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Freedom to Trade and the Competitive Process

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Abstract

Although antitrust courts sometimes stress the competitive process, they have not deeply explored what that process is. Inspired by the theory of the core, we explore the idea that the competitive process is the process of sellers and buyers forming improving coalitions. Much of antitrust can be seen as prohibiting firms' attempts to restrain improving trade between their rivals and customers. In this way, antitrust protects firms' and customers' freedom to trade to their mutual betterment.

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[B]y the omission of any direct prohibition against monopoly in the concrete [the Sherman Act] indicates a consciousness that **the freedom of the individual right to contract** when not unduly or improperly exercised was the most efficient means for the prevention of monopoly…

[T]he **right to freely contract** was the means by which monopoly would be inevitably prevented …

Justice White in *Standard Oil* (1911),[1] emphases added.

The freedom to switch suppliers lies close to the heart of the competitive process that the antitrust laws seek to encourage.

Justice Breyer in *Discon* (1998)[2].

Antitrust analysis considers both process and outcomes. That is, it asks both whether an activity or agreement interferes with the competitive process and whether it leads to outcomes that are inefficient and/or injure consumers. The mix of these two strands of analysis varies. For example, horizontal merger analysis is almost entirely outcome-focused,[3] while cartel enforcement scarcely addresses outcomes at all;[4] form-based and effects-based analyses continue to contest other areas of antitrust.

Recent decades have seen increasing weight placed on direct analysis of outcomes. Some commentators even suggest that whether an act is anticompetitive turns by definition on whether its outcome will be bad. Courts, on the other hand, still frequently stress the competitive process, even when they may not be particularly clear about what that process is.[5]

We take a step toward understanding what the competitive process entails, because we side with the courts in thinking that an analysis of impacts on the competitive process should remain central to antitrust.

A very intuitive and robust benefit of competition is that if firm A is greedy or incompetent, consumers can trade with firm B instead, in a way that makes both consumers and firm B better off. Firm A would of course love to thwart the formation of this improving coalition, and might sometimes be able to do so either in concert with B or on its own, as we illustrate below. These observations suggest a perspective that in large part the competitive process is *the process of sellers and buyers forming improving coalitions*.

We explore below the idea that the competitive process centrally involves the freedom to strike better deals. From this perspective much—though by no means all—of

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[1] Standard Oil v. United States 221 U.S. 1 (1911).

[2] NYNEX v. Discon 525 U.S. 128, 137 (1998).

[3] See, e.g., Horizontal Merger Guidelines, U.S. Department of Justice and Federal Trade Commission, August 19, 2010.

[4] See, e.g., United States v. Socony, 310 U.S. 150 (1940).

[5] Similarly, the central notion of "competition on the merits" is hard to make precise in general. See for instance OECD "Policy Brief: What is Competition on the Merits?", June 2006, and related Best Practices Roundtable (2005).

antitrust can be seen as prohibiting firms' attempts to *restrain or thwart* improving *trade* between their rivals and customers, echoing the Sherman Act's ban on agreements in "restraint of trade." In this way antitrust protects B's and consumers' *freedom to trade* to their mutual betterment.[6]

We also illustrate how some antitrust controversies arise when firm A itself is an essential participant in the improving coalition.

1. Outcomes, Process, and the Core

An entirely outcome-focused view would *define* restraints of trade as practices or agreements that lower economic (consumer or total) surplus, perhaps measured by quantity traded, in a market. Some mainstream antitrust commentary might approach this view. Posner [2001, p.22] views the "completed act" of violating section 1 as "an actual restriction of output," while Posner [1976, p. 53] argues that "antitrust policy is to be shaped by the monopoly problem" after explaining that monopolies lower output and raise price, relative to the perfectly competitive level or the level that would otherwise obtain. Similarly, Hovenkamp (2006, ch. 1) frames his "legal and economic structure" using outcome measures. Bork [1978, p. 51] states that "[t]he only legitimate goal of American antitrust law is the maximization of consumer welfare";[7] Salop (2010) also focuses on welfare outcomes (though he stresses that Bork used an odd definition of consumer welfare).

The freedom-to-trade perspective, in contrast, stresses process: the freedom of buyers and sellers to change their trading partners whenever that is mutually beneficial. The aspect of the competitive process that we study here is buyers and sellers exercising this freedom and forming improving coalitions, finding mutual gain in bypassing greedy or incompetent incumbents.

In a highly competitive market a seller who does not give its customers good deals will find that rivals offer better deals to attract these customers. The process of firms fighting over customers by offering them better and better deals makes consumers better off and also normally increases economic efficiency.

Until the outcome reaches what economists call the core, an improving coalition of buyers and sellers is always possible and the improving/competitive process will continue. In fact the core is defined as the set of outcomes or payoffs relative to which no coalition of people could improve all of their payoffs by trading among the coalition.[8]

Because it is flexible as to institutions and modes of trading, the core is more meaningful than perfectly competitive equilibrium in a broad range of markets of interest to antitrust. As Edgeworth (1881: p. 31) wrote,

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[6] Antitrust prohibits certain things (all statutes do), but it is a shallow paradox to observe that laws protecting freedom can take the form of prohibitions. (For instance, laws against kidnapping prohibit certain conduct but clearly protect freedom.)

[7] By consumer welfare Bork means (confusingly) what is more often called total welfare; but our point here is that he asserts that antitrust is outcome-focused.

[8] See, e.g., Telser (1978).

> *"[the core] is attained when the existing contracts can neither be varied without recontract with the consent of the existing parties, nor by recontract within the field of competition. The advantage of this general method is that it is applicable to the particular cases of imperfect competition; where the conceptions of demand and supply at a price are no longer appropriate."*

As with perfect competition, outcomes in the core are efficient, making the core a reasonable ideal to pursue if we judge by equilibrium outcomes.[9]

In the last half century, antitrust commentators have come to think of the outcome ideal or benchmark as a perfectly competitive equilibrium in which firms are price takers. This framing naturally inspires them to focus on acquisitions and maintenance of market power (often defined as the power to raise price above competitive levels) as a problematic outcome, but does not provide much process guidance of what acts are anticompetitive. Grinnell famously and unhelpfully identifies "willful acquisition" as its process prong.[10] On the other hand, if the outcome ideal is the core, as we consider here, then the process focus is relatively clear: whatever restrains, thwarts or blocks the formation of improving coalitions constitutes a process violation.

Our suggestion is that antitrust protects the formation of improving coalitions, a process that might converge toward the core. Lester Telser [1978] also considered connections between the core and antitrust. He argued that when the core is empty, as it might be in ocean shipping, collusion is justified and perhaps efficient. We are skeptical of the efficiency claim, and do not think that non-existence of theoretical equilibrium is a compelling reason to suspend antitrust, but these are not our focus here. We take it for granted that antitrust seeks to protect the competitive process and explore the implications of characterizing this process as the freedom to form improving coalitions and trade within them.

Some may fear that a focus on the competitive process rather than economic analysis of outcomes is a throwback to the (bad) old days of antitrust's first half century. Indeed, we think the spirit of freedom to trade animated much early antitrust discussion. Fear of a throwback is, however, needless. We are not endorsing decisions like *Dr. Miles*[11]; indeed, as we discuss below, RPM does not strictly violate freedom to trade. Second, rightly or wrongly, process concerns have remained important in antitrust, so it is important to work toward a better understanding and a coherent definition of the competitive process.

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[9] However, the (usual) *proof* that outcomes in the core are (Pareto) efficient relies on the prospect of forming the "grand" improving coalition containing everyone in the economy. If such coalitions are very hard to form, it becomes an appealing hypothesis rather than a theorem that the formation of improving coalitions tends toward efficiency.

[10] United States v. Grinnell Corp. 384 U.S. 563 (1966).

[11] Dr. Miles Medical Co. v. John D. Park & Sons Co. 220 U.S. 373 (1911).

2. Freedom to Trade and Horizontal Agreements under Section 1

To illustrate this view of the competitive process as freedom to trade, suppose that suppliers A and B collude and agree to charge a high price H. If their contract were legally binding, it would prohibit either from trading with a buyer at a lower price L < H.[12] In the case of a buyer who pays H to buy from A, the contract thwarts the {B, buyer} coalition that would otherwise improve on the status quo for both of its members. The contract thus restrains the freedom of B and the buyer to trade.[13]

Typically, of course, a cartel does not contemplate court enforcement; rather, A threatens that if B attracts buyers by offering a better deal, A will punish B through marketplace responses. This threat discourages the otherwise improving coalition. B is not entirely "free" to cut price so as to trade with the buyer, because A will punish him for doing so. Thus if we view the competitive process as centrally involving freedom to trade, cartels are a direct core violation of Section 1, whatever their likely outcome might be. We suspect this may "explain" per se treatment of cartels in a more fundamental way than the courts' mantra that "experience" shows that cartels almost always lead to bad outcomes.

Readers may ask why {A,B} isn't an improving coalition relative to the competitive outcome: why doesn't freedom to trade fatally include freedom to collude? Put differently, why isn't a cartel itself an improving coalition? In the language of the core, {A,B} is not an improving coalition because a coalition with only sellers yields no surplus: worthwhile coalitions must include the trading partners, because without including customers {A,B} can achieve nothing. And the coalition {A, B, customers} with trade at H does not "improve on" the competitive outcome because customers are worse off.[14] In the economic logic of the core, a cartel is prevented by the need to attract customers to the trading coalition. In antitrust, the fact that customers are not at the bargaining table justifies the legal restriction on cartel agreements.

Maricopa[15] may illustrate the view that restraining rivals' trade is illegal even in the face of a natural intuition that the effects might not be bad. The Court decided it was

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[12] Even if A and B are bound to their collusion by honor alone, an agreement not to deal with one another's customers restrains trade and discourages each from forming an improving coalition with the other's customers.

[13] In the economics of the core, the fact that an improving coalition of B and the buyer to trade at a lower price would hurt A (relative to a high-priced status quo) does not call for pause in calling it an improving coalition. As a result, not every improving coalition need improve total economic surplus or efficiency. This fact is reflected in competition policy economics, for instance, by the observation (Mankiw and Whinston, 1986) that profitable entry that benefits consumers may easily in itself lower economic welfare. The theorem/fact that the eventual resting place of a process of free formation of improving coalitions, the core, is economically efficient is thus *not* because every such step in the process necessarily increases efficiency.

[14] In principle one should specify the terms on which members of a coalition trade; in some cases we take the liberty of leaving that implicit.

[15] Arizona v. Maricopa County Medical Society, 457 U.S. 332 (1982).

per se illegal for doctors to agree on maximum prices—that is, to agree not to charge *more* than certain prices. In an outcome-focused approach, the Court's per se condemnation would be puzzling. After all, maximum prices would seem likely to expand output (if doctors have market power or information rents), suggesting at least a need for more analysis. On the other hand, the doctors were nakedly restraining one another's freedom to trade, although in ways that one might not have thought would be particularly tempting; for instance, each doctor was agreeing not to compete away business from the others by offering very high quality service at high prices. A freedom-to-trade approach appears to explain the result in Maricopa better than an outcome approach.

However, we do not suggest that outcomes can be ignored. To do so might risk returning antitrust to pre-*Chicago Board*[16] paradoxes such as whether all contracts are illegal restraints or whether all trade restrains other trade. In *BMI*, the Court declined to apply the per se rule.[17] Although the case literally involved fixing a price for the blanket license, each copyright holder remained free to trade on his own with a licensee.[18] One could thus analyze the case by saying that the blanket licenses did not limit anyone's freedom to trade. Alternatively, if one did view collective pricing of the blanket license as limiting freedom to trade, a court might allow the limitation if efficiencies are sufficiently compelling.

In *Engineers,*[19] engineers agreed not to quote a price until a customer had engaged a particular engineer. They argued that without this restriction, customers would choose low bidders, engineers would cut corners, and bridges would fall down. That defense goes to efficiencies, not to whether the horizontal agreement limits freedom to trade. A court might concern itself exclusively with the competitive process, and strike down the agreement; or it might evaluate the efficiency defense. In actuality, the Supreme Court took a confusing path somewhere in between. It pointed out that consumers can trade off quality against price, potentially the germ of a real efficiency analysis, but did not engage with an implied efficiency theory involving consumer irrationality. The short shrift given to the engineers' defense seems more compatible with a focus on restraints of the competitive process than with a focus on outcomes.

Illustrating some of these tensions and interweavings of process and outcome, consider an art dealer D who agrees to sell a painting to buyer A in a week for $500, but leaves it hanging in his gallery. Buyer B arrives mid-week and offers $750 for the painting. The forward contract between D and A prevents D from selling to B at the higher price. Does it "restrain" the freedom of B and D to trade to their mutual benefit and thwart an improving coalition {D, B}?

Had D and A entered a spot contract instead of a forward one, and had A taken the painting home with him, then when B arrived, D would plainly have no painting, so {D,B} would not be an improving coalition (let alone one that is thwarted). Inspired by this observation, one could analyze the forward sale by saying that {D, B} is not an

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[16] Chicago Board of Trade v. United States, 246 U.S. 231 (1918)

[17] Broadcast Music v. Columbia Broadcasting System 441 U.S. 1 (1979).

[18] This right to bypass ASCAP was the product of a prior antitrust settlement.

[19] National Society of Professional Engineers v. United States, 435 U.S. 679 (1978)

improving coalition because the painting is already sold even though it still hangs in the gallery. Here, and in many situations, this may be the soundest answer.

Another tack (less compelling in this instance but perhaps helpful in others) would say that the forward sale did limit {D, B}'s freedom to trade, but might yet not violate Section 1. First, the forward sale may well have helped D and A to trade in the first place, so it might on balance increase freedom to trade. This approach would try to balance pro and anticompetitive effects in terms of the competitive process, not directly balance efficiencies. Second, even if forward sales hinder the competitive process, one might allow them if they greatly improve efficiency. This approach would try more directly to balance inefficient outcomes against anticompetitive restraints.

3. Freedom to Trade and Monopolization

As the quotation from Justice White suggests, Section 2 tries to ensure that monopolies do not thwart others' incentives to trade around a greedy or incompetent monopoly. This might suggest glossing Section 2 as: *A monopoly may not block improving trade between customers and rivals who would offer customers a better deal.*

How, if at all, can a monopoly do that? Raising rivals' costs can do it: consider sabotaging a key rival's factory, or threatening customers who deal with rivals.[20] Less obviously, we show below how a firm might discourage improving coalitions using pricing—not price *levels* but pricing *patterns.* A low price may exclude, but only by its merit: that is, only by offering customers a genuinely good deal. But a pricing *pattern*, it turns out, can hinder the competitive process by forcing rivals to compete against a price lower than the price that customers pay.

To see how this can happen, we first note two simple models in which it fails. First, suppose that *n* firms each set a price simultaneously. Each firm's price to consumers is also the price against which its rivals compete. If a rival offers a better deal, it gets the business.

Second, in the contestability model of Baumol, Panzar and Willig [1982], an incumbent sets a price, and potential entrants make entry decisions knowing that (for long enough at least to recoup sunk costs of entry) they can compete against that price. Again, if a rival offers a better deal than what customers pay the incumbent, the rival wins the business.

Reflecting the powerful intuition of such models of simple price *level*, or more generally of simple competitive offers, Posner (2001: p. 34) wrote:

> *The framers of the Sherman Act were concerned with the "trust" problem, but what they conceived that problem to be is obscure, and indeed contradictory. They seem to have*

[2020] As this sentence indicates, otherwise-improving trade between a rival and a customer could be discouraged from either end. Blowing up a rival's factory is a popular hypothetical in antitrust commentary: see, for example, *Roundtable: Recent Developments in Section 2*, Antitrust Magazine, Fall 2003, p. 20. Somewhat similarly, *Conwood* involved a claim that one firm ruined another's sales displays. Conwood v. United States Tobacco 290 F. 3d 768 (2002).

> *been concerned with low prices harmful to small-business competitors of the trusts… as well as with high prices harmful to consumers. …Protecting competitors from low prices and consumers from high prices are incompatible objectives, with a few rare exceptions, such as when a monopolist prices below cost in an effort to intimidate a potential entrant.*

Indeed, if competition involved simply naming one price, that price could not simultaneously be too high and too low. But the contradiction disappears if the price confronting competitors is not the price that consumers pay.

For instance, monopoly M charges a high price *H*, but would cut its price upon entry to *L.* A potential rival R who knows this and who cannot compete successfully against *L* will not enter; with no entry, customers pay *H*. If R could profitably attract buyers away from *H* but not away from *L*, then R and the buyers are not "free to trade." Specifically, relative to the situation in which M charges *H*, there would be an improving coalition of R and customers, but its formation is thwarted by M's threat to lower price to *L*. Is M "competing on the merits," the touchstone of competitive behavior since *United Shoe?*[21] The "merit" of M's offer is inversely measured by the consumer price *H*, but it "competes" using *L*. In that sense, when *H* and *L* differ, M is not competing on the merits. We say that a firm has *moved the goalposts (thus restraining freedom to trade) if its rivals must compete against a price lower than the price its customers pay*.

Moving the goalposts restrains R and customers from trading to their mutual betterment, relative to M's pre-entry price of *H*. In more concrete effects terms, allowing monopolies to move the goalposts chills entry relative to the contestability benchmark, and may well have bad consequences (see Edlin (2002 and 2011)). That said, setting policy to prevent it raises very real difficulties, both practical and conceptual. At the conceptual level, M's post-entry price of *L* represents, ex post, an improving coalition of M and customers, relative to R's offer. Thus it has aspects both of blocking and of improving.

Antitrust has long wrestled with the concept of exclusionary pricing, often formulated (stressing the paradox) as whether prices can be "too low." That formulation suggests a focus on the *level* of price. But, as suggested by the discussion above, an incumbent's pricing *pattern* can restrain or tax potential trade by others. Here the low price is charged only out of equilibrium: consumers do not benefit from it.[22] In this view, neither high pricing nor low pricing is itself a problem, but a pattern could be. Cheating is moving the goalposts, not putting them in a "bad" spot. Note that nothing in this core logic turns on the relationship between the incumbent's price and its costs.

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[21] United States v. United Shoe Machinery Corporation, 110 F. Supp. 295

[22] Of course, a court would only observe a price that occurs. A lawsuit erupts only if an entrant mistakenly enters anyway, and then is driven out. But the fact that the case is brought only ex post does not imply that the antitrust analysis should focus on the ex post effects.

4. Bundling and Loyalty Pricing

Suppose that buyers buy good 1 from firm A, and may buy good 2 either from firm A or its rival firm B. If A worsens the terms of trade in good 1 when the buyer buys good 2 from B, the worsening creates a tax on trade between firm B and the buyer. When the monopolist A leaves the buyer significant surplus in good 1, relative to likely quantities and prices of good 2 (and it's fair to ask why A would do so), the tax may exclude trade between B and the buyer even while A charges a high marginal price for good 2. In this way, much as in our monopolization discussion above, B may have to compete against a low price (net of the tax) even while the buyer has to pay a high price for incremental units of good 2 (including the tax if it buys from B).[23]

These concerns seem to align with the general notion of moving the goalposts and finding a pricing pattern that hinders trade between the buyer and B by means other than simply charging low prices to the buyer. On the other hand, the tax is avoidable if the buyer ceases to buy good 1 from A, so it is limited by the buyer's surplus in good 1. Moreover, B and the buyer can trade between themselves if they are willing to say goodbye to A, so A's offers do not thwart that potential improving coalition, and thus do not violate plain freedom-to-trade. Thus, any concern about moving goalposts is in at least some ways broader than a concern about restraints on freedom to trade. When a practice harmfully moves the goalposts, but does not violate freedom to trade, the ban on "unfair methods of competition" in section 5 of the FTC Act might be a better fit than the ban on restraints of trade in the Sherman Act.[24] Regardless of what Act is involved, however, we think that a significant set of antitrust controversies arise in cases where those criteria differ: where a rival and buyer(s) would like to bypass a dominant firm in one line of business but where the buyers are not willing to eschew all trade with the dominant firm. To put it another way, consumers and firm B would like to form coalitions that improve their payoffs but that (at least in the short run) require firm A to continue to participate, and A declines to do so. The next section further illustrates how controversies can arise in such cases.

5. Vertical Agreements

The process-based freedom-to-trade criterion need not return us to pre-Chicago antagonism to vertical agreements. Some vertical agreements may restrain freedom to trade, but by no means all.

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[23] See e.g. Inderst and Shaffer (2010) and Farrell, Pappalardo and Shelanski (2010).

[24] It has long been asserted that the ban of unfair methods of competition under FTC Section 5 is broader than the bans of the Sherman Act. See, e.g., Federal Trade Commission v. Motion Picture Advertising Service Co., 344 U.S. 392 (1953). Efforts by the FTC to take advantage of this extra power, however, have thus far been thwarted. See, e.g., Kovacic and Winerman (2010) and du Pont v. Federal Trade Commission, 729 F.2d 128 (2d Cir. 1984). One linguistic interpretation of restraint of trade might limit it to restraints on strictly improving coalitions, while harmfully moving the goal posts might be an unfair method of competition even if nothing strictly restrains improving coalitions.

Consider for example retail price maintenance ("RPM"), involving a manufacturer M, retailer R, and consumer C, and a retail price r at which R agrees with M that it will sell to C. The RPM agreement means that R is then not free to charge a higher or lower price than r for M's product. Does this restrain the freedom of {R,C} to trade? The tone of *Dr. Miles*,[25] overruled by *Leegin*,[26] suggested so. But, in fact, freedom to form improving coalitions does not imply the *Dr. Miles* result and is quite consistent with *Leegin*. After all, {R, C} is not an improving coalition: by themselves the retailer and customer cannot do better because without M, the retailer has no goods to sell or consume.[27]

Consider now an exclusive distributorship. M and R agree that M will supply R but not a would-be competing retailer S. Is freedom to trade restrained? M could shift its business entirely to S, so if {M, S, C} is an improving coalition because S is a better (or less greedy) retailer than R, then that coalition is free to form. This argument suggests that freedom to trade is not restrained in the sense above. As with bundling, the thornier issue is whether there is an improving coalition that includes R, here {M, R, S, C}, and whether R's (or jointly M's and R's) refusal to negotiate towards such an improving coalition "should" count as restraining freedom of trade.

6. Freedom to Trade and the Goals of Antitrust

Commentators as diverse as Bork (1978), Posner (2001), Salop (2010), and Hovenkamp (2006) have argued that antitrust should seek to protect total or consumer welfare. Clearly it does so, but equally clearly it is not so simple. Antitrust doesn't just fail, but explicitly doesn't try, to protect total or consumer welfare against certain obvious threats, notably the exercise of legitimately acquired monopoly power by simply raising price.

While trying to address those threats would certainly involve administrative difficulties and could affect ex ante incentives, antitrust's refusal to try seems proud and categorical rather than regretful and pragmatic. We think that a straightforward account of why simple monopoly pricing is legal is found in the quotation from Standard Oil with which we began. Antitrust (mainly) seeks to protect against monopoly abuse not by barring monopoly outcomes, but by safeguarding the competitive process, which we suggest involves freedom to trade and the formation of improving coalitions. Simply charging monopoly prices harms welfare, but does not limit rivals' freedom to trade, Justice White's "surest protection against monopoly".

Antitrust protects the *potential beneficial trades between* competitors and consumers. Since both consumers and competitors gain from such trade, this view can explain why both consumers and thwarted competitors have antitrust rights, even though antitrust protects "competition and not competitors." Consumers are not protected from all high prices, but only from those that a competitor would be happy to beat but for some thwarting action; this explains why a pure monopoly does not violate the law simply by

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[25] Dr. Miles Medical Co. v. John D. Park & Sons Co. 220 U.W. 373 (1911).

[26] Leegin Creative Leather Products v. PSKS, Inc. 551 U.S. 877.

[27] If R is also a manufacturer, there is a horizontal problem, which is not our focus here, so we assume that R is purely a retailer.

charging high prices. Competitors meanwhile are not protected from actual everyday low prices, but only from tactics such as moving the goalposts that block them from giving customers a better deal than a monopoly does.

Antitrust does not ban everything that reduces consumer welfare. Instead Congress banned restraint of trade and monopolization, which can be understood as a monopoly's erection of "unnatural barriers" (*restraints*) that "restrict free competition" in the words of Judge Wyzanski in *United Shoe*.[28] We explored the idea that these prohibitions may be unified if the competitive process is understood to include the process of sellers and buyers forming improving coalitions. This contrasts with the ahistorical view that "competition" means anything that improves total or consumer welfare.[29]

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[29] On such redefinition, see for instance Farrell (2006).

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