Is There a Doctor in the House? The Value of Economic Expertise in Antitrust,

Consumer Protection, and Public Policy

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Thanks very much, Susan. And thanks to all of you for showing up. We face stiff competition from several concurrent sessions this morning, so I hope your switching costs are relatively high. I'd also like to remind you that what you are going to hear from me this morning reflects my views and not necessarily those of the Federal Trade Commission or any of the individual Commissioners.

A few years ago, I accepted an invitation to spend part of my summer as a visiting professor at Cambridge University. About a week before my departure, I developed a sinus infection. I was naturally concerned that an 8 hour transatlantic flight at 35,000 feet would heighten the excruciating pain in my head. I'm no dummy when it comes to recognizing the value of medical expertise in diagnosing the cause of pain, so I made a quick trip to my family doctor. He determined that I had a bacterial infection and prescribed some antibiotics, which I happily took. Thanks to my doctor's expertise, I felt as good as new in a few days. My headache was gone, and I had a productive visit on the other side of the pond.

I don't have to tell you that expertise is important in medicine, and that it is important for the expertise to be up-to-date. Centuries ago, medicine men in some civilizations treated headaches by trepanation—which is just a fancy way of saying that that they drilled holes in peoples heads.[1] If you've ever suffered from a sinus infection, you probably understand why early civilizations might have thought it wise to intervene by treating headaches through trepanation. When you have a sinus headache, a Black-and-Decker drill can look like a tempting cure.

[1] See, for instance, Chapter 1 in S. D. Silberstein, R. B. Lipton, and P. J. Goadsby, *Headache in Clinical Practice*, (2nd edition). Oxford, England: Martin Dunitz, 2002.

Many bacterial infections are effectively treated with antibiotics. But antibiotics are not useful in treating viral infections. In fact, the unnecessary use of an antibiotic provides no benefits but leads to a potential negative externality—it can cause antibiotic-resistant strains of bacteria to evolve, thereby preventing not only you but other people from being successfully treated with the antibiotic. In the presence of pain, it's easy to lose sight of the fact that the unnecessary use of antibiotics has the unintended consequence of helping bacteria develop resistance to the medicine.

Trust me—this is an ABA session, not a session of the AMA. There is a point in all this, and here it comes: Well-intentioned treatments—like trepanation or antibiotics—can be worse than the problem they attempt to cure. Well-intentioned interventions can have disastrous unintended consequences. It is precisely for this reason that the President, Congress, and the other Bureaus at the FTC rely on the economic expertise of staff in the Bureau of Economics. Like neurosurgeons and family doctors, staff economists are in place to ensure that well-intentioned ideas are based on sound and up-to-date economic principles and evidence, and will not lead to harmful unintended consequences. Since the policies of the FTC are concerned with the operation of markets, it makes sense that economists are substantially involved in these activities.

One area where the Bureau of Economics has provided such economic expertise this past year is oil and gas markets, where consumers have experienced the pain of higher gasoline prices. Economic theory as well as history teaches that price regulation—in this case, preventing the price system from allocating scarce gasoline—is not a cure, no matter how well-intentioned. Price controls eliminate producers' incentives to provide more gasoline and discourage consumers from reducing their consumption or seeking out substitutes. Both of these factors make allocation problems worse, not better. The Soviet Union collapsed in part because its command economy failed to allocate resources as efficiently as capitalistic markets.

Closer to home, it is useful to remember the history of previous attempts to control gasoline prices. In 1971, when I was begging my dad to teach me to drive, gasoline price controls were imposed as part of President Nixon's Economic Stability Program, and remained in place until 1979. These controls created chaos, particularly in the period after the 1974 Arab oil embargo and the 1979 Iraq-Iran War. Long lines formed in some areas of the country while in other areas there was an oversupply of gas. If you were one of those who managed to get ten gallons of gasoline by waking up at three in the morning to wait in line three hours, and if you valued your time at $5 per hour, the opportunity cost of your time waiting in line added $1.50 per gallon to the pecuniary price you paid at the pump.[2]

Additionally, because of fears of running short, many consumers filled their tanks well before their tanks were empty. This shifted inventory holdings from a market system that magically reallocated gasoline to other parts of the country as local demands (and prices) changed, to an inflexible and inefficient inventory system consisting of individuals' gas tanks. William Simon, the administrator of the Nixon program, has a great quote that I love to share with my students. In reference to his experience as the central planner in charge of price controls, he wrote: "…the kindest thing I can say about

[2] See Chapter 2 of Michael R. Baye, *Managerial Economics and Business Strategy*, 6th edition, McGraw-Hill, 2008.

it is that it was a disaster. The normal market distribution system is so complex, yet so smooth, that no government mechanism could simulate it." [3]

Thankfully, in recent years Congress and the President have not responded to the pain of high gasoline prices by imposing price controls. Instead, they have turned to the economic expertise of the FTC to diagnose whether the price increases were caused by natural market forces or anticompetitive behavior on the part of firms. For instance, a year before my arrival the Commission released a study requested by Congress that investigated the price increases that occurred in the wake of hurricane Katrina. The FTC determined that these price increases were driven by market forces.[4] This past August, the FTC released a report in response to a request by the President to provide a diagnosis of the cause of price increases during the spring and summer of 2006.[5] In these and other investigations, the Bureau of Economics provides expert analysis—a dispassionate, scientific evaluation of the evidence—that provides policymakers and lawyers the information they need to make sound decisions and to avoid unnecessary repeats of our experiences in the 1970s.

I spent the first two months of my tenure here at the FTC working with the staff of the Commission and the Department of Justice, and with assistance from the Department of Energy's Energy Information Administration, to finalize this most recent report. During the course of the entire investigation, economists in the Bureau of

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[3] William E. Simon, *A Time for Truth*, 1978.

[4] Federal Trade Commission, *Investigation Of Gasoline Price Manipulation And Post-Katrina Gasoline Price Increases* (2006), available at http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf

[5] Federal Trade Commission, *Report On Spring/Summer 2006 Nationwide Gasoline Price Increases* (2007), available at http://www.ftc.gov/reports/gasprices06/P040101Gas06increase.pdf.

Economics performed financial and economic analyses of crude oil and gasoline price data, as well as an analysis of data on the costs of other key components of finished gasoline. FTC staff also interviewed personnel at refineries, reviewed key business documents, and examined production statistics.

Our report identified and quantified the impact of six market factors that were responsible for the price increases. We found that, at the national level, about 75% of the price increases stemmed from the seasonal effects of the summer driving season, increases in the price of crude, and increases in the price of ethanol. The remaining 25% of the price increases stemmed from increases in demand that were coupled with declines in the production of gasoline due to refiners' transition to ethanol, persistent refinery damage related to past hurricanes, and other refinery outages caused by unexpected events and required maintenance. Further, our targeted examination of major refinery outages revealed no evidence that refiners conspired to restrict supply or otherwise violated the antitrust laws. That said, I would like to stress that gasoline markets tend to be local, and that our staff continue to monitor gasoline and diesel fuel price movements in 20 wholesale regions and approximately 360 retail areas across the nation.

On the antitrust side, another example where the Bureau's economic expertise came into play this past year is in the Commission's recent decision to close the Google/DoubleClick investigation.[6] As you are aware, the proposed merger of two of the most recognizable names in the Internet world stirred up significant lobbying and political frenzy. Outcries arose that Google would control online advertising, and other

[6]See *Statement of Federal Trade Commission Concerning Google/DoubleClick* FTC File No. 071-0170, available at http://www.ftc.gov/os/caselist/0710170/071220statement.pdf.

Internet titans, such as Microsoft and Yahoo!, opposed the transaction and marshaled considerable resources in their attempts to block the merger. The U.S. Senate held hearings.

The frenzy was largely driven by perceptions and untested opinions regarding the likely economic effects of the transaction. Yet, at the Commission, the analysis of the competitive implications of the proposed transaction was conducted in staffs' usual expert fashion. Information about the various markets in which Google and DoubleClick participate was gathered, and potential theories of competitive harm were investigated. Our investigation revealed that the advertising channels served by Google and DoubleClick are distinct relevant markets in which there is no current overlap. Thus, we concluded that there are no direct horizontal competitive effects from the transaction. We also considered a host of non-horizontal theories of harm, including foreclosure, and concluded that they were not supported by the evidence. As I'm sure you are aware, we closed our investigation in December, and earlier this month the EU reached a similar conclusion after its own investigation.[7]

Let me now turn to a couple of areas where economic expertise is playing an important role on the consumer protection side of the ledger. As you know, turmoil in the subprime mortgage market has led to an outcry for the government to intervene, and I obviously defer to Chairman Ben Bernanke and the Federal Reserve to assess the potential impact of various proposals on the safety and soundness of the financial system. But there is one small aspect of mortgage markets where I believe the economic expertise of the FTC provides valuable information to policymakers.

[7] See European Commission, "Commission Clears Proposed Acquisition of DoubleClick by Google" (2008), available at http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/426.

This past summer, the Bureau of Economics released a study showing that current mortgage disclosures required under the Truth-in-Lending Act and the Real Estate Settlement Procedures Act fail to convey critical information that borrowers need in making decisions.[8] For instance, about half of the borrowers in the study could not correctly identify the loan amount, two-thirds did not recognize that they would be charged prepayment penalties if they refinanced with another lender within two years, and nearly nine-tenths could not identify the total amount of up-front charges in the loan. Consumers with adjustable rate mortgages were not always aware that their monthly payments could increase, or of the extent of such increases. This lack of understanding cut across both prime and subprime borrowers.

This research suggests that prime and subprime borrowers alike would benefit from one clear disclosure document—such as a prototype disclosure tested in the study—that alerts them to the major costs and features of a mortgage. Improving mortgage disclosures is one way public policy could positively impact the functioning of mortgage markets without sacrificing the benefits of consumer choice and credit market access that are likely to be lost if the government becomes too deeply involved in regulating mortgage interest rates or the terms of mortgages.

The Bureau of Economics also issued a report this summer examining the effects of credit-based insurance scores on the price and availability of automobile insurance.[9] Using a large database of automobile insurance policies, the study shows that, across

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[8] See Federal Trade Commission, Bureau of Economics *Report on Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms* (2007), available at http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf.

[9] Federal Trade Commission, *Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance: A Report to Congress* (2007), available at http://www.ftc.gov/os/2007/07/P044804FACTA_Report_Credit-Based_Insurance_Scores.pdf.

different ethic and racial groups, credit scores are effective predictors of risk. For instance, controlling for income, race and other factors, people with high credit scores are less likely to file insurance claims than people with low credit scores. One theory is that people who are more cautious in one aspect of their life—such as their finances—are more likely to be cautious in other aspects of their life—like driving. In any event, the study shows that credit scores are useful in predicting risks in insurance markets, and while credit scores are correlated with race and ethnicity, their value to insurance companies is in predicting risk—not as a proxy for race or ethnicity.

Let me close with an area where I believe economists—and here I include fellow academic economists—can play an important role moving forward: privacy issues raised by behavioral advertising. Behavioral advertising is the tracking of a consumer's online activities—such as searches, web pages visited, and content viewed—so that businesses can deliver targeted ads that more closely match the interests of particular consumers. American consumers cherish transparency and autonomy, and this has led some groups to advocate various restrictions on behavioral advertising, including a Do-Not-Track proposal. However, as noted in the Commission's recent request for comment on self-regulatory principles for online behavioral advertising, behavioral advertising also provides benefits to consumers. This includes photo-sharing and blogging in virtual communities, robust search, free web content such as access to newspapers, and personalized ads that better match consumer preferences with products.[10] It is important to balance these benefits to consumers with attempts to protect against any harm to consumers' privacy. There are also externalities similar to those I described earlier

[10] Federal Trade Commission, "Online Behavioral Advertising: Moving the Discussion Forward to Possible Self-Regulatory Principles," available at http://www.ftc.gov/os/2007/12/P859900stmt.pdf.

regarding an individual’s decision to use an antibiotic: Because behavioral advertising currently supports free web content, choices by some consumers not to participate in behavioral advertising could harm other consumers by reducing the availability or quality of free web content. I believe economists have an important role to play in using their expertise to ensure that privacy policies take into account all of the benefits and costs to consumers, and in ensuring that there are no unintended consequences of such policies.

If you’re like my students, I’m concerned that after listening to me for 15 or 20 minutes some of you may be starting to come down with a sick headache. If you are, I assure you it’s an unintended consequence. So, let me stop here and thank you once again for giving me this opportunity to share my views on the value of economic expertise in the Agency’s antitrust, consumer protection, and policy work. Thank you.