 Antitrust Bull. 211, 228 (1988) ("Our experience has been that the U.S. business community has read the enforcement actions of the Reagan administration as an invitation to everyone to merger with anyone.").

17 *See*, e.g., Thomas L. Greaney, *Merger Mania Has Gone Too Far*, St. Louis Post-Dispatch, Feb. 27, 1991, at 3B ("At the height of the Reagan administration's permissiveness toward corporate mergers, a former assistant attorney general with the Carter administration summarized the advice he was giving clients: 'I simply tell them that there's no merger not worth trying.'").

18 *See*, e.g., Jonathan B. Baker & Carl Shapiro, *Reinvigorating Horizontal Merger Enforcement*, in How Chicago Overshot the Mark 235, 248-51 (Robert Pitofsky ed., 2008) (discussing DOJ decision not to oppose the merger of Whirlpool and Maytag).

19 The popularity of the pendulum metaphor is traced in William E. Kovacic, *The Modern Evolution of U.S. Competition Policy Enforcement Norms*, 71 Antitrust L.J. 377 (2003).

20 Robert Pitofsky, *Proposals for Revised United States Merger Enforcement in a Global Economy*, 81 Geo. L.J. 195, 196 (1992).

21 Arthur Austin, *Antitrust Reaction to the Merger Wave: The Revolution vs. the Counterrevolution*, 66 N. C. L. Rev. 931, 939 (1988).

22 The New Enforcers, The Economist, Oct. 7, 2000, at 79, 80.

23 Robert A. Skitol, *The Shifting Sands of Antitrust Policy: Where It Has Been, Where It Is Now, Where It Will Be in Its Third Century*, 9 Cornell J. L. & Pub. Pol'y 239, 253 (1999).

24 *Klein Spurs Consumer Action to Address Challenges of Information Age, Globalization*, 76 Antitrust & Trade Regulation Report (BNA) 559, 560 (May 20, 1999) (*hereinafter* Kein Spurs Consumer Action) (quoting Joel Klein, Assistant Attorney General for Antitrust, U.S. Department of Justice).

25 Janet L. McDavid & Robert F. Leibenluft, *What Impact Will Bush Have?*, Nat'l L.J., Feb. 5, 2001, at B8.

26 Eleanor M. Fox & Robert Pitofsky, *The Antitrust Alternative*, 62 N.Y.U. L. Rev. 931, 931 (1987).

27 Robert Pitofsky, *Does Antitrust Have a Future?*, 76 Geo. L.J. 321, 321 (1987).

28 Lawrence A. Sullivan & Wolfgang Fikentscher, *On the Growth of the Antitrust Idea*, 17 Berkeley J. Int'l L. 197, 206 (1998).

29 Eleanor M. Fox, *Can We Control Merger Control? – An Experiment, in* Policy Directions for Global Merger Review 79, 84 (Global Competition Review: Special Report by the Global Forum for Competition and Trade Policy, 1999). *See also* Jonathan B. Baker & Robert Pitofsky, *A Turning Point in Merger Enforcement: Federal Trade Commission v. Staples*, in Antitrust Stories 311, 315 (Eleanor M. Fox & Daniel A. Crane eds., 2007) ("during the second term of the Reagan Administration, merger enforcement came close to disappearing").

30 Walter Adams & James W. Brock, *Reaganomics and the Transmogrification of Merger Policy*, 33 Antitrust Bull. 309, 309 (Summer 1988).

31 *See* Eleanor M. Fox & Lawrence A. Sullivan, *Antitrust – Retrospective and Prospective: Where Are We Coming From? Where Are We Going?*, 62 N.Y.U. L. Rev 936, 945 (1987) (describing the role of William Baxter, Reagan's first Assistant Attorney General for Antitrust, in altering federal enforcement policy in the 1980s: "It is often said that extremists are necessary to move tradition a short step. This is, perhaps, what Baxter and the Chicago School have done.").

32 Lloyd Constantine, Remarks Concerning How Antitrust Should Assess the Role of Imports in Market Definition 1, 1 (Oct. 19, 1995) (statement at Federal Trade Commission Hearings on Global and Innovation-Based Competition), available at http://www.ftc.gov/opp/global/speech.htm.

33 *ABA Annual Meeting Emphasizes Competitiveness, International Trade*, 53 Antitrust & Trade Regulation Report (BNA) 311, 315 (Aug. 20, 1987) (remarks of Senator Howard Metzenbaum).

34 Fox & Sullivan, *supra* note 31, at 947.

35 Baker & Pitofsky, *supra* note 29, at 315-16.

36 Eleanor M. Fox & Daniel A. Crane, *Introduction*, in ANTITRUST STORIES 1, 4 (Eleanor M. Fox & Daniel A. Crane eds, 2007).

37 Klein Spurs Consumer Action, *supra* note 24, at 560 (reporting that Joel Klein "expressed belief that the antitrust 'pendulum' on his watch had swung back to the 'middle,' where 'big was not necessarily bad' but government prudently cracked down on anti-consumer deals and practices"); James Toedtman, *Ball Is in His Court*, NEWSDAY, June 7, 1998, at F8 (quoting Joel Klein, Assistant Attorney General for Antitrust: "The pendulum is in the middle.").

38 *See*, e.g., Baker & Pitofsky, *supra* note 29, at 315-16. During their tenure with the enforcement agencies, the Clinton antitrust officials took pains to position their program as occupying the sensible middle ground. *See* Robert Pitofsky, Chairman, Federal Trade Commission, An Antitrust Progress Report for the FTC: Past, Present, and Future, Remarks Before the Antitrust 1996 Conference of Business Development Associates Inc. 2 (Mar. 4, 1996) ("The Commission of the 1990s has tried to strike a middle ground between what many people believe was an excessively active enforcement in the 1960s and the minimalist enforcement of the 1980s."), available at http://www.ftc.gov/speeches/pitofsky/speech4.htm.

39 Robert Pitofsky, *Reinvigorating Merger Enforcement That Has Declined as a Result of Conservative Economic Analysis*, in HOW THE CHICAGO SCHOOL OVERSHOT THE MARK 233, 233 (Robert Pitofsky ed., 2008).

40 Baker & Shapiro, *supra* note 18.

41 *Id*. at 269 n. 31.

42 Pitofsky, *Reinvigorating Merger Enforcement That Has Declined as a Result of Conservative Economic Analysis*, *supra* note 39, at 234.

43 Robert Pitofsky, *Introduction: Setting the Stage, in How the Chicago School Overshot the Mark* 3, 6 (Robert Pitofsky ed., 2008).

44 Baker & Shapiro, *supra* note 18, at 251.

45 *Id.* at 244-46.

46 *Id.* at 247-48.

47 *Id.* at 247.

48 *Id.* at 244.

49 *Id.* at 248-51.

50 *Id.* at 269 & n. 31.

51 *Id.* at 240.

52 *Id.* at 266-67.

53 Thomas B. Leary, *The Essential Stability of Merger Policy in the United States*, 70 ANTITRUST L.J. 105, 106 (2002).

54 Statement of Senator Barack Obama for the American Antitrust Institute 1 (Feb. 20, 2008), available at http://www.antitrustinstitute.org/Archives/obama2.ashx.

55 *See*, e.g., Baker & Shapiro, *supra* note 18, at 266 ("We certainly do not propose a return to the horizontal merger control policies and precedents of the 1960s.").

56 The standards of legality established by Supreme Court merger decisions and government enforcement policy in the 1960s and through the early 1970s are described in Kovacic, *Enforcement Norms*, *supra* note 19, at 433-34.

57 Among other contributions, Elman authored the Commission decision that the Supreme Court ultimately upheld in Federal Trade Commission v. Procter & Gamble Co., 386 U.S. 568 (1967). For a summary of modern criticism of *Proctor & Gamble*, especially its suggestion that efficiencies caused by a merger either were irrelevant to the assessment of legality or might serve to condemn the transaction, *see* Ernest Gellhorn et al., ANTITRUST LAW AND ECONOMICS IN A NUTSHELL 462-63, 466-67 (5th Ed. 2004).

58 Turner's role as Assistant Attorney General for Antitrust from 1965 to 1968 and his contributions to improving the economic foundations of DOJ antitrust enforcement are examined in Oliver E. Williamson, *Economics and Antitrust Enforcement: Transition Years*, ANTITRUST 61 (Spring 2003), available at http://groups.haas.berkeley.edu/bpp/oew/Spring03-Williamson.pdf (last viewed 4/12/09).

59 Fox, *supra* note 29, at 84. Federal merger enforcement activities from 1981 to 1986 are documented in Ronald W. Davis, *Antitrust Analysis of Mergers, Acquisitions, and Joint Ventures in the 1980s: A Pragmatic Guide to Evaluation of Legal Risks*, 11 DEL. J. OF CORP. L. 25 (1986). Other surveys of the federal enforcement experience in this period include Leary, *supra* note 53, at 111-21 and Kovacic, *supra* note 19 at 435-47.

60 Fox & Crane, *supra* note 36, at 4. One gets a sense of the alertness of the FTC in the 1980s by reading noteworthy court of appeals opinions involving some of the enforcement decisions. These include Hospital Corp. of America v. Federal Trade Commission, 807 F.2d 1381 (7th Cir. 1986); Federal Trade Commission v. PPG Industries, 798 F.2d 1500 (D.C. Cir. 1986); Federal Trade Commission v. Warner Communications, Inc., 742 F.2d 1156 (9th Cir. 1984). These are not obscure cases.

61 *See supra* notes 31-33 and 42-43 and accompanying text.

62 The contributions of the 1982 DOJ merger guidelines to competition policy are examined in William B. Blumenthal, *Clear Agency Guidelines: Lessons from 1982*, 68 ANTITRUST L. J. 5 (2000); Gregory J. Werden, *The 1982 Merger Guidelines and the Ascent of the Hypothetical Monopolist Paradigm*, 71 ANTITRUST L.J. 253 (2003).

63 Another recent paper that travels largely the same path, with similar conclusions, based on activity levels is John D. Harkrider, *Antitrust Enforcement During the Bush Administration—An Economic Estimation*, 22 ANTITRUST 43 (Summer 2008).

64 These frailties are examined in Timothy J. Muris, *Facts Trump Politics: The Complexities of Comparing Merger Enforcement over Time and Between Agencies*, 22 ANTITRUST 37 (Summer 2008); *Roundtable Discussion, Advice for the New Administration*, 22 ANTITRUST 8, 13 (Summer 2008) (remarks of Timothy Muris).

65 Baker & Shapiro, *supra* note 18, at 250.

66 For a discussion of this pitfall and other limitations of first-person narrations of antitrust history, *see* William E. Kovacic, *Review of Antitrust Stories*, 4 Competition Policy International 241 (2008).

67 The transaction's competition issues are examined in detail in William E. Kovacic, *Transatlantic Turbulence: The Boeing-McDonnell Douglas Merger and International Competition Policy*, 68 ANTITRUST L. J. 805 (2001).

68 The FTC's opposition to Mobil's attempted purchase of Marathon and to Gulf Oil's attempted purchase of Cities Service is discussed in Kovacic, Enforcement Norms, *supra* note 19, at 444.

69 U.S. Government Accountability Office, Energy Markets: Effect of Mergers and Market Concentration in the U.S. Petroleum Industry (2004).

70 *See*, e.g., Market Forces, Anticompetitive Activity, and Gasoline Prices: FTC Initiatives to Protect Competitive Markets: Hearing on the Status of the U.S. Refining Industry Before the House Committee on Energy and Air Quality (July 15, 2004) (prepared statement of William E. Kovacic, FTC General Counsel), available at http://www.ftc.gov/os/2004/07/040715gaspricetestimony.pdf.

71 *See* Kovacic, *Norms*, *supra* note 19, at 433-438 (discussing merger enforcement trends over time); Kovacic et al., *supra* note 2.

72 The relevant jurisprudential developments are described in Kovacic, Enforcement Norms, *supra* note 19, at 433-47; Andrew I. Gavil et al., Antitrust Law in Perspective: Cases, Concepts and Problems in Competition Policy 436-38, 451-55, 467-68, 553-54 (2d Ed. 2008).

73 Kovacic et al, *supra* (discussing how recent judicial merger decisions may underestimate competitive dangers).

74 Kovacic, Ex Post Evaluations, *supra* note 10, at 516-32; FTC at 100, *supra* note 11, at 146-53, 166-69.

75 For a discussion of initiatives in the United States, *see* FTC at 100, *supra* note 11, at 100-09.

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Consumer Protection and Behavioral Economics: To BE or Not to BE?

J. Howard Beales III

The foundation of consumer protection policy is respect for consumer choice. Modern consumer protection recognizes the need to preserve information markets and to carefully structure interventions to ensure compatibility with how consumers actually process information. Behavioral economists have identified a number of behaviors inconsistent with the assumption that consumers rationally maximize their utility, leading some to argue for policy changes that would restrict choice in some instances.

Four interrelated concerns limit the applicability of behavioral economics to consumer protection policies. The experimental evidence that provides the most compelling evidence supporting various behavioral biases may not predict real-world behavior in markets. There is no consistent and coherent body of behavioral theory yielding clear predictions about which biases might be relevant in a given situation. There has been relatively little exploration of the implications of particular biases for the nature of the economic equilibrium. Finally, we have little reliable empirical evidence addressing the benefits and costs of possible interventions based on behavioral principles.

Behavioral economics offers useful insights into consumer behavior, many of which are already a part of consumer protection policy. Like other interventions, however, policies based on behavioral principles must be tested against actual market behavior. At present, we do not have an empirical foundation that would justify significant changes in policy.

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One of the hottest topics in the economics literature today is the burgeoning field of behavioral economics (BE). Based initially on experimental evidence that seems to contradict the standard economic model's assumption that consumers are rational utility maximizers, behavioral economists have increasingly questioned whether the economist's conventional respect for consumer preferences is really appropriate. Instead, some argue, it may be necessary to intervene in markets to protect consumers' true preferences, because they may fail to pursue those preferences effectively on their own. Interest in behavioral economics and the implications it should have for consumer protection policies have led to conferences exploring these issues at the Organisation for Economic Co-operation and Development (OECD),[1] the U.S. Federal Trade Commission (FTC),[2] and the Australian Productivity Commission.[3]

To their credit, most economists writing about behavioral economics issues have been restrained in their recommendations for public policy. They have a healthy skepticism about the potential unintended consequences of intervention, a respect for the importance of competitive markets, and a professional ethic of assessing the benefits and costs of policy actions. Writers in the behavioral law and economics (BLE) literature have been far less restrained, citing behavioral economics principles and findings as the basis for recommendations ranging from the relatively benign (e.g., changing the default choice for retirement savings plans[4]) to the extreme (e.g., the restoration of usury limits[5]).

To understand whether the finding of behavioral economics should change consumer protection policy, we first need to understand current policy. The foundation of consumer protection has always been the consumer's preferences, even if others might question those preferences. As the U.S. Supreme Court said in one of the early FTC consumer protection cases: "The consumer is prejudiced if upon giving an order for one thing, he is supplied with something else. In such matters, the public is entitled to get what it chooses, though the choice may be

1 OECD, Directorate for Science, Technology & Industry, Committee on Consumer Policy, Roundtable on Demand-Side Economics for Consumer Policy: Summary Report (2006) [hereinafter OECD Report].

2 U.S. Federal Trade Commission, Conference on Behavioral Economics and Consumer Policy, Washington, DC (Apr. 20, 2007), *at* http://www.ftc.gov/be/consumerbehavior/index.shtml (last visited Feb. 19, 2008).

3 Australian Government Productivity Commission, Review of Australia's Consumer Policy Framework, Draft Report app. B (2007) [hereinafter Australian Report], *available at* http://www.pc.gov.au/__data/assets/pdf_file/0006/73662/consumer2.pdf.

4 C.R. Sunstein & R.H. Thaler, *Libertarian Paternalism is Not and Oxymoron*, 70 U. Chi. L. Rev. 1159 (2003).

5 O. Bar-Gill, *Seduction by Plastic*, 98 Nw. U. L. Rev. 1373 (2004).

dictated by caprice or by fashion or perhaps by ignorance."[6] The issue is whether the findings of behavioral economics raise sufficient doubt about the assumption that consumers are rational utility maximizers to undermine this fundamental respect for revealed preferences.

This article begins with the modern economic approach to consumer protection, which is based on the economics of information and transaction-cost economics. It then turns to a brief review of the decision-making problems that behavioral economists have identified. Section III discusses the limitations of behavioral economics: its heavy reliance on experimental evidence, the lack of a clear theory of which behavioral biases matter in any particular context, the need to examine the effect of possible biases on the market equilibrium, and the limited empirical evidence addressing the benefits and costs of behavioral remedies. The final section discusses the relationship between behavioral economics and consumer protection policy.

I. The Economics of Consumer Protection

The twin foundations of consumer protection policy are the economics of information and transactions costs. Contrary to the assumptions of the perfectly competitive model, consumers do not have complete information about all products and all providers. Intervention may be necessary to prevent consumer deception, or to assure that consumers have sufficient information to make reasonable choices. Moreover, transactions are not cost-free, particularly when they require legal action to enforce their terms. When small amounts are at stake, it may not be worthwhile for consumers individually to enforce contractual rights, but the aggregate costs of breach of contract can be quite significant.

THE TWIN FOUNDATIONS OF CONSUMER PROTECTION POLICY ARE THE ECONOMICS OF INFORMATION AND TRANSACTIONS COSTS.

A. THE ECONOMICS OF INFORMATION

Since at least George Stigler's seminal 1961 article,[7] economists have recognized that the cost of acquiring information is an important issue in many markets. Consumers must decide how much information to acquire, and will not find it worthwhile to obtain complete information about every alternative. Because information will usually have value in the future as well as in the present, decisions about information acquisition are investment decisions. Consumers can obtain information from their own search across competing sellers in the market, they can purchase information from third-party intermediaries such as Consumer

6 FTC v. Algoma Lumber Co., 261 U.S. 67, 78 (1934) (citations omitted).

7 G. J. Stigler, *The Economics of Information*, 64 J. POL. ECON. 213 (1961).

Reports, they can hire experts to assist them with difficult decisions, or they can obtain information from advertising.

Advertising is a particularly important source of information for most consumers in most markets. Because advertising reduces the cost of search, it is, in Stigler's phrase, "an immensely powerful instrument for the elimination of ignorance."[8] Advertising may provide information directly, as it does when retail stores advertise the prices of various items, or when sellers describe easily verifiable characteristics of their products (available colors, size, and the like, frequently identified as search characteristics). It may provide information about characteristics that are more difficult for consumers to verify, such as whether a product will relieve minor pain or a stuffy nose, or the gas mileage of a new car. Advertising may also serve as a signal of product quality. If sellers depend on repeat purchases, then sellers of higher quality goods can signal their quality with greater advertising expenditures.[9] Advertising may also serve as a performance bond, because sellers may lose their intangible investment in advertising if they do not deliver the promised quality.[10]

Two insights from the economics of information are critical in understanding consumer protection policy. First, in a world of imperfect information, sellers have strong incentives to provide information to consumers. Of course, some sellers may try to take advantage of ill-informed consumers, and others may actively mislead consumers. Other sellers, however, will profit if they provide the information, and the product options, that consumers value. The incentive to provide positive information is straightforward, but the unfolding principle implies that sellers will also provide information about negative product characteristics. Sellers with less of the negative characteristic than others will reveal that advantage, which in turn will create incentives for others to disclose, until all but the worst seller discloses.[11]

Second, it is possible to achieve perfectly competitive outcomes without perfectly informed consumers. As long as an informed minority large enough to be worth competing for exists, competition for those who are informed will drive all sellers to provide product characteristics that informed buyers' value.[12] Even in

8 *Id*. at 220.

9 P. Nelson, *Advertising as Information*, 82 J. Pol. Econ. 729 (1974).

10 B. Klein & K. B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. Pol. Econ. 615 (1981).

11 Unfolding occurs if consumers assume that absent disclosure, a product is worse on the characteristic than products that disclose. *See* S. Grossman*, The Informational Role of Warranties and Private Disclosure About Product Quality*, 24 J.L. & Econ. 461 (1981); and P. Rubin*, The Economics of Regulating Deception*, 10(3) Cato J. 667 (1991).

12 A. Schwartz & L.L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. Pa. L. Rev. 630 (1979).

standard form contracts, the marginal informed consumer drives the contract terms that are offered to all consumers.[13]

Case studies of advertising restrictions, whether they restrict the ability to advertise at all or restrict specific content, demonstrate that seller-provided information produces important market benefits for consumers.[14] When sellers can advertise more freely, prices fall, and products are improved, compared to circumstances in which advertising is restricted. The value of advertising in enhancing market performance is well-documented, and protecting this flow of information is a key element of consumer protection.

Consumer protection economists have borrowed many insights about the flow of information in markets from the marketing literature. Marketing studies have found that consumer misunderstanding of advertising and other communications is commonplace, with a quarter to one-third of consumers generally giving incorrect answers to questions about the communication.[15] The fact that some consumers will misunderstand virtually any communication creates the need to distinguish actionable deception from simple mistakes.

At times, the FTC has attempted to protect consumers from what can only be described as idiosyncratic misinterpretations, contending, for example, that consumers might believe a "permanent" hair dye would color hair that had not yet grown out and that consumers might really think a one volume desktop encyclopedia actually did contain "everything you've ever wanted to know on every conceivable subject." Such efforts, however, plainly interfere with efforts to communicate with consumers, and have long since been abandoned.[16] Claims are not actionable unless they mislead a sufficiently large fraction of the audience, a test

13 For evidence addressing shopping for standardized franchise contracts, *see* J.H. Beales & T.J. Muris, *The Foundations of Franchise Regulation: Issues and Evidence*, 2 J. CORP. FIN.: CONTRACTING, ORGANIZATION & GOVERNANCE 157 (1995). For evidence of shopping for personal loan terms, *see* J.R. Barth, J.J. Cordes, A.M.J. Yezer, *Benefits and Costs of Legal Restrictions on Personal Loan Markets*, 29 J.L. & ECON. 157 (1986).

14 The first study finding that advertising reduced price was L. Benham, *The Effect of Advertising on the Price of Eyeglasses*, 15 J.L. & ECON. 337 (1972). For evidence of the impact of health claims on the market, *see* P.M. Ippolito & A.D. Mathios, *Information, Advertising and Health Choices: A Study of the Cereal Market*, 21 RAND J. ECON. 459 (1990). Other studies of both price and quality benefits of seller-provided information are identified in J. HOWARD BEALES & TIMOTHY J. MURIS, STATE & FEDERAL REGULATION OF NATIONAL ADVERTISING ch. 2 (1993).

15 For broadcast advertising, *see* J. JACOBY, W. D. HOYER & D. A. SHELUGA, MISCOMPREHENSION OF TELEVISED COMMUNICATIONS (Am. Ass'n Advertising Agencies, Nov. 1980). *See also* 46 J. MARKETING 12-43 (1982) for a summary of the study, critical comments on its validity, and a rejoinder. For print advertising, *see* J. Jacoby & W. D. Hoyer, *The Comprehension/Miscomprehension of Print Communication: Selected Findings,* 15 J. CONSUMER RES. 434 (1989).

16 The Commission formally abandoned the so-called "fools test" when it adopted the Deception Policy Statement in 1983. The emergence of the FTC's modern approach to advertising regulation is discussed in detail in Beales & Muris (1993), *supra* note 14.

that is ultimately an empirical one based on advertising copy tests of the communication in question.[17]

One key aspect of communicating information in the market is getting the consumer's attention. Like information, attention is a scarce resource, and must be allocated to some things rather than others. Many advertising techniques, such as celebrity endorsements, can be understood in part as attention-getting devices. Attention-getting devices, however, like other aspects of advertising, are subject to "wear out"; that is, an advertisement which is initially effective loses impact with more repetition.[18]

The marketing literature is also the source of the notion of information overload.[19] Providing too much information can lead consumers to ignore the information entirely. If we consider the cost of obtaining information, part of the cost of obtaining the relevant and interesting information is the irrelevant or less useful information that one must process first to obtain those useful nuggets. Unless additional information is well-organized and presented, too much information raises the costs of finding what the consumer is most interested in, and may lead the consumer to ignore the communication entirely.

An additional form of information overload is relevant to sellers. Requirements to provide more information raise the cost of conveying a message to consumers, especially in advertising. When particular claims "trigger" disclosure requirements, advertisers may choose to avoid the triggering claims entirely.[20] For example, the regulatory requirement to provide a "brief summary" of prescribing information with prescription drug advertisements effectively prohibited direct-to-consumer advertising on television until the requirement was removed.

Finally, additional information may lead consumers to make inferior choices, particularly if it suggests that consumers should consider a factor that is not actually relevant to the decision. Disclosing a mortgage broker's compensation from

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17 For a brief description of the FTC's analytical approach, *see* Pauline Ippolito, Consumer Policy at the FTC, Presentation at the FTC Conference on Behavioral Economics and Consumer Policy, Washington, DC (Apr. 20, 2007), *available at* http://www.ftc.gov/be/consumerbehavior/docs/transcript/transcriptc.pdf.

18 *See, e.g.,* C.S. Craig, B. Sternthal & C. Leavitt, *Advertising Wearout: An Experimental Analysis*, 13 J. Marketing Res. 365 (1976); A.J. Rethans, J.L. Swasy & L.J. Marks, *Effects of Television Commercial Repetition, Receiver Knowledge, and Commercial Length: A Test of the Two-factor Model*, 23 J. Marketing Res. 50 (1986).

19 *See* the discussion in J.P. Mulholland, Summary Report on the FTC Behavioral Economics Conference 25 (2007) (mimeo) (on file with the FTC), *at* http://www.ftc.gov/be/consumerbehavior/docs/070914mulhollandrpt.pdf [hereinafter Mulholland Summary]. *See also* J. Rudd, *The Consumer Information Overload Controversy and Public Policy*, 2 Pol'y Stud. Rev. 465 (1983).

20 H. Beales, R. Craswell & S.C. Salop, *The Efficient Regulation of Consumer Information*, 24 J.L. & Econ. 491 (1981).

yield spread premiums, for example, reduced the consumer's ability to identify the lowest cost mortgage.[21]

In short, imperfect information may lead to the need for government intervention in markets. The goal, however, is not perfection, an objective that is not worth the costs and may well be counterproductive. Consumer protection policy recognizes the need to preserve information markets and their mechanisms to convey information, and to carefully structure interventions that are compatible with how consumers actually process information.

CONSUMER PROTECTION POLICY RECOGNIZES THE NEED TO PRESERVE INFORMATION MARKETS AND THEIR MECHANISMS TO CONVEY INFORMATION, AND TO CAREFULLY STRUCTURE INTERVENTIONS THAT ARE COMPATIBLE WITH HOW CONSUMERS ACTUALLY PROCESS INFORMATION.

B. TRANSACTION COSTS

A second pillar of the economic analysis of consumer protection issues involves transaction costs. In the real world, consumers bear costs to negotiate, form, and enforce contracts. Government policies can help to reduce these costs. Indeed, the basic legal rules against fraud and breach of contract are the foundations of consumer protection.

To minimize transaction costs, the government provides default rules for contract terms that the parties have not expressly negotiated. Generally, defaults are not binding—parties can contract around the default if a different rule serves their purposes. But selecting the default that most parties would choose eliminates the need for them to consider and negotiate about a variety of remote contingencies. They can simply rely on the default rules.[22]

Transactions costs are also relevant in many government enforcement actions. Although consumers may have private rights of action, the high cost of using the legal system may in effect preclude consumers from enforcing those rights. Government agencies, such as the FTC, can enforce contractual rights on consumers' behalf.[23]

21 J. Lacko & J. Pappalardo, *The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment*, FTC BUREAU OF ECONOMICS STAFF REPORT (2004), *available at* http://www.ftc.gov/os/2004/01/030123mortgagefullrpt.pdf.

22 *See* I. Ayres & R. Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Default Rules,* 101 YALE L.J. 729 (1992); C.J. Goetz & R.E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms,* 73 CAL. L. REV. 261 (1985).

23 See T.J. Muris, The Federal Trade Commission and the Fugure Development of U.S. Consumer Protection Policy, Remarks before the Aspen Summit, Cyberspace and the American Dream, The Progress and Freedom Foundation, Aspen, Colorado (Aug. 19, 2003), *available at* http://www.ftc.gov/speeches/muris/030819aspen.shtm.

II. Behavioral Economics

Even with perfect foresight, people make mistakes, and, as a result, sometimes will make decisions that are contrary to their self-interest. Although we might sometimes wish to protect individuals from the consequences of those errors, few would think that random errors in decisions would justify significant intervention in the market. The heart of the behavioral economics proposition, however, is that errors are not random. Instead, behavioralists argue, consumer behavior displays systematic departures from the idea of rational utility maximization, particularly in the face of risk and uncertainty.

Behavioral economists and others have identified a number of biases in decision-making.[24] Choices exhibit "framing" effects; that is, consumers are more likely to find a choice attractive if it is presented as a potential gain, rather than presenting an equivalent choice as an expected loss. At least in some experiments, consumers suffer from "endowment effects," which lead them to value something more once they have it; that is, they require a larger payment to part with a particular product than they are willing to pay to acquire the product.

Consumers may experience "choice overload." If there are too many choices, they may decide not to choose at all. Similarly, they may exhibit "status quo bias," which is when they let the default rule make a decision for them. If the default rule is that consumers must "opt out" of a choice, whether it is organ donation[25] or an employer-sponsored savings plan,[26] most consumers will participate. If, however, the default rule is "opt in," most consumers will not participate. In either case, most consumers do not exercise their option to choose. Thus, choosing the default in fact determines the outcome for most consumers.

Behavioralists also argue that consumers have difficulty estimating probabilities, in particular relatively low probabilities, and appear to overestimate the likelihood of dramatic events such as airplane crashes. Because such events are widely publicized, they are more "available" to consumers, who consequently overestimate their frequency relative to more common events that garner less attention. If consumers are given an "anchor" for some quantity they are asked to estimate, estimates tend to be near whatever anchor is given. Estimates are more accurate without an anchor.

24 There is, as yet, no generally agreed on set of behavioral effects or terminology to describe them. This categorization draws heavily on the lists developed in the OECD (*supra* note 1) and Australian (*supra* note 3) Reports. Another useful categorization focused on factors relevant to excessive borrowing can be found in C.R. Sunstein, *Boundedly Rational Borrowing*, 73 U. CHI. L. REV. 249 (2006).

25 E. Johnson & D. Goldstein, *Do Defaults Save Lives?*, 302 SCI. 1338 (2003).

26 Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 Q.J. ECON. 1149 (2001).

Finally, consumers exhibit a present bias, or hyperbolic discounting. This bias has also been characterized as myopia or self-control problems. Consumers will choose a small reward today over a larger reward later. However, if both rewards are far in the future, then they will frequently choose the larger reward. Choosing short-term gains at the expense of long-term costs can lead to short-term decisions that generate long-term distress.

III. The Limits of Behavioral Economics

Behavioral economists have produced a number of intriguing results, which point the way to possible refinements of the standard model of the rational, utility-maximizing consumer with stable preferences. There is every reason to hope that a more fine-grained understanding of consumer decision-making processes can lead to better assumptions, and thus to better predictions of what will happen in actual markets. Nonetheless, the ultimate test of a theory remains the validity of its predictions, rather than the accuracy of its assumptions.[27] In that aspect, behavioral economics remains in its infancy.

Four interrelated concerns limit the potential applicability of behavioral economics to consumer protection policies. First, the experimental evidence that provides the most compelling evidence supporting various behavioral biases may not predict real-world behavior in markets. As always, there are issues about whether behavior in the laboratory reflects actual behavior when real money is at stake, but far more important is whether laboratory measures based on average responses can tell us much about the behavior of the marginal consumers who drive the economic equilibrium. Second, there is no consistent and coherent body of behavioral theory yielding clear predictions about which biases might be relevant in a given situation. Instead, both predicted effects and the predicted impact of possible interventions are somewhat ad hoc. Third, to date there has been relatively little exploration of the implications of particular biases for the nature of the economic equilibrium (although this state of affairs is beginning to change). As a result, we know little about likely or actual market responses to the phenomena that behavioralists have identified. Finally, we have little, if any, reliable empirical evidence addressing the benefits and costs of possible interventions based on behavioral principles.

A. EXPERIMENTS AND REAL-WORLD BEHAVIOR

The primary evidence supporting behavioral economics predictions is experimental, derived in a wide variety of laboratory settings. There is much that can be learned from experimental economics, and practitioners have made great strides in creating experimental environments that mirror real markets as closely as possible. Moreover, empirical behavioral economics research is increasingly moving

27 Milton Friedman, *The Methodology of Positive Economics*, *in* ESSAYS IN POSITIVE ECONOMICS (1953).

to field experiments, in which an offer is manipulated in the context of an actual choice in the market.[28] Nonetheless, laboratory findings remain the foundation of behavioral economics. By their nature, experiments are designed to test predictions; they do not in and of themselves generate testable hypotheses.

From the beginnings of experimental economics, there have been questions about the applicability of laboratory results to real-world economic problems. The level of motivation and attention that consumers devote to solving problems in the real world may differ from what consumers bring to the laboratory.[29] Experimental studies find that higher rewards tend to shift observed outcomes toward the predictions of the rational choice model,[30] and that the real-world consequences of decisions are likely large compared to the typical laboratory payoff. For example, higher paid workers with more to lose from poor choices are less likely to rely on default choices for retirement plans.[31]

Inherently, any experiment tests for both a behavioral effect and the impact of the laboratory setting. Disentangling the separate effects is often difficult.[32] Plott and Zeiler (2005), for example, find endowment effects in simple procedures with limited controls for possible misconceptions about the experimental task. With comprehensive controls for misconceptions, including an incentive-compatible mechanism to elicit valuations, comprehensive explanations, paid practice rounds, and anonymity, the effect disappears.[33] The endowment effect appears in many policy discussions, but it may be an artifact of the experimental procedures used to observe it.

Most importantly, experiments measure the difference in some outcome between the average member of a test and a control group. Crucial to the economic equi-

28 For example, much of the research presented at the FTC Conference on Behavioral Economics and Consumer Policy, *supra* note 2, was based on field experiments.

29 S. Levitt & J. List, What Do Laboratory Experiments Tell Us About the Real World? (2006) (mimeo, University of Chicago and NBER), *available at* http://pricetheory.uchicago.edu/levitt/Papers/jep%20revision%20Levitt%20&%20List.pdf; and J. List, *The Behavioralist Meets the Market: Measuring Social Preferences and Reputation Effects in Actual Transactions*, 114 J. Pol. Econ. 1 (2005).

30 Vernon L. Smith & James M. Walker, *Monetary Rewards and Decision Cost in Experimental Economics*, 31 Econ. Inquiry 245 (1993).

31 Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 Q.J. Econ. 1149 (2001).

32 H. Ergas, Policy Implications of Behavioural Economics: The Case of Consumer Protection, Paper presented at the Australian Productivity Commission's Roundtable on Behavioural Economics and Public Policy, Melbourne (Aug. 9, 2007).

33 C. Plott & K. Zeiler, *The Willingness to Pay–Willingness to Accept Gap, the "Endowment Effect," Subject Misconceptions, and Experimental Procedures for Eliciting Valuations*, 95(3) Am. Econ. Rev. 530 (2005).

librium, however, is the behavior of the marginal buyer. We would expect the average consumer who participates in a market to believe that purchasing the product increases utility. The marginal purchaser, however, is indifferent between buying and not buying—and (given supply) it is the marginal purchaser who determines the market price. Experiments describing average behavior tell us little about the marginal behavior that most matters in markets.[34] Moreover, forced choices in experiments may differ from market behavior, where one of the options is not to participate at all. Given the choice in an actual market, participants whose behavior drives experimental results may simply choose not to play.[35]

Changes in consumer protection policy or interventions based on behavioral principles will play out in real markets. Before adopting such policies, we should have some empirical evidence that the particular principle supporting the intervention is actually observable in the marketplace. At present, such evidence is scant.

Before adopting such policies, we should have some empirical evidence that the particular principle supporting the intervention is actually observable in the marketplace. At present, such evidence is scant.

B. WHEN DO BEHAVIORAL THEORIES APPLY?

By and large, particular predictions of behavioral economics have a specific theoretical basis, often drawn from psychology; that is, each predicted departure from fully informed rational decision-making has a theoretical basis. As the Australian Productivity Commission noted, however, a common theme of the behavioralist literature is that behavior depends on the environment,[36] and there is no cohesive body of theory that tells us which departures are likely to be important in any particular context.[37]

Consider, for example, cooling-off periods, a remedy that some behavioral economists have advocated to allow consumers to overcome the biases of hyperbolic discounting or myopia.[38] One could argue equally well that a cooling-off

34 E. Lazear, Remarks at the FTC Conference on Behavioral Economics and Consumer Policy, Washington, DC (Apr. 20, 2007), at 14, *available at* http://www.ftc.gov/be/consumerbehavior/docs/transcript/transcriptopen.pdf.

35 E. Lazear, U. Malmendier & R. Weber, Sorting in Experiments with Application to Social Preferences (Nat'l Bureau of Econ. Research, Working Paper No. 12041, 2006), *available at* http://www.nber.org/papers/w12041.

36 Australian Report, *supra* note 3, at 311.

37 N. Berg & G. Girgerenzer, *Psychology Implies Paternalism? Bounded Rationality May Reduce The Rationale To Regulate Risk-Taking*, 28 Soc. Choice Welfare 337 (2007), J. Klick & G Mitchell, *Government Regulation of Irrationality: Moral and Cognitive Hazards*, 90(6) Minn. L. Rev. 1620 (2006).

38 OECD Report, *supra* note 1, at 17.

period reduces the perceived risk of a purchase, and that consumers will overestimate the likelihood that they will revisit their decision. Moreover, once the purchase is made, one might expect that the status quo bias would be relevant, and consumers would be reluctant to part with their purchase.[39] On these arguments, cooling-off periods might reduce consumer welfare. The vast majority of purveyors of fraudulent products that the FTC has pursued offer money-back guarantees, which would seem to be the functional equivalent of a cooling-off period. It seems safe to say that these sellers are trying to reduce the perceived risk of the purchase, not providing a chance for consumers to reconsider their decision.

Similarly, consider the impact of credit card rewards programs. Some argue that because the rewards reduce the effective cost of current purchases, consumers who exhibit hyperbolic discounting may increase current purchases, resulting in more future debt.[40] Others argue that credit cards reduce the pain of paying, and may therefore lead to "over-indebtedness"[41] or the systematic overuse of credit cards.[42] Rewards cards, which literally pay consumers for current transactions, should be particularly prone to this bias. Either argument implies that consumers who obtain a new rewards card should be more likely to carry a balance on the card than those who obtain new cards without a rewards feature. Still others argue that rewards are often deferred, thereby reducing their importance for current choices, or that the fear of effectively losing the reward by having to pay interest on an outstanding balance would reduce the incentive to carry a balance on a rewards card.[43] In fact, consumers are less likely to carry a balance on a new rewards card than on other new cards,[44] contradicting one behavioral story, but not the other. Testing the applicability of a theory to real markets is difficult when its predictions are so uncertain.

39 J.P. Mulholland, Behavioral Economics and the Federal Trade Commission, Paper presented at the Australian Productivity Commission's Roundtable on Behavioural Economics and Public Policy, Melbourne (Aug. 9, 2007); and Mulholland Summary, *supra* note 19, at 27.

40 Bar-Gill (2004), *supra* note 5.

41 G. Loewenstein & T. O'Donoghue, *'We Can Do This the Easy Way or the Hard Way': Negative Emotions, Self-Regulation, and the Law*, 73 U. Chi. L. Rev. 183 (2006).

42 R.J. Mann, Credit Cards, Consumer Credit & Bankruptcy (University of Texas School of Law, Law and Economics Working Paper No. 044, 2005), *available at* http://www.ssrn.com/abstract=690701.

43 Transcript of Session F, Consumer Choice: Credit Cards, FTC Conference on Behavioral Economics and Consumer Policy, Washington, DC (Apr. 20, 2007), at 39-40, *available at* http://www.ftc.gov/be/consumerbehavior/docs/transcript/transcriptf.pdf.

44 J.H. Beales & L.L. Plache, Rationality, Revolving, and Rewards: An Analysis of Revolving Behavior on New Credit Cards, Paper presented at the FTC Conference on Behavioral Economics and Consumer Policy, Washington, DC (Apr. 20, 2007), *available at* http://www.ftc.gov/be/consumerbehavior/docs/papers/Beales_Plache_Paper.pdf.

Using behavioral principles as a basis for policy interventions requires policymakers to assume that the relevant principle is applicable in the context of that intervention. Without a theory that predicts which deviation from rational choice is most important in a particular context, there is little basis for that assumption. Particularly in the absence of a clear theoretical basis, policy interventions should have a more solid foundation than laboratory experiments.

C. BEHAVIORAL ECONOMICS AND MARKET EQUILIBRIUM

Compared to other social sciences, a unique component of economic analysis is the concept of equilibrium.[45] Economics is the study of consumer and producer behavior, moderated by the market, and it is the outcome of that interaction that is critical to either understanding or influencing market results. Because marginal, not average, consumers determine market outcomes, even if many consumers deviate from rational choice, the resulting market equilibrium may be essentially what the rational choice model would predict. Schwartz, for example, finds that if some buyers are naïve and others are not, competition may drive out contracts that take advantage of naïve buyers.[46] As with imperfect information, the flaw does not necessarily prevent efficient outcomes.

Two aspects of market interaction are particularly important in considering the policy implications of behavioral economics. First, consumers learn, from both their good experiences and their mistakes, and learning reduces the influence of deviations from rational choice. Second, firms' responses to consumer biases may moderate their influence, and may create profit opportunities for products and services that either avoid or correct the bias. Without equilibrium models, we cannot assess the impact of any particular bias on market outcomes.

Consumers who exhibit behavioral biases experience losses. These losses may be actual losses, or they may be opportunity losses in the sense that a choice yielding higher utility was available. There is every reason to expect that consumers will learn from their experience, in particular when the losses are actual losses.[47] The consumer will likely make a different decision from the one that led to the loss the next time the situation arises. Experiments that allow participants to learn over time find that learning eliminates observed behavioral phenomena in at least some circumstances. John List (2003), for example, investigated endowment effects in trading card markets, and found that "individual behavior

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45 E. Lazear, *Economic Imperialism*, 115(1) Q.J. Econ. 99 (2000).

46 Alan Schwartz, *How Much Irrationality Does the Market Permit?*, 37 J. Legal Stud. (forthcoming 2008).

47 Richard A. Epstein, *Behavioral Economics: Human Errors and Market Corrections*, 73 U. Chi. L. Rev. 111 (2006).

converges to the neoclassical prediction as market experience increases."[48] Actual market participants are frequently repeat players, and may have considerable market experience. Moreover, learning may also be more general, leading consumers to make better choices in similar situations.

In general, consumers can make investments (such as in education) to learn how to make decisions in a particular type of choice situation, or they can learn from their experience with such choices over time.[49] Either approach to learning has costs and produces a stock of human capital, which yields benefits in the form of better decisions over time. Additional experience adds to that stock. Moreover, the stock of human capital is presumably subject to depreciation, either in the form of forgetting or changing circumstances that reduce the relevance of past knowledge or experience. Thus, the human capital stock is likely to increase over time as investments are made, and eventually decline as reduced investment incentives and depreciation take their toll.

In the credit card market, there is evidence that consumers learn from the experience of paying late fees to avoid the fees in the future. There is also evidence of forgetfulness, leading to additional mistakes. The probability of owing late fees because of forgetfulness declines with age until sometime in middle age, and then increases again.[50] A similar pattern has been observed in other financial decisions.[51] This is exactly what one would expect from a stock of human capital in bill-paying habits. Miravete and Palacios-Huerta (2004) also found that consumers learned rapidly to make optimal decisions about which telephone pricing scheme to choose.[52]

Firm responses are also likely to affect the market relevance of behavioral findings. Consider framing, for example. Although sellers can presumably take advantage of framing in the way they present a product or service, the market consequences are unclear. Consumers make their choices in a marketplace in which sellers of competing alternatives will also seek to frame their offerings in

48 John A. List, *Does Market Experience Eliminate Market Anomalies?*, 118 Q.J. ECON. 41 (2003).

49 Becker and Stigler use the household production model to explore a number of situations in which human capital stocks are important. *See* G.J. Stigler & G.S. Becker, *De Gustibus Non Est Disputandum*, 67 AM. ECON. REV. 76 (1977).

50 S. Agarwal, J. C. Driscoll, X. Gabaix & D. Laibson, Stimulus and Response: The Path from Naïveté to Sophistication in the Credit Card Market (Aug. 2006), Paper presented at the FTC Conference on Behavioral Economics and Consumer Policy, Washington, DC (Apr. 20, 2007), *available at* http://www.ftc.gov/be/consumerbehavior/docs/Agarwal_Driscoll_Gabaix_Laibson.pdf.

51 S. AGARWAL, J. DRISCOLL, X. GABAIX & D. LAIBSON, THE AGE OF REASON: FINANCIAL DECISION-MAKING OVER THE LIFECYCLE (MIT Department of Economics, Working Paper No. 07-11, 2007).

52 E. Miravete & I. Palacios-Huerta, Rational Attention in a Repeated Decision Problem (2004) (mimeo, University of Texas), *available at* http://www.eco.utexas.edu/facstaff/Miravete/papers/EJM-IPH.pdf.

the best possible light. Advertisers, for example, are skilled at highlighting product benefits, but the evidence is clear than advertising enhances market performance. Similarly, if alternative choices are each framed in the way that is most likely to appeal to consumers, there is little reason to think framing distorts those choices.

Firms' incentives to sell their product can affect the market response to other potential behavioral biases as well. If, for example, consumers discount future consequences too heavily, sellers of products or services with long-term benefits have incentives to try to make those consequences more vivid and more salient to the consumer.[53] If complex pricing plans are difficult for consumers to understand, firms in competitive markets have incentives to simplify those plans to attract customers.[54]

THE MIX OF CONSUMERS, CONSUMER LEARNING, AND FIRM RESPONSES TO CONSUMER CHOICE PATTERNS WILL INFLUENCE THE MARKET EQUILIBRIUM THAT RESULTS, EVEN IF BEHAVIORAL PRINCIPLES ARE RELEVANT TO SOME CONSUMERS. WITHOUT UNDERSTANDING THE EQUILIBRIUM MARKET IMPACT OF PARTICULAR BIASES, THERE IS LITTLE BASIS FOR POLICY INTERVENTION.

The mix of consumers, consumer learning, and firm responses to consumer choice patterns (or mistakes) will influence the market equilibrium that results, even if behavioral principles are relevant to some consumers. Without understanding the equilibrium market impact of particular biases, there is little basis for policy intervention. As the Australian Productivity Commission noted, "conventional economic models explain outcomes 'as if' people behave optimally. The inability to pinpoint the dynamic, actual process that makes most markets efficient, is simply reflective of why Adam Smith called it the *invisible* hand."[55]

D. BENEFITS AND COSTS OF BEHAVIORAL REMEDIES

Experimental economics certainly has a valuable place in the literature, but it is generally unwise to treat public policy as an uncontrolled experiment. Before intervening in admittedly imperfect markets, policymakers should have a sound basis for concluding that the benefits of the intervention will exceed the costs and that the intervention will in fact increase consumer welfare.

Advocates of "soft" paternalism, whether asymmetric or libertarian, recognize the need for careful cost-benefit analysis of possible interventions. Soft paternalists have generally focused on interventions with a relatively limited impact on

53 This point was made by Pauline Ippolito at the FTC conference. *See* Mulholland Summary, *supra* note 19, at 23.

54 E. Miravete & I. Palacios-Huerta (2004), *supra* note 52.

55 Australian Report, *supra* note 3, at 319.

the choices consumers can actually make, such as the choice of default rules. These approaches allow consumers who think the choice is important and worth considering to pursue their own preferences. Nonetheless, advocates have recognized the need for careful cost-benefit analysis of particular proposals.

The asymmetric paternalism test seeks to adopt regulations that create benefits for those who make errors, but impose little or no harm on those who make correct decisions.[56] Its developers conclude that "a richer sense of the costs and benefits of regulation on individual market actors is a necessary step in the design of proper regulatory mechanisms."[57] As Mulholland (2007) has noted, the approach is very similar to the FTC's approach to analyzing possibly "unfair" practices. A practice is unfair if it causes substantial consumer injury, without offsetting benefits to consumers or competition, that consumers cannot reasonably avoid.[58] Libertarian paternalism also argues for cost-benefit analysis when possible, but allows the use of "rules of thumb" when cost-benefit analysis is too difficult or expensive.[59]

Hard paternalism advocates have been more willing to consider significant restrictions on consumer choices. Bar-Gill (2003), for example, considers policies to address behavioral biases in the credit card market ranging from stronger disclosures to prohibitions on late fees in unsolicited card offers to usury ceilings. Because these more restrictive policies would deny many consumers a choice that has emerged from competitive markets, they are far less likely to pass a cost-benefit test. Nonetheless, Bar-Gill challenges nonintervention, but "does not make an affirmative case for intervention. To make such a case would require a comprehensive cost-benefit analysis of the proposed policy response."[60]

The need for careful empirical analysis of specific interventions based on behavioral principles has been widely noted. At the FTC conference on behavioral economics, there was widespread agreement that careful analysis of specific proposals is an essential prerequisite to policy changes. At present, we simply do not have the empirical base to support significant policy changes.[61] Mulholland's

56 C. Camerer, S. Issacharoff, G. Loewenstein, T. O'Donoghue & M. Rabin, *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism"*, 151 U. Pa. L. Rev. 1211 (2003).

57 *Id.* at 1251.

58 Mulholland (2007), *supra* note 39. For a description of the FTC's current approach to unfairness analysis, *see* J.H. Beales, *The Federal Trade Commission's Use of Unfairness Authority: Its Rise, Fall, and Resurrection*, 22(2) J. Pub. Pol. & Marketing 192 (2003).

59 Sunstein & Thaler (2004), *supra* note 4.

60 Bar-Gill (2003), *supra* note 5, at 1378.

61 Mulholland (2007), *supra* note 39, at 13.

summary of the FTC conference concludes by saying "there was general agreement that more evidence based on actual market settings is required to justify" changes in consumer or competition policy.[62] Furthermore, the Australian Productivity Commission concluded: "Crucially, most policy proposals (regardless of their supporting premises) require a case-by-case, empirical evaluation of their costs and benefits."[63] Even the OECD, perhaps the most enthusiastic assessor of the potential impact of behavioral economics on policy, concluded: "[A]lthough there has been significant research in some areas (for example in certain financial markets), a more specific evidence base still needs to be identified before there is a more widespread policy approach."[64]

IV. Behavioral Economics and Consumer Protection Policies

Many of the key insights of behavioral economics are already a part of consumer protection policy.[65] Consumer protection economists have long understood that consumer interpretation of information, whether seller-provided or government-mandated, is ultimately an empirical question. In a world of costly information and costly transactions, consumers may rationally choose to remain imperfectly informed, and may rationally decide that the benefit of engaging in a transaction is simply not worth the cost. Similarly, the possibility that consumers may misinterpret information so that additional information may lead to worse decisions has long been recognized. Thus, consumer protection policy requires careful attention to the actual marketplace behavior of consumers.

Some behavioral phenomena fit comfortably within the conventional framework discussed in the previous sections. Choice overload, for example, if not the same is certainly a close cousin of the long-recognized phenomenon of information overload. It does not imply that consumers would wish to limit their choices, any more than information overload implies that consumers do not value more information. The lesson of information overload is that remedies must be considered cautiously, because providing additional useful information may actually be counterproductive. Choice overload has the same implication: mandating additional choices may make things worse. Even though bundling may reduce choice, it may be an efficient solution once the costs of making a decision are taken into account.

62 Mulholland Summary, *supra* note 19, at 24.

63 Australian Report, *supra* note 3, at 324.

64 OECD, *supra* note 1, at 5.

65 In the context of Australian consumer policy, which is broadly similar to the U.S. approach, the Australian Productivity Commission reached a similar conclusion: "Much policy is already based on, or implicitly accounts for, behavioral tenets." Australian Report, *supra* note 3, at 309.

In a world of imperfect information, an important dimension of competition among sellers is what information to provide and how best to convey that information to consumers. Sellers have incentives to avoid information overload, because it will undermine the message they are trying to convey. Similarly, if too many choices create problems for consumers, sellers have incentives to simplify the options. Miravete (2007), for example, finds that increased competition led to simplified pricing plans for wireless services.[66] Sellers can also simplify choices with bundling by offering, for example, a package of sports channels rather than requiring consumers to consider each component separately.

> THE LESSON OF INFORMATION OVERLOAD IS THAT REMEDIES MUST BE CONSIDERED CAUTIOUSLY, BECAUSE PROVIDING ADDITIONAL USEFUL INFORMATION MAY ACTUALLY BE COUNTERPRODUCTIVE. CHOICE OVERLOAD HAS THE SAME IMPLICATION: MANDATING ADDITIONAL CHOICES MAY MAKE THINGS WORSE.

One benefit of relying on markets wherever possible is that markets reveal what is important and what is not. If information about a particular product feature is important to consumers, then there are strong incentives for sellers to provide that information. Similarly, if particular options are valued, then there are incentives to offer them. In either case, there is also feedback to sellers that can correct mistaken or no longer valid assumptions that information or a choice was valued. Regulatory policies rarely offer such feedback.

Other behavioral phenomena can be understood in a transaction-cost framework. The importance of default rules, for example, may simply reflect the fact that making decisions is costly, and, when the consequences of the decision are small, it may not be worth the effort. Thus, the default prevails, regardless of how it is determined. If, for example, most consumers do not consider the privacy costs of commercial information sharing to be significant, they are unlikely to read privacy notices or exercise whatever choices may be permitted.[67] The default rule determines whether information sharing is permitted or not, not because of status quo bias, but simply because the decision itself is not worth the effort for most consumers. As with information provision, default rules that place costs on those who believe the decision is important protect those who are concerned without imposing costs on those who believe the costs are not worth bearing.

Behavioral economics offers many useful insights into consumer behavior, and can inform policy choices. Like other interventions, however, choices based on

66 Eugenio J. Miravete, The Doubtful Profitability of Foggy Pricing (2007) (mimeo, University of Texas), *available at* http://www.eco.utexas.edu/facstaff/Miravete/papers/EJM-Foggy.pdf.

67 J.H. Beales & T.J. Muris, Choice or Consequences: Protecting Privacy in Commercial Information, 75 U. CHI. L. REV. (forthcoming 2008).

behavioral principles must be tested against actual market behavior. Although much promising work is under way, at present, we do not have an empirical foundation that would justify significant changes in policy.

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Regulation of Information and Advertising

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Regulation of Information and Advertising

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Deception is the manipulation of information to gain some advantage. This paper considers commercial deception through advertising. The paper first discusses the economics of information. The literature has derived four major policy conclusions. First, truthful information regarding price should not be restricted by regulatory authorities. Second, deception is most likely and most harmful for credence goods, and regulation is most useful (if it is useful at all) for these goods. Third, truthful information should never be restricted. Fourth, regulation of advertising is best done by authorities that specialize in advertising, rather than by agencies with another mission. A fifth, more tentative, conclusion is that regulation should limit itself to statements that are actually false, and ignore those that are misleading or deceptive. The paper begins with a discussion of the First Amendment issues in regulating advertising. It then considers advertising of prices and regulation and types of goods. The next section examines regulation of true information about characteristics of goods other than price, with special reference to the U.S. Food and Drug Administration. The paper also discusses measures of deception and policies of mandating disclosure of negative information and remedies.

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I. Introduction

"Deception" is the manipulation of information to gain some advantage. While people engage in deception in many dimensions for many types of advantage, here I will confine myself to commercial deception through advertising. To understand the economics of deception, I begin with the economics of information. There have been several major analyses of the implications of the economics of information for the regulation of deceptive advertising (e.g., Schwartz & Wilde (1979); Jordan & Rubin (1979); Beales, Craswell & Salop (1981); Rubin (1991); and Calfee (1997)[1]). The literature has derived four major policy conclusions. First, truthful information regarding price should not be restricted by regulatory authorities. Second, deception is most likely and most harmful for "credence" goods, and regulation is most useful (if it is useful at all) for these goods. Third, truthful information should never be restricted. Fourth, regulation of advertising is best done by authorities that specialize in advertising, rather than by agencies with another mission. A fifth, more tentative conclusion, is that regulation should limit itself to statements that are actually false, and ignore those that are "misleading" or "deceptive".

I begin with a discussion of First Amendment issues in regulating advertising. In the following two sections, I discuss advertising of prices and regulation and types of goods. The next section examines regulation of true information about characteristics of goods other than price, with special reference to the U.S. Food & Drug Administration (FDA). Section V addresses measures of deception and policies of mandating disclosure of "negative" information. Section VI discusses remedies, and last, Section VII summarizes the paper and the policy conclusions reached. The economic literature on advertising is voluminous, and I mention only those parts which are relevant to issues of deception.[2]

First, I introduce some institutional background. There are at least five sources of regulation of advertising: The Federal Trade Commission (FTC); other feder-

1 This paper is an extension and updating of Rubin (1991), and many additional references may be found there. *See* P. Rubin, *The Economics of Regulating Deception*, 10(3) Cato J. 667-90 (Winter 1991). A very important excellent general source is J. Calfee, Fear of Persuasion: A New Perspective on Advertising & Regulation (1997).

See also A. Schwartz & L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. Penn. L. Rev. 630-82 (1979); E. Jordan & P. Rubin, *An Economic Analysis of the Law of False Advertising*, 8 J. Legal Stud. 116-55 (June 1979), *reprinted in* P. Rubin, Business Firms & the Common Law, Praeger (1983); H. Beales et al., *The Efficient Regulation of Consumer Information*, 24 J.L. & Econ. 291-539 (1981).

2 For some more general surveys, *see* W. Comanor & T. Wilson, *The Effect of Advertising on Competition: A Survey*, 17 J. Econ. Lit. 453-76 (1979); R. McAuliffe, Advertising, Competition, & Public Policy: Theories & New Evidence (1987); R. Ekelund, Jr. & D. Saurman, Advertising & the Market Process (1988); and Kyle Bagwell, *The Economic Analysis of Advertising*, *in* Handbook of Industrial Organization 3, ch. 28 (M. Armstrong & R. Porter, eds. 2007). This survey is quite extensive, but does not consider deception.

al agencies, such as the FDA and the Securities and Exchange Commission (SEC); state attorneys general; industry self-regulation, under the auspices of the National Advertising Review Board (NARB) or the National Advertising Division (NAD) of the Council of Better Business Bureaus; and private civil litigation under the Lanham Act and other statutes or common law doctrines. Of all these regulatory bodies, the FTC is now the only organization with responsibility for advertising regulation that explicitly considers economics in its decision making. The extent to which the FTC does rely on economics may come as a surprise to some who are not familiar with the internal workings of the agency. There are about 15 economists assigned to consumer protection, and from 2001 to 2005, an economist, not an attorney, was the Director of the Bureau of Consumer Protection at the FTC—the highest position in the FTC's consumer protection mission. Economists examine all advertising cases at the FTC and have the option of making independent recommendations to the Commission. While the level of participation varies with the regime, nonetheless, economists do participate in all cases. There is an equally strong role for economics in rulemakings, and the inputs of the economists, including cost-benefit analyses, are part of the public record for these proceedings.

One recommendation is that either the other regulatory bodies should adopt a more explicit use of economics or the FTC should be given more responsibility for such regulation.

To the extent that it is efficient to regulate advertising, it is desirable to have economic input into the process. Therefore, one recommendation is that either the other regulatory bodies should adopt a more explicit use of economics or the FTC should be given more responsibility for such regulation. In what follows, I will from time to time indicate ways in which FTC regulation differs from regulation by other agencies. However, I should note that I generally do not discuss the SEC and other regulations of financial information. I also confine my analysis to government regulation.[3]

II. Constitutional Issues in Regulating Information

An excellent economic analysis of First Amendment issues in advertising regulation of is McChesney (1997) and I borrow heavily from his analysis.[4]

3 For a discussion of private self-regulation, *see* Calfee (1997), *supra* note 1.

4 *See* F. McChesney, *De-Bates and Re-Bates: The Supreme Court's Latest Commercial Speech Cases*, 5 Sup. Ct. Econ. Rev. 81-139 (1997). For a useful legal analysis, *see* U.S. Federal Trade Commission, Comments of the Staff of the Bureau of Economics, The Bureau of Consumer Protection, and The Office of Policy Planning of the Federal Trade Commission Before The Department of Health and Human Services, Food and Drug Administration, in the Matter Of Request for Comment on First

footnote 4 cont'd on next page

Advertising is a form of "commercial speech." Although the First Amendment to the U.S. Constitution does not distinguish types of speech ("Congress shall make no law ... abridging the freedom of speech, or of the press ..."), nonetheless, until 1976 there was no constitutional protection for commercial speech. In that year, in a case involving advertising of eyeglasses in Virginia, the U.S. Supreme Court gave some protection to advertising that was truthful and not misleading.[5] Their reasoning was explicitly economic: advertising would lead to lower prices for consumers. In a 1977 case involving attorney advertising in Arizona, the Court strengthened its economic arguments.

The current standard for advertising regulation is the four-part "*Central Hudson* Test." First, commercial speech is not protected by the First Amendment if it concerns unlawful activity or is misleading. Second, if the commercial speech concerns lawful activity and is not misleading, the court will determine "whether the asserted governmental interest is substantial." Third, if the interest is substantial, the court "must determine whether the regulation directly advances the governmental interest asserted." Fourth, the court must determine "whether [the regulation] is not more extensive than is necessary to serve that interest." To survive a First Amendment challenge, a regulatory agency of the government has the burden of proving that its restriction on commercial speech satisfies the *Central Hudson* test. Note that the government has the burden of proof under this test. FTC regulation has generally been accepted by the courts as meeting this test. Some regulations of commercial speech (including some by the FDA) have not survived legal challenge; in the past, the FDA has asked the FTC for guidance on this issue.[6]

III. Regulation of Price Advertising

"Deceptive pricing" is the advertising of prices which are not actually common transaction prices.[7] Ads like "Regularly $50, now $25" or "$50 elsewhere, here $25" might be considered deceptive unless "enough" sales had occurred at the $50 price, where enough can be defined in various ways. The FTC seldom if ever brings deceptive pricing cases, and has not for many years. This is because the Commission generally recognizes that any advertising that stresses prices is likely to ultimately lead to lower prices for consumers. However, as discussed later in this article, the FTC still has in place "FTC Guides Against Deceptive Pricing."

footnote 4 cont'd

Amendment Issues, Docket No. 02n-0209 (Sep. 13, 2002). *See also* Hugo Mialon & Paul H. Rubin, *The Economics of the Bill of Rights*, Am. L. & Econ. Rev. (forthcoming 2008).

5 *See* L. Benham, *The Effect of Advertising on the Price of Eyeglasses*, 15 J.L & Econ. 337-53 (1972).

6 *See* U.S. Federal Trade Commission (2002), *supra* note 4.

7 For a good analysis of these issues, *see* Calfee (1997), *supra* note 1, at ch. 7.

If a product usually sells for $25 and the firm advertises it as being normally $50, on sale for $25, this ad will have no immediate benefits. Consumers are not given any new options, since $25 is the normal price. This is why such ads are sometimes challenged as being deceptive. Nonetheless, the process started by this ad may ultimately lead to lower prices for consumers. Price conscious consumers will be drawn to this firm since it is stressing price in its ads, and all consumers will be given some information about the distribution of prices in the marketplace. Other firms will be forced to respond to the ad, and some will respond by actually lowering prices below their current level, in part because of the price competition started by the information conveyed in the ad. Ultimately, even the firm initially advertising a price of $25 may be forced to sell for $20 as price advertising spreads throughout the industry. On the other hand, if the ad is initially stopped as being "deceptive", information about low prices is less likely to spread.

One general point that will recur in the analysis is that in analyzing advertising it is important to distinguish markets in equilibrium from those which are not. For a market to be in disequilibrium implies some informational failure, and advertising, by providing information, can move markets towards equilibrium.[8] For example, a market may be in disequilibrium with prices above equilibrium. Advertising may be an effective method of moving from the high-priced disequilibrium to the low-priced equilibrium. During the transition some ads may appear deceptive, but stopping these ads may have the effect of retarding the movement toward the new equilibrium. Schwartz & Wilde (1979) indicate that high-price equilibria are unstable, so that advertising of better prices or terms can destroy a "monopoly" equilibrium in an industry.[9] A second point is that examining one ad in isolation is an undesirable policy. Because consumer attention is limited, an advertiser might provide information in a series of short ads. Moreover, advertisers respond to each other's ads, and so the ultimate effect of an ad campaign might be very different from the apparent effect of a single ad viewed alone.

There is no evidence that price advertising deceives consumers. Moreover, even if some comparative price advertising deceives some consumers, the costs of limiting or forbidding such advertising are likely to be substantial. For example, consider the issue of the volume of sales that must occur at some price before it can be advertised as the "regular" or "normal" price, a common feature of attempts to regulate deceptive pricing. A firm might engage in predictable seasonal promotions, such as sales of tires or white sales of household furnishings. If consumers know that such sales occur, they will generally not buy except during the sale period. Thus, there will be relatively few units sold at "regular" prices, although these prices may be commonly available. In such circumstances, any attempt to limit

8 *See* Ekelund & Saurman (1988), *supra* note 2.

9 *See* Schwartz & Wilde (1979), *supra* note 1.

advertising would have one of two effects. The firm might be forced to offer less frequent specials so that more items would be sold at the normal price, a course of action that would clearly harm consumers. Alternatively, it might stop advertising the regular price, but if, for example, this price is comparable to other prices in the market, then consumers would be denied valuable information.

In addition, even if consumers are deceived, there is no evidence that they are harmed. In one experimental study that did find consumers deceived by price ads, it was nonetheless found that there was no measurable injury even to those consumers who were deceived.[10] Interestingly, the authors attribute their results regarding deception in part to the fact that their subjects may have believed that it is illegal to exaggerate reference prices, and that the law is strictly enforced. This indicates that incomplete enforcement of deceptive pricing laws may actually be harmful. If consumers are normally skeptical of such ads, then they cause little if any injury. However, partial enforcement may lead consumers to overestimate the level of enforcement and relax their normal skepticism. This will be particularly likely if there is wide publicity given to the few enforcement efforts that do occur. This is itself likely, given the political orientation of many state enforcement officials, who tend to bring such cases.

The basic problem with policies against deceptive pricing is that in general it is discount firms and firms stressing price that engage in these promotions. As a result, any effort to limit such advertising is likely to lead to higher prices in the market. As Robert Pitofsky, a former Chairman of the FTC and generally an advocate of rigorous enforcement of consumer protection regulations, has argued, "as long as consumers are accurately informed of the offering price, they can make sensible decisions, and the transactions may still be at prices lower than could be obtained at most other outlets in the marketing area."[11] Pitofsky views reduced enforcement of deceptive pricing claims as a gain for consumers. This is especially true since the possible gains from such enforcement are doubtful and speculative, while the costs are obvious and substantial.

THE BASIC PROBLEM WITH POLICIES AGAINST DECEPTIVE PRICING IS THAT IN GENERAL IT IS DISCOUNT FIRMS AND FIRMS STRESSING PRICE THAT ENGAGE IN THESE PROMOTIONS. AS A RESULT, ANY EFFORT TO LIMIT SUCH ADVERTISING IS LIKELY TO LEAD TO HIGHER PRICES IN THE MARKET.

The FTC seldom brings deceptive pricing cases. For example, when asked by the NAD to examine jewelry pricing by J.C. Penney, the FTC ultimately declined to do so. However, the states still do. An example is a 2000 case brought by the

10 *See* J. Urbany et al., *The Effect of Plausible and Exaggerated Reference Prices on Consumer Perceptions and Price Search*, 15 J. CONSUMER RES. 95-110 (1988).

11 *See* R. Pitofsky, *Beyond Nader: Consumer Protection and the Regulation of Advertising*, 90 HARV. L. REV. 661-701, 688 (1977).

Attorney General of Vermont regarding "rent-to-own" companies. Moreover, a Google search of "deceptive pricing" finds that the FTC guidelines are still important. Many trade associations (particularly in the jewelry industry) warn members against deceptive pricing based on these guides. Of course, trade associations have an interest in maintaining high prices for members, and price advertising (whether "deceptive" or not) leads to reduced prices, benefiting consumers but harming sellers. Therefore, it is not surprising that trade associations try to convince members not to engage in price advertising. Many law firms also post notices about these guides, presumably in the hope of generating business from firms that want to avoid punishment for violation. If the FTC is serious about not enforcing these rules because of their harm to consumers, then they should consider repealing their guidelines, rather then merely failing to enforce them.

IV. Regulation and Types of Goods

A public authority charged with advertising regulation has a substantial amount of discretion. The nature of language is such that almost any claim could be interpreted as being deceptive or misleading under some readings, so that there are many cases which could be brought.[12] In addition, most cases brought by the government are settled through consent decrees (a procedure under which the firm does not admit to wrongdoing, but promises to cease the challenged conduct), so that there is little litigation over the issue of deception. This may be because of the high reputation cost to a firm from being named as engaging in "deception".[13] Mathios & Plummer (1989) find that firms that contest FTC orders end up with greater capital losses than firms that consent without a contest.[14] Since few cases are contested, it is important for regulatory officials to have a strong theoretical basis for bringing some cases and not others. Economics provides this theoretical basis. Economists argue that the basis for regulation should be the effect of claims on consumer welfare, and economics provides a framework for determining which types of ads are most likely to reduce consumer welfare.

Economic analysis suggests that there are three types of characteristics of goods with respect to advertising. These are called "search", "experience", and "credence" characteristics.[15] Search characteristics can be determined before the

12 *See* R. Craswell, *Interpreting Deceptive Advertising*, 65 Boston Univ. L. Rev. 658-732 (1985).

13 *See* S. Peltzman, *The Effects of FTC Advertising Regulation*, 24 J.L. & Econ. 403-48 (1981).

14 *See* A. Mathios & M. Plummer, *The Regulation of Advertising by the Federal Trade Commission: Capital Market Effects*, *in* 12 Research In Law & Economics 77-93 (Richard O. Zerbe ed., 1989).

15 For the discussion of search and experience goods, *see* P. Nelson, *Advertising as Information*, 82 J. Pol. Econ. 729-54 (1974) and P. Nelson, *Information and Consumer Behavior*, 78 J. Pol. Econ. 311-29 (1970). For credence goods, *see* M. Darby & E. Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J.L & Econ. 67-88 (1973). For an application to regulation of advertising, *see* Jordan & Rubin (1979), *supra* note 1.

associated goods are purchased; an example is the color of a suit. Goods must be purchased and used before experience characteristics can be evaluated; an example is the cleansing power of a bar of soap. For credence characteristics, the consumer may never know if the characteristic exists, even after purchase; an example is unnecessary repair to a TV (or unnecessary surgery), for the TV (or the body) will work afterwards even if the repair was unneeded.

Given this classification, some principles of regulation of advertising are instantly obvious. First, for search characteristics, there is no need for regulation. Consumers can determine if the good has the advertised characteristic, and cannot be deceived. Moreover, since this is so and firms understand that it is so, there is no incentive for deceptive advertising with respect to these characteristics. Transaction price is a search characteristic (i.e., consumers will know the transaction price before purchase), which is why regulation of advertising of transactions prices, discussed earlier, is unneeded and counterproductive. Second, for inexpensive goods, there is little cost to deception about experience characteristics. The consumer will be deceived at most one time about such goods, and so in general losses will be small. Regulators should concentrate on relatively expensive experience goods and particularly on credence goods.

This analysis has additional implications. In particular, it points to the importance of reputation as a protection against deception and to the importance of advertising in generating a reputation.[16] Economists had long been puzzled by apparently non-informative advertising. Nelson showed that in certain circumstances the very existence of advertising would itself provide information.[17] Advertising would only be worthwhile if it led to repeat sales for experience goods, but firms could expect repeat sales only if the product were of sufficiently high quality. Therefore, the willingness of a firm to spend money on advertising would itself provide information to the market that the firm expected repeat sales because it believed that its products were of high quality.

Problems of assuring or guaranteeing quality arise in many markets. The problem was first analyzed by George Ackerlof in his 1970 Nobel Prize-winning article dealing with "lemons", as the term is used in the used car market.[18] A lemons market is defined as a market that fails because only low quality items are sold, even though consumers would be willing to pay high prices for high quality items. Three conditions are necessary to generate a lemons market. First, consumers must be unable to determine quality before purchase. Second, higher quality goods must cost more to produce than lower quality. Finally, there can-

16 *See* P. Rubin, Managing Business Transactions, ch. 8 (1990).

17 *See* P. Nelson (1974, 1970), *supra* note 15.

18 *See* G. Ackerlof, *The Market for Lemons: Qualitative Uncertainty and the Market Mechanism*, 84 Q.J. Econ. 488-500 (1970).

not be a credible way for a firm to guarantee quality. If these three conditions are met, then the market mechanism may break down. This will happen because no firm will be able to convincingly promise high quality items. As a result consumers cannot be sure of getting the higher quality and so will not pay the higher price for higher quality items. Thus, even though consumers would be willing to pay a higher price for more quality and firms would be willing to sell higher quality items for prices consumers would be willing to pay, there is no effective way in which this desire can be satisfied. It is in this sense that the market may malfunction.

The lemons problem identified by Ackerlof exists only if firms cannot convincingly communicate to consumers the quality of their products. If firms can produce high quality products and convince consumers that they are doing so, then the market failure disappears. There is a substantial literature devoted to the economics of information which demonstrates ways in which markets can and do solve the problem.

Klein & Leffler (1981) explicitly related Nelson's discussion of advertising to Ackerlof's lemons problem.[19] They showed that the mechanism identified by Nelson and related mechanisms could be used to solve the lemons problem. Investments in non-salvageable firm-specific capital (capital which would become worthless if the firm were to shut down) would serve to guarantee quality since the firm would lose the value of these investments if consumers dissatisfied with low quality products forced it to shut down by withdrawing patronage. Besides advertising (including endorsements by celebrities) such capital includes investments in establishing trademarks and brand names, and in physical assets, such as signs and decor. Generalizations to the analysis were provided by Shapiro (1983) and many others.[20] Lynch, Miller, Plott & Porter (1986) provided an experimental test of these models.[21] They found that it is possible to generate lemons markets in laboratory settings, that truthful advertising will eliminate problems associated with such markets, and that reputations will sometimes serve to eliminate these problems.

ONE POTENTIAL FUNCTION OF AGENCIES REGULATING ADVERTISING IS TO PREVENT FIRMS FROM EXPLOITING THIS BRAND NAME CAPITAL.

One potential function of agencies regulating advertising is to prevent firms from exploiting this brand name capital. For example, a firm might suffer busi-

19 *See* B. Klein & K. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. Pol. Econ. 615-41 (1981).

20 *See* C. Shapiro, *Premiums for High Quality Products as Returns to Reputation*, 98 Q.J. Econ. 659-79 (1983).

21 *See* M. Lynch et al., *Product Quality, Consumer Information and 'Lemons' in Experimental Markets*, *in* Consumer Protection Economics 251-306 (P. Ippolito & D. Scheffman eds., 1986).

ness reverses and plan on leaving a market. However, if the firm has established a reputation in this market, it may be worthwhile for the firm to draw down this reputation capital by offering relatively shoddy goods and thus implicitly deceiving consumers. It might be worthwhile for regulatory agencies to police the market to prevent this sort of behavior, although by the time the deception is detected the firm may have exited.

Once it has been decided to confine analyses to particular types of ads and product characteristics, however, the problem is not solved. Many deceptive ads will deceive some and inform others. Therefore, a balancing test of some sort is required to determine if a case is worth bringing. An economic analysis of deception has provided exactly this sort of balancing test: "An advertisement is legally deceptive if and only if it leaves some consumers holding a false belief about a product, and the ad could be cost-effectively changed to reduce the resulting injury."[22] This criteria for deception says that an ad is deceptive only if the costs of changing it are less than the benefits. Included in the cost of changing the ad is any information lost by those consumers who were not deceived by the initial ad and who would find a proposed substitute less informative. This cost-benefit criterion is a useful guideline for exercise of prosecutorial discretion, and is based on an explicitly economic analysis.

A related issue is the "burden of proof" for regulation. At one time, the FTC had the burden of proof; that is, the FTC had to prove that an ad was false or misleading. In about 1983, the agency has adopted an "advertising substantiation" policy: a firm must have adequate substantiation for an ad. This has essentially shifted the burden of proof from the agency to prove falsity to the advertiser to prove truth.

V. True Claims About Characteristics Other Than Price: The FDA

The FTC generally allows any advertising which is truthful, with only a few exceptions, such as mandated disclosure, discussed later. The FDA, on the other hand, greatly restricts even truthful advertising. This is part of the general problem with regulating advertising by an agency whose primary responsibility is health regulation. As Calfee (1997) points out, health agencies have several deficiencies in regulating advertising.[23] First, they tend to overestimate the power of advertising. Second, they also underestimate the benefits of advertising, because they do not perceive the ongoing process whereby advertisers respond to each other and collectively generate more information than is available from any

22 *See* Craswell (1985), *supra* note 12, at 657.

23 *See* Calfee (1997), *supra* note 1.

one ad. Third, they impose restrictions on advertising that are not related to the way in which consumers perceive or use advertising. Finally, these agencies have more power than agencies that regulate only advertising. The FDA has the power to approve or disapprove drugs. Therefore, firms advertising drugs are unwilling to challenge the FDA's advertising regulations in court to the extent that would occur if the FTC, with no additional power, tries to impose irrational or counterproductive policies on advertising. These points can be best understood if we examine some actual FDA policies. I begin with a discussion of FDA decision making in the face of uncertainty.

A. REGULATION OF UNCERTAIN CLAIMS

We begin with some claim that may or may not be true. Then there are two possible errors that a regulator can make. One error can occur if the claim is false and producers are nonetheless allowed to make the claim. That is, a decision maker (here, the FDA) might err by allowing a false claim. This error is called a "Type I" error. On the other hand, the agency might err by not allowing a true claim. That is, if the claim is actually true but the regulator does not allow producers to make the claim, then this is also an error. This is called a "Type II" error. The possibility of these errors exists for any decision problem; there is no way to avoid the possibility. Statistical decision theory helps us manage the two types of errors, but it cannot eliminate them. The two types of errors are illustrated in Figure 1.

Figure 1

Types of Errors

	Accept Claim	Reject Claim
If Claim is False	Type I Error	No Error
If Claim is True	No Error	Type II Error

The structure of a decision problem is such that if we use a decision procedure that reduces the chance of committing a Type I error, then we necessarily increase the chance of committing a Type II error. That is, if the decision maker tries to be more certain that no one makes any false claims (for example, by requiring a higher standard of proof), then the decision maker also increases the probability that producers are forbidden from making some true claims. For example, if the FDA requires proof of a nutrient-disease relationship to a near certainty before a producer is allowed to make a health claim for some substance, then many true claims for substances will not be allowed.

There is no "solution" to the general problem: for a given amount of information, anything that reduces the probability of one error increases the probability of the other. This trade-off is inherent in the problem, and cannot be removed. The only way to reduce the chance of both types of errors is to gather more data. However, even this is not a solution. First, during the time when data is being gathered or research is being conducted, useful information about a product's possible utility is not available to consumers. Second, in some circumstances it will not pay for anyone to gather the additional information. This will occur when a product cannot be patented or is off patent; here, no one will find it worthwhile to spend the resources to prove a claim even if everyone believes it to be true. It may also be true a market is small enough so that the value of the additional information is simply less than its cost—particularly since the FDA requires substantial testing to approve a claim.

Rational policy making would minimize the total expected costs of the two types of errors. Let P_1 and P_2 be the probabilities of each type of error (determined by the agency's policy) and let C_1 and C_2 be the costs of each error. Then the agency should try to choose P_1 and P_2 to minimize the sum of the expected costs: $P_1C_1 + P_2C_2$. C_1 is the cost of a Type I error—that is, allowing a claim if it turns out to be false. There are two situations in which a Type I error could have a high health cost. One is if the substance is actually harmful, so that taking the substance itself actually causes health problems. The other situation is one in which there is a better treatment available and consumers instead use a less beneficial remedy. If neither of these situations holds, then the main cost of a Type I error is the money that the consumer might spend for a product with few or no benefits. The health cost of a Type II error is the foregone health benefits of the product if the claims actually are true. That is, the health cost is that the consumer might suffer a loss of health benefits that would otherwise be experienced if purchases were made based on the claim.

RATIONAL POLICY WOULD THEN SERVE TO GIVE THE CONSUMER THE INFORMATION NEEDED TO MAKE THE APPROPRIATE DECISION. THERE IS NO SOUND JUSTIFICATION FOR DENYING THE INFORMATION TO THE CONSUMER.

Thus, it is very important to note that for a substance with no good substitutes and with no harmful effects the trade-off is between a reduced chance of suffering from some condition and spending some money on a substance that might not help. This is not an issue that a health authority can decide. It is instead an issue of personal choice. If the consumer has valid information about the probability that the substance is helpful, then in a market economy it is proper that the consumer decide if the expected benefit is worth the cost. Rational policy would then serve to give the consumer the information needed to make the appropriate decision. There is no sound justification for denying the information to the consumer.

The FDA traditionally places a very high value on not committing a Type I error. That is, the FDA almost always tries to be sure that no one makes a false claim by requiring a very high degree of certainty before it allows a claim to be made. But this high level of certainty means that many Type II errors will be made. That is, by requiring a high degree of proof to avoid Type I errors, the FDA forces a situation in which there are too many Type II errors. (The agency acts as if C_1, the cost of a Type I error, is higher than it actually is. This may be because the political cost to the agency itself of a Type I error is very high.) A Type II error is a failure to make a true claim. Therefore, the result of the FDA's decision strategy is that many true claims (which would provide consumer benefits) will not be made, and so consumers will be denied the benefits of the associated products. The mistakes the FDA makes in restricting information and not allowing true and useful claims are systematic, not random. In all cases that have been studied, the FDA has been overly restrictive in allowing claims. I discuss examples of this decision making below.

B. HISTORICAL EXAMPLES OF FDA DECISION MAKING

In general, the FDA puts too much weight on not allowing a false claim and so refuses to allow many beneficial true claims. I show this about three particular episodes—health claims for foods, direct-to-consumer advertising of prescription drugs, and advertising of "off-label" uses of approved drugs. In all cases, the FDA was excessively restrictive. (Other examples, not discussed in this paper, include some true claims for over the counter drugs, such as claims about the ability of aspirin to reduce first heart attacks, and claims regarding dietary supplements, an issue over which the FDA lost a First Amendment challenge.)

1. Health Claims for Foods

Traditionally, the FDA did not allow producers to make health claims for foods.[24] The argument was that if such claims were made, then the food was being marketed as a drug, and the manufacturer was required to have the food go through the new drug approval process. As a result, there were no health claims for foods. For example, for many years after significant scientific evidence of the harmful effect of high dietary cholesterol and saturated fats had been published, the FDA would not even allow food companies to state that their products contained little or no cholesterol or saturated fat.

In 1984, the Kellogg Company and the National Cancer Institute (NCI) jointly began an advertising campaign aimed at selling Kellogg's All-Bran and also at informing consumers of the health benefits of fiber, a message the NCI had had little success in spreading. The FDA attempted to stop this ad campaign, using the usual argument that the health claim meant that the product should

24 For a history, see *id.*

undergo the new drug approval process. However, the FTC intervened, and ultimately the FDA backed down and allowed the advertising. Advertising of the health benefits of fiber led to remarkable results. Consumers learned about the benefits of fiber, and this learning was more important for lower income and less educated consumers, who had not benefited from the NCI information programs.[25] Moreover, manufacturers began to formulate additional brands with fiber. Manufacturers began to advertise that their products were high in fiber and also low in sugar and salt. There was also an explosion of research regarding foods and health, and of more health claims and information about other products. The promotion led manufacturers to reformulate products to improve their health characteristics.

Thus, this episode illustrates four relevant points. First, the FDA was hostile to health claims advertising, and for many years suppressed this form of information. Second, when the FDA strictures were relaxed, there was a tremendous increase in the amount of consumer information available. Third, the ability to publicize health claims caused manufacturers to reformulate products and to do research on other health properties of foods. Fourth, advertising the health benefits of these healthier foods led consumers changing their diets to eat more of the healthier foods and less of the foods most likely to cause serious health problems. The FDA's pre-1984 policies caused tremendous harm to health of American consumers. A recent comprehensive study shows that health claims rise and fall with changes in regulation, and provide substantial benefits when they are allowed.[26]

2. Direct-to-Consumer (DTC) Advertising of Prescription Drugs

Before 1981, there was little if any DTC advertising.[27] Some firms began such advertising in the early 1980s. In response, the FDA declared a moratorium on such advertising in 1983. After seeking public comment, the FDA lifted its ban in 1985. However, the form of the regulations was such that there was almost no advertising of pharmaceuticals on television. If an ad indicated both the name of the drug and the condition for which it was to be used, then a "brief summary" (brief only by bureaucratic standards) was required, and it was difficult or impossible to put the brief summary on television. Thus, there were ads listing a condition (e.g., "See your doctor for new remedies for baldness") but no drug, or ads naming drugs (e.g., "Try Rogaine"), but no condition.

25 *See* P. Ippolito & A. Mathios, *Information, Advertising and Health Choices: A Study of the Cereal Market*, 21(3) RAND J. ECON. 459-80 (1990).

26 *See* P. Ippolito & J. Pappalardo, *Advertising, Nutrition & Health: Evidence from Food Advertising, 1977-1997,* U.S. Federal Trade Commission, Bureau of Economics Staff Report (2002).

27 For a history, *see* J. Thomas, *Direct-to-Consumer Pharmaceutical Advertising: Catalyst for a Change in the Therapeutic Model in Psychotherapy?*, CONN. L. REV. 209-48 (Fall 2000).

In 1997, the FDA changed its policy and began to allow DTC advertising on television. As a result, the amount of such advertising has greatly increased. This advertising has provided substantial health benefits—benefits that were denied to consumers for many years by the FDA's previous policy of effectively forbidding such advertising. Analysis of DTC advertising has identified several health benefits. It might appear that physicians have enough information to prescribe drugs for consumers, but there are cases where consumers have information about themselves that may not be available to a physician. This may be because patients do not tell physicians all relevant information, either because they do not know that it is relevant or for other reasons, or because some potential beneficiaries of medication are not in contact with a physician. Thus, benefits accrue because consumers will have some information about themselves that is not readily accessible to a physician. The information known only to individual consumers about their own health status can be combined with information in pharmaceutical ads to better match patients and drugs. Of course, the physician also has information about pharmaceuticals, and has the final say in prescribing decisions.

We may identify several types of benefits from direct advertising.[28] A consumer may suffer some symptoms (e.g., thirst) without realizing that these are symptoms of a disease (e.g., diabetes). A consumer who does not realize that symptoms indicate a disease will not consult a physician and so cannot learn in this way that he has a treatable disease. Ads have informed consumers that urinary problems may be symptomatic of prostate enlargement, and that there is a non-surgical treatment for this condition. Ads discuss the symptoms of depression.

Advertising can inform a consumer that a treatment exists for some condition. A consumer might know that he has the condition, but not know that there is a treatment. Because the consumer believes that the disease is not treatable, or because previous remedies have been ineffective, he will not contact a physician and will not learn about the new therapy. Advertising tells those who suffer from migraine that there is a new treatment. This class of advertising is becoming and will continue to become more important as the rate of introduction of new therapies increases.

Ads can warn consumers about conditions with no overt symptoms. Ads for anti-cholesterol drugs warn consumers of the dangers of high cholesterol. Such ads may be very useful. Several studies have shown that this class of drugs can reduce cardiac deaths by 24 percent to 42 percent. Only about one-third of the 13 million Americans with heart disease symptoms are now treating it with anti-cholesterol drugs, and an additional 16 million with no symptoms but with significantly elevated cholesterol levels are not being treated. Advertising can induce many of these people to seek medical care. After advertising for these drugs began,

28 For the first article identifying some of these benefits, *see* A. Masson & P. Rubin, *Matching Prescription Drugs and Consumers*, 313 New Eng. J. Med. 513-15 (1985).

8.8 million people sought treatment in 1997 for cholesterol-related therapies, up from 7.2 million in 1996, perhaps in part because of an ad campaign.

Advertising can alert consumers to a new remedy with reduced side effects that has become available. In this example, advertising can provide benefits in two ways. Consumers who do not know that symptoms they are experiencing are side effects, and so would not ask a physician about them, may learn from ads that there are alternatives without these side effects. Consumers who have stopped treatment because of side effects, and so are not seeing a physician, may start treatment again if they learn of therapies that do not impose the same side effects. Either class of consumers can benefit from ads indicating that a treatment with reduced side effects is available.

Ads can inform consumers simply that a medication is available that is more convenient than existing medications. A physician might not be aware that the less convenient form is a problem for a particular consumer, and so might not suggest the other form of the medicine. Alternatively, a consumer might have stopped using the medication because of the inconvenience, and so not be in contact with a physician at all. Learning of the more convenient form can then induce the consumer to see a physician and re-enter treatment. Patient non-compliance with physician prescriptions is a serious medical problem, and this class of ads can alleviate this problem.

Advertising can inform consumers that some conditions are medically treatable. Consumers might not think of conditions treated by some medicines as medical, or might not know of the availability of treatments. A leading example is the advertising of Viagra, the impotence remedy. Other examples include ads for hair loss treatments and for aids in smoking cessation.

Some patients may be embarrassed to discuss some conditions with a physician. In an ad for Viagra, former presidential candidate Robert Dole is quoted as saying "It may take a little courage to ask your doctor about erectile dysfunction." These ads and others may induce consumers more generally to be willing to discuss certain conditions with friends and family members as well as with physicians.

These benefits are now available to consumers. However, the previous policy of the FDA, spanning from 1985 to 1997, of not allowing ads on television had the effect of denying these benefits and therefore greatly reduced the health of American consumers. In most European countries, such ads are still illegal, and so health of citizens of these countries is harmed. A recent meta-analysis of research on DTC advertising has found that overall DTC advertising is beneficial to consumers.[29]

29 P. Rubin & A. Atherly, The Cost Effectiveness of Direct to Consumer Advertising for Prescription Drugs (Feb. 2008) (mimeo, Emory University), *available at* http://ssrn.com/abstract=1092164.

3. Off-Label Uses

Once a pharmaceutical is approved by the FDA, then physicians are free to prescribe the drug for any condition. Uses other than the approved uses are called "off-label" or "unapproved" uses. The FDA does not allow pharmaceutical companies to inform physicians about such off-label uses, unless the physician requests the information. It is even forbidden for companies to hand out reprints of medical journal articles describing research into off-label uses. It is in the interests of patients suffering from conditions that can be alleviated or cured by a drug to have their physician aware of this property, whether it is on- or off-label. The patient's interest is in the treatment, not in the details of the drug approval process. The interests of the patient and the firm are congruent, in that both want physicians to be aware of all characteristics of the drug, whether on- or off-label.

Medical journals routinely publish articles discussing unapproved uses, and medical textbooks and compendia of information also provide such information. This information is widely used. These off-label uses of drugs are commonly an important part of medical therapy.[30] In one study, the General Accounting Office found that one-third of drug administrations in cancer patients were for off-label uses, and that fifty-six percent of all patients received at least one drug for an off-label use. Eighty-one percent of AIDS patients received at least one drug off-label, and 40 percent of all reported drug use was off-label. Eighty to 90 percent of all pediatric patients are prescribed drugs off-label. For patients receiving anti-depressants, 56 percent of use was for unapproved uses.

When drugs are effective in off-label uses, but pharmaceutical companies cannot provide information about these uses, then physicians are less likely to learn of the uses and patients will suffer. Practicing physicians overwhelmingly believe that the restriction of information about off-label uses is harming their practice, and thus harming patients, by restricting the use and dissemination of information. Several polls of physicians have found that between 65 and 80 percent of physicians in various specialties agree that information about off-label uses should not be restricted. Manufacturers can seek approval for new uses from the FDA, but such approval is expensive to obtain, and the FDA gives lower priority to supplemental approvals, so that these take longer. In addition, medical knowledge advances more quickly than can the FDA. Thus, new uses are discovered and research describing these uses is published, but the FDA is much slower in approving new uses. Even if drug firms applied for supplemental labeling for all new uses, the FDA would be unable to process these requests promptly, and there would still be many useful and beneficial but unapproved uses of many drugs.

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30 *See* H. Beales, *FDA Regulation of Pharmaceutical Advertising: Economic Analysis and the Regulation of Pharmaceutical Advertising*, 24 Seton Hall L. Rev. 1370 (1994) and A. Tabarrok, *Assessing the FDA via the Anomaly of Off-Label Prescribing*, V(1) Indep. Rev. 25-53 (Summer 2000).

The result of these factors is that if physicians cannot learn about off-label uses, there are many valuable uses of drugs that will never be communicated to physicians and so will never benefit patients. There is evidence that use of new drugs is associated with greatly increased health and longevity.[31] While this evidence does not deal directly with the issues here, it is evidence that utilization of new drugs is highly beneficial, and information provision by the manufacturer is an important way in which the medical community learns about new drugs.

Providing information about medicines to physicians is useful, but provision of such information is expensive, on both the demand and the supply side. That is, it is expensive to communicate the information to physicians, and it is expensive (in terms of lost time) for physicians to absorb the information. The pharmaceutical companies are in the best position to bear the costs of information provision. They know the information, and know it sooner than others. Thus, while there are other methods of information dissemination, the pharmaceutical companies can play a crucial role in this process.

THE PHARMACEUTICAL COMPANIES ARE IN THE BEST POSITION TO BEAR THE COSTS OF INFORMATION PROVISION. THEY KNOW THE INFORMATION, AND KNOW IT SOONER THAN OTHERS. THUS, WHILE THERE ARE OTHER METHODS OF INFORMATION DISSEMINATION, THE PHARMACEUTICAL COMPANIES CAN PLAY A CRUCIAL ROLE IN THIS PROCESS.

VI. Deception by Omission and Mandated Disclosures

So far, I have dealt with deception in the form of false statements. However, a further class of acts which are sometimes viewed as deceptive are statements which are true but incomplete in some way which is viewed as material. For these cases, regulatory agencies impose various remedies. Sometimes sellers are held to commit "deception by omission." In other cases, there is some mandated disclosure associated with an ad. These mandated disclosures may be required "across-the-board" for all advertising of a product, or may be "triggered" by some claim.

An example of a statement which is alleged to be deceptive by omission is from a recent filing before the FTC, "in re: The Almond Board of California 'Petition To Prohibit False And Misleading Advertising,'" submitted by the Center for Science in the Public Interest January 29, 2001. The allegation was that "[w]hile the almond ad states that increased almond consumption will lower

31 *See* F. Lichtenberg, *Pharmaceutical Knowledge-Capital Accumulation and Longevity*, *in* MEASURING CAPITAL IN THE NEW ECONOMY (C. Corrado et al. eds., 2003) and F. Lichtenberg & S. Virabhak, *Pharmaceutical-embodied Technical Progress, Longevity, and Quality of Life: Drugs as "Equipment for Your Health"*, 28(4-5) MANAGERIAL & DECISION ECON. 371-92 (2007).

your blood cholesterol levels, and thereby lower your risk of CHD, it fails to disclose that almonds are high in calories."

An example of mandated disclosure is the set of warnings on cigarette packs and in cigarette advertising. These disclosures are across-the-board since any ad for a cigarette requires a health warning. Triggered disclosures are disclosures required only if some other claim is made. For example, under the Truth in Lending Act (1968), a U.S. federal statute requiring disclosure of certain terms and costs of any credit contract, whenever a statement about interest rates is made, there must also be statements about amount of down payment and the number and size of monthly payments.

While such disclosure remedies are common, economic analysis casts doubt on their general utility. (It is often useful for government to devise an appropriate metric, or scoring system, for measuring some attribute. Truth in Lending requires the use of the Annual Percentage Rate as the interest rate; the "R-value" rule requires the use of R values for measuring the effectiveness of insulation.) There is much support in the literature for the proposition that, as long as deception is not allowed, there are incentives for sellers to disclose even the negative attributes of their products. This is because consumers will rationally assume that any advertisement that omits a critical piece of information (say, the durability of a product) will imply that the value of that attribute for that product is at the lowest level. Thus, producers of products with quality levels above the minimum will have incentives to advertise this fact, and in the limit the market will provide complete information. The models which prove this result are quite general, and the result seems robust. This result has been shown in Grossman (1981), Milgrom (1981), and many other sources.[32]

At first, this proposition may seem unrealistic. However, consider price. The price of a product is a negative characteristic; we would all prefer to get products free. Nonetheless, sellers do routinely advertise prices. As the theory would predict, the advertising is driven by those firms with the lowest prices (that is, the least bad value for a negative attribute). Higher priced sellers may not advertise price at all, but when a consumer observes a product being advertised with no price information, the normal assumption is that it is not a discount price, and may be a high price.

Another example is the advertising of tar and nicotine content of cigarettes.[33] In the 1950s (and perhaps earlier), consumers began to fear the health effects of smoking, and began to believe that tar and nicotine were undesirable. As a

32 *See* S. Grossman, *The Informational Role of Warranties and Private Disclosure About Product Quality*, 24 J.L. & Econ. 461-83 (1981) and P. Milgrom, *Good News and Bad News: Representation Theorems and Application*, 12 Bell J. Econ. 380-91 (1981). For a summary discussion, *see* D. Spulber, Regulation & Markets 449-55 (1989).

33 *See* J. Calfee, *The Ghost of Cigarette Advertising Past*, Regulation 35-45 (Nov/Dec 1986).

result, cigarette companies began to advertise the levels of tar and nicotine, with the advertising being stimulated by those brands with the lowest levels. (The process was greatly slowed down in 1959 when the FTC virtually stopped such advertising.) Nonetheless, there was a substantial incentive for advertisers to publicize the negative aspects of their products, as long as some brands had less negative characteristics than others.

From a theoretical perspective, the process of advertising negative characteristics is the obverse of the lemons problem, discussed earlier. In a lemons market, information is not verifiable, and so only low quality products are sold because sellers cannot convince buyers to pay for high quality products. The process discussed in this section requires some form of verification, but the theory indicates that if there is some method of checking on claims, then sellers will offer complete information about both high and low quality products. The analysis shows that if the lemons problem can be solved, sellers of high quality products will have incentives to reveal that their products are indeed of high quality. But this means in the limit that any seller of a product that is of any quality above the minimum will indicate quality. Consumers may then assume that any product that does not disclose quality is of minimum quality, and the informational problem is solved.

In making policy about disclosure, it is important to distinguish between equilibrium and disequilibrium situations. At equilibrium, there will be a substantial amount of disclosure in markets. However, many interesting policy issues occur in periods of disequilibrium. Decision makers in regulatory agencies may observe this disequilibrium and formulate incorrect policies. It is possible for these policies to lead to consumer injury by delaying or preventing movements toward equilibrium. The disequilibrium may be about advertising, but it may be about actual product characteristics as well. Advertising affects sales at current prices of existing products. It also influences characteristics and prices of products that firms will offer in the future. Advertising changes future product characteristics because a firm will only produce products or establish prices that it expects to be able to advertise. Thus, interferences with the ability of firms to advertise product characteristics may also have adverse effects on the actual menu of products offered in the market.

A disequilibrium is likely in a market which has changed in some way. Possible changes are in product characteristics, in information about products, or in consumers' tastes. Because there has been some change, existing products will not perfectly satisfy consumers' desires. Nonetheless, producers of those products closest to satisfying new wants will have an incentive to advertise this fact. In such circumstances, some advertisers may initially offer partial information to consumers. At some point, other advertisers will compete by offering more complete information, and others may compete by further changing the product to reflect changed tastes. The final equilibrium will occur with relatively full information and with the optimal set of products being offered. However, if the process is stopped because regulatory authorities think that the partial information is deceptive, then the full information equilibrium will never be reached, and the best set of products may not be sold.

A good example is the history of advertising of the fiber content of breakfast cereals, discussed earlier. Another example of a change in product characteristics caused by advertising is cigarette advertising, also mentioned earlier. When advertising began, tar content of filter cigarettes was virtually no lower than for regular cigarettes. Nonetheless, over a short period (from 1957 to 1959), levels (weighted by sales) fell by 40 percent because of heavy advertising of tar and nicotine content. The first cigarettes to advertise had perhaps only marginally lower tar levels than other brands, and when regulators looked at this advertising they ultimately stopped it as being deceptive. The long-run effect of the advertising before it was stopped was to actually change product characteristics. As sellers competed by advertising tar and nicotine levels, some producers found it worthwhile to reduce levels to be able to advertise lower amounts. Other firms responded, and the ultimate result was reduced levels of tar and nicotine. The benefits to consumers of this dynamic effect of the advertising greatly outweighed any potential harmful effects from any alleged initial deception.

An additional claim that is sometimes held deceptive is a "false uniqueness" claim. A product may advertise some characteristic common to all versions of that product. For example, a margarine manufacturer may claim that his produce has "no cholesterol". While this claim may be true, it is also true for all manufacturers of margarine, and so regulators may require a manufacturer to either indicate that it is true for all, or to stop making the claim. In either case, the firm will stop, since there is no point in advertising the benefits of competitors' products. In such instances when the claim is true, the policy of policing false uniqueness claims can deny consumers valuable information.

VII. Remedies

Some remedies for deception which have been used or proposed are, in increasing order of severity, cease and desist orders, corrective advertising, consumer redress, and fines. To evaluate these remedies, it is useful to set forth a theory as to the goal of the remedy. The ultimate goal is maximization of consumer welfare and this can be achieved if it does not pay for firms to engage in acts likely to lower welfare. Policies should therefore be aimed at making sure that harmful acts do not pay.

What is relevant is that a remedy provides the correct amount of deterrence. For the types of activities discussed in this paper, it is possible to have either under-deterrence or over-deterrence. Under-deterrence is the situation in which whatever penalties exist are too low, so that too much deception occurs. Over-deterrence occurs when penalties are too high. While it may appear that it is impossible to have "too little" deception, it is nonetheless possible to over-deter with what is called deceptive advertising. This is because, as indicated at many points in this chapter, the line between deception and useful information is not always clear and one result of over-deterring deception through excessive penalties would be the suppression of provision of information that many consumers will find useful.[34]

What is relevant is that a remedy provides the correct amount of deterrence.

The traditional FTC remedy for deception was a cease and desist order requiring the firm to stop the offending ad. In general, such orders include language forbidding the practice in question in the future, and are enforced by fines in the event of a violation. This remedy is relatively mild and therefore unlikely to over-deter, although there is evidence dealing with the stock market effects of these orders which indicates that they may be much more costly than is apparent.[35] The Magnuson-Moss FTC Improvements Act of 1975 gave the Commission broader powers, including the power to enforce rules with monetary penalties and the power to seek redress for fraud under some circumstances. The Commission relies heavily on the theory of optimal deterrence in computing fines, and the economists are deeply involved in these computations.

For most deception cases, the Commission still relies on cease and desist orders. Usually this is the appropriate remedy. As indicated above, a determination that an ad is deceptive is difficult, and many ads may be innocently written and later interpreted as being deceptive. Even when using their best efforts, firms will sometimes err and produce an ad that is later held to be deceptive. Since this is so, any penalties more severe than an order to stop could easily cause firms to reduce the amount of potentially actionable material in their ads. This could be done by simply reducing the information content of the ads, and relying instead of puff or image advertising.

The Commission has also reduced its reliance on corrective advertising. This is appropriate since most evidence indicates that the effects of advertising are short-lived and so the effects would likely have dissipated before the corrective ad would appear. The only purpose of a corrective ad would therefore be extra deterrence, but if desired this can be achieved more efficiently through direct methods.

34 On the general issue of optimal deterrence, *see* G. Becker, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169-217 (1968); R. Posner, Economic Analysis of Law, ch. 7 (7th ed. 2007); and A.M. Polinsky & S. Shavell, *The economic theory of public enforcement of law*, 38(1) J. Econ. Lit. 45-76 (2000). For a discussion of over-deterrence of "white collar crime," including advertising, *see* P. Rubin & R. Zwirb, *The Economics of Civil RICO*, 20 U.C. Davis L. Rev. 883-912 (Spring 1987).

35 *See* Peltzman (1981), *supra* note 13 and Mathios & Plummer (1989), *supra* note 14.

The FTC has powers to name advertising agencies as well as advertisers in complaints for deception. If agencies have skills in assuring that ads are not illegally deceptive, then finding them liable would seem to increase the ability of the Commission to deter deception. However, advertisers have contractual agreements with agencies. Therefore, if advertisers want agencies to help them comply with the law, then they can contract for these services. It would even be possible for an advertiser to contract with an agency for indemnification in the event of liability. More generally, it would not be efficient for agencies to determine the truth or degree of substantiation for each ad they produce. Imposing liability would increase the costs of advertising since agencies would be forced to make an independent investigation of each ad.

Holding agencies liable would perhaps increase deterrence, but as we have seen there is no evidence that deception is being under-deterred, and some fear of over-deterrence. Moreover, if it is desired to increase deterrence, then this can be done directly—for example, by giving increased publicity to Commission findings of deception. Since orders for agencies would cover ads in many areas and for many types of products, over-deterrence is particularly likely. Therefore, there is no general argument for finding agencies liable for classic deception.

For those acts that are to be punished by a fine, it is important to use the correct fine. First, it is appropriate to restrict the use of fines to true fraud (deception where the firm is consciously attempting to deceive) since this reduces the chances of over-deterring provision of true information. Second, it is important to realize that there are market (including labor and stock market) penalties for being punished at all by the FTC, and so fines should take into account these market punishments. Third, the correct fine is one which total penalties (including market penalties) are just equal to the (expected) harm caused by the deception. Such a fine will provide firms with the correct incentives. Since some who engage in deception will not be caught, the actual punishment must be greater than the observed harm for those who are detected. If, for example, one offender of three is detected, then the penalty must be equal to three times the harm caused by those who are punished. In this case, the probabilistic value of the fine to someone considering violation will just be equal to the harm his act will cause, and the result will be that firms will not undertake acts that impose net harms on consumers. As indicated above, this is the exact goal of deterrence.

More recently, the FTC has begun bringing more cases involving actual fraud and fewer classic "deception" cases, and so is relying more heavily on fines. For hard-core fraud, it may be difficult to obtain optimal penalties since the money may be spent or hidden. Thus, there may be a serious problem of under-deterrence in these cases. This may also provide some justification for holding advertising agencies liable, since this will increase the amount of deterrence possible.

VIII. Summary

While it is difficult to summarize the policy implications of an analysis which is itself a summary, there is one recommendation which others have made and which is worth reinforcing: The most harmful regulatory policy towards advertising is the suppression of true information. Consumers have greatly benefited by increased price advertising because of various policy initiatives. The FTC, both in its enforcement policies and in its submissions to other regulatory bodies, is increasingly encouraging disclosure. Other regulatory bodies (the states with respect to true price claims, the FDA with respect to true health claims) have not fully absorbed this lesson. While it has long been known that true information about price is useful, this point is more general, and all true information should be encouraged. One way to move towards this goal is to rely on agencies with an expertise in advertising and economics to enforce advertising restrictions.

THE MOST HARMFUL REGULATORY POLICY TOWARDS ADVERTISING IS THE SUPPRESSION OF TRUE INFORMATION.

There is an additional major recommendation: Rules mandating disclosure are generally unnecessary, and often harmful. There are powerful incentives for disclosure of even adverse information. Firms will disclose approximately optimal amounts of information, and markets will use this information and provide the correct set of products. Inefficient policies may limit the amount of information that consumers will receive. Additionally, and more importantly, inappropriate rules regarding disclosure can thwart the tendency of markets to provide the correct set of products for consumers. No regulatory agency has yet absorbed this lesson.

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Unfair Commercial Practices and Misleading and Comparative Advertising: An Analysis of the Harmonization of EU Legislation in View of the Italian Implementation of the Rules

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Unfair Commercial Practices and Misleading and Comparative Advertising: An Analysis of the Harmonization of EU Legislation in View of the Italian Implementation of the Rules

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Most antitrust experts tend to consider consumer protection the son of a lesser God in comparison to antitrust rules. Indeed, customer protection is the very essence of competition policy. A market that functions without distortions will benefit consumers' capability to choose a larger variety of products at a cheaper price. However, not all market distortions fall within the notion of agreements and neither do they represent an abuse of market power, but very often they may constitute the result of an illegitimate aggressive or misleading behavior by companies. After decades of antitrust legislation and case law aimed at fine-tuning the level of protection to a common market, a directive to harmonize the level of consumer protection within the Member States has become essential.

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I. Introduction

Directive 2005/29/EC (the "Directive"),[1] adopted by the European Parliament and the Council on May 11, 2005, has revised the structure of unfair commercial practices in Europe with the aim of fully harmonizing national legislations on unfair practices. These new rules have introduced a substantial innovation in the EU system protecting consumers from unfair commercial practices and from misleading and comparative advertising. They have also redefined some important concepts already regulated by the previous legislation and introduced new categories of unfair conduct.

This paper analyzes the impact that the new rules are likely to have on consumers and enterprises. It initially focuses on the history of consumer protection in Europe and, in particular, on several attempts made, throughout the last four decades, to harmonize relevant national provisions. Furthermore, the new fully harmonizing approach endorsed by the Directive is analyzed, together with the structure of the same act. The newly prescribed concepts of aggressive practice and per se prohibited conducts are critically assessed as well as the interconnection that exists between the different categories of unlawful commercial practices. The paper then highlights the possible divergences that exist with the Directive and the Italian legislation that applies the Directive at Member State level (i.e., LD 145 and LD 146).[2]

Finally, attention is also given to the Italian procedural system set for the concrete implementation of the new rules, among which the alternative dispute resolution system plays an important role.

1 Directive 2005/29/EC of the European Parliament and of the Council of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market and amending Council Directive 84/450/EEC, Directives 97/7/EC, 98/27/EC & 2002/65/EC of the European Parliament and of the Council and Regulation (EC) No 2006/2004 of the European Parliament and of the Council, 2005 O.J. (L 149) 22 [hereinafter Directive].

2 Decreto Legislativo 2 agosto 2007, No. 145, Attuazione dell'articolo 14 della direttiva 2005/29/CE che modifica la direttiva 84/450/CEE sulla pubblicità ingannevole (GU 207 del 6/9/2007) and Decreto Legislativo 2 agosto 2007, No. 146, attuazione della direttiva 2005/29/CE relativa alle pratiche commerciali sleali tra imprese e consumatori nel mercato interno e che modifica le direttive 84/450/CEE, 97/7/CE, 98/27/CE, 2002/65/CE, e il Regolamento (CE) 2006/2004 (GU 207 del 6/9/2007) [hereinafter Consumers' Code]. In particular, LD 146 has completely renewed articles 18 to 27 of the Consumers' Code (Legislative Decree 206/2005).

II. Consumer Protection in Europe and the New Directive: Pursuing Full Harmonization

A. FULL HARMONIZATION VERSUS A FRAGMENTARY APPROACH

National rules and approaches towards consumer protection in Europe have been far from coherent and homogeneous. Member States' relevant legislations can be classified and differentiated according to three main criteria. [3] First, a distinction can be drawn between States adopting a public law approach (e.g., Scandinavian countries) and those adopting a private one (e.g., Germany). Second, differentiation can be made between countries in which the rules governing commercial practices are an autonomous branch of law with a related system of legal protection (e.g., Northern European countries), and those in which the same rules are part of a broader system of law of unfair competition (e.g., Belgium and Germany). Third, there are some Member States that apply, with varying degrees of intensity, general fair trading clauses in the national legislation (e.g., Germany), and others that do not have these clauses altogether (e.g., Belgium, Ireland, and the United Kingdom). Historical and practical experience reveals different approaches by Member States, even if a recent uniform trend toward an economic-oriented, cost-benefit analysis can be detected in several States.[4]

At EC level, even if the original Treaty of Rome did not provide a specific legal basis for consumer protection,[5] the attention to consumers' rights has been constantly present in the policy debate throughout the years. As early as the 1960s, the Commission launched its first ambitious proposal aimed at harmonizing the rules on unfair competition. But, given the structural differences in national legislations and, above all, the varying degree of sensitivity among Member States to the issue, the "project resulted [only] in a marvellous comparative series of books edited by the Munich Max Planck Institute under the editorship of Eugen Ulmer"[6] and was finally abandoned.

3 *See*, in particular, J. Stuyck, E. Terryn, & T. Van Dyck, *Confidence through fairness? The new Directive on unfair business-to-consumer commercial practices in the internal market*, 43 Common Mkt. L. Rev. 107 (2006); T. Bourgoigne, *Characteristic of consumer law*, 14(3) J. Consumer Pol'y 293 (1991). More generally, *see* H. W. Micklitz, *An expanded and systemised Community Consumer law as alternative or complement?*, 13(6) Eur. Bus. L. Rev. 583 (2002).

4 Examples of significant cost-benefit analysis oriented amendments to national legislations are detectable in, among others, the Netherlands (1997) and Germany (2001).

5 Consumer protection became an autonomous policy aim in 1987 with the adoption of the Single European Act. A specific legal basis for pursuing consumer protection policies was provided in 1992 by the Treaty on European Union (the Treaty of Maastricht) which introduced a special Title IX on consumer protection.

6 Stuyck et al. (2006), *supra* note 3, at 110.

However, one outcome of the intense debate held during the 1960s and 1970s,[7] is that the European Council adopted a number of Directives on specific issues beginning in the mid-1980s. They focused on misleading advertising (1984); doorstep selling (1985); television sales (1989); unfair contract terms (1993); timeshare (1994); comparative advertising (1997); distance selling (1997); and consumer sales (1999).[8] Compared to the Commission's more ambitious initial intention to harmonize the legislation, these sector-based rules were a modest result, driven by pragmatism and policy.

Nevertheless, the Directives reflected an increasingly market-oriented approach based on the assumption that only properly informed consumers are in the position to make efficient choices leading to the maximization of consumer welfare. This information paradigm is supposed to produce two effects: on the one hand, the internal market will function properly as a space where consumers are aware of all the opportunities they are offered and where the free movement of persons, services, goods, and capital is guaranteed;[9] on the other hand, it will restore fair competition in the market where the choices of well-informed consumers punish unfair traders.[10]

THE DIRECTIVES REFLECTED AN INCREASINGLY MARKET-ORIENTED APPROACH BASED ON THE ASSUMPTION THAT ONLY PROPERLY INFORMED CONSUMERS ARE IN THE POSITION TO MAKE EFFICIENT CHOICES LEADING TO THE MAXIMIZATION OF CONSUMER WELFARE.

In 2001, to overcome this fragmented situation, the Commission published the Green Paper on European Consumer Protection.[11] The main scope of the initiative was to trigger an EU-wide debate among scholars, legislators, and the

7 *See* K. J. CSERES, COMPETITION LAW AND CONSUMER PROTECTION 193-202 (The Hague, 2005); N. REICH & H. W. MICKLITZ, CONSUMER LEGISLATION IN EC COUNTRIES, A COMPARATIVE ANALYSIS (1980); H.W. Micklitz, *A General Framework Directive on Fair Trading*, *in* THE FORTHCOMING EC DIRECTIVE ON UNFAIR COMMERCIAL PRACTICES (Collins ed., 2004).

8 *See* Directive 84/450/EEC, 1984 O.J. (L 250) 17; Directive 85/577/EEC, 1985 O.J. (L 372) 31; Directive 89/522/EEC as amended by Directive 97/36/EC, 1989 O.J. (L 202) 23; Directive 93/13/EEC, 1993 O.J. (L 96) 29; Directive 94/47/EC, 1994 O.J. (L 280) 83; Directive 97/7/EC, 1997 O.J. (L 144) 19; Directive 97/55/EC, 1997 O.J. (L 290) 18; Directive 99/44/EC, 1999 O.J. (L 171) 12 . (Listed here in the same order as in the text of the paper.)

9 On this regard, *see* Case C-362/88, GB INNO BM v. Commission, 1990 E.C.R. 667; G. Howells & T. Wilhelmsson, *EC Consumer Law: Has it come of* age, 28(3) EUR. L. REV. (2003); G. Howells & T. Wilhelmsson, *EC and US approach to consumer protection - should the gap be bridged?*, *in* THE YEARBOOK OF EUROPEAN LAW 17 (A. Barav et al. eds., 1997), at 207-67; Stuyck et al. (2006), *supra* note 3, at 108.

10 Le Marché Intérieur après 1992: répondre au défi, Rapport présenté à la Commission par le Groupe à haut niveau sur la fonctionnement du Marché Intérieur (Sutherland report) (1992).

11 EUROPEAN COMMISSION, GREEN PAPER ON ON EUROPEAN UNION CONSUMER PROTECTION, COM(2001) 531 final (Oct. 2, 2001).

business community over how to harmonize the rules on consumer protection The outcome of the debate was a new Directive by the Commission aimed at achieving total harmonization of unfair business-to-consumer commercial practices rules among Member States.

Total harmonization (under Article 95 of the EC Treaty) implies that once the legislative measure (the Directive) has been adopted (within its scope of application), Member States cannot implement national diverging provisions that are either stricter or more indulgent, except where explicitly permitted. Member States maintain their freedom to make policy and regulate choices only on conducts outside the Directive's scope of application. Therefore, in the case of full harmonization, it is extremely important to precisely delimit the scope of application of the Directive and, conversely, the fields not covered by its provisions. In our case, the concrete application of this principle implies that consumers throughout Europe will be entitled to the same degree ("to no less, but also to no more"[12]) of protection everywhere.

In this regard, it has to be mentioned that, according to the European Court of Justice (ECJ), EU rules can be based on Article 95 only where total harmonization is demonstrated to be an effective instrument in eliminating obstacles to the free movement of goods or the freedom to provide services, or those obstacles that significantly distort competition. The mere finding of disparities among Member States' national legislations, or the fact that some impediments to effective competition do exist, is not sufficient to justify total harmonization of rules.[13] Accordingly, when new legislation is proposed, the need for total harmonization must be demonstrated.

These considerations are important to understand the significance of the Directive and the Explanatory Memorandum to the original proposal.[14] In the latter, the European Commission provides extensive quantitative and qualitative data to demonstrate that real obstacles to consumers' choice, as well as barriers to cross-border trade, exist in the internal market. The Memorandum concluded that the Directive would constitute a unique instrument to eliminate transaction costs, increase consumer confidence, and consequently, increase cross-border demand, thus stimulating competitive pressure. According to Article 1, the Directive's purpose is "to contribute to the proper functioning of the internal market and achieve a high level of consumer protection by approximating the laws, regulations and administrative provisions of the Member States on unfair commercial practices harming consumers' economic interests."

12 Stuyck et al. (2006), *supra* note 3, at 116.

13 *See* Case C-376/98, Germany v. Parliament and Council, 2000 E.C.R I-8419.

14 Explanatory Memorandum concerning the original Proposal for a Directive on Unfair Commercial Practices, COM (2003) 356 final.

We believe that total harmonization and the consequent implementation of the Directive in all 27 Member States indisputably increases the level of protection for consumers and the degree of legal certainty for all market players. The highly detailed formulation of the text of the Directive, coupled with the narrow margin of discretion left for Member States in its implementation, allows companies to implement unique commercial and marketing strategies throughout the entire European Union.

Nonetheless, the evident drawback of the total harmonization approach is that Member States are denied any opportunity—at least in theory—to adapt the scope of the Directive to the actual necessities of their country taking into account cultural, historical, commercial, and legal differences.[15] As noted in the literature,[16] full harmonization would have been equally achievable by means of a framework directive setting principles and objectives, even in a stringent manner where necessary, rather than via extremely detailed provisions (e.g., lists of conducts) that leave no room whatsoever for state intervention. A system as such runs the risk of being too rigid to be able to dynamically react to new emerging market practices, technological innovations, and consumers attitudes that arise in a continuously evolving sector such as commercial and sales practices.

III. The Directive and Its Implementation in the Italian Legal System

A. THE NEW RULES ON BUSINESS-TO-CONSUMERS UNFAIR PRACTICES

1. Limits of Application

The Directive applies only to business-to-consumer commercial practices.[17] This implies that all practices that are deemed to harm only the economic interests of traders, either as customers or competitors, are not affected by the new rules.

Recital 7 excludes the applicability of the Directive to national requirements on taste and decency. Given that taste and decency are very difficult to define, it will be of some interest to verify which application, at both a national and EU level, the administrative and judicial bodies will give them. It will also be interesting to see if, by means of extensive interpretation of those concepts, other eth-

15 On the necessity to leave some room for State intervention, *see* CSERES (2005), *supra* note 5. *See also* H. W. Micklitz & S. Weatherhill, *Consumer Policy in the European Community: before and after Maastricht*, 16(3-4) J. CONSUMER POL'Y 379 (2002).

16 *See* Stuyck et al. (2006), *supra* note 3, at 143 et seq., in particular the interesting parallel with the conclusions of the Committee of wise man on the regulation of European securities markets of February 2001.

17 Directive, *supra* note 1, at art. 3.

ical rules, possibly regulating commercial practices, will also fall outside the scope of the harmonized rules. In addition, rules on competition and intellectual property rights (IPRs), both Community and national, are untouched by the new rule (Recital 9).

Recital 10 of the Directive recalls and confirms the residual nature of the new rules in relation to special provisions regulating certain aspects of commercial practices. In that framework, Article 3 of the Directive explicitly states that the new rules do not affect:

(i) contract law and in particular the rules on formation, validity, and effects of the contract;[18]

(ii) Community and national rules on health and safety aspect of the products;[19] and

(iii) rules disciplining the jurisdictional competence of the Courts,[20] and all rules governing regulated professions.[21]

Article 3(9) excludes financial services and immovable property; indeed, in these sectors, Member States are entitled to adopt diverging rules, either more stringent or more lenient, considering the specific complexity and circumstances of the transactions at stake. Last, Article 3(10) surprisingly excludes rules relating to the certification and indication of the fineness of precious metal articles from the scope of the Directive. Does this mean that an 18-carat gold ring could have different values for an Italian woman than an Estonian one?

2. Some Notions

Article 2 of the Directive defines "consumer" as the natural person who, in commercial practices covered by the new rules, acts for purposes that are outside his trade, business, craft, or profession. However, Articles 5, 6, 7, and 8 talk about the "average consumer". According to the interpretation given by the ECJ, the "average consumer" is someone who is reasonably well informed and reasonably observant and circumspect, taking into account social, cultural, and linguistic factors.[22] In Italy, both the supreme administrative court (Consiglio di Stato) and

18 *Id.* at art. 3(2).

19 *Id.* at art. 3(3).

20 *Id.* at art. 3(7).

21 *Id.* at art. 3(8).

22 *See* recently, inter alia, Case C-412/05 P, Alcon v. OHIM, 2007 E.C.R. I-nyr (judgment of Apr. 26, 2007); Case C-74/06, Commission v. Greece, 2007 E.C.R. II-nyr (judgment of Sep. 20, 2007); or *see also*, tracing back a consolidated case law, Case C-470/93, Mars, 1995 E.C.R. I-1923 and Case C-342/97, Lloyd Schuhfabrik Meyer, 1999 E.C.R. I-3819.

the national competition authority (the Autorità) have repeatedly held an interpretation of the concept that is in line with that of the ECJ.[23] Nonetheless, criteria like those envisaged by the ECJ may potentially give rise to inconsistent interpretations by national judicial and administrative bodies throughout Europe. This is especially true considering that the ECJ's definition of "average consumer" is not a static one, but rather a dynamic notion that could change depending on the products or services involved. Therefore, the practical delineation of "average consumer"—the fulcrum of the protective intents of the entire new rule—is of particular interest.

The term "trader" is any natural or legal person acting for purposes related to his trade, business, craft, or profession, and anyone acting in his name or behalf. Business-to-consumer commercial practices are defined as "any act, omission, course of conduct or representation, and commercial communication (including advertising and marketing) by a trader directly connected with the promotion, sale or supply of a product to consumers."[24] Thus, the concept of trader is broader than in the past, whereas it used to be defined as the "advertising agent"; the subject ordering the advertising campaign, or the owner of the medium used to communicate the practice.

In Italy,[25] the trader is supposed to be "only" connected, and not "directly" connected to the promotion, sale, or supply of a product to consumers. This is a very significant difference that could jeopardize full harmonization, to the extent that it widens the scope of the Directive to activities that are carried out primarily for purposes other than those stated therein. Judicial interpretation of the substantial differences between the Directive and national rules may be helpful in understanding any consequences potentially deriving from it.

3. The General Prohibition

Article 5 of the Directive provides the general clause that prohibits unfair commercial practices.[26] It gives a general definition of unfair practice (in paragraph 2) and specifies, in paragraph 4, two specific subcategories of prohibited practices (misleading and aggressive).

23 *See*, inter alia, Case 1263/2006, Consiglio di Stato (judgment of Mar. 8, 2006).

24 Directive, *supra* note 1, at art. 2.

25 Consumers' Code, *supra* note 2, at art. 18.

26 Article 20 of the Italian Consumers' Code (*id.*), as general prohibited category, refers to "incorrect" commercial practices rather than to "unfair" (like in the original formulation of the Directive). This terminological discrepancy is due to the need to avoid confusions and overlapping with the provisions of the civil code on unfair competition.

Based on two criteria, a commercial practice is deemed to be unfair when:

(i) it is contrary to the requirements of professional diligence; and

(ii) it materially (appreciably in the formulation of the Italian rules) distorts or is likely to materially distort the economic behavior (with regard to the product) of the average consumer whom it reaches or to whom it is addressed, or of the average member of a group when a commercial practice is directed to a particular group of consumers.

To consider a practice as unfair and thus to prohibit it, both criteria must be satisfied. Consequently, a practice that is able to appreciably distort the economic conduct of the consumer, but that is carried out with due professional diligence, will escape the prohibition as set out in Article 5.

With regards to the first criterion, Article 2 of the Directive defines "professional diligence" as "the standard degree of specific skills and care which a trader may reasonably be expected to exercise toward consumers, commensurate with honest market practices and/or the general principle of good faith in the trader's field of activity." The definition given by the Italian legislator is slightly different and refers to "correctness" rather than to honest market practices. Besides possible semantic differences, the two concepts are likely to coincide in their application. As for the notion of correctness and good faith, it is likely that the abundant jurisprudence developed in other fields of law will be recalled to interpret their application in the case of unfair practices.

Two conditions have to be satisfied. On the one hand, the consumer must be driven to a transactional decision that he would not have taken without the trader's intervention. On the other hand, the practice must be able to appreciably distort the consumer's ability to make an informed decision.

The second criterion requires that the practice (is able) to distort the consumer's economic behavior in an appreciable way. The distortion does not have to actually occur; indeed, it is enough that the distortion is likely to occur as a result of the practice. This kind of distortion is defined in Article 2 as "using a commercial practice to appreciably impair the consumer's ability to make an informed decision, thereby causing the consumer to take a decision of commercial nature that he would have not taken otherwise."

As a result, two conditions have to be satisfied. On the one hand, the consumer must be driven to a transactional decision that he would not have taken without the trader's intervention. On the other hand, the practice must be able to appreciably distort the consumer's ability to make an informed decision. This implies that minimum influence exercised in the regular development of commercial and marketing practices are excluded by the scope of the new rules. This approach reflects the original intentions of Recital 6 of the Directive which states that:

> "[I]n line with the principle of proportionality, this Directive protects consumers from the consequences of . . . unfair commercial practices where they are material but recognises that in some cases the impact on consumers may be negligible. [. . .] Further, this Directive does not affect accepted advertising and marketing practices, such as legitimate product placement, brand differentiation or the offering of incentives which may legitimately affect consumers' perception of products and influence their behaviour without impairing the consumers' ability to make an informed decision."[27]

There is a difference between the Italian and the English versions of the Directive (reflected in the Italian national rules) that is worth mentioning. The English version refers to an "informed" consumer's decision, while the Italian text speaks of a conscious or aware ("consapevole") decision. The Italian adjective seems to be broader than the English one, as it potentially includes not only commercial information, normally the purpose of an advertising and marketing campaign, but also some other elements (e.g., behavioral, cultural, and emotional) that play an important role in the formation of the final willingness and choice of the consumer.

Taking into account that the Italian legislator's policy seems to be inspired by the idea that consumers act economically, and that economic behavior is based on the ability of the consumer to make a conscious or informed decision as well as on the need not to have that ability unduly impaired, the semantic difference might be of some relevance. In fact, the range of elements on which traders try to exercise influence and persuasion might (or might not) fall within the scope of the rule depending on the interpretation of "informed decision".

Besides the figure of the average consumers, Article 5(3) of the Directive regulates cases in which commercial practices:

> "are likely to materially distort the economic behaviour of a clearly identifiable group of consumers who are particularly vulnerable to the practice or the underlying product because of their mental or physical infirmity, age or credulity in a way which the trader could reasonably be expected to foresee. [Those practices] shall be assessed from the perspective of the average member of that group."[28]

27 Directive, *supra* note 1, at recital 6.

28 *Id.* at art 5(3).

Therefore, particularly vulnerable consumers are granted a strengthened form of protection when they are among the intended audience of commercial practices. In these circumstances, particular responsibility and precaution is required of the trader with respect to the rights guaranteed to vulnerable consumers. In Italy, for example, the judicial enforcement system has strengthened these rules by introducing an inversion of the burden of proof in which the trader is expected to demonstrate, with factual allegations, that he could not have reasonably foreseen the impact of the practice on those consumers.[29] In any case, these provisions are "without prejudice to the common and legitimate advertising practice of making exaggerated statements or statements which are not meant to be taken literally."[30]

In this regard, it is important to bear in mind that the rule of unfair practices applies to all practices operated before, during, and after the commercial transaction related to a certain product. This implies that traders will be subject to the new rule, not only within the timeframe of their actual contractual relations with the consumers, but throughout the entire development of their activities.[31]

4. The Two Subcategories of Prohibited Conducts: Misleading and Aggressive Conducts

As mentioned before, Article 4 of the Directive provides that misleading and aggressive practices are prohibited. Articles 6 and 7 define and set out the limits of misleading actions and omissions. Furthermore, Articles 8 and 9 define the aggressive practices and the criteria for their evaluation and assessment. The definition of both misleading and aggressive practices does not require contrariety to professional diligence; rather, it refers only to the average consumer. It does not mention the possible impact of the practice on particular categories of vulnerable consumers.

The absence of reference to professional diligence tends to enlarge the number of cases that may fall within the concepts of misleading and aggressive practices, in the sense that a practice can be either misleading or aggressive even in the absence of a breach of professional diligence. One wonders how to interpret the absence of explicit reference to vulnerable categories of consumers, since it is clear that a coherent application of the rule, in any case, requires adequate protection of weaker subjects especially in the case of practices that are the most likely to be perpetrated.

29 Consumers' Code, *supra* note 2, at art. 27(5).

30 Directive, *supra* note 1, at art. 5(3).

31 *Id*. at recital 13.

a) Misleading actions

Misleading practices are those:

- **(i)** that contain false information and, therefore, are untruthful;
- **(ii)** that, in their overall presentation, even if they contain factually correct information, deceive or are likely to deceive the average consumer with regards to one or more of the essential elements of the offer as we will examine later in this paper; and
- **(iii)** that, in either case, cause, or are likely to cause, consumers to make a decision of a commercial nature that they would not have taken otherwise.[32]

As anticipated in the previous paragraph, the last criterion qualifies the previous two, in the sense that the false or deceivable information must have a material impact on the decision process of the consumer, influencing his commercial choice.

The elements that may mislead or deceive the average consumer include:

- **(a)** the existence or nature of the product;
- **(b)** the main characteristics of the product (e.g., its availability, benefits, risks, execution, composition, accessories, after-sale customer assistance and complaint handling, method and date of manufacture or provision, delivery, fitness for purpose, usage, quantity, specification, geographical or commercial origin, expected results from its use, or results from the product tests carried out on it);
- **(c)** the extent of the trader's commitments, the reasons for the commercial practice and the nature of the sales process, or any statement or symbol in relation to direct or indirect sponsorship or approval of the trader or the product;
- **(d)** the price or the manner in which the price is calculated, or the existence of a specific price advantage;
- **(e)** the need for a service, part, replacement, or repair;
- **(f)** the nature, attributes, and rights of the trader or his agent, such as his identity and assets, his qualifications, status, approval, affiliation, or connection and ownership of industrial, commercial, or IPRs or his awards and distinctions; and
- **(g)** the consumer's rights, including the right to replacement or reimbursement.[33]

32 *Id*. at cfr. art. 6.

33 *Id.*

Having taken into account all features and circumstances of each case, commercial practices will also be considered misleading if they cause, or are likely to cause, the consumer to make a decision of commercial nature that he would not otherwise have taken, if they involve any of the following:

(a) any marketing of the product that creates confusion with any other products, trademarks, trade names, or other distinguishing marks of a competitor, including illegal comparative advertising; or

(b) a trader's non-compliance with the duties contained in the codes of conduct under which the trader has agreed to be bound, where these duties are verifiable.[34]

As discussed in Section II.B later in this paper, the formulation of the provisions referring to possible confusion on products and distinguishing marks of competitors affecting consumers' choices may generate parallel (or even multiple) application of the new rules together with those on unfair competition[35] and those on misleading advertising in the business-to-business dealings. In other words, misleading comparative advertising may at the same time infringe this Directive as well as Directive 2006/114/EC ("Directive 114").[36]

As is clear from the wording of the provision, it disciplines omissions more than actions. Therefore, its inclusion among active misleading practices is certainly susceptible to criticism from a coherence point of view.

Transposing these principles in the Italian system, the legislator has added two further paragraphs that provide consumers with special protection with respect to practices concerning products possibly hazardous for security and health, and products that may be harmful specifically to the health of children and adolescents. In our opinion, the choice of the Italian legislator to provide special protection to certain categories of products and consumers is compatible with, on the one hand, Article 3(3) of the Directive leaving "without prejudice … national rules relating to the health and safety aspects of products" and, on the other hand, with the general principle analyzed before to provide strengthened protection for categories of weaker consumers.

In particular, commercial practices concerning products that could potentially endanger the health and the safety of consumers are misleading if they fail to inform consumers of the risk and induce them to not respect normal standards of

34 *Id*. at cfr. art. 6(2). The last criterion is the same one adopted both in the general prohibition clause and in the rest of the provisions on misleading practices.

35 *See*, in particular, Article 2598 of the Italian civil code.

36 Directive 2006/114/EC of the European Parliament and of the Council of 12 December 2006 concerning misleading and comparative advertising (codified version) (Text with EEA relevance), 2006 O.J. (L 376) 21 [hereinafter Directive 114].

prudence and control. As is clear from the wording of the provision, it disciplines omissions more than actions. Therefore, its inclusion among active misleading practices is certainly susceptible to criticism from a coherence point of view.[37] Commercial practices are also misleading when they are capable of reaching children and adolescents, and when they are able to threaten, even indirectly, their safety.[38]

b) Misleading omissions

A commercial practice is considered to be a misleading omission, taking into account all of its features and circumstances, in the factual context in which it is carried out, as well as the limitation of the communication medium, if:

- **(i)** it omits material information; and
- **(ii)** it causes, or it is likely to cause, the average consumer to take a decision of a commercial nature that he would not have taken otherwise.[39]

A "misleading omission" is defined as practices that a trader hides or provides in an unclear, unintelligible, ambiguous, or untimely manner, or any relevant material information that the trader fails to identify in the commercial intent of the practice (if not already evident from the contest) and, as set forth in the general prohibition clause, that "cause, or are likely to cause, the consumer to take a decision of commercial nature that he (or she) would not have taken otherwise."[40]

In all circumstances, the omissive nature of the practice must be assessed, taking into account the medium used to communicate the commercial practice and the limitations in time and space arising from its nature. The efforts made by the trader to provide necessary information by other means must also be considered when assessing the possible omission.[41]

Specific and detailed rules regulate instances in which an invitation to purchase is extended. This is defined in Article 2 of the Directive as a "commercial communication which indicates characteristics of the product and the price in a way appropriate with respect to the means used for the commercial communication and therefore enabling the consumer to make a purchase." Accordingly, Article 7(4) imposes far-reaching positive disclosure duties on traders with regard to information they are obliged to provide, including:

37 Consumers' Code, *supra* note 2, at cfr. art. 21(3).

38 *Id.* at cfr. Art. 21(4).

39 Directive, *supra* note 1, at art. 7(1).

40 *Id.* at cfr. art. 7(2).

41 *Id*. at art. 7(3).

(a) an appropriate description of the main characteristics of the product;

(b) coordinates or those of the trader he is acting on behalf of;

(c) the price, inclusive of taxes, or the manner in which the price is calculated, as well as, where appropriate, all additional freight, delivery, or postal charges or, where these charges cannot reasonably be calculated in advance, the fact that such additional charges may be payable;

(d) the arrangements for payment, delivery, performance, and the complaint handling policy, if they depart from the requirements of professional diligence; and

(e) for products and transactions involving a right of withdrawal or cancellation, the existence of such a right.

Moreover, under Article 7(5), all other information requirements provided by Community law related to commercial communication are relevant under Article 7(1). This creates a clear link between the new rule and the existing EU rules.[42] To assess the relevance of further Community disclosure obligations (including the residual opportunity of Member States to maintain more stringent disclosure requirements), Article 7(5) must be examined in combination with Recital 15 of the Directive, which reads:

> "Where Member States have introduced information requirements over and above what is specified in Community law, on the basis of minimum clauses, the omission of that extra information will not constitute a misleading omission under this Directive. By contrast Member States will be able, when allowed by the minimum clauses in Community law, to maintain or introduce more stringent provisions in conformity with Community law so as to ensure a higher level of protection of consumers' individual contractual rights."[43]

c) Aggressive practices

For the first time, the Directive has introduced the category of aggressive practices. A commercial practice is regarded as aggressive if:

42 A non-exhaustive list of the Communitarian information requirements is contained in Annex II of the Directive.

43 In this regard, *see* the prospected contractual implication of recital 15 on the national legal system in Stuyck et al. (2006), *supra* note 3, at 129-30.

(i) the trader exercises harassment or coercion, including the use of physical force or undue influence over the consumer;

(ii) the trader's conduct significantly impairs or is likely to significantly impair the average consumer's freedom of choice or conduct with regard to the product; and

(iii) the trader's conduct thereby causes, or it is likely to cause, him to take a decision of a commercial nature that he would not have taken otherwise.[44]

As in the general prohibition clause and in the active and omissive misleading practices, the final effect is that consumers adopt a decision different from what they would have otherwise made without the practice. In this case, the final decision depends on the limitation of freedom (the word thereby connects the second and the third criteria). Once again, the "average consumer" is the relevant subject for the application of the rule.

The definition of aggressive practice is straightforward, leaving little space for interpretation. In fact, even if the concepts of harassment and coercion are not defined in the Directive or in the (Italian) national legislation, they can be considered as quite simply identifiable in the common experience. Coercion includes physical force, but is not limited to it. Undue influence is defined as the exploitation of "a position of power in relation to the consumer so as to apply pressure, even without using or threatening to use physical force, in a way which significantly limits the consumer's ability to make a conscious decision."[45] The trader, with the aim of frightening the consumer, might also deliberately create a position of power. The limitation (i.e., the influence exercised on the consumer) is explicitly required to be significant.[46]

Some factors have to be taken into consideration in order to determine if a practice implies harassment, coercion, use of physical force, or undue influence, such as:

(a) the timing, location, nature, or persistence of the practice;

(b) the use of threatening or abusive language or behavior;

(c) the exploitation by the trader of any specific misfortune or circumstance of such gravity as to impair the consumer's judgment, of which the trader is aware, to influence the consumer's decision with regard to the product;

44 Directive, *supra* note 1, at cfr. art. 8.

45 *Id.* at art. 2.

46 *See also* L. Di Nella, *Prime considerazioni sulla disciplina delle pratiche commerciali aggressive*, *in* CONTRATTO E IMPRESA IN EUROPA 1 (2007).

(d) any onerous or disproportionate non-contractual barriers imposed by the trader where a consumer wishes to exercise rights under the contract, including rights to terminate a contract or to switch to another product or another trader; and

(e) any threat to take any action that cannot legally be taken.[47]

This list is certainly not exhaustive and other factors should be considered separately and not collectively. This means that, on the one hand, in the practical application of national rules implementing Article 9, other factors might also be relevant and, on the other hand, the presence of only one element might be considered enough to judge a practice aggressive.

5. The Black List: Per Se Prohibitions

The Directive enumerates a long and detailed list of 31 practices that are per se illegal regardless of the circumstances of the case. The factual consequence is that, since the expiration of the implementing period granted to Member States on December 12, 2007, those practices are, as such, prohibited in the entire European Union.[48]

The list of conducts contains a heterogeneous variety of practices (23 misleading and eight aggressive) that vary from practices already prohibited in the legislation of the majority of Member States, to other newly introduced by the Directive. The listed misleading practices mainly refer to traders providing false information about products' features or origin, endorsement of code of conducts, market conditions, price, or contractual terms. Bait advertising as well as bait and switch practices are also included in the black list. False statements aimed at persuading consumers that a product is available only for a very limited period of time, "in order to elicit an immediate decision and deprive consumers of sufficient opportunity or time to make an informed choice," are also per se prohibited. It is also prohibited to provide post-sales services in a language different from that in which the trader has communicated prior to the transaction or to give the impression that those services are available only in a State different from the one where the product is sold. Moreover, presenting consumers' rights as if they were a distinctive feature of the trader's offer is blacklisted too. Some specific commercial strategies, such as pyramidal sales system, also constitute prohibited practices. Claims that the product is free when it is not or offers of promotions without awarding the prize are also blacklisted.

Similarly, a number of practices are considered to be aggressive in any case. They mainly refer to strong pressure exercised on consumers, such as creating the

47 Directive, *supra* note 1, at cfr. art. 9.

48 *Id.* at cfr. annex 1. The expiration date has not been respected strictly by all Member States. For example, the United Kingdom has announced that it will implement the Directive by April 2008, *see* Department for Business Enterprise & Regulatory Reform, Unfair Commercial Practices Directive, *at* http://www.berr.gov.uk/consumers/buying-selling/ucp/index.html (last visited Feb. 15, 2008).

impression that the consumer cannot leave the premises until the conclusion of the contract, conducting unsolicited house calls, and marketing products via remote media "except in circumstances and to the extent justified under national law to enforce a contractual obligation."[49] Practices aimed at dissuading consumers from exercising their contractual rights, including unauthorized direct targeting of children to buy products, or demanding immediate or deferred payment for unsolicited products are also prohibited.

The provision of a specific list of per se prohibited clauses represents one of the major innovations introduced by the Directive. Nonetheless, when referred to commercial practices, this approach does not escape some possible criticisms.

The idea of creating lists of per se prohibited practices is well-known in competition law since the very beginning of its enforcement. As early as 1965 the first Block Exemption Regulation[50]—exempting exclusive distribution and purchasing agreements from the application of Article 86(1) of the EC Treaty[51]—empowered the Commission to specify "the restrictions or clauses which must not be contained in the agreements."[52] The provision of blacklisted clauses is built on the assumption, supported by economic analysis, that some conduct will always be detrimental for competition. Blacklisted clauses have been increasingly used in all the Block Exemption Regulations adopted in competition law.[53]

The provision of a specific list of per se prohibited clauses represents one of the major innovations introduced by the Directive. The declared aim is to increase legal certainty for traders and consumers, throughout Europe and within each single member state, as to which practices are forbidden. Nonetheless, when referred to commercial practices, this approach, that undoubtedly provides market players with a number of (fully harmonized) benchmarks, does not escape some possible criticisms.

First, the automatic presumption of illegality does not align with the market-oriented approach of the new rule. In fact, the practices are prohibited even if they do not produce any effect on consumers' behavior and are unlikely to do so.

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49 Directive, *supra* note 1, at 26 (annex I).

50 Regulation 19/65/EEC of 2 March of the Council on application of Article 85 (3) of the Treaty to certain categories of agreements and concerted practices, 1965 O.J. (L 36) 533.

51 Now Article 81(1).

52 *Ibidem* at art. 1(2).

53 *See*, in particular, Regulation 2790/1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, 1999 O.J. (L 336) 1; Regulation 2958/2000 on the application of Article 81(3) of the EC Treaty to categories of specialization agreements, 2000 O.J. (L304) 3; Regulation 2659/2000 on the application of Article 81(3) of the EC Treaty to categories of research and development agreements, 2000 O.J. (L 304) 7, all of which are still in force.

Second, possible interpretative issues may arise when applying the black list. Some of the expressions used in the list, such as "systematic failure" or "pertinent correspondence", are not so undisputed as to exclude any possible interpretative problems. If it is certainly true that at a national level those concepts have to be, and will be, interpreted according to settled case law and tradition, then it is also true that such an interpretation might give rise to a divergence of understanding, that is legal uncertainty, in the application of the black list in the Member States. In the following years, it will probably be the ECJ, via preliminary rulings judgments, that will settle the disputes concerning different national interpretation of these prohibited practices.

The final concern pertains to the static nature of the black list which, as mentioned earlier, can be modified only via a modification of the Directive, which is a very complex and time-consuming procedure.[54]

6. Article 4 of the Directive: The Internal Market Clause

As already argued, the main purpose of full harmonization is to make the EU internal market more effective. For this reason, Article 4 of the Directive provides that "Member States shall neither restrict the freedom to provide services nor restrict the free movement of goods for reasons falling within the field approximated by this Directive." This is the "internal market clause", which provides that Member States may not hinder, through their national rules, the effective achievement of the internal market. This type of clause generally refers to the principle of mutual recognition and home country control (also called the "country of origin rule"). According to this principle, each Member State can recognize as legitimate, and thus allow goods or services (such as commercial practices) legally produced or provided in another Member State (the country of origin) entrance into its territory. As a result, only the latter State exercises control with regards to the respect of the rules.

In the event of full harmonization, this principle should be implied. Nonetheless, the wording of Article 4 is not so unequivocal, showing a political compromise underneath it. This is even more so, if one compares the final version of the Article to its original draft in which the principle was clearly recognized.[55] Since some Member States were more in favor of allowing the hosting state to impose higher mandatory requirements in protection of consumers, the

54 *See supra* text, at Section II.A.

55 The original Proposal for the Directive, *supra* note 14, at art. 4 provided that:

> 1. Traders shall only comply with the national provisions, falling within the field approximated by this Directive, of the Member State in which they are established. The Member State in which the trader is established shall ensure such compliance.
>
> 2. Member States shall neither restrict the freedom to provide services nor restrict the free movement of goods for reasons falling within the field approximated by this Directive.

explicit reference to the principle has been eliminated from the final formulation of the Directive. If one were to interpret Article 4 as giving Member States the possibility to adopt stricter rules, this would jeopardize the same scope of the Directive, which, as already stated, tends towards full harmonization. However, the current formulation of Article 4 is not clear and leaves room for several plausible interpretations. We believe that, even without an explicit reference to the home country principle, Article 4 guarantees legal certainty via the provision of a rebuttable presumption of legality. Once a practice has been deemed fair by one Member State, it will be considered so in all other Member States until the contrary is proven. Such an interpretation seems to be the only one compatible with the intent of total harmonization.[56]

7. The New Rules in Relation to Existing EU Legislation

To guarantee coordination with existing rules on commercial practices, the Directive's action has been two-fold. On the one side, it has modified some other Directives. In particular it is worth mentioning that the scope of the Directive 84/450/EEC[57] on misleading and comparative advertising has been limited to business-to-business practices. Furthermore, among the conditions of allowance for comparative advertising, the not-misleading nature of the practice as defined in the new Directive has been added.[58] Further amendments have been made to the rules on unsolicited supply (Directive 97/7/EC).[59] The rules on injunction for the protection of collective consumers' interests have also been modified with the inclusion of the Directive in the list of directives covered by the scope of application of those rules (Directive 98/27/EC).[60] The object of the Directive has also been included in the topics where cooperation between the Commission and the national competition authorities is allowed in accordance with Regulation 2006/2004/EC.[61]

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56 *See* European Consumer Law Group, Proposed Directive on Unfair Commercial Practices, ECLG/134/2004 (Dec. 2004), *available at* www.europeanconsumerlawgroup.org; T. Wilhelmsson, *The Abuse of the Confident Consumer as a Justification for EC Consumer Law*, 27(3) J. Consumer Pol'y 317 (2004).

57 Council Directive 84/450/EEC of 10 September 1984 relating to the approximation of the laws, regulations and administrative provisions of the Member States concerning misleading advertising, 1984 O.J. (L 250) 17.

58 *See* Directive, *supra* note 1, at art. 14.

59 Directive 97/7/EC of the European Parliament and of the Council of 20 May 1997 on the protection of consumers in respect of distance contracts, 1997 O.J. (L 144) 19.

60 Directive 98/27/EC of the European Parliament and of the Council of 19 May 1998 on injunctions for the protection of consumers' interests, 1998 O.J. (L 166) 51.

61 Regulation (EC) No. 2006/2004 of the European Parliament and of the Council of 27 October 2004 on cooperation between national authorities responsible for the enforcement of consumer protection laws (the Regulation on consumer protection cooperation)Text with EEA relevance, 2004 O.J. (L 364) 1.

On the other side, the Directive (and consequently the national implementing rules) explicitly limits its scope of application to areas where there are no "specific Community law provisions regulating specific aspects of unfair commercial practices."[62] Therefore, in strict application of the principle lex specialis derogat legi generalis, reflecting the omni-comprehensive scope of the EU legislator, the Directive is defined as having a residual nature.

Finally, the Directive establishes a transitional period allowing Member States to continue to apply until 2013 national provisions:

> "within the field approximated by (the) Directive which are more restrictive or prescriptive than (the) Directive and which implement directives containing minimum harmonization clauses. These measures must be essential to ensure that consumers are adequately protected against unfair commercial practices and must be proportionate to the attainment of this objective."[63]

B. MISLEADING AND COMPARATIVE ADVERTISING

Following the adoption of the Directive, the EU rule of misleading and comparative advertising, as modified by the same Directive, has been codified in Directive 114. This Directive pursues a minimum harmonization goal. Accordingly, it does not prevent Member States from adopting more stringent provisions aimed at protecting competitors. Being an exception, the conditions of legality of comparative advertising are provided as exhaustive (i.e., fully harmonized). This approach reflects the great importance explicitly recognized by Directive 114 to this particular form of advertising for the fair and undistorted development of competition within the internal market.

The main difference between the previous rule and the new one is that the new one is limited to the business-to-business commercial practices. As stated in Article 1, the objective of Directive 114 is indeed to protect traders from misleading advertising and from its unfair consequences as well as to determine the conditions of legality of comparative advertising. Being the scope of Directive 114 the minimum harmonization of national rules, the new national rules are not entirely coincident with its provisions. Therefore, we describe the Italian rules with a particular focus on the prescriptions resulting from EU rules.

62 Directive, *supra* note 1, at recital 10.

63 *Id.* at art. 3(5).

The Italian legislator has substantially confirmed the previous rule on misleading advertising. It has adapted it to the novelties contained in Directive 114 and transposed it in an independent legislative tool (the LD 145). Under Article 1 of LD 145, publicity must be evident, truthful, and correct. It is considered misleading if:

(i) it is able to induce traders in error;

(ii) where, due to its misleading nature, it is able to distort their economic behavior; or

(iii) it is able to harm a competitor.

It seems unlikely that misleading advertising may be detrimental only to a competitor, and not also to final consumers. Therefore, the question is, if a behavior is misleading to both the competitor and the final consumers, does it infringe both the Directive and Directive 114? And may it be punished twice or does the violation of the former absorb the violation of the latter?

> IF A BEHAVIOR IS MISLEADING TO BOTH THE COMPETITOR AND THE FINAL CONSUMERS, DOES IT INFRINGE BOTH THE DIRECTIVE AND DIRECTIVE 114? AND MAY IT BE PUNISHED TWICE OR DOES THE VIOLATION OF THE FORMER ABSORB THE VIOLATION OF THE LATTER?

These questions remain unanswered. In Italy, two factors seem to indicate that the dispute would be regulated exclusively by rules on business-to-consumer practices. First, the fact that those rules realize full harmonization and—in the EU legislator's intention—a complete abolition of all impediments to cross-border transactions seems to indicate that, where consumers are involved, these rules prevail and apply to all practices. Second, and this is simply a factual observation, officials of the Italian Competition Authority, in their first interpretation given to the new rules, have also taken this position.[64]

To determine the misleading character of the advertising, all its features and aspects must be considered, and in particular:

(a) the main characteristics of goods or services, such as their availability, nature, execution, composition, method and date of manufacture or provision, fitness for purpose, uses, quantity, specification, geographical or commercial origin or the results to be expected from their use;

(b) the price or the manner in which the price is calculated, and the conditions on which the goods are supplied or the services provided; and

(c) the nature, attributes, and rights of the advertiser, such as his identity

64 Le nuove regole delle pratiche commerciali aggressive, sleali, ingannevoli, ITA Conference Milan (Nov. 15-16, 2007).

and assets, his qualifications and ownership of industrial, commercial or intellectual property rights or his awards and distinctions.[65]

Article 5 of LD 145 requires that the advertising nature of the practice has to be clearly detectable and prohibits every form of subliminal campaign. Moreover, LD 145 reproduces, in Articles 6 and 7, the rules protecting health and safety as well as children and adolescents provided by Articles 21(3) and 21(4) of the Consumers' Code.[66] In addition, the rule protecting children includes a further paragraph that defines as misleading the publicity that abuses children's credulity and lack of experience or that uses children and adolescents in an advertising campaign (besides when explicitly allowed by law).[67] These articles (which as already mentioned are not included in the original Directives) confirm the special sensitivity demonstrated by the Italian legislator toward the protection of children and of health and safety.

Finally, Article 4 reproduces the conditions of legality of comparative advertising listed in Article 4 of Directive 114. These conditions realize a full harmonization of the EU rule in this sector. Comparative advertising will be permitted when (all) of these conditions are met:

(a) it is not misleading;

(b) it compares goods or services meeting the same needs or intended for the same purpose;

(c) it objectively compares one or more materials, relevant, verifiable, and representative features of those goods and services, which may include price;

(d) it does not create confusion among traders, between the advertiser and a competitor or between the advertiser's trademarks, trade names, other distinguishing marks, goods or services and those of a competitor;

(e) it does not discredit or denigrate the trademarks, trade names, other distinguishing marks, goods, services, activities, or circumstances of a competitor;

(f) for products with designation of origin, it relates in each case to products with the same designation;

(g) it does not take unfair advantage of the reputation of a trademark, trade name or other distinguishing marks of a competitor or of the designation of origin of competing products; and

65 Directive 114, *supra* note 36, at cf. art. 3.

66 *See* page X of this paper.

67 Consumers' Code, *supra* note 2, at art. 7.

(h) it does not present goods or services as imitations or replicas of goods or services bearing a protected trademark or trade name.

The third paragraph of Article 4, adding something to the provisions of the Directive, specifies that in the case of special offers, their terms of validity have to be indicated clearly and unequivocally.

IV. The Italian Administrative and Judicial Protection of the Rights Granted by the New Rule

It is an established principle of EU law that Member States are substantially free, in the framework of their domestic judiciary system, to set the rules they consider most appropriate to protect individuals' rights deriving from EU law. Member States are only bound by the principle of effectiveness and equivalence. Accordingly, the Directive has left a great deal of the part dedicated to the enforcement provisions to Member States' discretion.[68] They have been only required to guarantee "adequate and effective means ... to combat unfair commercial practices in order to enforce compliance with the provisions of the Directive."[69] To this aim, the Directive has left open a number of provisions that States are allowed to adopt that may better suit their national system.

As for the Italian implementing legislation, it has to first be said that the two new rules, as introduced by LD 145 and LD 146, have both granted wide powers to the national competition authority (the Autorità) for the effective protections of rights guaranteed by the new rules. To this end, the Autorità can investigate and sanction unfair practices in a way that is largely comparable with the Italian competition act. This circumstance seems to suggest that the Italian legislator assigns the same social disvalue to antitrust violation (namely, collusive and abusive conducts) as to unfair practices. If this interpretation is correct, the approach, nevertheless, is highly debatable. In fact, it appears clear to us that the net social effect, in terms of total welfare decrease, of an antitrust infringement may be much larger than the effect of an unfair commercial practice which is likely to impact a limited number of consumers.

Even if the Directive does not require it, the Autorità has the power to initiate ex officio investigations[70] and to wait for a complaint (that can be lodged by all subjects or organizations with an interest to do so)[71] in order to open an inves-

68 *Id.* at art. 11-13.

69 *Id.* at art. 11(1).

70 This power is granted by Article 8(2) of LD 145 in case of misleading and comparative advertising and by Article 27(2) of the Consumers' Code in case of unfair business-to-consumer practices.

71 Procedural regulations, *infra* note 70, at art. 5. Also these provisions are not entirely clear about what type of "interest" an organization must have to ask the Authority intervention.

tigation. What is more, the procedural regulations, recently approved by the Autorità,[72] have granted the power to initiate a procedure to the official responsible for the procedure "having considered all the elements in his possession or brought to his attention by complaints."[73] This clearly gives enormous, as well as questionable, discretional power to initiate antitrust investigations to a single individual rather than to the Autorità as a whole.

Furthermore, this official maintains a high degree of discretional power during all of the procedures. In fact, he is entitled to play a substantial role already in the pre-investigative phase. In particular, before opening an investigation, the official has the opportunity to collect whatever material he might consider useful to the evaluation of the circumstance, and to request information and documents of all private or public subjects. At the same stage, except in instances of particularly grave conduct, the official, having informed the plenum of the Autorità, can invite the trader to eliminate "the elements of potential unfairness" through "more suasion".[74]

This last possibility is actually quite odd. It implies that, standing an alleged infringement of the new rule(s), the official can invite the trader to stop the practice. Thus, if the trader is effectively perpetrating an infringement, then it has an opportunity to eliminate the possibility of procedures with no consequences whatsoever and, apparently, without giving any compliance guarantee. But, what happens formally to the illicit? Is the response potentially given to the "invitation" binding? And, if so, according to which normative provision? The answers to these questions remain obscure.

During the procedure, the official has the power to ask for all information considered necessary, of all public or private subjects, and to dispose the hearing of the parties.[75] Only in order to carry out inspections, with the help of fiscal police, the authorization of the Autorità is required.[76] Once again, these powers seem overly broad.

The second main feature of the procedure is that it is based somewhat on an inversion of the burden of proof. The new rules state that, where justified by the

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72 The power to self-adopt procedural regulations is granted to the Autorità under Article 8(11) of LD 145 in case of misleading and comparative advertising and under Article 27(11) of the Consumers' Code in case of unfair business-to-consumer practices.

73 Regolamento sulle procedure istruttorie in materia di pubblicità ingannevole e comparativa illecita (adopted with decision 17590/2007 on the 15 November 2007, GU 283/2007) and Regolamento sulle procedure istruttorie in materia di pratiche commerciali scorrette (adopted with decision 17589/2007 on the 15 November 2007, GU 283/2007) [hereinafter Procedural regulations].

74 Procedural regulations, *supra* note 72, at art. 4.

75 *Id.* at art. 12.

76 *Id.* at art. 14.

circumstances of the case, the Autorità can ask the trader to prove the correctness of the factual data shown in his commercial practice. If the demonstration is omitted, or considered insufficient, the data are considered incorrect.[77] The policy choice of the legislator has strong implications and provides the widest spectrum of regulatory powers to the Autorità. The problem here is that the procedural regulations[78] have imparted the power to dispose the inversion of the burden of proof on the individual responsible for the procedure, not the Autorità. This poses, once more, an issue of conformity with the principle of legality, together with a clear interpretative problem about what is and is not considered the Autorità, when the law refers to it.

Another significant innovation is the ability of the trader, except in case of practices seriously and manifestly misleading, following the opening of the procedure, to offer commitments to eliminate the profiles of illegitimacy of the practice.[79] Where the Autorità considers those commitments appropriate, it can make them binding on the trader (even if the procedural rules say "make" them binding, contrary to the Legislative Decrees that use a more hypothetical "can make") and can order their publication at the trader's expense. The clear advantage for the trader in presenting commitments is that the procedure is closed without any admittance of guiltiness and, consequently, with no decision ascertaining (and declaring) a violation of the rules. For the Autorità, this should guarantee a shortened procedure and significant cost-saving that, considering its scarce resources, should allow it to pursue more cases.

FOR THE AUTORITÀ, THIS SHOULD GUARANTEE A SHORTENED PROCEDURE AND SIGNIFICANT COST-SAVING THAT, CONSIDERING ITS SCARCE RESOURCES, SHOULD ALLOW IT TO PURSUE MORE CASES.

Nonetheless, what is not clear from these provisions is the possible practical content of these commitments. In the Italian antitrust act, the recently introduced possibility to offer commitments[80] is clearly second to the elimination of

77 Consumers' Code, *supra* note 2, at art. 8(5) of LD 145 & 27(5).

78 Procedural regulations, *supra* note 72, at art. 15.

79 *See* Consumers' Code, *supra* note 2, at rt. 8(7) of LD 145 & 27(7). Those provisions have been specified and implemented by Article 8 of the Procedural regulations (*supra* note 72).

80 Referring to Article 9 of Regulation 1/2003 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty (2003 O.J. (L 1) 1), Legislative Decree 223/2006 has introduced the new Art. 14*ter* of the Italian Competition Act (l. 287/1990). The new article allows firms to offer commitments aimed at meeting concerns expressed by the Autorità and at eliminating the alleged anticompetitive conducts. *See* W. P. J. Wils, *Settlement of EU Antitrust Investigations: Commitment Decisions under Article 9 of Regulation 1/2003*, 29(3) WORLD COMPETITION 345 (2006); L. Di Via, *Le decisioni in material di impegni nella prassi decisionale dell?autorità garante*, IX(2) MERCATO CONCORRENZA E REGOLE 229 (2007); F. Cintioli, *Le nuove misure riparatorie del danno alla concorrenza*, *in* I GIURISPRUDENZA COMMERCIALE 1 (forthcoming 2008).

the anticompetitive distortions of the market as a result of the undertaking's behavior by means of the proposed commitments. On the contrary, in the new rule, it is not entirely clear what the content of the trader's proposal should be and, in particular, if the mere guarantee not to perpetrate the practice anymore should be considered appropriate. If this is the case, the rule should be strongly criticized since it would allow the trader to violate the rules and, should a proceeding be initiated, solve everything with a simple "sorry, I won't do that again". This is not, in our opinion, in the spirit of the rules. The problem is that it is actually quite complicated to foresee a different content for commitments in this field, where the elimination of the profiles of illegitimacy can hardly consist in something different than stop the practice.

Another power given to the Autorità is to adopt, acting on its own initiative, interim measures that suspend the commercial practice or the advertising.[81] Once more, the transposition of the new powers bestowed on the Autorità by the Italian competition act in case of antitrust violation appears to be rather mechanical.[82] It is currently unclear, or even imaginable, what grave and irreparable damage (to the market or to consumers?) could arise from the perpetration of the conduct justifying the adoption of interim measures.

At the outcome of the proceeding, the Autorità can prohibit the diffusion or the continuation of the practice, order the publication of its decision at trader's expenses, or order the publication of the corrective declaration aimed at impeding the practice to produce further effects. With the decision, the Autorità can also impose pecuniary sanctions ranging from EUR 5,000 to 500,000. Moreover, in the case of repeated non-compliance with its interim measures and decisions, or with the approved commitments, the Autorità can impose a sanction of up to EUR 150,000 (minimum EUR 10,000) and suspend the trader's commercial activities.

Appeals against decisions of the Autorità are subject to the exclusive jurisdiction of the administrative judge, which, in the Italian legal system, means the jurisdiction of the Regional Administrative Tribunal of Lazio (TAR Lazio) in first instance and the Consiglio di Stato as the judge of second instance reviewing the legality of the act.

81 Procedural regulations, *supra* note 72, at art 9.

82 Law Decree 223/2006 (that later become Law N. 248/2006) has introduced the new Article 14*bis* of the Italian Competition Act (l. 287/1990) allowing the Autorità to adopt interim measures in cases of urgency due to the risk of serious and irreparable damage to competition.

A. SELF-DISCIPLINE AND CODES OF CONDUCT

Finally, it is certainly remarkable that, following the dispositions of the Directive,[83] the Italian rules give a strengthened and renovated role to code of conducts, adopted by entrepreneurial and professional associations and organizations, disciplining the conduct of traders that commit themselves to respect them. The codes are supposed to indicate the subject (or the body) responsible for supervising their effective implementation. Interestingly enough, codes have to be available also in English and "properly" made known to consumers.[84] These rules seems to be aimed at encouraging the extension of companies' activities, and to the entrepreneurial world as a whole, of codes of conduct inspired by the deontological codes disciplining liberal professions. This certainly appears to deserve encouragement and support.

Article 27-*ter* of the Consumers' Code and Article 9 of LD 145 provide for forms of self-discipline, allowing consumers and traders to agree on resorting to the subject responsible for the effective implementation of codes of conduct—prior to the regular procedure in front of the Autorità—in order to consensually solve the dispute concerning the unfair practice. In doing so, parties can agree not to resort to the Autorità until the final pronouncement.

These rules seem to envisage an alternative dispute resolution system (ADR) that is somewhat non-mandatory and discretional for the parties and, if used effectively, might reduce the workload of the Autorità. Given the fact that the right to go to the Autorità for recourse is completely unaffected by the opportunity offered by the ADR, and the fact that in Italy ADR plays a relatively small role, it will be interesting to see if practical results will be obtained. An opportunity to attain this is given, at least in case of unfair business-to-consumer practices, by the Autorità and professional and entrepreneurial associations, and organizations compelled to periodically transmit to the Ministry for Economic Development all decisions adopted under the new rule. The Ministry intends to make public the key facts about the decisions adopted, their content, and the adopting authority. The Italian legislator intends, and this is likely to happen after the start-up period, that this should create a kind of case law and maxims digest that should reduce future disputes and, in particular, recourses to the Autorità.[85]

83 Directive, *supra* note 1, at art. 10.

84 *See* Consumers' Code, *supra* note 2, at art. 27*bis.*

85 *Id.* at art. 27*quater*.

V. Conclusions

In this paper, we have described the characteristics and the structure of the new rule focusing on the main innovations brought about by the EU (and Italian) system of consumer protection and advertising regulation. We have also focused on possible discrepancies between the Italian rules and the provisions of the Directive that, in a field of law leaning towards full harmonization in Europe, might create some systemic inconsistencies.

Having described the material provisions of the Directive, a few words are needed to describe the interplay existing between the general prohibition clause, the two sub-categories, and the black list. Stuyck, Terryn, and Van Dyck's (2006)[86] interpretation is very interesting, as it describes the three levels as non-concentric circumferences, none of which entirely coincide with one another. According to the three authors, for each of the three categories of practices there are some practices that do not overlap with the other two categories. This would imply that the general prohibition clause of Article 5 does not comprehend all practices and, accordingly, that some misleading, aggressive, and blacklisted practices escape the general definition of unfairness.

In the absence of a more rigorous judicial interpretation clarifying the issue, we believe that the general clause will certainly also catch practices that are neither misleading nor aggressive (and, of course, also not blacklisted), as it constitutes a general prohibition that encompasses all practices able, in any way, to distort consumers' economic conduct. At the same time, it seems difficult to imagine conduct that is either aggressive, misleading, or blacklisted, and not, at the same time, unfair.

As for the policy choices of the EU legislator, we welcome another step towards effective consumer protection and legal certainty for market operators throughout the whole internal market. Nonetheless, we also emphasize the peculiar choice of adopting rules as detailed as to impede Member States, in a continuously changing sector, to introduce even minor amendments that might be triggered by unexpected national necessities or market developments. The difficulty faced by the EU system to maintain coherence and effective harmonization must also be stressed.

We welcome another step towards effective consumer protection and legal certainty for market operators throughout the whole internal market. Nonetheless, we also emphasize the peculiar choice of adopting rules as detailed as to impede Member States to introduce even minor amendments that might be triggered by unexpected national necessities or market developments.

86 *See* Stuyck et al. (2006), *supra* note 3, at 132-34.

Finally, describing the system of administrative and judicial protection structured by the Italian legislator and by the same Autorità, we have focused on a number of inconsistencies and debatable legislative choices that, in few cases, also raise the question of the compatibility of the drafted system with the general principle of legality. In particular, the degree of discretion recognized to the official in charge of the procedure has raised serious doubts and perplexities.

After only a few months since the effective implementation of the Directive, it is still quite difficult to foresee the effects it will have on consumer protection and traders' and companies' behavior. Experience and concrete cases, together with some resolving ("harmonizing", some might say) preliminary rulings of the ECJ, will clarify a number of open interpretative issues. In the case of Italy, in particular, there are a number of new rules that have to be tested for their impact on the market and, more generally, on the country's existing culture of consumer protection. The Autorità has very recently activated, and published on its website, a free phone number that can be used by consumers to point out cases of suspected unfair commercial practices, or misleading and occult advertising. Apparently the line is very busy and receives an enormous number of calls every day. If this is true, then it might be a sign of the increasing establishment of a culture in which consumers are aware of the necessity of truly effective competition, of their rights, and of the necessity to personally take action to enforce them.

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A Perspective on the *Whole Foods* Decision: Would the Most Important Evidence Please Stand Up?

Deborah L. Feinstein and Michael B. Bernstein

In the old game show, *To Tell the Truth*, panelists tried to convince the audience that they were the one associated with a particular story. They had to weave facts and details into the story to make it sound like the events had happened to them. The audience had to try to figure out which facts were likely to be consistent with the actual story. At the end, the host asked the real person associated with the story to stand up.

Analyzing a merger has many similarities to this old game show. While hopefully no one in a merger analysis is actively trying to mislead, the decision makers must still sort through a plethora of facts to determine which are consistent with a theory that would condemn a merger versus a theory that would clear a merger. This is a particularly difficult exercise in a retail merger. There are no customers to interview and there are no customers' documents from which one can glean how they might behave in the event of changes in the competitive environment. Which facts are meaningful and which are simply details that serve only to obscure the story? Which facts should be given weight and which should be ignored? And, how much weight should documentary and testimonial evidence be given as compared to economic evidence?

An examination of these issues in the *Whole Foods* matter shows that what the U.S. Federal Trade Commission (FTC) and the district court thought the evi-

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dence showed, and what weight to give various evidence, differed so significantly that they reached entirely different conclusions about the matter.

I. The Evidence Focused On by the FTC

The FTC began investigating this transaction in February 2007. In looking through the companies' documents, they must have been struck immediately by the parties' descriptions of their respective businesses. First, the products the merging parties carried were premium natural and organic products as opposed to more run-of-the mill products offered in traditional grocery stores. Second, the positioning of the stores and the type of customers they attracted were not those of traditional supermarkets. Whole Foods' and Wild Oats' customers are buying something more than just the food product—they are seeking a shopping "experience," where environment can matter as much as price. Both Whole Foods' and Wild Oats' internal documents demonstrated that they viewed their stores as not just supermarkets, but a destination for something more. John Mackey, Whole Foods' CEO explained:

> "Superior quality, superior service, superior perishable product, superior marketing, superior branding, and superior store experience working together are what makes Whole Foods so successful."[1]

Wild Oats' Vice President of Marketing had a similar view:

> "Succeeding in this business is about staying true to your message and mission but also . . . creating a community that will attract new customers. [. . .] It's about mind, body and soul through food, information, vitamins and supplements, recipes, books, body care—you name it. Wild Oats is more than a retail chain—it's about a lifestyle, and that's how we market ourselves."[2]

1 Memorandum in Support of Plaintiff's Motions for Temp. Restraining Order and Preliminary Injunction at 14, *Whole Foods*, 502 F. Supp. 2d 1 [hereinafter Plaintiff's Memorandum for TRO], *available at* http://www.ftc.gov/os/caselist/0710114/070710PublicVersiontromemo.pdf.

2 *Id.*

The Commission was also confronted with the parties' characterizations of competition. The former CEO of Wild Oats stated that, "[T]here's really only two players . . . of any substance in the organic and all natural, and that's Whole Foods and Wild Oats."[3] Similarly, Whole Foods referred to markets where only Wild Oats was present as "monopoly markets,"[4] with a Regional President further demonstrating how such a "monopoly market" could price: "[P]rices were higher at [the newly opened Wild Oats store in Tampa, Florida, because] [b]eing the only game in town gives them that freedom. [. . .] Their pricing was high since they are the only large natural food store in the area."[5]

Whole Foods even acknowledged that without competition from another premium natural and organic grocery store "we potentially become slow and lazy. Our prices go up and our customer service goes down."[6] Thus, it focused its attention on challenging Wild Oats with the intent of creating "monopoly markets" for themselves. As Mr. Mackey explained:

> "Whole Foods says they will open 25 stores in OATS territories in the next 2 years. . . . The writing is on the wall. The end game is now underway for OATS. [. . .] Whole Foods is systematically destroying their viability as a business-market by market, city by city."[7]

The evidence went beyond the parties' mere characterizations of each other as significant competitors. The FTC found examples of intense competition between the companies as well, including:

- Whole Foods' reduction of prices 10 percent across the board in response to a planned opening of a Wild Oats store in Boulder;
- Whole Foods complaining of low margins in Louisville because of "having to match some ridiculously low special pricing" at Wild Oats;
- Increased spending on remodeling and updating stores, and adding amenities when confronting one another; and

3 *Id.* at 1.

4 *Id.* at 4, 27.

5 *Id.* at 27, n.11.

6 *Id.* at 24.

7 *Id.* at 27.

- Whole Foods responding to a 20 percent-off sale by Wild Oats with price-matching, free samples, and taste tests.

Finally, the FTC found evidence of what Whole Foods' CEO, John Mackey, thought the impact of the transaction would be. In a memo to the Board, Mr. Mackey explained:

> "By buying them we will ... avoid nasty price wars in Portland (both Oregon and Maine), Boulder, Nashville, and several other cities which will harm our gross margins and profitability. OATS may not be able to defeat us but they can still hurt us. Furthermore, we eliminate forever the possibility of Kroger, Super Value, or Safeway using their brand equity to launch a competing national natural/organic food chain to rival us."[8]

He reiterated this view in testimony:

> "So it is either Whole Foods buy them or we potentially see someone like Kroger or Safeway or Tesco or God knows who else, a private equity firm, buys them and recapitalize them, potentially bring in new management. And we would rather not see that happen.[9]
>
> [...]
>
> One of the motivations is to eliminate a competitor. I will not deny that. That is one of the reasons why we are doing this deal. That is one of the reasons we are willing to pay $18.50 for a company that has lost $60 million in the last six years. If we can't eliminate those stores, then Wild Oats, frankly, isn't worth buying."[10]

Further evidence of the impact of the merger was found in the company's plans to close down stores. The FTC alleged that the proposed transaction

8 *Id.* at 1.

9 *Id.*

10 *Id.* at Ex. 2, 75:13-21; Plaintiff FTC's Corrected Brief on Its Motion for Preliminary Injunction at 2, *Whole Foods*, 502 F. Supp. 2d 1.

would eliminate future competition in seven local areas where Whole Foods had plans to open stores in process and where Whole Foods and Wild Oats had planned to compete with one another, including areas "located within: Fairfield County, Connecticut; Miami, Florida; Naples, Florida; Nashville, Tennessee; Palo Alto, California; Reno, Nevada; and Salt Lake City, Utah."[11] Whole Foods believed the impact on competition would have been so great that they were even willing to pay USD 2 to 3 million per Wild Oats store that Whole Foods would acquire and then close.[12]

THE FTC ALLEGED THAT THE PROPOSED TRANSACTION WOULD ELIMINATE FUTURE COMPETITION IN SEVEN LOCAL AREAS WHERE WHOLE FOODS HAD PLANS TO OPEN STORES IN PROCESS AND WHERE WHOLE FOODS AND WILD OATS HAD PLANNED TO COMPETE WITH ONE ANOTHER.

In addition, the FTC used internal business documents in an attempt to demonstrate how Whole Foods' acquisition of Wild Oats basically put an end to the opening of Wild Oats' flagship store in Boulder, Colorado where Whole Foods thought it would face significant competition:

> "[A]s we approach the opening on the new Wild Oats flagship in Boulder in March . . . [m]y goal is simple—I want to crush them and am willing to spend a lot of money in the process. We are going to run a [redacted] day strategy against Oats that includes many different aspects but value is a key component."[13]

As much as the merging parties focused on each other, the Commission found evidence that the merging parties were dismissive of other competitors. A Whole Foods document stated, "Safeway . . . and other conventional [stores] . . . can't really effectively focus on Whole Foods core customers without abandoning 90% of their own customers."[14] The FTC pointed to a Whole Foods study that found entry by other premium and natural organic supermarkets had greater effect on Whole Foods sales and margins than did entry by other retailers.

11 *Whole Foods*, 502 F. Supp. 2d at 38 (citation omitted).

12 Plaintiff's Memorandum for TRO, *supra* note 1, at 4-5, Ex. 7.

13 *Id.* at 18.

14 *Id.* at 4, 30.

The Commission also, relying on research conducted by Dr. Murphy, an economist from the University of Chicago, found evidence that Whole Foods' store-level margins were lower in areas where a Wild Oats store is present. The evidence, as Dr. Murphy presented it, was that Whole Foods' entry in certain markets had a significant impact on Wild Oats' sales and margins, and that this effect was greater than the effects of entry by other stores. By inference, he concluded that an exit of Wild Oats would lead to an increase in Whole Foods' sales and margins.

The FTC did not find any systematic evidence that Whole Foods' prices were affected by the existence or non-existence of a Wild Oats store. While they pointed to documents suggesting that Wild Oats forced Whole Foods to lower prices, they never backed the claim up with concrete evidence, nor did they conduct an economic study to that effect. Interestingly, CRA International has written that it presented evidence to the FTC prior to the court challenge that Whole Foods and Wild Oats did not meaningfully constrain each other's prices in markets where both chains operated.[15] CRA undertook an econometric analysis of the impact of a Whole Foods store opening near a Wild Oats store or a Wild Oats store closing near an existing Whole Foods stores. The findings were that Whole Foods did not meaningfully respond to Wild Oats' exit from a trade area by raising prices, nor did Wild Oats meaningfully respond to Whole Foods' entry by lowering prices. We do not know the basis on which the Commission rejected this evidence in making its decision to block the transaction.

II. The Evidence Focused On by the Merging Parties

The merging parties seized on the lack of systematic pricing evidence. The lack of this evidence was as important to the merging parties as the affirmative evidence they did have. The parties did an economic study of their own where Dr. Scheffman analyzed the register price of all items carried in multiple Whole Foods and Wild Oats stores in a region for one specific day, as no historical data was available due to system capacity. This study revealed that there was no systematic pricing pattern based on the presence or absence of competition from premium natural and organic supermarkets.[16]

But the pricing study was not the key component of the parties' case. Rather, they relied heavily on a critical-loss analysis conducted by Dr. Scheffman. Such an analysis seeks to determine how many sales must be lost for a price increase to be unprofitable. As a first step, a critical-loss analysis must determine how many marginal customers there are (i.e., those "who would switch where he or

15 CRA Int'l, *U.S. District Court Clears Way for Whole Foods-Wild Oats Merger* 1 (Nov. 2007), *available at* http://www.crai.com/pubs/pub_7768.pdf.

16 *Whole Foods*, 502 F. Supp. 2d at 39.

she shops in a response to a ... small but significant and nontransitory price increase"[17]). Dr. Scheffman found that:

- "[O]n average, the opening of a new Whole Foods store generated substantially more sales of natural and organic products than existed in the area prior to the opening";
- "[I]n every instance, the new Whole Foods store generated substantially more in sales than the Wild Oats store previously had";
- "A significant number of Whole Foods customers 'cross-shop' between Whole Foods and other supermarkets, such as Delhaize, Kroger, Safeway, Albertsons, Ahold, Publix, and H-E-B";
- "Wild Oats customers also cross-shop at conventional supermarket";
- "[S]ome Whole Foods' customers shop in other stores as often as once a week"; and
- "Research by other supermarket chains also shows that their customers are cross-shopping at Whole Foods."[18]

Based on evidence that marginal consumers constituted a significant portion of the business, he concluded that the likely loss of sales would make a price increase unprofitable.

The parties also focused their arguments around the fact that they intently focused on competition from other grocery store operators. For instance, Whole Foods' internal business documents showed that Whole Foods not only checks its prices against the prices of other supermarkets, but also performs a competitive assessment of other supermarkets with regard to "prices, product offerings, configuration, and other attributes."[19] Additionally, according to a 2006 study by the Natural Marketing Institute, "there is a significant overlap of private label offerings between Whole Foods, Safeway, Kroger, Costco, and Ahold, although each retailer has put effort into diversifying their product line."[20] Whole Foods' Senior Coordinator for Private Label also explained that, "[b]ecause more than [redacted] of Whole Foods shoppers cross-shop at Trader Joe's, other supermarkets, and mass market stores, we want customers to purchase from Whole Foods more of the products they purchase from competing stores."[21]

17 *Id.* at 17.

18 *Id.* at 20, 26-27.

19 *Id.* at 29, n.14.

20 *Id.* at 30.

21 *Id.*

The same focus on other supermarket competitors exists when Whole Foods looks at new sites for stores, as it considers every significant supermarket chain in the area a potential competitor and in projecting sales at the new store, it presumes that the vast majority of its sales will come from other large supermarket chains. Wild Oats' internal documents show similar consideration of all other supermarkets when it conducts its site selection process. The parties not only appeared to consider other chains when opening new stores, but as Whole Foods' Co-President A.C. Gallo stated:

> "[E]very time [Safeway, Giant Eagle, Giant, Stop & Shop, Harris Teeter, Food Lion, and Publix] open[s] a new store or remodel[s] an existing one with better perishables and natural foods we see a hit. [. . .] [Shoppers that] come to us for certain special items do not have to come to us as frequently now."[22]

As much as Whole Foods' and Wild Oats' own documents showed the parties considered other supermarkets as significant competitors, the parties pointed to evidence that other supermarkets believed they competed with Whole Foods and Wild Oats. From evidence about other supermarkets routinely price-checking Whole Foods and adjusting prices as a result, to the number of new private-label organic product offerings at various supermarkets, the parties pointed to the internal business documents of other supermarkets to demonstrate that these supermarkets acted as a constraint on Whole Foods.[23]

III. The Evidence Focused On by the Court

A. MARKET DEFINITION

In a 93-page decision, district court Judge Paul Friedman analyzed a variety of evidence presented by the parties. His opinion focused extensively on the evidence concerning the proper definition of the relevant product market.[24] The court looked in particular at the economic evidence in concluding, "because so many people are cross-shopping for natural and organic foods and are marginal rather than core customers, the actual loss from a [small but significant and non-

22 *Id.* at 31.

23 *Id.* at 29, 44-48.

24 *Id.* at 14.

transitory price increase] would exceed the critical loss."[25] From this finding, the court concluded that, "the relevant product market within which to evaluate the proposed transaction must be at least as broad as the retail sale of food and grocery items."[26]

The court also relied on evidence presented by Dr. Scheffman concerning the effect of Whole Foods' entry, including:

- When Whole Foods enters a market, it "generates substantial sales that are overwhelmingly captured from the local traditional or conventional supermarkets and grocery retailers regardless of whether there are other [premium natural and organic supermarkets] in the areas"[27]; and
- Combined Whole Foods and Wild Oats revenues after entry of Whole Foods are much greater than the revenues of the Wild Oats store prior to entry.

The court considered the evidence presented by Dr. Murphy that margins and volume in nearby Wild Oats stores decreased after Whole Foods entered. The court implicitly accepted, for purposes of analysis, that such evidence was correct. Where the court disagreed, however, was with the interpretation of that evidence. While Dr. Murphy concluded by analogy that if Whole Foods closed a Wild Oats store that prices at the Whole Foods store would increase, the court was unwilling to make that leap. It was "unwilling to accept the assumption that the effects on Wild Oats from Whole Foods' entries provide a mirror from which predictions can reliably be made about the effects on Whole Foods from Wild Oats' future exits if this transaction occurs."[28]

THE COURT IMPLICITLY ACCEPTED, FOR PURPOSES OF ANALYSIS, THAT SUCH EVIDENCE WAS CORRECT. WHERE THE COURT DISAGREED, HOWEVER, WAS WITH THE INTERPRETATION OF THAT EVIDENCE.

While the opinion began with a discussion spanning about 13 pages of the economic evidence, the court then considered evidence on a variety of subjects. First, the court considered the nature of consumer demand for natural and organic products, focusing on evidence presented by the defendants' food marketing expert as well as the deposition transcripts. The court noted that "a typical

25 *Id.* at 19.

26 *Id.*

27 *Id.* at 20.

28 *Id.* at 21.

Whole Foods store carries all the traditional categories of products"[29] and Whole Foods and Wild Oats "target a large base of supermarket shoppers who shop for larger categories of food products in competition with other supermarkets."[30] It cited various testimony of the parties' employees in recognizing that they emphasize high levels of customer service and "have an emphasis on 'social and environmental' responsibility."[31] The court pointed to Whole Foods' internal documents indicating that it faced "eroding product differentiation," and to evidence that Whole Foods' supermarket competitors reacted to consumer demands for fresh, natural, and organic foods, such as by launching their own private-label store brands of natural and organic foods.[32]

In considering whether consumers would switch retailers in the event of a price increase, the court found evidence that "the majority of natural and organic goods sold in the United States are sold by so-called 'conventional' supermarkets" and that Whole Foods and Wild Oats customers cross-shop at conventional supermarkets and vice versa.[33]

The court recited the various evidence that showed that Whole Foods and Wild Oats competed with conventional supermarkets and vice versa. While the information as to other supermarkets' views of Whole Foods was largely redacted, the several pages devoted to that subject show that the evidence must have been extensive and persuasive. In addition, the court cited evidence from Whole Foods' documents and testimony, in particular:

(i) Whole Foods' pricing against other supermarkets and being price-checked by them, and

(ii) Whole Foods' consideration of every significant supermarket chain as a potential competitor when it reviews a potential store location.[34]

Finally, the court analyzed the parties' actual prices and pricing strategies in rejecting the notion that Whole Foods and Wild Oats uniquely constrained each other. It pointed to evidence that:

29 *Id.* at 22.

30 *Id.* at 23.

31 *Id.* at 23, 28.

32 *Id.* at 25.

33 *Id.* at 27.

34 *Id.* at 29.

- "Whole Foods does not have any specific competitive policies, practices, or strategies directed specifically at Wild Oats";[35]
- Wild Oats' prices are generally higher than Whole Foods'[36]; and
- The proportion of Wild Oats' sales that might transfer to Whole Foods after a merger is a small portion of Wild Oats' sales.[37]

B. ANALYSIS OF HARM TO COMPETITION

The court then turned to an analysis of the competitive effects of the transaction, holding that the evidence overcame any presumption of anticompetitive effects.

First, the court was swayed by evidence that, "Whole Foods and Wild Oats pricing practices do not differ based on the presence or absence of the other in the area."[38] Whole Foods does not have price zones or other pricing policies that depend on whether a Whole Foods store competes with a Wild Oats store. In one example, after Wild Oats closed its store, the Whole Foods store experienced no increase in margins.[39]

Second, in light of the evidence that Wild Oats' prices are consistently higher, the court held that it offers no unique constraint on Whole Foods.[40] In fact, evidence that Whole Foods often does not price-check Wild Oats for that reason was of significant weight to the court.[41]

Third, the court pointed to evidence from the parties and their experts that there had been significant repositioning and entry by other retailers into premium natural and organic products and that such repositioning and entry is continuing. Going through numerous retailers' strategies in some detail, the court concluded that there are "firms that have already proven themselves adept at repositioning and proving competitive in the premium natural and organic food field."[42]

35 *Id.* at 33.

36 *Id.*

37 *Id.* at 34.

38 *Id.* at 39.

39 *Id.* at 40.

40 *Id.*

41 *Id.* at 41.

42 *Id.* at 41-43.

As interesting as what evidence the court focused on is what evidence the court did not discuss at all. There was no mention of two fundamental pieces of evidence emphasized by the FTC.

First, the court made no mention of the various statements by Whole Foods—through its CEO and in its documents—that indicated this deal was motivated by a desire to eliminate significant competition and "avoid nasty price wars." This is somewhat puzzling in light of the significant focus the FTC placed on this evidence. Perhaps the court accepted the argument made by Whole Foods' counsel during the closing arguments that the CEO is very literal, believes all acquisitions reduce competition, and dislikes all of his competitors.

Second, the court did not address the FTC's evidence that Whole Foods was planning to close stores and that such store closings were inherently anticompetitive. The court may have simply found addressing this unnecessary; once it determined the product market expanded beyond the stores of the merging parties, the mere closing of a handful of stores would not be expected to have any impact on competition.

The inevitable question raised by the *Whole Foods* decision is why was the result different than in the seemingly similar *FTC v. Staples*[43] matter? The simple answer is the pricing data. In *Staples*, there was evidence that Staples priced higher in markets without office superstore competition and that it set price zones based on the extent of office superstore competition.[44]

But, the more complicated answer is that the court in *Whole Foods* was persuaded by a range of evidence. The bulk of the opinion was not about the critical-loss analysis, nor Dr. Scheffman's one-day pricing study. It was about how Whole Foods set its prices, who it price-checked, what its competitors were doing, what Whole Foods' documents said about those competitors, and the like.

IV. Evidence the Appeals Court Will Be Asked to Focus On

The Commission has appealed the district court's opinion to the U.S. Court of Appeals for the DC Circuit. The crux of the Commission's appeal is that the district court simply ignored evidence presented by the FTC. First, they summarized the contents of the various documents of the parties:

- characterizing Whole Foods and Wild Oats as the only two players of substance in the organic and all natural arena;

43 970 F. Supp. 1066 (D.D.C. 1997).

44 *Id.* at 1078.

- suggesting that repositioning is difficult; and
- suggesting that the purpose of the merger was to eliminate competition.[45]

They also criticized the court's reliance on declarations of the parties, rather than these documents.[46] However, that criticism is too simplistic. The parties' declarations were peppered with preexisting documents that supported the declarants' statements.[47]

Second, they contend that the district court ignored various econometric analyses by Dr. Murphy. One was a study that showed Whole Foods cut its prices where it faced competition from Earth Fare, a regional chain of premium natural and organic supermarkets. From this, Dr. Murphy concluded something similar would occur where Wild Oats entered. Another was a study that indicated that Whole Foods only marginally lowered its prices in response to market entry by Safeway Lifestyle in Boulder, Colorado, but dramatically lowered prices in anticipation of Wild Oats' entry. The judge had excluded the latter study as untimely.[48]

Finally, the FTC argues that the expert evidence the district court relied on was flawed.[49] Here, they focus on Dr. Scheffman's testimony. They note that the district court "entirely failed, for example, to address Dr. Scheffman's admission that *he had made no effort to calculate* 'actual loss'." (emphasis added)[50] They also deny any basis for Dr. Scheffman's assumption of the fact that "cross shopping" meant that consumers would readily switch to conventional grocery stores in the event of a price increase. They pointed to a document indicating that consumers shop at different stores for different products.

As of the time of this article, Whole Foods and Wild Oats had not filed a brief in response, but they will no doubt argue that the judge examined the evidence properly. They will focus on the fact that the court cited the parties' documents as well as declarations containing those documents numerous times. They will note that those documents are consistent with actions of the parties that the

45 *See* Proof Brief for Appellant Federal Trade Commission at 7-13, FTC v. Whole Foods Mkt., Inc., No. 07-5276 (D.C. Cir. Jan. 14, 2008) [hereinafter Appellant Proof Brief].

46 *Id.* at 13.

47 *See* Paul H. Friedman & Gorav Gindal, *Federal Trade Commission v. Whole Foods Market, Inc. — A View From the Dugout,* 8 The Threshold 3, 3 (Fall 2007) [hereinafter *A View From the Dugout*], *available at* http://www.dechert.com/library/Friedman and Jindal Fall 2007 - FTC - Whole Foods.pdf.

48 Appellant Proof Brief, *supra* note 45, at 45-48.

49 *Id.* at 52.

50 *Id.*

court placed great weight on (e.g., that Whole Foods price-checked other stores, but did not price-check Wild Oats, and that Whole Foods examined all competitors in considering new store locations). The parties will point to the fact that the court considered Dr. Murphy's primary analyses, but found that the analogy he tried to draw did not hold. They may well note that the FTC did not even attempt to cross-examine the industry expert, Dr. Stanton, nor did it make reference in its brief to his testimony which is cited some fifty-five times in the district court opinion.[51] And, they will likely note that some of Dr. Scheffman's assumptions were supported by the expert industry testimony of Dr. Stanton.

One cannot predict how the U.S. Court of Appeals for the DC Circuit will rule in this matter. However, several conclusions about the role of the evidence can be drawn from this case. First, it should come as no surprise to anyone who has ever worked on either side of a merger investigation that the documents rarely support one view uniformly. For every document the FTC points to that suggests the parties focus most intensely on each other, the parties have a document from which one can draw the conclusion that the traditional supermarkets' efforts to sell more organic and natural produce are of great concern to the parties.

WHAT IS CLEAR IS THAT THERE IS NO "REAL EVIDENCE" IN THIS CASE. THERE IS NO SINGLE PIECE OF EVIDENCE THAT STANDS ABOVE THE REST, NO "MAGIC BULLET" EXPERT TESTIMONY, NO "SMOKING GUN" STATEMENT BY THE PARTIES' CEOS

Second, the expert reports played a fairly important role in this case and the court's opinion, but it would be incorrect to characterize this case as a war of the experts. The documents and parties' testimony played an equally large part, and in fact accounted for a larger portion of the district court's opinion.

Finally, what is clear is that there is no "real evidence" in this case. There is no single piece of evidence that stands above the rest, no "magic bullet" expert testimony, no "smoking gun" statement by the parties' CEOs. Instead, there is a variety of evidence that is probative on the salient issues of the case and it is how one feels about the bulk of that evidence that determines the outcome. The Commission felt it supported a challenge; the district court did not. How the court of appeals will assess the evidence remains to be seen.

51 *A View From the Dugout*, *supra* note 47, at 7, n.8; *see also Whole Foods*, 502 F. Supp. 2d 1.

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How Should Competition Law Be Taught?

Einer Elhauge

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How Should Competition Law Be Taught?

Einer Elhauge

In a recent review of *Global Competition Law and Economics*, a book I co-wrote with Damien Geradin, John Kallaugher raises some interesting questions about the very premises of the book.[1] These questions seem worth addressing because they go well beyond an assessment of the book to raise fundamental pedagogical issues about the best approach to teaching competition law in the 21st century.

The fundamental differences are threefold. John Kallaugher argues that competition law courses should:

(1) favor vocational training over analytical and economic issues;

(2) limit their scope to a single legal jurisdiction; and

(3) focus on procedure rather than substance.

The premises of the book are precisely the opposite, and conform to my own views about how best to teach a competition law course. First, competition law courses should focus on underlying analytical and economic ideas, rather than on vocational memorization of particular doctrinal formulations, mainly because it is the underlying ideas that drive the actual resolution of cases. Those ideas are

1 The book is E. Elhauge & D. Geradin, Global Antitrust Law & Economics (Foundation Press 2007). The review is J. Kallaugher, *Review of Elhauge & Geradin's* Global Competition Law and Economics, 3(2) Competition Pol'y Int'l 241-48 (Autumn 2007).

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thus central to good antitrust lawyering, as well as to a sophisticated understanding of the content of modern competition law. Second, competition law courses should abandon the blinkered focus on one legal jurisdiction, because the reality of modern international markets means that business and law firms must understand the combination of laws that apply to conduct and mergers, and ideas and trends in legal development constantly flow between jurisdictions. Third, competition law courses should focus on the substance of how cases are resolved, rather than fixating on procedural rules, because it is the substantive analysis that is more distinctive to competition law, harder for lawyers to learn on the job, and in the end determines how businesses can act.

Before addressing these more fundamental issues, I should offer a word of appreciation for John Kallaugher's kind praise for the quality of the book. He calls it a "very strong work," commends the editing and choice of materials, and compliments the thoughtfulness and clarity of the questions, commentary, and economics analysis.[2] He also acknowledges that the book does a good job of explaining the basic analytical framework common to U.S. and EC law.[3] Rather, "the real issue" to him is "what a course on basic antitrust law is meant to achieve."[4] That is an issue on which we have a real difference, and because he has been so charitable on the book's quality, I focus on that fundamental issue, which can be broken down into three sub-issues.

First, John Kallaugher argues that the "primary goal" of a competition law course should not be "to help students understand and apply the analytical model," but rather should be "vocational training."[5] On this, I could not disagree more: law schools should aspire to being much more than vocational trade schools whose job is to just teach doctrine. This would be so even if we adopted the narrow careerist perspective that we did not care whether students understood the deeper theoretical and policy issues about competition law, as long as we taught them skills they could use as practicing lawyers. The reason is that good lawyering depends on understanding the underlying analytical and economic models. Lawyering without such an understanding is bad lawyering, because formalisms that lack firm grounding in functional theories are unhelpful and unpersuasive in practice. The lawyer who argues nothing but for-

LAW SCHOOLS SHOULD ASPIRE TO BEING MUCH MORE THAN VOCATIONAL TRADE SCHOOLS WHOSE JOB IS TO JUST TEACH DOCTRINE.

2 *See* Kallaugher (2007), *supra* note 1, at 242-43 and 247.

3 *Id.* at 244-45.

4 *Id.* at 245.

5 *Id.* at 245-46.

malisms and spins of case quotations will lose to the lawyer who offers a functional theory that can make economic sense of the doctrine in a way that adjudicators find attractive. The lawyer who does not understand the underlying antitrust analysis and economics cannot effectively cross examine expert witnesses or understand the key issues in her own case, and the adjudicator who does not understand the underlying ideas will make bad decisions that worsen market performance and harm consumer welfare.

Nor does it make sense to focus on doctrinal details at the expense of the underlying theoretical issues, because the doctrinal details change from year to year and jurisdiction to jurisdiction. Such a focus would thus fill students' minds with what is most likely to become obsolete. Further, in competition law the legal doctrines often consist of vague formulations, like "dominant position", "monopoly power", "abuse of dominance", or "exclusionary conduct", that are devoid of real content unless one understands the underlying analytical model and economics.

Even if one were merely interested in doctrine for vocational reasons, I think there would be little basis to his claim that this book would not be useful to a student likely to practice in the United States.[6] The book includes every antitrust topic covered by the leading U.S. antitrust casebooks, and just about every case (other than those whose interest is mainly historical), as well as adding many cases other U.S. casebooks do not include. Perhaps he would also say that none of the U.S. antitrust casebooks prepares students for antitrust practice, but if so, that just underscores that the underlying issue is a fundamental difference about the best approach for preparing students for practice.

Second, John Kallaugher argues that competition law is not really global.[7] Here, I think he confuses being global with being uniform. The book certainly acknowledges that competition law is not uniform. The difference is much less than one would think from superficial differences in doctrinal formulations. But focusing on the underlying analytical and economic issues does reveal some real areas of substantive difference. This does not undermine a global approach, though, because firms on international markets must conform their conduct to antitrust regulation by multiple nations and, as he acknowledges, the various nations share a common analytical approach. His premise that being global must mean being uniform is odd, because he acknowledges that U.S. contract law is a single body of law, even though it is not uniform. Likewise, his claim that product safety law illustrates the inadvisability of a multi-jurisdictional approach seems odd, because in fact multi-state approaches are taken to teaching product safety law in the United States.

6 *Id.* at 248.

7 *Id.* at 243-44.

He also makes the related claim that "no lawyer can claim to practice global antitrust law or offer advice on a truly global basis."[8] This claim is thoroughly disproven by the modern reality of competition law practice by global law firms. Not only does each leading antitrust law firm stress its global practice, it is clear that they are actively taking their sophisticated understanding of antitrust analysis and applying it to great advantage in other nations. Indeed, I understand that the international extension of antitrust practices is one of the major growth areas in modern law firms. In my own experience, analysis of mergers and challenged conduct in jurisdictions throughout the world turns much more on underlying conceptual and policy analysis that is common to all the jurisdictions, than on specific doctrinal formulations that differ.

John Kallaugher also argues that a global approach obscures the unique aspects of individual systems.[9] In fact, the supposed examples he points to involve issues where he missed the portions of the casebook that addressed those aspects.[10] More important, if we have slighted any unique aspects, then that simply reflects our failings as authors, rather than the inevitable result of taking a global approach. Indeed, I have found precisely the contrary: presenting the materials in a global framework *highlights* the unique aspects of individual systems because contrast throws them into sharp relief. For example, as a U.S. antitrust teacher, I could never quite get students to seriously debate whether predatory pricing doctrine should have a recoupment element and be extended to above-cost price cuts, and thus could not really drive home the importance of those elements to the nature of U.S. antitrust law. But because each contrasts with the different conclusions of EC law, the unique features of each jurisdiction are very much put in sharp relief, and far better understood.

PRESENTING THE MATERIALS IN A GLOBAL FRAMEWORK *HIGHLIGHTS* THE UNIQUE ASPECTS OF INDIVIDUAL SYSTEMS BECAUSE CONTRAST THROWS THEM INTO SHARP RELIEF.

8 *Id.* at 244.

9 *Id.* at 246-47.

10 For example, he says we failed to deal with the structure of Article 81(3) EC analysis (*id.* at p.247, n.10). In fact, we do so many times (*see* DAMIEN & GERADIN (2007), *supra* note 1, at 63-65, 93-96, 109-14, 180, 220-23, 310-11, 313, and 667-71). He claims we missed the point that, given lower thresholds for dominance, Article 82 may cover the same ground as attempted monopolization (Kallaugher (2007), *supra* note 1, at 247, n.9). In fact, we made that point explicitly (DAMIEN & GERADIN (2007), *supra* note 1, at 233). He also asserts the book errs by saying the excessive pricing doctrine comes from the courts rather than the treaty (Kallaugher (2007), *supra* note 1, at 247, n.9). In fact, we are explicit that "Article 82(a) … expressly states that an abuse may, in particular, consist of unfair prices or output limitations" (DAMIEN & GERADIN (2007), *supra* note 1, at 233). So we didn't miss the point at all. The part he seems to miss, though, is that the "may" and "unfair prices" language could have been interpreted by the Court to be discretionary or applicable to more limited phenomenon.

Third, John Kallaugher asserts that competition law issues are not usually substantive, but rather procedural.[11] To him, "[i]n the vast majority of cases, the issues raised by such filings are procedural (e.g., filling in the proper forms, obtaining the required information, delaying the 'closing' until clearance is obtained)."[12] Once again, we have quite a difference in perspective. Perhaps procedural issues account for more billable hours, but the issues that actually determine outcomes are the substantive ones. And it is the results that clients pay for, and that ultimately matter.

It also seems to me that, in choosing what to teach in a competition law course, it is important to consider which issues are most distinctive to competition law and most need systematic treatment in a course. Procedural issues are common to many courses and can be picked up much more easily in practice. The substance of competition law is unique and much harder to pick up on the fly.

None of this is to deny that procedure is important. Indeed, our book does devote one of the eight chapters entirely to procedure, and stresses throughout how different procedures and remedies might explain U.S.-EC differences in substantive law. However, it is certainly true that the book reflects a deliberate decision to focus on substantive issues. In this, it represents a change from old EC competition law books, which seemed oddly uninterested in substance and instead focused on rather dull technicalities of procedure. But it seems to me that approach never made much sense, and in any event the era for it has long since passed.

John Kallaugher also raises some other more specific objections, but as he rightly points out, the disagreement on specific points is not the "real issue." The real issue is does one favor, as he does, an approach that stresses vocational training over analytical and economic issues, limits itself to a single jurisdiction, and focuses on procedure rather than substance. If those are one's preferences, then I must cheerfully acknowledge ours is not the book for you. It is, rather, quite proudly, a book that stresses analytical and economic issues as essential to good antitrust lawyering, that considers a global perspective as reflecting the reality and future of antitrust, and that focuses on substance rather than fixating on procedures. In short, the choice boils down to whether one thinks antitrust courses should be vocational, parochial, and procedural or instead theoretical, global, and substantive. The latter three elements are, I think, central to a well-designed antitrust course—no matter what book one uses to teach it.

11 Kallaugher (2007), *supra* note 1, at 244, 247.

12 *Id.* at 244.

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Introduction to Chapters VII and IX of Augustin Cournot, *Researches into the Mathematical Principles of the Theory of Wealth*

Michael A. Salinger

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Introduction to Chapters VII and IX of Augustin Cournot, *Researches into the Mathematical Principles of the Theory of Wealth*

Michael A. Salinger

I. Introduction

In November 2007, the European Commission accepted a set of guidelines concerning its review of non-horizontal mergers. The section on conglomerate mergers contains a discussion of the possibility that merging firms will bundle their products together. It reads, in part:

> "[W]hen producers of complementary goods are pricing independently, they will not take into account the positive effect of a drop in the price of their product on the sales of the other product. Depending on the market conditions, a merged firm may internalise this effect and may have a certain incentive to lower margins if this leads to higher overall profits (this incentive is often referred to as the "Cournot effect")."[1]

1 Commission Notice, Guidelines on the assessment of non-horizontal mergers under the Council Regulation on the control of concentrations between undertakings ¶117 (Nov. 28, 2007), *at* http://ec.europa.eu/comm/competition/mergers/legislation/nonhorizontalguidelines.pdf (last visited Apr. 8, 2008).

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The Cournot to which this passage refers is Augustin Cournot, the nineteenth century French mathematician whose treatise *Recherches sur les principes mathématiques de la théorie des richesses* (*Researches into the Mathematical Principles of the Theory of Wealth*) was published in 1838.[2] The two chapters of the English translation of the book reprinted in this issue are the two that are most relevant for industrial economics and antitrust enforcement. The first of these chapters presents what is known as the Cournot oligopoly model. The second concerns pricing decisions by monopolist sellers of complementary products and is the basis for the "Cournot" effect referenced in the EC's non-horizontal merger guidelines.

While these chapters cover topics in what is now known as industrial economics, the book as a whole is not a precursor of modern industrial economics texts. Economists today would characterize the subject of the book as price theory (at the University of Chicago and like-minded places) or microeconomic theory (everywhere else). The reference to wealth is a bit misleading, as it seems to suggest a treatment of saving and investment. For Cournot, what made something a source of wealth was the ability to exchange it in a market. Therefore, an individual's wealth depends critically on the price he can receive for whatever he has to sell, hence the link between the reference to wealth in the title and the book's focus on prices.

Even if the reference to wealth in the title misleads modern readers, the reference to mathematics will not. The book is not highly sophisticated by modern standards in economics, but the treatment is most definitely mathematical. Readers comfortable with mathematics (i.e., most antitrust economists and some antitrust attorneys) will find the chapters republished in this issue to be a real pleasure. The chapters will be more of a challenge to those who are not "fluent" in mathematics (i.e., most, but not all, antitrust attorneys); but, as I try to explain in Section III of this paper, they are worth reading while skipping over the equations. Before turning to that explanation, I briefly address what, as an economist, I found most interesting.

II. Interest to Economists

My first reaction upon revisiting this book after many years is how far ahead of his time Cournot was. Few modern economists question the proposition that mathematics is an essential tool of economic theory. Indeed, to be a modern "economic theorist", one must, virtually by definition, construct mathematical models. The likes of John Kenneth Galbraith and Joseph Schumpeter no longer count as economic theorists. This was not the case when Cournot wrote. The

2 Augustin Cournot, Researches into the Mathematical Principles of the Theory of Wealth (N.T. Bacon trans., Augustus M. Kelley, 1971) (1838) [hereinafter Cournot (1838)]. Chapters VII and IX are reprinted in this issue, 4(1) Competition Pol'y Int'l 283-305 (Spring 2008) [hereinafter Cournot reprint].

preface to Cournot's book takes on what he views as a condemnation of the use of mathematics by the "theorists" of political economy of his time such as Adam Smith, Jean-Baptiste Say, and David Ricardo. In Cournot's view, Smith and Say "preserved all the beauties of a purely literary style;"[3] whereas Ricardo, who did rely on algebra, "disguised it under arithmetical calculations of tiresome length."[4] The notion that mathematics was a useful tool for exploring the generality of economic propositions was not even the cutting edge of economics until the late nineteenth century. For economists, this book, published in 1838, reads remarkably well today.

FOR ECONOMISTS, THIS BOOK, PUBLISHED IN 1838, READS REMARKABLY WELL TODAY.

Given how innovative Cournot's approach was, a second remarkable feature is how much progress he was able to make. Cournot was the first economist to write a mathematical equation for the demand curve that linked the quantity demanded to the price charged.[5] From such a rudimentary beginning, it would have been impressive had he merely derived the monopoly price. His contributions far exceeded that, however. Not only did he derive a coherent model of duopoly, he generalized the model to an arbitrary number of firms,[6] allowed for the possibility that the firms would have different costs, and showed that perfect competition is the limit of the Cournot oligopoly model as the number of firms goes to infinity.[7] This is just what he covered in two chapters, neither of which includes the chapter that arguably contains the book's most enduring insight.

Finally, Cournot's analysis was the first example of mathematical game theory (i.e., the mathematical analysis of interdependent decisions). In both the chapters reprinted in this issue, the equilibria are examples of what are now referred to as Nash equilibria. Cournot does not seem to have appreciated the inherent indeterminacy of oligopolistic outcomes. In a paragraph to which I return later in this paper, he clearly understood the incentive for oligopolists to coordinate on outputs and prices, but he does not seem to have anticipated the possibility that they could do so without explicit coordination.

It is interesting that he chose to model duopolists as choosing outputs and complementary monopolists as choosing prices. Cournot does not explain the difference in modeling choices, but he does point out that his arguments gener-

3 Cournot (1838), *id.* at 4.

4 *Id.*

5 *Id.* at ch. IV, "Of the Law of Demand."

6 Cournot reprint, *supra* note 2, at 287.

7 Cournot (1838), *supra* note 2, at ch. VIII, "Of Unlimited Competition."

ally require that the mathematical functions underlying the analysis be continuous.[8] With homogenous products, the profit functions for oligopolists choosing prices (taking the competitor's price as given) are discontinuous at the competitor's price. In a model of complementary monopolists choosing outputs, the payoff functions are continuous, but they have a kink at the quantity chosen by the other firm. This kink then complicates the determination of the division of the value between stages, one of the topics Cournot sought to address. The differences in the choices might well have been for purely mathematical reasons.

Regardless of his reasons, from the standpoint of economic theory, how to combine the two models presented here (i.e., how to construct a model with a small number of suppliers at successive or complementary stages when some of the firms produce at both), is quite a challenging problem. As part of the development of its guidelines, the European Commission commissioned Professor Jeffrey Church to survey the theoretical literature for possible insights to serve as a basis for the guidelines.[9] That report contains an extensive discussion of attempts to combine the two models. As a thorough review of the issues is beyond the scope of this introduction, interested readers should read the Church report. Suffice it to say, Cournot's modeling choices glossed over some deep issues.

This last point is no more a criticism than it would be a critique of the Wright brothers that their plane was primitive by modern standards. First efforts are supposed to be primitive. In Cournot's case, he advanced the ball so far that it took the profession many years to catch up and advance it further. Economists will marvel at these chapters, and I suspect many who have not done so already will be inspired to read the book in its entirety.

III. Interest to Antitrust Practitioners

Less mathematically inclined readers might not share economists' wonder and awe at Cournot's achievement. Indeed, some might suspect that Cournot was where all the trouble began. But, they too should marvel at the work. If Cournot's insights had been appreciated before they in fact were, many of the false steps made by early antitrust analysis might have been avoided.

The first of the chapters reprinted in this issue, chapter VII, "Of the Competition of Producers," contains analysis that is at the heart of much of antitrust enforcement. It follows the derivation in chapter V of the monopoly price and the analysis in chapter VI of the effect of tax on the price of a monopolized commodity. Chapter VII begins with an extension of the number of firms

8 *Id.* at 49.

9 Jeffrey Church, The Impact of Vertical and Conglomerate Mergers on Competition, Report for DG Competition, European Commission (Sep. 2004), *available at* http://ec.europa.eu/comm/competition/mergers/studies_reports/merger_impact.pdf.

in the market from one to two. Starting with the end of the second paragraph, Cournot hones in on a key issue. He is analyzing the market outcome under duopoly assuming firms act independently. As he correctly points out, the firms would choose the monopoly price if they could come to an agreement. The following mathematical analysis culminates at the end of paragraph 45. Mathematically, the key is that the "root of equation (3) is always smaller than that of equation (4)."[10] The economic significance is that "the result of competition is to reduce prices."[11] Even those who do not understand how a mathematical equation could have this meaning will be hard-pressed to imagine a more concise statement of the philosophy underlying antitrust laws.

> IF COURNOT'S INSIGHTS HAD BEEN APPRECIATED BEFORE THEY IN FACT WERE, MANY OF THE FALSE STEPS MADE BY EARLY ANTITRUST ANALYSIS MIGHT HAVE BEEN AVOIDED.

Do not, however, skip to the bottom line, as some of the intermediate argument contains great insight. In the two full proceeding paragraphs, Cournot considers the question of why producers do not choose the price that maximizes industry profits (i.e., "the value of *p* derived from equation (4)"). He goes on to explain that if one firm were indeed to produce half the monopoly output, then:

> "the other will be able to fix his own production at a higher or lower rate with a *temporary benefit*. To be sure, he will soon be punished for his mistake, because he will force the first producer to adopt a new scale of production which will react unfavourably on producer (2) himself. But these successive reactions . . . will separate them further and further from it. In other words, this condition [. . .], although most favourable for both producers, [] can only be maintained by means of a formal engagement."[12]

Either because the possibility of tacit collusion did not occur to him or because he was skeptical of its practical importance, Cournot apparently believed competitors would have to meet to fix prices to overcome what we now refer to as "Prisoner's Dilemma".

10 Cournot reprint, *supra* note 2, at 287.

11 *Id.*

12 *Id.* at 286. It is puzzling that Cournot did not realize that the competitor would necessarily choose a higher rate of output.

While the conclusion in chapter VII about the relationship between competition and prices was certainly a fundamental insight, the insight of chapter IX, "Of the Mutual Relations of Producers," may have been Cournot's most impressive contribution to antitrust. (If the depth of an insight is judged by how long it took for its importance to be recognized, chapter IX easily trumps chapter VII.) The problem covered by the chapter concerns the pricing of two or more goods that are combined (in fixed proportions) into a third good. The example he gives is the pricing of copper and zinc for the purposes of making brass. Having set up the problem, he goes through a mathematical analysis that in many ways parallels the derivation in chapter VII leading to equation (c), which he then compares to equation (c').[13] Commenting on the comparison, Cournot notes that "there is this essential and very remarkable difference, that the root of (c) is always greater than that of the equation (c') . . . " To translate, the "root of (c)" means the value of p, the price of the final good (brass) with the two monopolized inputs (zinc and copper), that causes equation (c) to be true (i.e., the price consumers would have to pay for brass if the zinc and copper monopolists set their prices independently). The comparison with the "root of (c')" is with the price of the final good if they were to set their prices cooperatively. The "very remarkable difference" is:

> "[T]he composite commodity will always be made more expensive, by reason of separation of interests than by reason of the fusion of monopolies. An association of monopolists, working for their own interest, in this instance will also work *for the interest of consumers*, which is exactly the opposite of what happens with competing producers."[14] (emphasis added)

This result forms the basis for Cournot's admonition in the chapter's introductory paragraph that "[T]he influence of the *mutual relations* of producers of different articles … must not be confounded with that of the *competition* of producers."[15]

The general principle Cournot derived is sometimes referred to as "double marginalization." Cournot showed that it was quite a general principle. But a principle that holds true in general must also hold true in a specific case, and specific cases can be easier to understand. Suppose that in a particular locality, one firm has a state-franchised, unregulated monopoly on peanut butter and another

13 *Id.* at 295.

14 *Id.*

15 *Id.* at 292.

has a state-franchised, unregulated monopoly on jelly. Suppose further that residents of this locality are quite fussy about their peanut butter and jelly sandwiches, insisting that they contain exactly one ounce of peanut butter and one ounce of jelly. Production costs for peanut butter and jelly are both $2.00 per 8 ounce jar, and the monopolist sellers of both currently charge $4.00. They both sell 2 million jars per year, which yields a profit of $4 million each.

THE GENERAL PRINCIPLE COURNOT DERIVED IS SOMETIMES REFERRED TO AS "DOUBLE MARGINALIZATION."

Consumer demand for peanut butter and jelly sandwiches depends on prices. Because consumers purchase them in fixed proportions to make the sandwiches, the demand for each good depends on both prices. Currently, the peanut butter and jelly inputs combined cost consumers $1 per sandwich.[16] Suppose that if the cost to consumers were to drop to $0.90 per sandwich, they would buy 2.6 million jars of both goods.

One way for the price to drop to $0.90 per sandwich would be for the jelly producer to lower its price to $3.20 per 8 ounce jar or $0.40 per ounce (i.e., per sandwich). If it did so, its profits would be ($3.20 – $2.00) × 2.6 million = $3.12 million, or $0.88 million less than it earns when it charges $4.00 per jar. Therefore, it has no incentive to cut the price. The same analysis applies to the peanut butter producer. Suppose, instead, that both monopolists cut their prices to $3.60 per jar, which would also reduce the cost to consumers to $0.90 per sandwich for the peanut butter and jelly input. Then, profits for both would be ($3.60 – $2.00) × 2.6 million = $4.16 million, which is more than the both earn when they both charge $4.00 per jar. Absent a merger or agreement on prices, both have an incentive to keep their price at $4.00 per jar even though a price reduction by both is in their mutual interest. If they were to merge, they would internalize the effect the price reduction of one good has on sale of the other and, therefore, would have an incentive to lower prices.

Today, the fundamental distinction between horizontal and vertical effects is an insight widely accepted by antitrust practitioners. Such was not always the case, however. In 1968, the U.S. Supreme Court ruled in Albrecht v. Herald Co.[17] that maximum resale price maintenance was to be treated as a per se violation of the antitrust laws as if it were equivalent to horizontal price-fixing by competitors. Had the Supreme Court understood Cournot's insight, it would not have taken until its 1997 State Oil Company v. Khan[18] decision to recognize the

16 Given the assumption that a sandwich requires an ounce of peanut butter and an ounce of jelly, buying one eight-ounce jar of each (for a total of $8) provided the peanut butter and jelly needed for eight sandwiches.

17 Albrecht v. Herald Co., 390 U.S. 145 (1968).

18 State Oil Co. v. Khan, 522 U.S. 3 (1997).

difference between vertical and horizontal price-fixing. One can, of course, debate whether Cournot provided a complete justification for the more recent *Leegin* decision,[19] overturning the per se rule against minimum resale price maintenance. Cournot's model explains why a monopolist manufacturer might want to limit the price charged by its retailers, but not why it would set a price floor. Yet, the search for the subsequent explanations[20] arguably started with Cournot's insight that the "*mutual relations* of producers" are fundamentally different from the "*competition* of producers."

It is sometimes said that the mark of a great piece of economic theory is that readers consider its central proposition to be obviously wrong before reading it and obviously right after reading it. Since thirty years passed before virtually anyone acknowledged Cournot's contribution and many more years before its importance was widely recognized, this hallmark of greatness did not occur for each individual reader. But the current widespread view that Cournot's insights are obvious even by people who are challenged by his mathematical approach is testimony to the enduring greatness of his achievement.

19 Leegin Creative Leather Products, Inc. v. PSKS, Inc., 551 U.S. ___ , 127 S. Ct. 2705 (2007).

20 *See* Lester G. Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. ECON. 86-105 (1960); and Howard P. Marvel & Stephen McCafferty, *Resale Price Maintenance and Quality Certification*, 15(3) RAND J. ECON. 346-59 (1984).

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Researches into the Mathematical Principles of the Theory of Wealth

Augustin Cournot

This article is a reprint of Chapters VII and IX of Augustin Cournot, *Researches into the Mathematical Principles of the Theory of Wealth* (N.T. Bacon trans.) (New York: Augustus M. Kelley, 1971) (1838).

Chapter VII: Of the Competition of Producers

43. Every one has a vague idea of the effects of competition. Theory should have attempted to render this idea more precise; and yet, for lack of regarding the question from the proper point of view, and for want of recourse to symbols (of which the use in this connection becomes indispensable), economic writers have not in the least improved on proper notions in this respect. These notions have remained as ill-defined and ill-applied in their works, as in popular language.

To make the abstract idea of monopoly comprehensible, we imagined one spring and one proprietor. Let us now imagine two proprietors and two springs of which the qualities are identical, and which, on account of their similar positions, supply the same market in competition. In this case the price is necessarily the same for each proprietor. If p is this price, $D = F(p)$ the total sales, D_1 the sales from spring (1) and D_2 the sales from the spring (2), then $D_1 + D_2 = D$. If, to begin with, we neglect the cost or production, the respective incomes of the proprietors will be pD_1 and pD_2; and *each of them independently* will seek to make this income as large as possible.

We say *each independently*, and this restriction is very essential, as will soon appear; for if they should come to an agreement so as to obtain for each the greatest possible income, the results would be entirely different, and would not differ, so far as consumers are concerned, from those obtained in treating of a monopoly.

Instead of adopting $D = F(p)$ as before, in this case it will be convenient to adopt the inverse notation $p = f(D)$; and then the profits of proprietors (1) and (2) will be respectively expressed by

$$D_1 \times f(D_1 + D_2), \text{ and } D_2 \times f(D_1 + D_2),$$

i.e. by functions into each of which enter two variables, D_1 and D_2.

Proprietor (1) can have no direct influence on the determination of D_2: all that he can do, when D_2 has been determined by proprietor (2), is to choose for D_1 the value which is best for him. This he will be able to accomplish by properly adjusting his price, except as proprietor (2), who, seeing himself forced to accept this price and this value of D_1, may adopt a new value for D_2, more favourable to his interests than the preceding one.

Analytically this is equivalent to saying that D_1 will be determined in terms of D_2 by the condition

$$\frac{d[D_1 f(D_1 + D_2)]}{dD_1} = 0,$$

and that D_2 will be determined in terms of D_1 by the analogous condition

$$\frac{d[D_2 f(D_1 + D_2)]}{dD_2} = 0,$$

whence it follows that the final values of D_1 and D_2, and consequently of D and of p, will be determined by the system of equations

$$f(D_1 + D_2) + D_1 f'(D_1 + D_2) = 0, \tag{1}$$

$$f(D_1 + D_2) + D_2 f'(D_1 + D_2) = 0. \tag{2}$$

Let us suppose the curve m_1n_1 (Fig. 2) to be the plot of equation (1), and the curve m_2n_2 that of equation (2), the variables D_1 and D_2 being represented by rectangular coördinates.

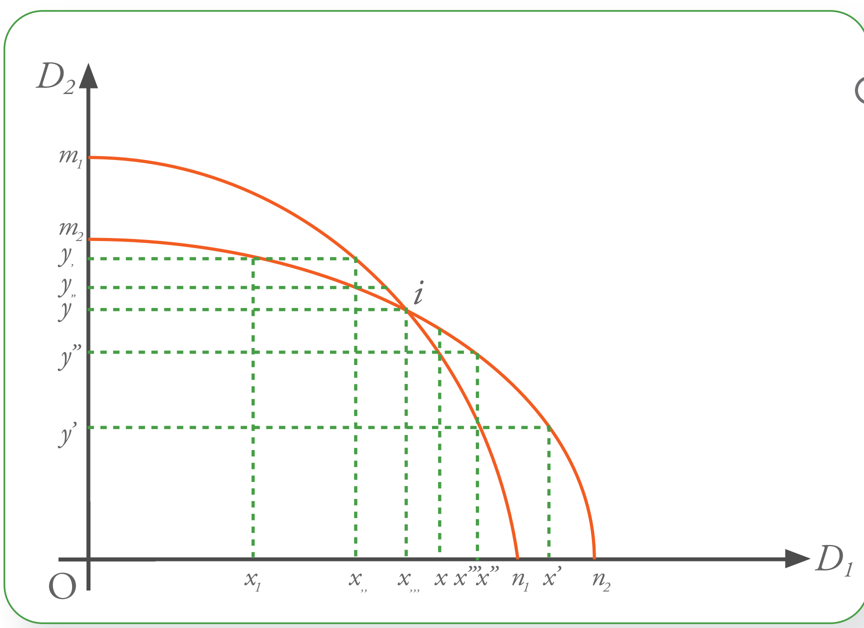


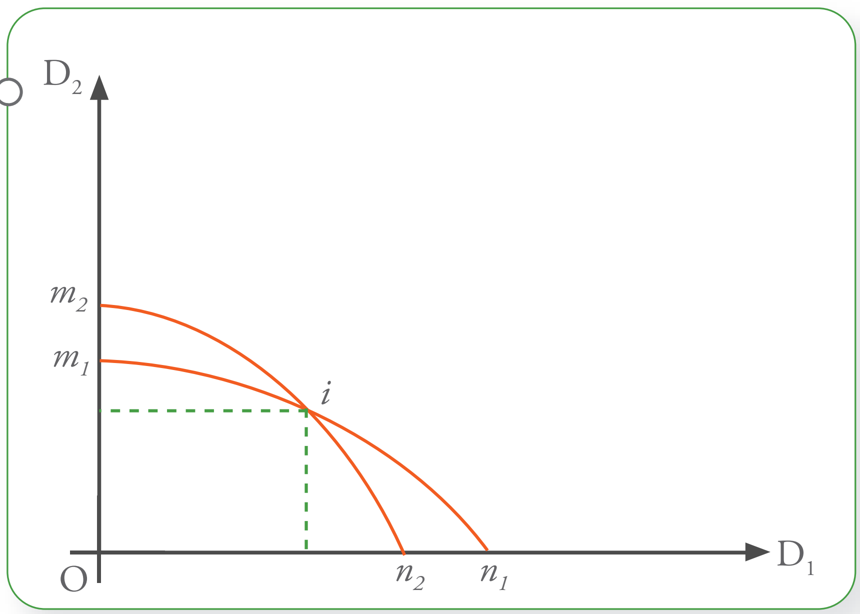
Figure 2

If proprietor (1) should adopt for D_1 a value represented by ox_1, proprietor (2) would adopt for D_2 the value oy_1, which, for the supposed value of D_1, would give him the greatest profit. But then, for the same reason, producer (1) ought to adopt for D_1 the value ox_{11}, which gives the maximum profit when D_2 has the value oy_1. This would bring producer (2) to the value oy_{11} for D_2, and so forth; from which it is evident that an equilibrium can only be established where the coördinates ox and oy of the point of intersection i represent the values of D_1 and D_2. The same construction repeated on a point of the figure on the other side of the point i leads to symmetrical results.

The state of equilibrium corresponding to the system of values ox and oy is therefore *stable*; *i.e.* if either of the producers, misled as to his true interest, leaves it temporarily, he will be brought back to it by a series of reactions, constantly declining in amplitude, and of which the dotted lines of the figure give a representation by their arrangement in steps.

The preceding construction assumes that $om_1 > om_2$ and $on_1 < on_2$: the results would be diametrically opposite if these inequalities should change sign, and if the curves m_1n_1 and m_2n_2 should assume the disposition represented by Fig. 3.

Figure 3



The coördinates of the point i, where the two curves intersect, would then cease to correspond to a state of stable equilibrium. But it is easy to prove that such a disposition of the curves is inadmissible. In fact, if $D_1 = 0$, equations (1) and (2) reduce, the first to

$$f(D_2) = 0,$$

and the second to

$$f(D_2) + D_2 f'(D_2) = 0.$$

The value of D_2 derived from the first would correspond to $p = 0$; the value of D_2 derived from the second corresponds to a value of p which would make the product pD_2 a maximum. Therefore the first root is necessarily greater than the second, or $om_1 > om_2$, and for the same reason $on_2 > on_1$.

44. From equations **(1)** and **(2)** we derive first $D_1 = D_2$ (which ought to be the case, as the springs are supposed to be similar and similarly situated), and then by addition:

$$2f(D) + Df'(D) = 0,$$

an equation which can be transformed into

$$D + 2p\,\frac{dD}{dp} = 0, \tag{3}$$

whereas, if the two springs had belonged to the same property, or if the two proprietors *had come to an understanding*, the value of p would have been determined by the equation

$$D + p\,\frac{dD}{dp} = 0, \tag{4}$$

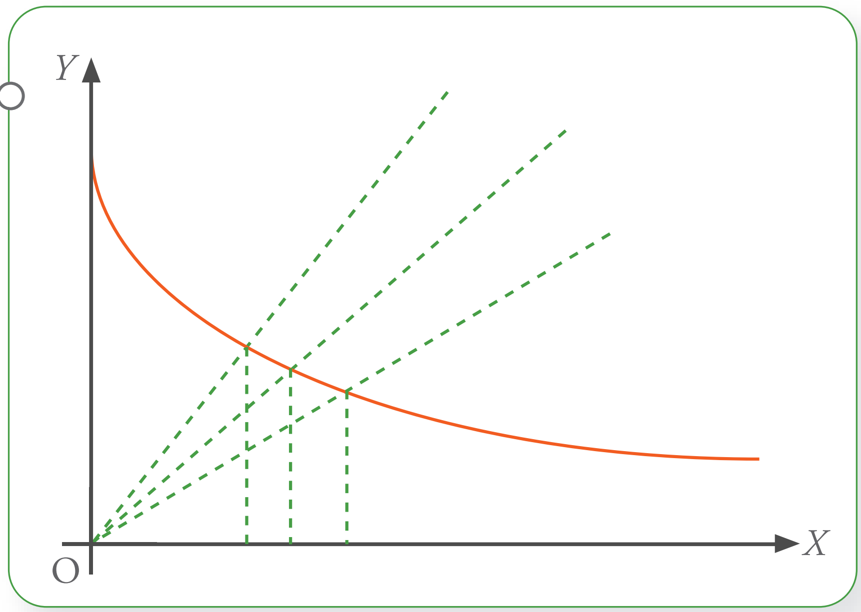
and would have rendered the total income Dp a *maximum*, and consequently would have assigned to each of the producers a greater income than what they can obtain with the value of p derived from equation **(3)**.

Why is it then that, for want of an understanding, the producers do not stop, as in the case of a monopoly or of an association, at the value of p derived from equation **(4)**, which would really give them the greatest income?

The reason is that, producer (1) having fixed his production at what it should be according to equation **(4)** and the condition $D_1 = D_2$, the other will be able to fix his own production at a higher or lower rate with a *temporary benefit*. To be sure, he will soon be punished for his mistake, because he will force the first producer to adopt a new scale of production which will react unfavourably on producer (2) himself. But these successive reactions, far from bringing both producers nearer to the original condition [of monopoly], will separate them further and further from it. In other words, this condition is not one of stable equilibrium; and, although the most favourable for both producers, it can only be maintained by means of a formal engagement; for in the moral sphere men cannot be supposed to be free from error and lack of forethought any more than in the physical world bodies can be considered perfectly rigid, or supports perfectly solid, etc.

45. The root of equation **(3)** is graphically determined by the intersection of the line $y = 2x$ with the curve $y = -\frac{F(x)}{F'(x)}$; while that of equation **(4)** is graphically shown by the intersection of the same curve with the line $y = x$. But, if it is possible to assign a real and positive value to the function $y = -\frac{F(x)}{F'(x)}$ for every real and positive value of x, then the abscissa x of the first point of intersection will be smaller than that of the second, as is sufficiently proved simply by the plot of Fig. 4.

Figure 4



It is easily proved also that the condition for this result is always realized by the very nature of the law of demand. In consequence the root of equation **(3)** is always smaller than that of equation **(4)**; or (as every one believes without any analysis) the result of competition is to reduce prices.

In consequence the root of equation (3) is always smaller than that of equation (4); or the result of competition is to reduce prices.

46. If there were 3, 4, …, n producers in competition, all their conditions being the same, equation **(3)** would be successively replaced by the following:

$$D + 3p\frac{dD}{dp} = 0, D + 4p\frac{dD}{dp} = 0, \ldots D + np\frac{dD}{dp} = 0;$$

and the value of p which results would diminish indefinitely with the indefinite increase of the number n.

In all the preceding, the supposition has been that natural limitation of their productive powers has not prevented producers from choosing each the most advantageous rate of production. Let us now admit, besides the n producers, who are in this condition, that there are others who reach the limit of their productive capacity, and that the total production of this class is Δ; we shall continue to have the n equations

$$\text{(5)} \qquad \begin{cases} f(D) + D_1 f'(D) = 0, \\ f(D) + D_2 f'(D) = 0, \\ \quad \ldots \\ f(D) + D_n f'(D) = 0, \end{cases}$$

which will give $D_1 = D_2 = \ldots = D_n$, and by addition,

$$nf(D) + nD_1 f'(D) = 0.$$

But $D = nD_1 + \Delta$, whence

$$nf(D) + (D - \Delta)f'(D) = 0,$$

or

$$D - \Delta + np \frac{dD}{dp} = 0.$$

This last equation will now replace equation **(3)** and determine the value of p and consequently of D.

47. Each producer being subject to a cost of production expressed by the functions $\phi_1(D_1)$, $\phi_2(D_2)$, …, $\phi_n(D_n)$, the equations of **(5)** will become

$$\text{(6)} \qquad \begin{cases} f(D) + D_1 f'(D) - \phi_1'(D_1) = 0, \\ f(D) + D_2 f'(D) - \phi_2'(D_2) = 0, \\ \quad \ldots \\ f(D) + D_n f'(D) - \phi_n'(D_n) = 0. \end{cases}$$

If any two of these equations are combined by subtraction, for instance if the second is subtracted from the first, we shall obtain

$$D_1 - D_2 = \frac{1}{f'(D)} [\phi_1'(D_1) - \phi_2'(D_2)]$$

$$= \frac{dD}{dp} [\phi_1'(D_1) - \phi_2'(D_2)].$$

As $\frac{dD}{dp}$ is essentially negative, we shall therefore have at the same time

$$D_1 \gtrless D_2, \text{ and } \phi_1'(D_1) \lessgtr \phi_2'(D_2).$$

Thus the production of plant A will be greater than that of plant B, whenever it will require greater expense to increase the production of B than to increase the production of A by the same amount.

For a concrete example, let us imagine the case of a number of coal mines supplying the same market in competition one with another, and that, in a state of stable equilibrium, mine A markets annually 20,000 hectoliters and mine B, 15,000. We can be sure that a greater addition to the cost would be necessary to produce and bring to market from mine B an additional 1000 hectoliters than to produce the same increase of 1000 hectoliters in the yield of mine A.

This does not make it impossible that the costs at mine A should exceed those at mine B at a lower limit of production. For instance, if the production of each were reduced to 10,000 hectoliters, the costs of production at B might be smaller than A.

48. By addition of equations **(6)**, we obtain

$$nf(D) + Df'(D) - \Sigma\phi_n'(D_n) = 0,$$

or **(7)**
$$D + \frac{dD}{dp}[np - \Sigma\phi_n'(D_n)] = 0.$$

If we compare this equation with the one which would determine the value of p in case all the plants were dependent on a monopolist, viz.

(8)
$$D + \frac{dD}{dp}[p - \phi'(D)] = 0,$$

we shall recognize that on the one hand substitution of the term np for the term p tends to diminish the value of p; but on the other hand substitution of the term $\Sigma\phi_n'(D_n)$ for the term $\phi'(D)$ tends to increase it, for the reason that we shall always have

$$\Sigma\phi_n'(D_n) > \phi'(D);$$

and, in fact, not only is the sum of the terms $\phi_n'(D_n)$ greater than $\phi'(D)$, but even the average of these terms is greater than $\phi'(D)$, *i.e.* we shall have the inequality

$$\frac{\Sigma\phi_n'(D_n)}{n} > \phi'(D).$$

To satisfy one's self of this, it is only necessary to consider that any capitalist, holding a monopoly of productive property, would operate by preference the plants of which the operation is the least costly, leaving the others idle if necessary; while the least favoured competitor will not make up his mind to close his works so long as he can obtain any profit from them, however modest.

Consequently, for a given value of p, or for the same total production, the costs will always be greater for competing producers than they would be under a monopoly.

It now remains to be proved that the value of p derived from equation **(8)** is always greater than the value of p derived from equation **(7)**.

For this we can see at once that if in the expression $\phi'(D)$ we substitute the value of $D = F(p)$, we can change $\phi'(D)$ into a function $\Psi(p)$; and each of the terms which enter into the summational expression $\Sigma\phi_n'(D_n)$, can also be regarded as an implicit function of p, in virtue of the relation $D = F(p)$ and of the system of equations **(6)**. In consequence the root of equation **(7)** will be the abscissa of the point of intersection of the curve

$$(a) \qquad y = -\frac{F(x)}{F(x)},$$

with the curve

$$(b) \qquad y = nx - [\Psi_1(x) + \Psi_2(x) + \ldots + \Psi_n(x)];$$

while the root of equation **(8)** will be the abscissa of the point of intersection of the curve (a) with one which has for its equation

$$(b') \qquad y = x - \Psi(x).$$

As has been already noted, equation (a) is represented by the curve MN (Fig. 5), of which the ordinates are always real and positive; we can represent equation (b) by the curve PQ, and equation (b') by the curve $P'Q'$.

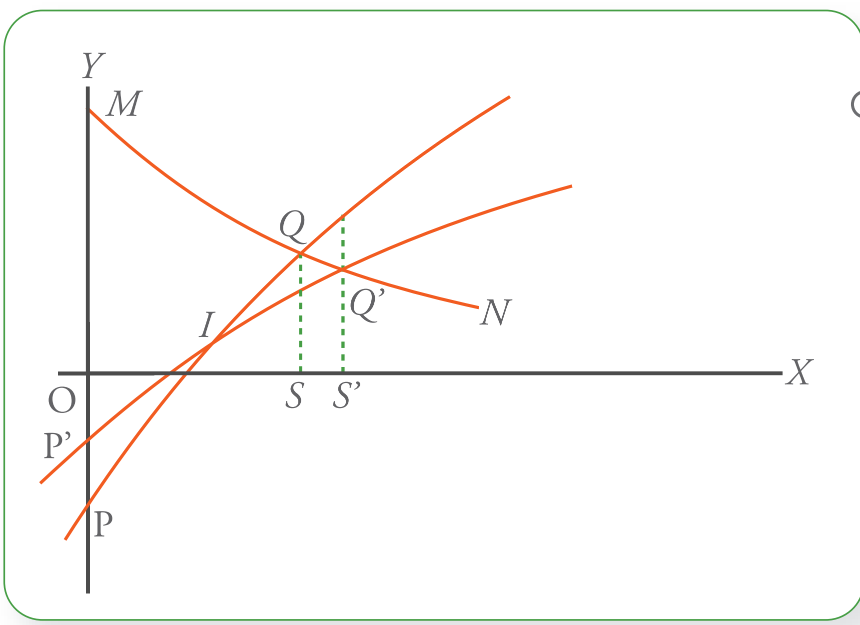


Figure 5

In consequence of the relation just proved, viz.,

$$\Sigma\Psi_n(x) > \Psi(x),$$

we find for the value $x = 0$, $OP > OP'$. It remains to be proved that the curve $P'Q'$ cuts the curve PQ at a point I situated below MN, so that the abscissa of the point Q' will be greater than that of the point Q.

This amounts to proving that at the points Q and Q', the ordinate of the curve (b) is greater than the ordinate of the curve (b') corresponding to the same abscissa.

Suppose that it were not so, and that we should have

$$x - \Psi(x) > nx - [\Psi_1(x) + \Psi_2(x) + \ldots + \Psi_n(x)],$$

or

$$(n - 1)x < \Psi_1(x) + \Psi_2(x) + \ldots + \Psi_n(x) - \Psi(x).$$

$\Psi(x)$ is an intermediate quantity between the greatest and smallest of the terms $\Psi_1(x), \Psi_2(x), \ldots, \Psi_{n-1}(x), \Psi_n(x)$; if we suppose that $\Psi_n(x)$ denotes the smallest term of this series, the preceding inequality will involve the following inequality:

$$(n - 1)x < \Psi_1(x) + \Psi_2(x) + \ldots + \Psi_{n-1}(x).$$

Therefore x will be smaller than the average of $n - 1$ terms of which the sum forms the second member of the inequality; and among these terms there will be some which are greater than x. But this is impossible, because producer (k), for instance, will stop producing as soon as p becomes less than $\phi_k'(D_k)$ or $\Psi_k(p)$.

49. Therefore if it should happen that the value of p derived from equations **(6)**, combined with the relations

(9) $$D_1 + D_2 + \ldots + D_n = D, \text{ and } D = F(p),$$

should involve the inequality

$$p - \phi_k'(D_k) < 0,$$

it would be necessary to remove the equation

$$f(D) + D_k f'(D) - \phi_k'(D_k) = 0$$

from the list of equations **(6)**, and to substitute for it

$$p - \phi_k'(D_k) = 0,$$

which would determine D_k as a function of p. The remaining equations of **(6)**, combined with equations **(9)**, will determine all the other unknown quantities of the problem.

Chapter IX: Of the Mutual Relations of Producers

55. Very few commodities are consumed in just the form in which they left the hands of the first producer. Ordinarily the same raw material enters into the manufacture of several different products, which are more directly adapted to consumption; and reciprocally several raw materials are generally brought together in the manufacture of each of these products. It is evident that each producer of raw materials must try to obtain the greatest possible profit from his business. Hence it is necessary to inquire according to what laws the profits, which are made by all the producers as a whole, are distributed among the individuals in consequence of the law of consumption for final products. This short summary will suffice to make known what we mean by the influence of the *mutual relations* of producers of different articles, an influence which must not be confounded with that of the *competition* of producers of the same article, which has been analyzed in the preceding chapters.

THIS SHORT SUMMARY WILL SUFFICE TO MAKE KNOWN WHAT WE MEAN BY THE INFLUENCE OF THE *MUTUAL RELATIONS* OF PRODUCERS OF DIFFERENT ARTICLES, AN INFLUENCE WHICH MUST NOT BE CONFOUNDED WITH THAT OF THE *COMPETITION* OF PRODUCERS OF THE SAME ARTICLE.

To proceed systematically, from the simple to the complex, we will imagine two commodities, (*a*) and (*b*), which have no other use beyond that of being jointly consumed in the production of the composite commodity (*ab*); to begin with, we will omit from consideration the expenses caused by the production of each of these raw materials taken separately, and of the costs of making them effective, or of the formation of the composite commodity.

Simply for convenience of expression we can take for examples copper, zinc, and brass under the fictitious hypothesis that copper and zinc have no other use than that of being jointly used to form brass by their alloy, and that the cost of production of copper and zinc can be neglected, as well as the cost of making the alloy.

Let p be the price of a kilogram of brass, p_1 that of a kilogram of copper, and p_2 that of a kilogram of zinc; and m_1:m_2 the proportion of copper to zinc in the brass, so that we should have, according to hypothesis,

$$m_1 p_1 + m_2 p_2 = p. \tag{a}$$

In general, let p, p_1, and p_2 denote the price of the unit of the commodity for the composite article (*ab*) and for the component commodities (*a*) and (*b*); and m_1 and m_2 the numbers of units, or of fractions of the unit, of each component commodity which enter into the formation of the unit of the composite commodity.

Furthermore, let

$$D = F(p) = F(m_1p_1 + m_2p_2)$$

be the demand for the composite commodity, and

$$(b) \qquad \begin{cases} D_1 = m_1F(m_1p_1 + m_2p_2), \\ D_2 = m_2F(m_1p_1 + m_2p_2), \end{cases}$$

the demand for each of the component commodities; if we suppose each of these to be handled by a monopolist, and if we apply to the theory of the mutual relations of producers the same method of reasoning which served for analyzing the effects of competition, we shall recognize that the values of p_1 and p_2 are determined by the two equations

$$\frac{d(p_1D_1)}{dp_1} = 0, \text{ and } \frac{d(p_2D_2)}{dp_2} = 0,$$

of which the development gives

$$\begin{cases} F(m_1p_1 + m_2p_2) + m_1p_1F'(m_1p_1 + m_2p_2) = 0, & (1) \\ F(m_1p_1 + m_2p_2) + m_2p_2F'(m_1p_1 + m_2p_2) = 0; & (2) \end{cases}$$

no other system of values but the one resulting from these equations being compatible with a state of stable equilibrium.

56. To prove this proposition, it is sufficient to show that the curves m_1n_1 and m_2n_2 (which would be the plots of equations **(1)** and **(2)**, under the hypothesis that the variables p_1 and p_2 represent rectangular coördinates) assume one or the other of the dispositions shown by Figs. 7 and 8; for, if that is admitted, we can show, as in Chapter VII, and, by the same construction, sufficiently indicated by the dotted lines of either figure, that the coördinates of the point of intersection i (or the roots of equations **(1)** and **(2)**) are the only values of p_1 and p_2 compatible with stable equilibrium.

We observe that when p_2 is equal to zero, p_1 has a finite value Om_1, *i.e.* the one which renders the product $p_1F(m_1\,p_1)$ a maximum. Thereupon, as p_2 increases, the value of p_1, which will procure the greatest profit for producer (1), may continue to increase (as is the case in Fig. 7), or to decrease (as is the case in Fig. 8); but, even under the latter hypothesis, it can never become absolutely equal to zero. The one case or the other will occur according to the form of the function F, and according as we find

$$\frac{[F'(p)]^2 - F(p)\cdot F''(p)}{2\,[F'(p)]^2 - F(p)\cdot F''(p)} \gtrless 0.$$

In this inequality p denotes a function of p_1 and p_2, determined by equation (a).

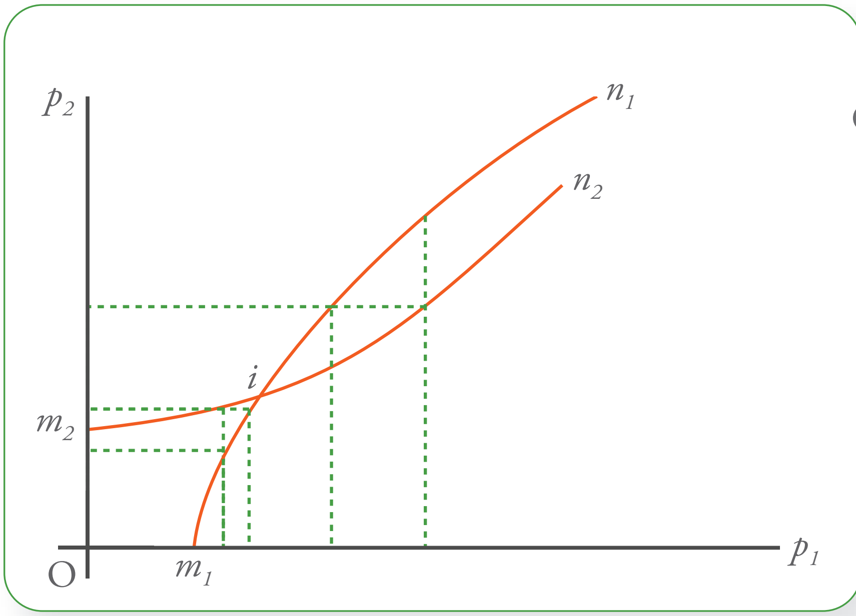


Figure 7

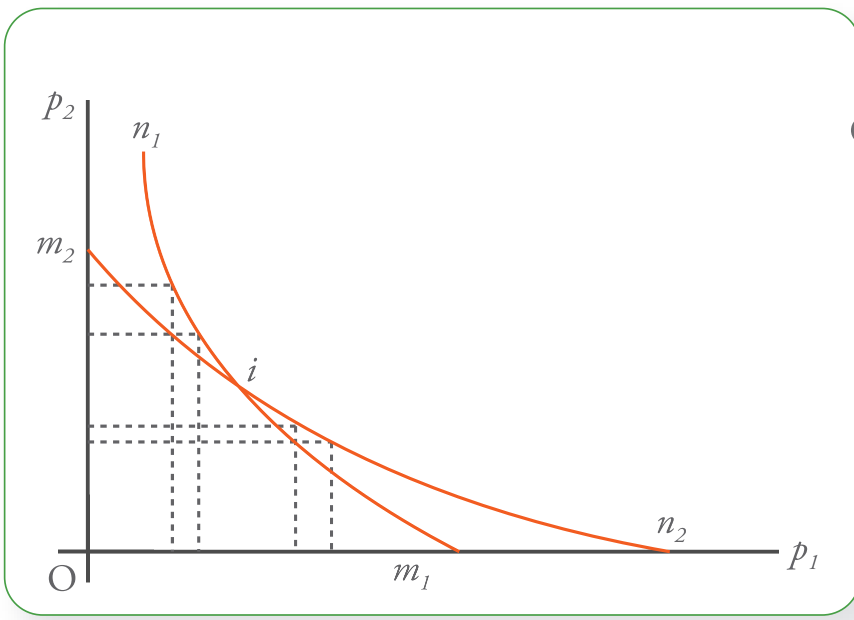


Figure 8

But since equations **(1)** and **(2)** and the preceding inequality are symmetrical with reference to m_1p_1 and m_2p_2, it will result that, whenever the form of the function F is such that the ordinates p_2 of the curve m_1n_1 continue to increase for increasing values of p_1, then the abscissas p_1 of the curve m_2n_2 will go on increasing for increasing values of p_2, so that the two curves will assume the disposition represented by Fig. 7. On the contrary, whenever the ordinates p_2 of the curve m_1n_1 decrease for increasing values of p_1, the abscissas p_1 of the curve m_2n_2 will likewise go on decreasing for increasing values of p_2, and then the two curves will assume the disposition represented by Fig. 8.

57. As equations **(1)** and **(2)** can be considered as determined, in consequence of the previous discussion, we will remark that they yield at once

$$m_1 p_1 = m_2 p_2 = \frac{1}{2} p;$$

that is to say, that by the purely abstract hypothesis under consideration, the profits would be equally divided between the two monopolists; and, in fact, there would be no reason why the division should be unequal, and to the profit of one rather than of the other.

By addition of equations **(1)** and **(2)**, we can deduce

$$(c) \qquad F(p) + \frac{1}{2} pF'(p) = 0,$$

while, if the interests of the two producers had remained undistinguished, p would have been determined by the condition that $pF(p)$ should be a maximum, *i.e.* by the equation

$$(c') \qquad F(p) + pF'(p) = 0.$$

To prove the accuracy of this distinction, exactly the same method of reasoning should be used that we took in treating of the competition of producers.

But there is this essential and very remarkable difference, that the root of equation (c) is always greater than that of equation (c'), so that the composite commodity will always be made more expensive, by reason of separation of interests than by reason of the fusion of monopolies. An association of monopolists, working for their own interest, in this instance will also work for the interest of consumers, which is exactly the opposite of what happens with competing producers.

An association of monopolists, working for their own interest, in this instance will also work for the interest of consumers, which is exactly the opposite of what happens with competing producers.

Furthermore, the higher value of the root of equation (c) than of that of equation (c') can be shown by the same graphical construction which served to establish the opposite result in the chapter in which we treated of competition.

If we had supposed n commodities thus related, instead of only two, equation (c) would evidently have been replaced by

$$F(p) + \frac{1}{n} pF'(p) = 0;$$

from which we should conclude, that the more there are of articles thus related, the higher the price determined by the division of monopolies will be, than that which would result from the fusion or associations of the monopolists.

58. Such a form might be given to the function F that the curves represented by equations **(1)** and **(2)** would not intersect; for instance, if it were

$$F(p) = \frac{a}{b + p^2},$$

equations **(1)** and **(2)** would become

$$b - m_1^2 p_1^2 + m_2^2 p_2^2 = 0, \text{ and } b + m_1^2 p_1^2 + m_2^2 p_2^2 = 0,$$

and would represent two conjugate hyperbolas (Fig. 9), of which the limbs $m_1 n_1$ and $m_2 n_2$ have a common asymptote and cannot meet.

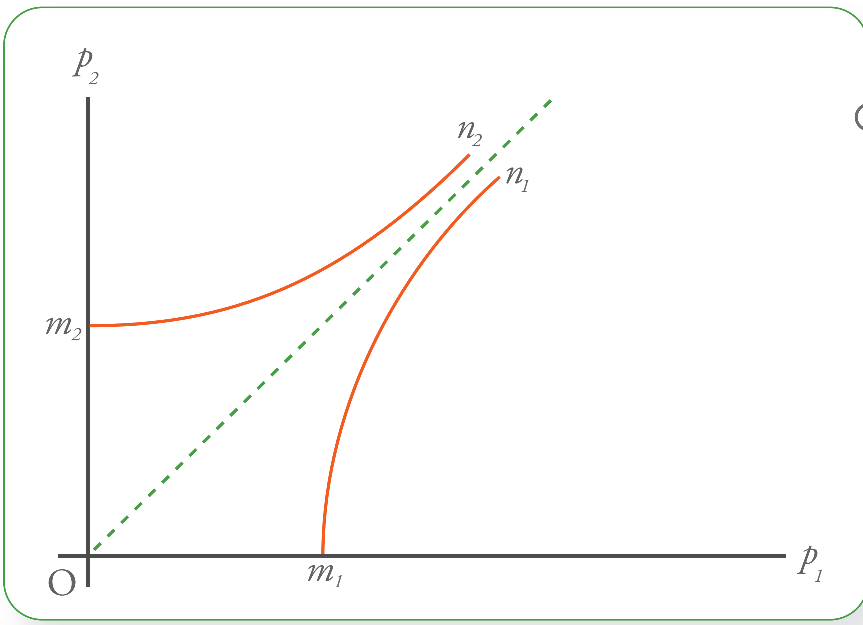


Figure 9

A passing note is sufficient for these peculiarities of analysis, which cannot have any application to actual events.

Another peculiarity of the same kind would appear if we suppose that the roots of equations **(1)** and **(2)** establish a value of p, and, consequently, a value of D which exceeds the quantity which one or other of the producers can furnish. Let Δ be the limit which D cannot exceed, because of a necessary limitation in the production of one or the component articles, and π the corresponding limit of p according to the relation $D = F(p)$. We shall therefore have

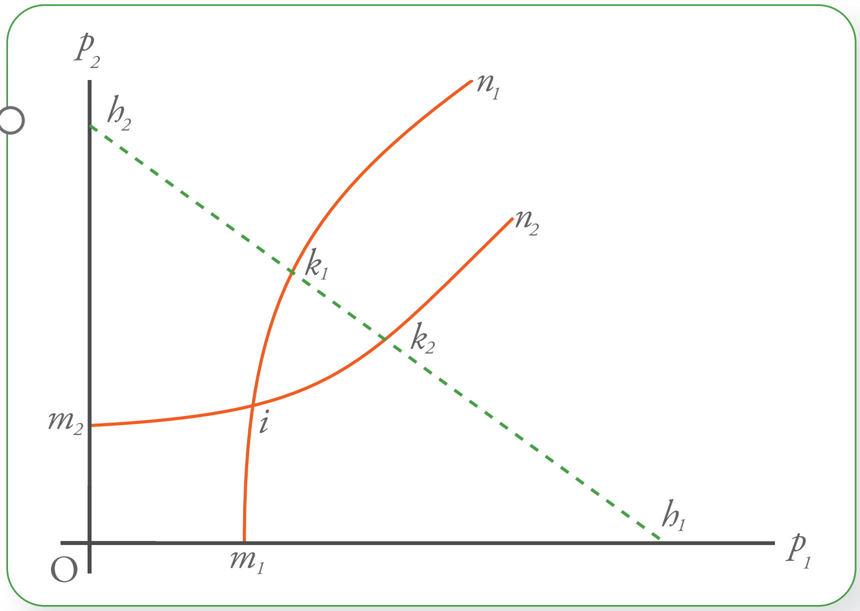
$$m_1 p_1 + m_2 p_2 > \pi;$$

i.e. the variables p_1 and p_2 can be the coördinates only of a point situated above the line h_1h_2 (Fig. 10), which would have for its equation

$$m_1p_1 + m_2p_2 = \pi;$$

and consequently, if the point i, where the two curves m_1n_1 and m_2n_2 intersect, falls below the line h_1h_2, its coördinates cannot be taken for the values of p_1 and p_2.

Figure 10



From this the conclusion can be drawn, if necessary by aid of the graphical construction indicated above, that the values of p_1 and p_2 are indeterminate, being subject only to this condition, that the points which would have the values of these variables for coördinates fall on the part k_1k_2 of the line, which is intercepted between the curves m_1n_1 and m_2n_2.

This singular result springs from an abstract hypothesis of the nature of those which we can discuss in this essay. It is very plain that in the order of actual facts, and where all the conditions of an economic system are accounted for, there is no article of which the price is not completely determined.

59. We will now take into consideration the costs of production of the two component articles, which we will represent by the functions $\phi_1(D_1)$ and $\phi_2(D_2)$. The values of p_1 and p_2 will now result from the two equations

$$(d) \qquad \begin{cases} \dfrac{d[p_1D_1 - \phi_1(D_1)]}{dp_1} = 0, \\ \dfrac{d[p_2D_2 - \phi_2(D_2)]}{dp_2} = 0, \end{cases}$$

which will become, by reason of equations (a) and (b),

$$(e_1) \quad F(m_1p_1 + m_2p_2) + m_1F'(m_1p_1 + m_2p_2) \cdot [p_1 - \phi_1'(D_1)] = 0,$$

$$(e_2) \quad F(m_1p_1 + m_2p_2) + m_2F'(m_1p_1 + m_2p_2) \cdot [p_2 - \phi_2'(D_2)] = 0.$$

From these we derive

$$m_1[p_1 - \phi_1'(D_1)] = m_2[p_2 - \phi_2'(D_2)],$$

or, by reason of the condition

$$\frac{m_1}{m_2} = \frac{D_1}{D_2},$$

$$D_1[p_1 - \phi_1'(D_1)] = D_2[p_2 - \phi_2'(D_2)].$$

From this it follows that if the functions $\phi_1'(D_1)$ and $\phi_2'(D_2)$ reduce to constants, the net profits of the two coöperating producers will be equal. But this will no longer be so in the more general case where the functions $\phi_1'(D_1)$ and $\phi_2'(D_2)$ vary respectively with D_1 and D_2. The net profits of the two producers will then be expressed by

$$D_1\left[p_1 - \frac{\phi_1(D_1)}{D_1}\right] \text{ and } D_2\left[p_2 - \frac{\phi_2(D_2)}{D_2}\right];$$

so that if we have, for instance,

$$\phi_1'(D_1) > \frac{\phi_1(D_1)}{D_1} \text{ and } \phi_2'(D_2) < \frac{\phi_2(D_2)}{D_2},$$

the net profit of producer (1) will be greater than that of producer (2). From equation (a) and equations (e_1) and (e_2) there can further be deduced

$$(f) \qquad 2F(p) + F'(p)[p - m_1\phi_1'(D_1) - m_2\phi_2'(D_2)] = 0,$$

$$m_1p_1 = \frac{1}{2}[p + m_1\phi_1'(D_1) - m_2\phi_2'(D_2)],$$

and

$$m_2p_2 = \frac{1}{2}[p + m_1\phi_1'(D_1) - m_2\phi_2'(D_2)].$$

But if there had been a fusion of monopolies, equation (f) would have been replaced by

$$(f') \qquad F(p) + F'(p)[p - m_1\phi_1'(D_1) - m_2\phi_2'(D_2)] = 0.$$

By recourse to the graphic representation which has served us for similar cases, it will easily be recognized that the root of equation (f) is greater than that of equation (f'), and, therefore, that an increase in price is the result of separation of the monopolies.

60. Up to this point we have neglected to account for the expenses involved in putting the raw materials to use in the formation of the resultant article, as well as the transportation of this resultant commodity to the market where it is consumed, the taxes which may be imposed on it, etc.

But if we suppose that these expenses are proportional to the quantity turned out, which is ordinarily the case, and that the sum of these expenses, for each unit of the resultant article, is expressed by the constant h, equation (a) will be replaced by

$$p = m_1 p_1 + m_2 p_2 + h,$$

and instead of equation (f) we shall have

$$2F(p) + F'(p)[p - h - m_1\phi_1'(D_1) - m_2\phi_2'(D_2)] = 0.$$

Thus the result will be the same as if the expenses had been borne directly by producers (1) and (2), and as if the burden of these expenses had been divided between them in the ratio of m_1 to m_2.

61. By a less restricted hypothesis than the one which we have considered till now, each of the component articles is susceptible of various uses besides that of coöperating in the formation of the composite article. Let $F(p)$ be, as before, the demand for the composite article, and $F_1(p_1)$ and $F_2(p_2)$ the demand for article (1) and that for article (2), for other uses than that of coöperating in the production of the composite article. The values of p_1 and p_2 will still be given by the equations (d), but we shall have

$$D_1 = F_1(p_1) + m_1 F(m_1 p_1 + m_2 p_2),$$

and

$$D_2 = F_2(p_2) + m_2 F(m_1 p_1 + m_2 p_2),$$

by reason of which the equations (d) become

$$F_1(p_1) + m_1 F(m_1 p_1 + m_2 p_2) + [F_1'(p_1) + m_1^2 F'(m_1 p_1 + m_2 p_2)][p_1 - \phi_1'(D_1)] = 0,$$

$$F_2(p_2) + m_2 F(m_1 p_1 + m_2 p_2) + [F_2'(p_2) + m_2^2 F'(m_1 p_1 + m_2 p_2)][p_2 - \phi_2'(D_2)] = 0.$$

These expressions thus become too complicated to make it easy to derive any general consequences from them. Without further delay we will therefore pass on to a case far more important, and which can easily be treated in as general a manner as is desired. This is the case where each of the two articles concurrently used is produced under the influence of unlimited competition.

62. According to the theory developed in Chapter VIII, we now obtain two series of equations:

$$(a_1)\quad \begin{cases} p_1 - \bar{\phi}_1'\bar{D}_1 = 0, \\ p_1 - \phi_2'\bar{D}_2 = 0, \\ \quad\dots \\ p_1 - \bar{\phi}_n'\bar{D}_n = 0; \end{cases} \qquad (a_2)\quad \begin{cases} p_2 - \bar{\bar{\phi}}_1'\bar{\bar{D}}_1 = 0, \\ p_2 - \bar{\bar{\phi}}_2'\bar{\bar{D}}_2 = 0, \\ \quad\dots \\ p_2 - \bar{\bar{\phi}}_n'\bar{\bar{D}}_n = 0. \end{cases}$$

Over the letters ϕ and D we set one or two horizontal lines according as they relate to article (1) or article (2). The subscripts to these letters serve to distinguish the producers in each of the two series.

Together with the equations of (a_1) and (a_2) the two following equations should be considered:

$$(b_1)\qquad \bar{D}_1 + \bar{D}_2 + \dots + \bar{D}_n = F_1(p_1) + m_1F(m_1p_1 + m_2p_2),$$

$$(b_2)\qquad \bar{\bar{D}}_1 + \bar{\bar{D}}_2 + \dots + \bar{\bar{D}}_n = F_2(p_2) + m_2F(m_1p_1 + m_2p_2).$$

If we deduce from the equations of (a_1) and (a_2) the values of $\bar{D}_1$, $\bar{D}_2$ … and $\bar{\bar{D}}_1$, $\bar{\bar{D}}_2$ … as functions of p, equations (b_1) and (b_2) will assume the forms

$$\textbf{(3)}\qquad \Omega_1(p_1) = F_1(p_1) + m_1F(m_1p_1 + m_2p_2),$$

$$\textbf{(4)}\qquad \Omega_2(p_2) = F_2(p_2) + m_2F(m_1p_1 + m_2p_2),$$

in which $\Omega_1(p_1)$ denotes a function of p_1 which increases with p_1, and $\Omega_2(p_2)$ another function of p_2 which increases with p_2.

Suppose that the production of article (1) is subjected to an increase of expense u, such as would result from a specific tax; the values of p_1 and p_2, which before the increase in expense were determined by equations **(3)** and **(4)**, will become $p_1 + \delta_1$ and $p_1 + \delta_2$, and we shall have, to determine δ_1 and δ_2, the equations

$$\textbf{(5)}\qquad \Omega_1(p_1 + \delta_1 - u) = F_1(p_1 + \delta_1) + m_1F(m_1p_1 + m_2p_2 + m_1\delta_1 + m_2\delta_2),$$

$$\textbf{(6)}\qquad \Omega_2(p_2 + \delta_2) = F_2(p_2 + \delta_2) + m_2F(m_1p_1 + m_2p_2 + m_1\delta_1 + m_2\delta_2).$$

If we admit that in comparison with p_1 and p_2, u, δ_1, and δ_2 are small fractions, of which the powers higher than the first can be omitted in our calculations, then equations **(5)** and **(6)** will become, in virtue of equations **(3)** and **(4)**,

$$\delta_1\{\Omega_1'(p_1) - F_1'(p_1) - m_1^2F'(m_1p_1 + m_2p_2)\} - \delta_2 m_1m_2F'(m_1p_1 + m_2p_2) = u\Omega_1'(p_1),$$

and

$$-\delta_1 m_1m_2F'(m_1p_1 + m_2p_2) + \delta_2\{\Omega_2'(p_2) - F_1'(p_1) - m_2^2F'(m_1p_1 + m_2p_2)\} = 0.$$

To simplify the notation, we will write Ω_1' instead of $\Omega_1'(p_1)$, F' instead of $F'(m_1p_1 + m_2p_2)$, and so on throughout. Finally, let us put

$$Q = \Omega_1'\Omega_2' - \Omega_1'F_2' - \Omega_2'F_1' - m_2^2F'\Omega_1' - m_1^2F'\Omega_2' + F_1'F_2' + m_1^2F'F_2' + m_2^2F'F_2'.$$

From this and from the two preceding equations we can derive

(7) $$\delta_1 = \frac{u}{Q} \cdot (\Omega_1'\Omega_2' - \Omega_1'F_2' - m_2^2F'\Omega_1'),$$

and **(8)** $$\delta_2 = \frac{u}{Q} \cdot m_1 m_2 \Omega_1' F'.$$

If we observe that the quantities Ω_1' and Ω_2' are essentially positive, whereas the quantities F', F_1', and F_2' are essentially negative, inspection of the values of δ_1 and δ_2 will now permit us to observe the following results:

1. δ_1 is of the same sign as u; for $\frac{\delta_1}{u}$ is equal to a fraction, of which both numerator and denominator have all their terms positive.
2. δ_1 is smaller than u; for the denominator of the aforementioned fraction contains all the terms of the numerator, and besides them a number of terms which are all positive.
3. δ_2 is of opposite sign to δ_1; for the denominator of the fraction $\frac{\delta_1}{u}$ is the same as that of the fraction $\frac{\delta_2}{u}$, and the numerator of this latter fraction is a negative quantity.

Although we only obtained these results by supposing u, δ_1 and δ_2 very small with reference to p_1 and p_2, it is easy to see that this restriction can be removed by supposing that any increase of expense, of whatever kind, takes place by a succession of very small increments. As the signs of the quantities Ω' and F' do not change in the passage from one state to the other, the relations which we have just found between the elementary variations u, δ_1, and δ_2 will also hold between the sums of these elements (Article 32).

THERE MUST ALSO RESULT A SMALLER CONSUMPTION OR PRODUCTION OF ARTICLE (2); AND, AS THIS ARTICLE IS NOT SUBJECTED TO AN INCREASE IN THE COST OF PRODUCTION, THE RESTRICTION OF PRODUCTION FOR THIS ARTICLE CAN ONLY BE CAUSED BY A DECREASE IN THE PRICE.

In consequence, any increase in expense in the production of article (1) will increase the price of that article, but, nevertheless, so that the rise is less than the increase in expense; and at the same time the price of article (2) will fall.

It would be easy to show the necessity of all these results by methods of reasoning, independent of the preceding calculations. If article (1) did not rise in price when affected by an increase in cost, the producers of it would be obliged to restrict their output to avoid a loss, and it is impossible that the price should fail to increase when the quantity delivered diminishes. The article must rise therefore, and must rise less than the increase in cost, as otherwise the producers would have no reason for restricting their output. Finally, since there results a smaller consumption of article (1), as well for the manufacture of the composite article as for all other uses, there must also result a smaller consumption or production of article (2); and, as this article is not subjected to an increase in the cost of production, the restriction of production for this article can only be caused by a decrease in the price.

The variation in the price of the composite article, resulting from the opposite variations δ_1 and δ_2 in the prices of the component articles, is equal to $m_1\delta_1 + m_2\delta_2$, and from equations **(7)** and **(8)** we obtain

$$m_1\delta_1 + m_2\delta_2 = m_1u \cdot \frac{\Omega_1'(\Omega_2' - F_2')}{Q}.$$

It results from this expression that the variation in the price of the composite article is of the same sign as u and δ_1, and that it is less than m_1u which is as it should be, on account of the fall in the price of article (2).

If we suppose any number of articles used concurrently, it could be demonstrated in the same manner, and by calculations which would offer no other difficulty than their length, (1) that an increase in cost occurring in the production of one of the articles, raises the price of this article and that of the composite article, and causes a fall in the prices of all the other component articles; (2) that the increase in the price of the article affected is less than the increase in cost or than the tax laid upon it.

63. Let us now consider the case where the increase in cost u falls directly on the composite article, whether it is a specific tax imposed on this article, on an increase occurring in the cost of distribution of the article to consumers. Equations **(3)** and **(4)** will be replaced by

$$\Omega_1(p_1 + \delta_1) = F_1(p_1 + \delta_1) + m_1F(m_1p_1 + m_2p_2 + m_1\delta_1 + m_2\delta_2 + u),$$

and

$$\Omega_2(p_2 + \delta_2) = F_2(p_2 + \delta_2) + m_2F(m_1p_1 + m_2p_2 + m_1\delta_1 + m_2\delta_2 + u);$$

and these, when treated as were equations **(5)** and **(6)**, will give

$$\delta_1\Omega_1' = \delta_1F_1' + m_1^2\delta_1F' + m_1m_2\delta_2F' + m_1uF',$$

and $$\delta_2\Omega_2' = \delta_2F_2' + m_1m_2\delta_1F' + m_2^2\delta_2F' + m_2uF';$$

from which we derive

$$\delta_1 = \frac{um_1F'(\Omega_2' - F_2')}{Q},$$

and
$$\delta_2 = \frac{um_2F'(\Omega_1' - F_1')}{Q},$$

in which the polynomial represented by Q is composed of the same terms as in the preceding article.

From these expressions we easily conclude, in virtue of the signs of the quantities Ω' and F':

1. That both δ_1 and δ_2 are of the opposite sign to u.
2. That the quantity $m_1\delta_1 + m_2\delta_2$ is numerically less than u.

Moreover, the variations δ_1 and δ_2 in the prices of the component articles are mutually connected by this vary simple relation:

$$\frac{\delta_1}{\delta_2} = \frac{m_1(\Omega_2' - F_2')}{m_2(\Omega_1' - F_1')},$$

which is independent of the function F. Consequently, any increase of expense, or any tax which affects the composite article, will lower the prices of the component commodities, and at the same time will raise the price of the composite article, but by a quantity less than u, since this rise in price will be expressed by

$$u = m_1\delta_1 + m_2\delta_2,$$

and since $m_1\delta_1 + m_2\delta_2$ is, as we have just seen, numerically less than u, and of opposite sign.

These results can readily be generalized, whatever the number and kind of the component commodities, so long as they are produced under the influence of unlimited competition. They are worthy of serious consideration, as they have all the certainty of mathematical theorems, without being such as must, on that account, be excluded from the number of practical truths.

64. Let us go on to the case where article (2) has a limit to its production, so that the value of p_2 derived from equations **(3)** and **(4)** would correspond to a demand for this article which its producers could not satisfy. If we denote by Δ_2 this limit of production, the values of p_1 and p_2 will be determined by the system of equations

$$\Omega_1(p_1) = F_1(p_1) + m_1F(m_1p_1 + m_2p_2),$$

and
$$\Delta_2 = F_2(p_2) + m_2F(m_1p_1 + m_2p_2).$$

Under these circumstances there will be no change in the equations which determine the values of p_1 and p_2, if we suppose that there falls on article (2) a tax, or an increase in the cost of production, denoted by u; consequently these values will remain the same, and the entire increase in the cost will be borne by producers of (2), without any loss resulting to the consumers of the component commodities, or of the composite article.

THE ENTIRE INCREASE IN THE COST WILL BE BORNE BY PRODUCERS OF (2), WITHOUT ANY LOSS RESULTING TO THE CONSUMERS OF THE COMPONENT COMMODITIES, OR OF THE COMPOSITE ARTICLE.

If the tax u falls on article (1), both of the old prices p_1 and p_2 will vary, and may be represented by $p_1 + \delta_1$ and $p_2 + \delta_2$. Equations **(5)** and **(6)** are applicable to this case by replacing the function $\Omega_2(p_2 + \delta_2)$ in the second of these equations by the constant Δ_2, which amounts to supposing the derivative Ω_2' equal to zero in the formulas derived from these equations.

Thus, under the hypothesis that the variations u, δ_1, and δ_2 can be treated as very small quantities, we shall have:

$$\delta_1 = \frac{-u\Omega_1'(F_2' + m_2^2 F')}{R},$$

and

$$\delta_2 = \frac{u m_1 m_2 \Omega_1' F'}{R},$$

$$\frac{\delta_1}{\delta_2} = -\frac{F_2' + m_2^2 F'}{m_1 m_2 F'},$$

$$m_1\delta_1 + m_2\delta_2 = \frac{-u m_1 \Omega_1' F_2'}{R};$$

in which the composition of the polynomial R is given by the auxiliary equation

$$R = -\,\Omega_1'(F_2' + m_2^2 F') + F_1'F_2' + m_1^2 F' F_2' + m_2^2 F' F_1'.$$

From these equations are derived the following consequences, which are applicable to all values of the variations u, δ_1, and δ_2:

1. δ_1 is of the same sign as u, and numerically smaller; the article affected by the tax increases in price, but by an amount less than the tax, so that there will be a diminution in the quantity produced and in the income of its producers;

2. δ_2 is of opposite sign to u, so that the article which is not directly affected by the tax falls in price, to the disadvantage of the producers of this article, even though the quantity produced does not vary;

3. $m_1\delta_1 + m_2\delta_2$ is of the same sign as u; thus the composite article will rise in price, the rise of the taxed article more than compensating for the fall of the other article.

It would be found in the same way that the prices of both component articles would fall if the tax or the increase in cost bears directly on the resultant article.

65. Let us now suppose that for some reason the limit Δ_2 changes and becomes $\Delta_2 + v_2$ without the occurrence of any change in the cost of production. Treating, according to our method, the variation v_2 and the resulting variations δ_1 and δ_2 to begin with as very small, we shall have:

$$\delta_1 = v_2 \cdot \frac{-m_1 m_2 F'}{R},$$

$$\delta_2 = v_2 \cdot \frac{-(\Omega_1{}' - F_1{}' - m_1{}^2 F')}{R},$$

$$m_1\delta_1 + m_2\delta_2 = v_2 \cdot \frac{-m_2(\Omega_1{}' - F_1{}')}{R}.$$

From these expressions we conclude that whatever the extent of the variations, raising the limit Δ_2 depresses the price of article (2), and raises the price of article (1), but in a less degree, so that it brings about a fall in the price of the resultant article.