

Do We Need a “New Economy” Exception for Antitrust?

By Jonathan M. Jacobson
Akin, Gump, Strauss, Hauer & Feld, L.L.P.

Judge Bork explained in *The Antitrust Paradox* that almost everything you need to know about antitrust was known by 1914.¹ The Section of Antitrust Law’s International Officer, Tad Lipsky, has disagreed, at least in part. In a recent paper, he demonstrated how most of the key economic concepts underlying antitrust doctrine were in fact known by 1838, when Antoine Cournot published his *Recherches sur les Principes Mathématiques de la Théorie des Richesses*.²

Of course, we have learned some useful things since 1838, and even since 1914, and the industrial landscape has changed dramatically over those many years. The last decade in particular has given rise to ubiquitous personal computing, the astonishing growth of the Internet, and many new and more effective ways of communicating and receiving vast amounts of information nearly instantaneously. These rapid transformations have led many thoughtful observers to question the appropriate role of antitrust in a world where change can occur so rapidly and so significantly. Some — focusing in particular on the *Microsoft* case — have expressed doubt as to whether there is any substantial role for antitrust to play in this new world.³ The specific question addressed here is whether, as Microsoft and its defenders have so vigorously argued, the “new economy” is so different in kind from the economies of the past as to warrant the view that practices that restrict output, create or enhance monopoly power, or raise artificial barriers to new competition are no longer the sorts of things the law should strive to prevent.⁴ The conclusion reached here, in a word, is “no.”

Déjà vu?

A useful place to start the analysis is with history. It turns out that calls for a “new economy” or other special industry exception to antitrust are themselves almost as old as the Sherman Act. The very first Sherman Act case decided on the merits by the Supreme Court, *Trans-Missouri Freight Association* in 1897, was defended on the basis that the high fixed costs in the railroad industry would lead to ruinous competition that the defendants had a right to prevent.⁵ The Court, famously, rejected that argument, recognizing that “[i]t is true the results of trusts, or combinations of that nature, may be different in different kinds of corporations, and yet they all have an essential similarity, and have been induced by motives of individual or corporate aggrandizement as against the public interest.”⁶

There were similar pleas in *Northern Securities*, in 1903, that applying antitrust to corporate stock acquisitions would imperil the stock market;⁷ in *Appalachian Coals*, in 1933, that antitrust would ruin the coal-mining industry⁸; and in *Republic/LTV*, in 1983, that applying antitrust to the steel industry would endanger our national competitiveness⁹

— to name but a notorious few. Antitrust has survived each of these onslaughts — although with occasional setbacks, such as *Appalachian Coals*, where a cartel-like arrangement was approved, that invariably have been proven misguided.

What's New?

The arguments as to why today's "new economy" is different from the "new economies" of old focus primarily on the following attributes:

- High fixed costs
- Increasing returns to scale, or downward sloping supply curves at relevant output levels
- Network effects, or greater utility with each user, often with a "winner-take-all" outcome
- Rapid change¹⁰

The question is whether these attributes are really new. On analysis, there is little really new here at all:

High fixed costs

Industries with high fixed costs have been with us since the dawn of the Industrial Revolution. Early examples include railroads — where the industry's high fixed costs formed the principal basis for the rejected plea for a Sherman Act exception in *Trans-Missouri* — as well as aluminum, steel, automobile manufacture, and many now deregulated industries such as airlines, trucking, telephones, television and radio, and electric power.

Increasing returns to scale

At relevant output levels, many markets exhibit increasing returns to scale (or downward-sloping supply curves). In fact, any industry subject to significant scale economies will (almost by definition) exhibit increasing returns as scale economies grow. Industries where scale economies are not exhausted at *some* point (i.e., where the slope of the industry supply curve never turns upwards) are comparatively rare, but not unprecedented. And increasing returns of the type exhibited by software, the paradigmatic "new economy" product, have long been a characteristic of reproducible works of art (e.g., books), advertising copy, as well as television, radio, and motion picture content. The local provision of local telephone service and electric power provide more traditional, "old economy," examples of markets with generally increasing returns to scale.

Network effects

Products (and industries) where the addition of an incremental user enhances utility for prior users have, similarly, been with us for many decades. Examples include the telephone, telex, the fax machine, and (in important respects) radio, television, VCRs, CDs, and DVDs.

Rapid change

The rapidity of change is an inherently subjective matter. Operators of horse-drawn carriages surely believed that the onset of the automobile came much more quickly than they would have preferred. Consumers who purchased Betamax VCRs in 1975 were

surely amazed by the speed with which VHS usurped the market the very next year. The rise of the PC in particular and the “new economy” generally has been rapid but not astonishingly so:

- CompuServe was founded in 1969.
- E-mail was first used in 1972.
- Xerox PARC exhibited a graphical user interface and mouse for the “Xerox Alto” in 1979; the mouse itself was developed by Douglas Engelbart in 1963
- WordPerfect was introduced in 1983, with MS Word 1.0 later the same year
- There were 1000 Internet hosts by 1984, and 100,000 by 1989.¹¹

It is true enough that software and Internet technologies have been changing rapidly, but hardly more so than tastes in fashion, food and beverages, or developments in major “old economy” markets arising out of the World Trade Center and Pentagon tragedies.

What are the policy implications of these effects?

For most of the past 110 years, one of the typical solutions to markets exhibiting high fixed costs, increasing returns to scale, and network effects was regulation. Electricity, natural gas pipelines, railroads, telephones and telephone service, radio, television, airlines and other industries were all subject to various forms of government regulation, frequently including direct regulation of rates and restrictions on entry.¹² In other contexts where a “natural monopoly” product, however important, was less critical to everyday life, antitrust laws have been applied with full force. The classic example is the “one newspaper town” case, illustrated by *Union Leader Corp. v. Newspapers of New England*.¹³ Over the past twenty-five years, we have developed a broad national consensus in favor of *deregulation*, based on our faith in the forces of competition — protected by the principles of antitrust.¹⁴ Although there have been occasional glitches in the process — such as the power shortages in California in 2001¹⁵ — the impact of deregulation (and the consequent application of antitrust) have been overwhelmingly positive. The telecommunications explosion, the expansion and cost reduction in air travel, and many other benefits we now take for granted would not have been possible had we not traded regulation for antitrust.

Whatever one’s view of the wisdom of regulation or deregulation, there has been one constant over the entire 110-year period of Sherman Act history. We have had either regulation or the application of antitrust rules (or, in many cases, a combination of the two) in every industry. We have never, however, had neither. Yet that is the import of what the “new economy” advocates seem to be seeking now. They are in no way suggesting that “new economy” markets be regulated. They are suggesting instead that antitrust principles simply be ousted, or at least relaxed. Having neither antitrust nor regulation is a solution we have not witnessed since the days before the Sherman Act was passed.¹⁶

The question becomes whether there is anything so different about software and other “new economy” products as to warrant such a fundamental departure. The main argument is that traditional antitrust rules may discourage innovation by diminishing the

rewards dominant firms expect to gain from their inventions and developments; that a market may rapidly change with entry of firms using entirely new technologies and, recognizing this potential, incumbent firms may reduce their investments in innovation unless allowed greater freedom to exploit their (presumably transient) market power.¹⁷ Yet this argument too is as old as they come. It is essentially the same argument many economists made in 1889 about investments in improvements by the old Trusts in arguing that the Sherman Act should not be passed.¹⁸ In the more recent version of this argument — focusing specifically on incentives to innovate — “new economy” proponents cite the work of Joseph Schumpeter as support for the proposition that high-tech monopolies will be eroded over time by new innovations, and that monopolies tend to innovate more vigorously due to scale economies in R&D and a greater opportunity to exploit the value of the innovations made.¹⁹

The Schumpeter view has been challenged, on a theoretical level, by the work of Kenneth Arrow, who emphasized the monopolist’s disincentive to dilute its own monopoly rents through inventions likely to cannibalize its own sales.²⁰ And on an empirical basis, the arguments of the “new economy” proponents have relatively meager support. There certainly is no consensus that application of ordinary antitrust rules retards innovation generally – and a substantial body of data suggests that unchecked market power impairs rather than enhances long-run innovation.²¹ As Professor Porter recently concluded, “[w]hile technological innovation is the result of a variety of factors, there is no doubt that healthy competition is an essential part.”²² “[U]sing Schumpeter as a justification for ignoring anticompetitive behavior or supporting mergers,” Porter added, “dramatically underestimates the time between [monopoly-displacing] occurrences, even in high tech industries.”²³

Nor have past experiences with “new economy” exceptions to antitrust principles proven successful. Perhaps the most prominent prior venture in this area was *SCM Corp. v. Xerox Corp.*, 645 F.2d 1195 (2d Cir. 1981), *cert. denied*, 455 U.S. 1016 (1982). Relying on the patent law policy favoring (a limited) monopoly as an inducement for innovation, the Second Circuit held that the “policies of the patent laws preclude the imposition of antitrust liability” for any acquisition of patents occurring prior to the emergence of the relevant market embodying the patented inventions, thus upholding acquisitions of patents by Xerox that provided it with long-term control of the technology for plain paper photocopying. *Id.* at 1207-09.²⁴ In opposing SCM’s subsequent petition for certiorari, the Department of Justice took the analysis one step further. The position expressed by DOJ was that no acquisition of any asset, patented or otherwise, prior to the emergence of the relevant market could give rise to antitrust liability.²⁵ The reasoning in both instances was based on a perception that application of otherwise pertinent antitrust rules would deter investments in innovation.

Both the Second Circuit’s opinion and the Justice Department’s even broader position in *SCM v. Xerox* have failed the test of time. The “new economy” exception of *SCM* would permit a merger of firms controlling the only two drug treatments for a common disease if the merger occurred during the drugs’ FDA-approval process — for, in that event, the market would not yet have emerged. That is plainly not the law, at least in practice, today. Although there are no litigated cases specifically rejecting *SCM*, it has become routine for both DOJ and the FTC to challenge mergers in which the market has

not yet emerged but where its emergence is foreseeable — consistent with the “reasonable foreseeability” standard argued unsuccessfully by SCM.²⁶ The view of both enforcement agencies, confirmed by the practice of many well-advised merger proponents who have declined to contest that view in court, is that competition in future markets is well within the scope of legitimate antitrust protection. And that is clearly sound. Exempting all acquisitions that are consummated before a foreseeable market has developed would risk preventing new discoveries from ever coming to market and allowing significant price increases for those that do — while spurring no incremental innovation. The *SCM* experience teaches that any “new economy exception” requires a foundation a good deal stronger than a fear that application of basic antitrust concepts — which incorporate the likely impact on innovation incentives into the analysis in any event — will diminish some unquantified incentive to innovate.

What would the new rules be?

If current antitrust law were replaced with new rules for the “new economy”, what would the new rules be? A number of observers, including Professor Salop and FTC Chairman Timothy Muris have suggested that the “tipping” and “winner-take-all” aspects of some “new economy” markets should counsel *heightened* antitrust scrutiny for “new economy” markets, at least in some respects.²⁷ “New economy” proponents recommend the opposite. But how would diminished scrutiny work if it were to be applied? Would market-power tolerances simply be raised? If so, how much? Would some otherwise unlawful practices be allowed? If so, which ones? An equally important question is how, if we agree on some reduced level of scrutiny for “new economy” markets, the markets qualifying for “new economy” treatment would be determined? There are no satisfactory answers to these questions.

Probably the most serious challenge in dealing with “new economy” cases is the speed of change. But there are ample existing tools for dealing with that phenomenon — including entry and contestability defenses. If market power is likely to be dissipated in one to two years by new products, or if an innovation is on the horizon that would cause displacement of the market itself, existing antitrust doctrine teaches that the market power is too transient to be the basis for remedial concern.²⁸ The dynamic aspects of an industry will almost always be of great importance in this analysis. Antitrust, especially in the context of merger enforcement, is often devoted to predictions of future effects. The more uncertain the future effect may be, the greater the need for caution rather than intervention. Consequently, the more dynamic the market, the more certainty should be required before reaching a conclusion of condemnation or other intervention.

One of the great strengths of antitrust has always been its flexibility in dealing with new and different markets. We have in the United States today a large body of consensus-driven, highly successful antitrust principles. They have as their premise the basic proposition that transactions and practices that reduce output, increase price, or lower quality are bad. Proponents of the “new economy” exception have suggested nothing that makes decreased output good in “new economy” markets, or that implies that consumers will be better off with higher prices or lower quality. If antitrust enforcers and courts simply keep to the core fundamentals, as they have fairly well in recent years, there is simply no reason to throw out our existing rules for “new economy” practices.

Microsoft

How did the *Microsoft* court respond to these questions? The prevailing wisdom is that the court of appeals rejected a “new economy” defense. That is not entirely clear. Yes, the court specifically rejected the argument when it came to evaluating the pretty easy question whether Windows gives Microsoft monopoly power.²⁹ But then, in determining whether Microsoft had unlawfully tied its Internet Explorer browser to the Windows operating system, the court appeared to do an about-face and accept the new economy argument. Specifically, the court ruled that software markets were too new, and the judiciary too inexperienced in dealing with them, to apply the same per se rule for tying arrangements the Supreme Court has adopted in other industries.³⁰ The qualification that the court *appeared* to accept the “new economy” argument is important. As has been argued elsewhere, closer scrutiny indicates that the problem was not really the “new economy” aspects of software integrations. It was the per se tying rule itself,³¹ which seems ripe to go the way of *Schwinn* and *Albrecht*.³² Whichever view is correct, the circuit court decision in *Microsoft* will undoubtedly be cited for many years by both sides in the debate over the applicability of antitrust to the “new economy.”

The facts underlying some aspects of *Microsoft* present an important policy problem. A common operating system that everyone can use provides enormous social benefits. But if the law allows the operating system monopolist to wipe out competition in applications markets at will (or to preempt those middleware applications that might have threatened the ongoing importance to the consumer of the operating system itself as the primary portal to applications) by bolting the Microsoft version of the application to the operating system, no one is going to invest good money in developing applications (or middleware representing the next generation of operating systems). That cannot be good. The product integration decision and accompanying tactics may well be beneficial, rather than harmful, and should be analyzed with significant deference. But the conduct should at least be analyzed, not given an automatic pass.³³ We want Microsoft to innovate, but we want others to innovate, too. The challenge is to apply a legal standard that encourages innovation both in operating systems and applications. Existing antitrust doctrine allows us to do just that. A “new economy” exception might not.

-end-

BIOS: Jonathan M. Jacobson, a member of the New York Bar, is Co-Chair of the firmwide antitrust practice group.

Endnotes

-
- ¹ Robert H. Bork, *The Antitrust Paradox* 15 (1978) (“The years 1890 to 1914 witnessed the origin of every major theory that drives and directs the evolution of antitrust doctrine today.”).
 - ² Abbott B. Lipsky, Jr., *Predicting the Competitive Effects of Structural Transactions: Should the Antitrust Rules Change?*, in ABA Section of Antitrust Law, *Perspectives on Fundamental Theory* 369, 369-71 (2001) (forthcoming).

-
- ³ See *United States v. Microsoft Corp.*, 253 F.3d 34, 49 (D.C. Cir. 2001) (“We decide this case against a backdrop of significant debate amongst academics and practitioners over the extent to which ‘old economy’ § 2 monopolization doctrines should apply to firms competing in dynamic technological markets characterized by network effects.”) (citing sources).
- ⁴ See Brief for Appellant Microsoft Corp. at 16-19, 88-92, 133, *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001); David S. Evans & Richard Schmalensee, *Some Economic Aspects of Antitrust Analysis in Dynamically Competitive Industries*, (Nat’l Bureau of Econ. Research (NBER) Working Paper W8268 (Apr. 2001); Christian Ahlborn, David S. Evans & Alilano J. Podilla, *Competition Policy in the New Economy: Is European Competition Law Up to the Challenge?*, 2001 E.C.L.R. 156.
- ⁵ *United States v. Trans-Missouri Freight Ass’n*, 166 U.S. 290, 369 (1897) (White, J., dissenting).
- ⁶ *Id.* at 322-23. This passage was followed by the following significant statement: “In business or trading combinations [trusts] may even temporarily, or perhaps permanently, reduce the price of the article traded in or manufactured, by reducing the expense inseparable from the running of many different companies for the same purpose. Trade or commerce under those circumstances may nevertheless be badly and unfortunately restrained by driving out of business the small dealers and worthy men whose lives have been spent therein, and who might be unable to readjust themselves to their altered surroundings. Mere reduction in the price of the commodity dealt in might be dearly paid for by the ruin of such a class, and the absorption of control over one commodity by an all-powerful combination of capital.” *Id.* at 323.
- ⁷ *Northern Securities Co. v. United States*, 193 U.S. 197 (1903). See *id.* at 409 (Holmes, J., dissenting) (“I do not expect to hear it maintained that Mr. Morgan could be sent to prison for buying as many shares as he liked of the Great Northern and the Northern Pacific, even if he bought them both at the same time and got more than half the stock of each road.”).
- ⁸ *Appalachian Coals, Inc. v. United States*, 288 U.S. 344, 361-63 (1933) (economic state of the coal industry “for many years has indeed been deplorable,” given excess capacity, leading to “destructive practices”).
- ⁹ *United States v. LTV Corp.*, 1984-2 Trade Cas. ¶ 66,133 (D.D.C. 1984) (noting “sharp criticism from Commerce Secretary Malcolm Baldrige and United States Trade Representative William Brock”).
- ¹⁰ Ahlborn, Evans & Podilla, *supra* note 4, at 158-60; Evans & Schmalensee, *supra* note 4, at 6-14.

-
- 11 Each of these references is from *The 20th Anniversary of the PC: Timeline*, PC Magazine, Sept. 4, 2001, <http://www.pcmag.com/>.
- 12 *See generally* Stephen Breyer, *Regulation And Its Reform* (1982).
- 13 284 F.2d 582 (1st Cir. 1960). *Union Leader* involved a struggle to be the surviving newspaper in Haverhill, Massachusetts, the proverbial “one newspaper town.” Notwithstanding the fact that a monopoly outcome was inevitable, the First Circuit held that monopoly power acquired by anticompetitive conduct was prohibited: “[W]e cannot say that it could not be in the public interest to have one newspaper rather than another. Where there is no identity of performance we will not say that the public does not have an interest in competition even though that competition be an elimination bout.” *Id.* at 584 n.4.
- 14 *See generally* *Statement of Commissioner Mozelle W. Thompson Before the House Committee on the Judiciary*, 106th Cong., 1st Sess. (July 28, 1999); *Statement of A. Douglas Melamed Before the House Committee on the Judiciary*, 105th Cong., 1st Sess. (June 4, 1997).
- 15 *See* John C. Hilke & Michael Wise, *Who Turned Out The Lights? Competition and California’s Power Crisis*, *Antitrust*, Summer 2001, at 76.
- 16 A possible, but unique, exception is baseball. *See* *Flood v. Kuhn*, 407 U.S. 258 (1972). Even there, however, there is today a prohibition against collusion in the governing collective bargaining agreements.
- 17 *See* Evans & Schmalensee, *supra* note 4, at 50-52.
- 18 *See* William Letwin, *Congress and the Sherman Antitrust Law: 1887-1890*, 23 U. Chi. L. Rev. 221, 235-40 (1956).
- 19 *See* Joseph Schumpeter, *Capitalism, Socialism, And Democracy* 81-106 (1942). For a more recent expression of this view, see Richard T. Rapp, *The Misapplication of the Innovation Market Approach to Merger Analysis*, 64 *Antitrust L.J.* 19 (1995).
- 20 Kenneth J. Arrow, *Economic Welfare and the Allocation of Resources for Innovation*, in *The Rate and Direction of Inventive Activity* (1962); *see* F.M. Scherer & David Ross, *Industrial Market Structure & Economic Performance* 653 & *passim* (3d ed. 1990); Richard J. Gilbert & Steven C. Sunshine, *The Use of Innovation Markets: A Reply to Hay, Rapp & Hoerner*, 64 *Antitrust L.J.* 75, 76-78 (1995). For an excellent summary of the pertinent arguments on both sides of this debate, see Jonathan B. Baker, *Fringe Firms & Incentives to Innovate*, 63 *Antitrust L.J.* 621, 637-41 (1995); *see also* Richard M. Brunell, *Appropriability in Antitrust: How Much Is Enough?*, 69 *Antitrust L.J.* 1 (2001).

-
- 21 See Baker, *supra* note 20, at 639-41 & n.89; Gilbert & Sunshine, *supra* note 20, at 76-78.
- 22 Michael E. Porter, *Competition and Antitrust: Towards a Productivity-Based Approach to Evaluating Mergers and Joint Ventures*, in ABA Section of Antitrust Law, Perspectives on Fundamental Theory 123, 131 (2001) (forthcoming).
- 23 *Id.* at 167.
- 24 Xerox ultimately surrendered control of the technology by entering into a consent decree with the Federal Trade Commission pursuant to which it agreed to license the xerographic patents. See 645 F.2d at 1201-02.
- 25 See Brief for the United States As Amicus Curiae at 9-13, *SCM Corp. v. Xerox Corp.*, 455 U.S. 1016 (1982). The Justice Department's reasoning was that "no output restriction, and therefore no anticompetitive effect, can result from the transfer of an asset when at the time of the transfer neither party has any market power." *Id.* at 11.
- 26 See, e.g., Sensormatic Electronics Corp., 60 Fed. Reg. 5428 (FTC Jan. 27, 1995) (consent order) (anti-shoplifting labels); American Home Products Corp., 59 Fed. Reg. 60,807 (FTC Nov. 28, 1994) (consent order) (rotavirus vaccines). For a list of cases through mid-1995, see the appendix to Robert J. Hoerner, *Innovation Markets: New Wine In Old Bottles*, 64 Antitrust L.J. 49, 70-73 (1995). For more recent examples, see, e.g., Ciba-Geigy, Ltd., 62 Fed. Reg. 409 (FTC Jan. 3, 1997); *Baxter Int'l*, 62 Fed. Reg. 408 (FTC Jan. 3, 1997); Hoechst, AG, File No. 991-0071 (FTC Dec. 7, 1999); Zeneca Group, PLC, Dkt. No. C-3880 (FTC June 7, 1999).
- 27 E.g., Steven C. Salop & R. Craig Romaine, *Preserving Monopoly: Economics Analysis, Legal Standards, and Microsoft*, 7 Geo. Mason L. Rev. 617, 654-55, 663-64 (1999); Timothy J. Muris, *Is Heightened Antitrust Scrutiny Appropriate for Software Markets?*, in *Competition, Innovation And The Microsoft Monopoly: Antitrust In The Digital Marketplace* 83, 89-91 (Jeffrey A. Eisenach & Thomas M. Lenard, eds., 1998).
- 28 See, e.g., U.S. Dep't of Justice & Federal Trade Commission, Merger Guidelines § 3 (1992).
- 29 234 F.3d at 48-50.
- 30 *Id.* at 89-95 (distinguishing *Jefferson Parish Hospital v. Hyde*, 466 U.S. 2 (1984)). The court of appeals did not go so far in rejecting Supreme Court tying doctrine based on "new economy" principles, however, as might have been expected from

the panel decision rendered in the prior consent decree proceeding in 1998. *See* *United States v. Microsoft Corp.*, 147 F.3d 935 (D.C. Cir. 1998).

³¹ *See* Jonathan M. Jacobson & Abid Qureshi, *Did the Per Se Rule on Tying Survive Microsoft?*, N.Y.L.J., Aug. 14, 2001, at 1.

³² *Albrecht v. Herald Co.*, 390 U.S. 145 (1968) (vertical maximum price-fixing illegal per se), *overruled by* *State Oil Co. v. Khan*, 522 U.S. 3 (1997); *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967) (vertical territorial restraints illegal per se), *overruled by* *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977).

³³ *See generally* M. Sean Royall, *Coping With The Antitrust Risks of Technological Integration*, 68 *Antitrust L.J.* 1023 (2001).