

**Looking for the Keys under the Lamppost:  
Insights from Economics into Standards for Unilateral  
Conduct**

By

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Prepared Comments for  
ABA Section of Antitrust Law,  
Economics and Section 2 Committees Brownbag,  
FTC Conference Center,  
Washington, DC  
July 24, 2006

I haven't done a scientific survey, but I am confident that the most frequently told economics joke is the one about assuming a can opener. I won't repeat it here. I suspect, albeit somewhat less confidently, that there are two candidates for runner-up and they both involve lampposts. There is the one about using data the way a drunk uses a lamppost – for support rather than illumination. And then there is the one about the woman who happens upon a man on his hands and knees under a lamppost outside a tunnel. What is he doing? Looking for his keys. Is that where he lost them? No, he lost them inside the tunnel. Why isn't he looking there? It's dark in there; it's light under the lamppost. I will argue that this last joke comes close to characterizing the state of the economics literature with respect to unilateral conduct. For the analogy to hold, however, I need to embellish the story a bit. Imagine that the man on his knees had a set of keys on a key ring, that the key ring became unattached, and that the keys fell off, but in different places – some inside the tunnel and some underneath the lamppost. In my extended version, looking under the lamppost is not a useless exercise, but it is not sufficient for finding all the keys that we need to formulate sensible antitrust standards for unilateral conduct. Let me add one further embellishment. There is more than one lamppost outside the tunnel, and another one might be casting a brighter light.

At a broad level, I don't think there is much controversy about what we would like to know. Of course, as I might be wrong about the lack of controversy, I should stress that this is just my opinion and not necessarily that of the Federal Trade Commission or any individual commissioner. Still, as an economist, I find both striking and encouraging the wide acceptance of decision theory as a way to organize our thinking about legal standards.<sup>1</sup> Decision theory starts with the premise that mistakes are inevitable. If you think about it, issues of what needs to be demonstrated and by whom only make sense if you entertain the notion that mistakes will happen; and the problem then is how to minimize the damage.

Decision theory is clear on the factors that enter the consideration of legal standards. For any particular practice, there are three broad considerations, each of which has a number of constituent parts.

- 1) What do we know about anticompetitive aspects of the practice? What is the underlying theory of how it can be anticompetitive? When it is, what is the cost to consumers and to economic welfare? (That tells us about the error cost of permitting anticompetitive instances.) How often is the practice anticompetitive?<sup>2</sup>
- 2) What do we know about the pro-competitive uses of the practice. What is the nature of the pro-competitive benefit? When the practice

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<sup>1</sup> Mark S. Popofsky, *Defining Exclusionary Conduct: Section 2, the Rule of Reason, and the Unifying Principle Underlying Antitrust Rules*, 73 ANTITRUST L.J. 435 (2006) as a recent example. For early treatments, see Paul L. Joskow & Alvin K. Klevorick, *A Framework for Analyzing Predatory Pricing Policy*, 89 YALE L. J. 213 (1979) and C. Frederick Beckner III & Steven C. Salop, *Decision Theory and Antitrust Rules*, 67 ANTITRUST L.J. 41 (1999).

<sup>2</sup> For an exposition of the importance of the relative frequency of pro-competitive and anticompetitive instances of a practice, see Keith N. Hylton & Michael Salinger, *Tying Law and Policy: A Decision-Theoretic Approach*, 69 ANTITRUST L.J. 469 (2001).

is pro-competitive, how large are the gains from it? (That tells us about the error cost of inadvertently chilling pro-competitive instances of it.) How often is the practice pro-competitive or competitively neutral?

- 3) What sort of tests might one use to identify anticompetitive instances? For any such test, what is the risk that it will label a pro-competitive instance as anticompetitive and what is the risk that it will fail to catch an anticompetitive instance?

No one seriously supposes that we can objectively measure all of these factors. In particular, there is no practical way to take a random sample of instances of a particular practice like tying or bundled discounts and assess the relative frequency of pro-competitive and anticompetitive instances. Still, any policy implicitly rests on judgments about these factors, so it is useful to form subjective estimates of the answers when objective measures are not available.<sup>3</sup> Doing so can form the basis for understanding disagreements about policy when such disagreements occur.

In my view, the silver standard for this general approach to unilateral effects doctrine is predatory pricing. I would not quite call it the gold standard, as there remain issues as to whether we have gotten it entirely right. Still, in formulating the current doctrine, we have gone through the right process and asked the right questions. To prevail in a predatory pricing case, the plaintiff bears a tough standard of proof to show that pricing was below some relevant notion of cost, and that the structural conditions of the industry are such that recoupment is feasible. The rationale for the doctrine is the belief that price cutting for pro-competitive reasons is common, that the cost of chilling price competition is high, that anticompetitive price cuts are rare and that the cost of allowing them is low, particularly in markets where any attempt to reap monopoly profits can induce relatively rapid entry.

If one looks at the literature related to other practices, many of the pieces of the puzzle are just missing. Much of the literature starts from the assumption of a monopolist typically faced with one specific known entrant and the absence of any valid business justification for the practice. It then works out whether there are a set of assumptions under which the anticompetitive use of the practice is a Nash equilibrium. (As an aside, the lamppost under which many industrial economists seem to look is the Nash equilibrium. In my view, the light emanating from that lamppost is not nearly as bright as most of my colleagues seem to believe. Indeed, sometimes I think economists are attracted to it because they are the only ones with sufficiently keen eyesight to find anything there.) Without going into the details of those concerns, this type of analysis at most answers the first part of the first question, what is the theory under which the practice is anticompetitive? It does not tell us the cost of the anticompetitive practice when it occurs, nor does it tell us how common it is for the practice to be used for anticompetitive purposes. The answers to these questions and, in particular, the latter,

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<sup>3</sup> Warren S. Grimes, *The Antitrust Tying Law Schism: A Critique of Microsoft III and a Response to Hylton And Salinger*, 70 ANTITRUST L.J. 199 (2002) and Hylton and Salinger *id.*

remain inside the dark tunnel. Also lying somewhere other than under the Nash equilibrium lamppost is the analysis of competitive behavior.

The specific area of unilateral conduct that I have worked on the most is tying. As I have recently argued in an article with my FTC colleague Alden Abbott,<sup>4</sup> I believe that the economics profession should view the tying literature as a complete embarrassment. Ask yourself this question. Does the economics literature on tying explain the tying we observe in practice? To be sure, the economics literature (as well as the legal literature) has always acknowledged that efficiencies can explain tying and, indeed, can explain most of the tying that we observe in practice. A common example used to illustrate the point is pairs of shoes. That is an unfortunate example, in my view, because it creates the impression that tying occurs when most people want all the components anyway. This is misleading both because tying need not occur just because most people want all the components and, more importantly, because there are countless instances of tying in which customers take components they do not want. The simple example I keep using is this set of plug adapters that I purchased at Radio Shack some years ago. Until David Evans and I raised this example, I would contend that the economics literature on tying did not contain an explanation for it.<sup>5</sup> Unless we understand why cases like this occur and take note of how frequently they occur, we will not have all the keys that decision theory tells us we need to formulate the optimal rule on tying.

Like the law on tying, the economics literature on tying might be unusually bad. I think we understand the efficiency justifications for exclusive dealing better than those for tying.<sup>6</sup> Exclusive dealing can help solve agency problems when the contracts between a manufacturer and a distributor are inherently incomplete. Also related to contractual incompleteness, a manufacturer might insist on exclusivity if it has to share proprietary information with firms it supplies and it wants to prevent its competitors from getting that information. Finally, some buyers faced with suppliers who might collude might choose to purchase from one supplier exclusively in order to disrupt the collusion. I don't think we know much about how large these benefits are or how frequently they arise.

With all units and bundled discounts – practices that have garnered a great deal of interest recently – our understanding is more up in the air. This area has the virtue that everyone seems to have a fair amount of humility in acknowledging that we need to understand them better. Much of the analysis to date has been theoretical.<sup>7</sup> I am not sure that we know much about the competitive benefits. Even if we figure them out qualitatively, I would like to know how big the benefits are relative to the alternatives. There is a pretty obvious rule to consider, which is that firms with dominant positions must price so that

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<sup>4</sup> Alden F. Abbott and Michael A. Salinger, *Learning from the Past: The Lessons of Vietnam, IBM, and Tying*, 2 COMPETITION POLICY INTERNATIONAL 3 (2006).

<sup>5</sup> David S. Evans & Michael Salinger, *Why Do Firms Bundle and Tie? Evidence from Competitive Markets and Implications for Tying Law*, 22 YALE J. ON REG. 37 (2005).

<sup>6</sup> Michael D. Whinston, *Exclusivity and Tying in U.S. v. Microsoft: What we Know and What We Don't Know*, 15 J. ECON. PERSP. 63 (Spring 2001).

<sup>7</sup> PATRICK GREENLEE & DAVID REITMAN, COMPETING WITH LOYALTY DISCOUNTS (Economic Analysis Group, Working Paper No. EAG 04-2, Feb. 2004), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=600799](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=600799).

the incremental revenue over any substantial portion of commerce exceeds the incremental avoidable costs. Even if there are some agency-based explanations for bundled and/or loyalty discounts, I would be surprised if there were not less exclusionary alternatives that are nearly as good.

In my elaboration of the joke about looking for keys under the lamppost, I posited the existence of another lamppost, perhaps one giving off brighter light. What I had in mind was simple observations of examples of particular practices under sufficiently competitive conditions that anticompetitive exclusion is not a candidate explanation. I think that lamppost is emitting much brighter light than the Nash equilibrium lamppost.

Now, of course, you might argue that examples like the adapters are subject to the criticism implicit in the other economist lamppost joke – the one about using data (or evidence) more for support than illumination. I acknowledge the danger here, but I still would not agree with that criticism. I think cases like these are quite illuminating.

Of course, the law cannot wait for economists to figure out all that in principle we need to get the optimal policy. I must say that I find the debates comparing the relative merits of the no economic sense test, the profit sacrifice test, and the consumer welfare test not to be particularly illuminating because I am skeptical that the appropriate standard is the same for all practices. A “no economic sense” standard can be appropriate when we have a low tolerance for risks of false positives, as is arguably the case with predatory pricing. With different practices, though, we are going to weigh the risks of “false positives” and “false negatives” differently, and a different standard will be appropriate.

My guess is that we will then end up with a set of rebuttable presumptions about particular practices that, when taken by a firm with monopoly power, are or are not illegal. I don’t think that our understanding of any practice, including tying, is sufficient to merit per se legality or per se illegality.

In deciding what practices carry a presumption of legality and which carry a presumption of illegality, the distinction between behavior that is overly aggressive and behavior that raises rivals’ costs is a useful one.<sup>8</sup> As a rule, we should be suspicious when dominant firms pay their customers or suppliers not to deal with their rivals, or undertake policies that have that effect. In this regard, exclusive dealing by a firm with sufficient monopoly power should be treated with suspicion as companies must pay something for exclusivity. When a firm with monopoly power pays for exclusivity, it in effect pays its supplier or customer not to deal with its (i.e., the dominant firm’s) rivals. Another practice I would treat with great suspicion is bundled and loyalty discounts provided they entail incremental revenues over a substantial range of commerce that is less than the avoidable cost.<sup>9</sup>

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<sup>8</sup> Steven C. Salop & David T. Scheffman, *Raising Rivals’ Costs*, 73 AM. ECON. REV. 267 (1983).

<sup>9</sup> The basis for my suspicion is not that all-units and bundled discounts are raising rivals’ costs strategies. Rather, it is based on how compelling the competitive explanation for them are. While they may not fail a “no economic sense” test (Sreya Kolay, Greg Shaffer, and Janusz A. Ordover, *All-Units Discounts in Retail Contracts*, 13 JOURNAL OF ECONOMICS & MANAGEMENT STRATEGY 429 (2004)), I suspect that

As I know we want to leave time for discussion, I will end my comments here.

Thank you.

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any efficiencies they generate are small compared to less restrictive alternatives. I should stress, though, that this judgment is tentative. I hope that the FTC/DOJ unilateral conduct hearings will provide evidence to support a rational standard.