May 29, 2019

Antitrust Law: An Introduction

Concerns over economic concentration and the rise of dominant technology platforms have recently generated renewed congressional interest in antitrust law. This In Focus offers a brief introduction to antitrust by reviewing the economic assumptions on which it is based and the key substantive provisions of the Sherman Antitrust Act of 1890 and the Clayton Antitrust Act of 1914.

Rationale for Antitrust Law

Contemporary antitrust doctrine is based on the idea that economic competition optimizes the allocation of scarce resources by inducing firms to adopt the most efficient production methods and price their products at or near their costs of production. These virtues of competition are often illustrated with the stylized hypothetical of a "perfectly competitive" market—that is, a market with homogenous products, many well-informed buyers and sellers, low entry barriers, and low transaction costs. In such a market, firms must price their products at their costs of production in order to avoid losing their customers to competitors.

However, real-world markets often deviate from this textbook model of perfect competition. Some markets have significant entry barriers. Many firms sell differentiated products that certain consumers prefer over competing products because of non-price considerations. And many market participants face high transaction costs and information asymmetries. These sorts of structural deviations from perfect competition give many firms *market power*—the ability to profitably raise their prices above perfectly competitive levels. At the extreme, a market can be *monopolized* when a single firm possesses significant and durable market power. Moreover, even in the absence of structural deviations from perfect competition, firms can acquire market power and replicate the effects of monopoly by agreeing among themselves to limit their competitive behavior.

According to standard justifications for antitrust, the existence of significant market power harms both consumers and society as a whole. A firm's exercise of market power harms consumers when it requires them to pay higher prices for goods and services than they would pay in a competitive market. And a firm's exercise of market power harms society as a whole by reducing output (i.e., when prices rise, quantity demanded falls) and eliminating value that would have been enjoyed in a competitive market. Contemporary antitrust doctrine is focused on preventing these harms by prohibiting anticompetitive conduct and mergers that enable firms to exercise market power.

Key Antitrust Statutes

The Sherman Antitrust Act of 1890

Congress passed the Sherman Antitrust Act—the nation's first antitrust statute—in 1890 in response to concerns about the power of large "trusts" like U.S. Steel and Standard Oil. The Sherman Act contains two main substantive provisions that prohibit agreements in restraint of trade and monopolization, respectively. These provisions are enforced by the Antitrust Division of the Department of Justice (DOJ), the Federal Trade Commission (FTC), and private plaintiffs.

Section 1: Agreements in Restraint of Trade. Section 1 of the Sherman Act prohibits "[e]very contract, combination . . . , or conspiracy in restraint of trade or commerce." Despite this broad language, the Supreme Court has relied on the statute's common law background to conclude that Section 1's prohibition applies only to agreements that *unreasonably* restrict economic competition. In applying this standard, the Court has identified certain categories of behavior as categorically unreasonable and therefore *per se* unlawful. However, the Court analyzes most Section 1 claims under a standard commonly known as the "Rule of Reason"—a totality-of-the-circumstances approach that asks whether a challenged restraint is on the whole good or bad for competition.

In applying Section 1, courts have distinguished "horizontal" agreements between competitors in the same market from "vertical" agreements between firms at different levels of the distribution process. Courts have held that certain horizontal restraints—such as "naked" price-fixing and market-division agreements—are *per se* unlawful under Section 1. Other horizontal restraints—including agreements to exchange information, professional standards-setting arrangements, and agreements that are ancillary to a joint venture—are analyzed under the Rule of Reason. By contrast, courts analyze vertical restraints (with the exception of certain "tying" arrangements in which a manufacturer refuses to sell a product unless a buyer also purchases another product) under the Rule of Reason.

Section 2: Monopolization. Section 2 of the Sherman Act makes it unlawful to monopolize or attempt to monopolize "any part of the trade or commerce among the several States, or with foreign nations." The Supreme Court has made clear that the mere possession of monopoly power and the charging of monopoly prices do not violate Section 2. Rather, a firm is guilty of monopolization only if it (1) possesses monopoly power in a properly defined market, and (2) acquires or maintains that power through anticompetitive conduct, as opposed to legitimate commercial behavior. Similarly, a firm is guilty of attempted monopolization when it (1) engages in anticompetitive conduct, (2) with the intent to monopolize, and (3) has a dangerous probability of achieving monopoly power.

Courts and commentators have struggled to formulate a test for distinguishing anticompetitive conduct from permissible commercial behavior. According to one inquiry known as the "profit-sacrifice" test, conduct is anticompetitive when it involves a sacrifice of short-term profits with the expectation that those profits will be recouped when rival firms are eliminated from the market. Similarly, an inquiry known as the "no-economic-sense" test posits that conduct is anticompetitive when it (1) has a tendency to eliminate competitors and (2) makes no economic sense but for that tendency. Another standard—the "equally-efficient-competitor" test—condemns practices that are likely to exclude equally or more efficient competitors from a defendant-firm's market.

While the Supreme Court has not definitively endorsed a single test for identifying anticompetitive conduct, some of these standards can explain certain categories of behavior that the Court has identified as anticompetitive. Specifically, the Court has held that predatory pricing—that is, charging below-cost prices in order to drive competitors from a market—is anticompetitive when a firm has a dangerous probability of recouping its losses by charging monopoly prices once its competitors have been eliminated. Similarly, courts have held that exclusive contracts with customers or suppliers, denying competitors access to an "essential facility," and filing frivolous lawsuits against rivals can qualify as anticompetitive conduct in certain circumstances.

The Clayton Antitrust Act of 1914

In addition to prohibiting a number of practices that are independently unlawful under the Sherman Act, the Clayton Antitrust Act of 1914 bars certain forms of price discrimination and mergers that are likely to harm competition.

Section 2: Price Discrimination. Section 2 of the Clayton Act (as amended by the Robinson-Patman Act of 1936) prohibits certain forms of price discrimination, making it unlawful for a seller to charge buyers different prices for commodities of "like grade and quality" when such discrimination is likely to injure competition. Under the Robinson-Patman Act, competitive injury can consist of "primary line" or "secondary line" injury. Primary line injury occurs when a firm's *competitors* are harmed by its price discrimination (i.e., where a firm sells a commodity at below-cost prices in certain regions in order to eliminate competitors while recouping its losses in other regions). By contrast, secondary line injury occurs when a firm's disfavored *customers* are harmed by its price discrimination (i.e., where a disfavored customer is placed at a competitive disadvantage relative to a price-discriminating firm's favored customers). While the Robinson-Patman Act remains good law, many commentators have advocated its repeal, arguing that its compliance costs outweigh the limited instances in which the act prohibits truly anticompetitive conduct. This criticism appears to have persuaded federal antitrust regulators, as the DOJ no longer enforces the act's price-discrimination provisions and the FTC does so only rarely. However, despite this decline in government enforcement, private plaintiffs retain the ability to bring actions under Robinson-Patman.

Section 7: Mergers. Section 7 of the Clayton Act prohibits mergers that are likely to harm competition. Section 7 applies to both "horizontal" mergers between competitors and "vertical" mergers between companies that operate at different stages in a distribution chain.

Horizontal merger analysis generally requires courts and regulators to define a relevant antitrust market in order to assess whether a merger will harm competition. In brief, a properly defined market includes the relevant product and its substitutes—that is, other products that are "reasonably interchangeable" with the relevant product. Specifically, two products likely compete in the same market if a "hypothetical monopolist" of one product—that is, a hypothetical firm that is the only seller of that product—would be unable to profitably raise prices because of the sales it would lose to sellers of the other product. For example, if a "hypothetical monopolist" selling coffee would be unable to profitably raise its prices because of the sales it would lose to tea companies, then coffee and tea likely compete in the same market. But if sellers of tea and other beverages do not discipline coffee sellers in this fashion, coffee may represent its own distinct antitrust market.

Once a market is defined according to these general principles, courts and regulators typically evaluate the merged firm's market share and the relevant market's concentration post-merger. If these inquiries and other factors suggest that a merger would harm competition (e.g., by facilitating collusion or allowing the merged firm to profitably raise prices), the DOJ or the FTC may sue to block the merger. Proponents of the merger may contest the government's allegations by arguing that powerful buyers or new entrants are likely to discipline its exercise of market power, or by identifying merger-specific efficiencies that the combined company will realize and pass on to customers.

Vertical mergers raise different antitrust concerns than horizontal mergers. While vertical mergers are scrutinized less aggressively than horizontal mergers, they may raise competition concerns when a firm with significant power in one market (e.g., widget manufacturing) enters another market (e.g., widget retailing). Such mergers may be anticompetitive in cases where the resulting vertical integration would raise entry barriers in either market or deny competitors access to a needed input or distribution channel.

Jay B. Sykes, jsykes@crs.loc.gov, 7-1064

IF11234