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Working Paper

Consumer Surplus as the Appropriate Standard for Antitrust Enforcement

EAG Discussion Paper, No. EAG 07-9

Provided in Cooperation with:

Economic Analysis Group (EAG), Antitrust Division, United States Department of Justice

Suggested Citation: Pittman, Russell (2007) : Consumer Surplus as the Appropriate Standard for Antitrust Enforcement, EAG Discussion Paper, No. EAG 07-9, U.S. Department of Justice, Antitrust Division, Economic Analysis Group (EAG), Washington, DC

This Version is available at:

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ECONOMIC ANALYSIS GROUP
DISCUSSION PAPER

Consumer Surplus as the Appropriate
Standard for Antitrust Enforcement

by

Russell Pittman *
EAG 07-9 June 2007

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Abstract

In antitrust enforcement as in cost-benefit analysis, neoclassical economics may be interpreted as arguing for the use of a “total welfare” standard whose implementation treats transfers as welfare-neutral. Several recent papers call for antitrust agencies to move in the direction of this version of a total welfare standard for enforcement. However, as Williamson (1968) noted, horizontal mergers typically result in transfers that may greatly exceed in magnitude any deadweight loss or efficiency gain, so that a decision to ignore transfers may be quite important. I argue that such transfers are likely overall to be quite regressive, and thus that a consumer surplus standard rather than a total welfare standard may be appropriate for antitrust. Two common arguments against this standard – that most mergers are in markets for intermediate goods, and that a consumer welfare standard implies a tolerance for monopsony – are examined and found wanting. I argue in addition that, even if a total welfare standard is used, both the finance literature on merger outcomes and the structure of the U.S. enforcement agencies suggest that the use of a consumer surplus standard by the agencies is more likely to achieve that goal.

JEL codes: D02, D31, G34, K21, L40

The discussion of the proper welfare standard for antitrust enforcement – with a focus on merger analysis – continues. The *Horizontal Merger Guidelines* of the U.S. agencies spell out an enforcement standard that is arguably close to a consumer surplus standard, focusing on the effect of a merger on the prices paid by customers and emphasizing the desirability of efficiencies that lower marginal costs and thus are likely to have a direct impact on post-merger prices.¹ However, recent papers by Heyer (2006) and Carlton (2007) argue forcefully for the orthodox standard of neoclassical economics, total welfare: consumer surplus plus producer surplus, with transfers canceling each other out. Ross and Winter (2005) also argue for total surplus, but at least in part because they believe that accounting for transfers by adding additional weight to changes in consumer surplus would generally not change things much – assuming that the weight chosen is appropriate.

On the other hand, other recent papers – for example, Lyons (2002), Neven and Röller (2005), and Fridolfsson (2007) – more or less accept total welfare as the outcome standard for enforcement but suggest that, given various factors in the process of merger investigation and enforcement, a total-welfare-maximizing outcome might be more likely to result from an agency’s use of consumer surplus rather than total welfare as its own standard.² Farrell and Katz (2006) conclude a detailed discussion of both perspectives with a divided judgment between total vs. consumer surplus as a standard – as we “muddle along until we understand more” – though they also join Foer (2006) in urging continued focus on the process of competition as an equally important end and standard in itself.

The current paper presents one factor that arguably supports consumer surplus rather than total welfare as the outcome standard and follows with two factors supporting the argument that, even if one prefers total welfare as the outcome standard, a consumer surplus standard on the part of the enforcement agency is the best way to get there. In particular, I will argue that

- It is both appropriate and workable to include distribution factors in the general (but not the specific) analysis of mergers;
- Both the industrial organization and (especially) the finance literature cast some doubt on the tempting economists’ assumption that because firms themselves propose mergers, we may assume that these mergers will increase at least the producer surplus portion of total welfare; and
- If the enforcement agency pursues total welfare as its standard, the outcome of the process in the U.S. and other countries is likely to be significantly biased in favor of producer surplus rather than total welfare.

¹ U.S. Department of Justice and Federal Trade Commission, *Commentary on the Horizontal Merger Guidelines*, March 2006.

² As Kaplow and Shapiro (2007) summarize the argument: “[The enforcement agencies’] adopting a consumer welfare standard may induce firms to undertake deals that obtain potential synergies while causing less harm to competition, leading to even higher total welfare than would a total welfare standard.” See also Brito and Catalão-Lopes (2006).

1. The Welfare Outcome of Mergers: Must We Really Ignore Distribution?

“Who are you gonna believe? Me, or your lyin’ eyes?”

Richard Pryor

In the paper most often cited in support of total surplus as the standard for antitrust enforcement, Williamson (1968) points out that “the income redistribution which occurs [as a result of a merger] is usually large relative to the size of the deadweight loss.” Thus, notes Williamson, “attaching even a slight weight to income distribution effects can sometimes influence the overall valuation significantly.” My own analysis of one proposed U.S. rail merger (Pittman, 1990) may serve as an example: in the proposed merger of the Santa Fe and Southern Pacific Railroads in the mid 1980s, I estimated that transfers from shippers to the merged railroad would be anywhere from twice to five times the value of the direct welfare loss, depending on the assumptions made regarding certain demand and cost parameters. And yet the use of total welfare as a merger standard, combined with the refusal of mainstream neoclassical economics to consider assigning differing values for the marginal utility of income at different income levels, forces us to ignore these sometimes large transfers of income and wealth as beyond our concerns and/or specialized expertise.³ Must we really be so detached from these transfers?

After all, it is difficult to ignore the rather plain evidence that, on average, firm owners are better off than final consumers – especially the owners of firms large enough to be subject to agency merger review – and that pure transfers from final consumers to owners, which are ignored as the total welfare standard is generally applied but included in a consumer surplus standard, are overwhelmingly likely to be regressive. (“Regressive” is of course a value-laden term; readers who do not share the author’s assumption that a dollar redistributed from the rich to the poor is in general welfare-enhancing will likely not be persuaded by what follows.)

Regarding owners vs. consumers broadly, the aggregate pattern of ownership of corporate assets in the US is not much in dispute – and it certainly does not appear to be changing in the direction of less inequality. Using data from the most recent *Survey of Consumer Finances* from the Federal Reserve Board, Bucks, *et al.* (2006) report that “ownership of any type of bond is notably concentrated among the highest tiers of the income and wealth distribution,” and that

The direct ownership of publicly traded stocks is more widespread than the direct ownership of bonds, but, as with bonds, it is also concentrated among high-income and high-wealth families.

Kennickell (2006) elaborates:

In 2004, slightly more than one-third of total net worth was held by the wealthiest one percent of families.... The next-wealthiest nine percent of families held 36.1 percent

³ See, *e.g.*, Musgrave (1959), Harberger (1971), and Kaplow (2004).

of total wealth.... Families in the bottom half of wealth distribution ... held only 2.5 percent of total wealth....⁴

In other words, we can be pretty confident that, as a general matter, transfers of income and wealth to the owners of large firms from individual customers are transfers from the less to the more well off.

Farrell and Katz (2006), and others, would not, I think, dispute such points. However, they argue against an enforcement agency's taking distributional considerations into account in merger analysis with what may be summarized as four points:

- It would be very difficult to learn enough to take distribution into account in particular merger cases.
- "Owners and workers of firms are people too" – Heyer even claims to have seen them shopping – so that it is not clear why one should favor one group of people as consumers over another as producers. Furthermore, for some products like luxury goods it is very likely the case that customers are better off than workers (though not necessarily better off than owners).
- Many – perhaps most – mergers involve intermediate goods, whose sellers and buyers are both firms. "We are aware of no evidence that the wealth distribution of shareholders varies systematically according to a firm's place in the value chain."
- Finally, there is a logical "division of labor among public policies: if antitrust enforcement and some other public policies focus on total surplus, other public policies can redistribute that surplus in accord with notions of fairness." (In fact the argument for this kind of division of labor goes back at least to Musgrave [1959].)

The first point is a strong one, but it clearly argues only against efforts to analyze the distributional consequences of individual merger proposals; it does not relate to the proposal in this paper to consider distributional concerns more generally. Farrell and Katz in fact point out – though they are arguing a different point – that "in the face of transactions costs, it is desirable to implement policies that work well on average (rather than exactly case by case) even when one has strong distributional preferences." And of course antitrust enforcers (and courts) use similar reasoning every day in their *per se* prohibition of cartel agreements: though no one denies that there are situations (such as countervailing power against a monopolist) where the formation of a cartel may improve welfare, those situations are considered insufficiently important to outweigh the strong presumption that in general, cartels harm welfare, so that detailed examination of every

⁴ Kennickell further notes that, while the first two of these figures have been stable in recent years, the share held by families in the bottom half "is significantly [below] ... the ... estimates for 1995, 1998, and 2001." Furthermore, "African Americans overall are 23.3 percentage points less likely to have direct or indirect holdings of publicly traded stocks than all families; Hispanics are 28.3 percent less likely."

cartel agreement would impose investigative and adjudicative costs exceeding their social value.

Why, then, should we not conduct merger investigations as if most transfers from customers to owners are regressive, rather than treating them as benign by assumption?

It is true, as Farrell and Katz note, that a good deal of merger activity takes place in markets for intermediate goods. It may be that we can say nothing about the progressivity or regressivity of transfers between different groups of owners, but that is not the end of the story. As everyone who has ever conveyed doubts about the existence of free lunches will agree, in general cost increases – in this case, the merger-induced transfers – get passed along. They may or may not get passed along 100 percent, but under most circumstances a significant portion are passed along. In their valuable paper that (among many other things) reviews the literature on this topic in the taxation and international trade arenas, Röller, *et al.* (2000) suggest as a summary result “that pass-on roughly varies between 30% and 70%,” depending of course on a variety of circumstances.⁵ Generally the (derived) demand curves for intermediate inputs are likely to be inelastic – purchasers will be relatively unresponsive to price increases so long as their competitors face the same increases – and thus pass-on in this context should be at the high end of that range.⁶ Heyer notes that

Where final demand is inelastic and pass-through is likely to be nearly complete, intermediate goods customers may (correctly) believe that they will not be very much harmed by even a substantial post-merger increase in the price of what they buy. Final consumers, of course, are unambiguously harmed.

It seems fully appropriate, then, to treat transfers to sellers from purchasers of intermediate goods as indirect but real transfers to sellers of intermediate goods from the final consumers of the goods that embody those intermediate goods.

In turn, this issue leads to a response to arguments that “if only consumers matter, then a buying cartel should be perfectly legal and indeed should be encouraged.”⁷ This may be true regarding buying cartels formed by final consumers, but it does not apply in the vast majority of merger cases that involve intermediate goods. As Schwartz (1999) notes, if a monopsonist lacks market power when it sells, the monopsony has no impact on downstream customers; the entire harm from the monopsony is the upstream welfare loss. If the monopsonist has market power when it sells, the low monopsony price that it

⁵ See also the theoretical discussion in Bulow and Pfleiderer (1983).

⁶ Indeed it is the relative inelasticity of the derived demand curve for the intermediate product that yields the common outcome of merger-induced transfers far exceeding merger-induced deadweight welfare losses.

⁷ Carlton (2007). See also Heyer (2006) (“It is worth noting that literal application of a pure consumer welfare standard ... would appear to immunize consumer buyer groups that exert efficiency-reducing monopsony power over sellers. I suspect that many supporters of a consumer welfare standard for sellers would be uncomfortable applying its logic equally to the buyer side of the market.”) and Kaplow and Shapiro (2007) (“If only consumer welfare mattered, increases in buyer power through horizontal mergers and otherwise might be praised, not condemned.”).

pays for inputs is not passed along to its customers, and so on downstream; on the contrary, it is the output reduction and associated welfare loss that are passed on, so that final consumers suffer rather than benefit.⁸ It is only in the case of a buying cartel among final consumers that the arguments in this section would seem to imply approval rather than disapproval of monopsony, and in this case, if the sellers possess market power then the cartel would not be condemned unambiguously even under a total surplus standard. In general, then, arguments for consumer surplus as a merger standard that are based on the ultimate effects of mergers on final consumers – as in this section of this paper – do not imply a tolerance for monopsony.

We may conclude, then – subject to many caveats about our confidence in particular theories and findings – that the transfers from customers to owners that result from some horizontal mergers are typically regressive, and that such transfers are likely to be passed along to final customers to a significant degree even if they originate in intermediate goods markets. I do not consider here the Schumpeterian argument that on balance market power is a good thing, because monopoly profits are a necessary incentive to innovation and the “creative destruction” that is capitalism at its most productive, except to note the strong theoretical and empirical argument that this effect is weakened or even reversed at a sufficiently high level of market power.⁹ Nor do I consider the objectivist argument that regressive transfers of income may be a good thing in general, for similar reasons.

I would argue, however, that it does not seem very satisfying or comforting to note that whenever total welfare increases, income redistribution policies *could* make everyone better off as a result (Kaplow, 2004) – if in fact they do not. The “compensation principle” (Viscusi, *et al.*, 2005) does not pay the rent. One may be happier when changes in government policies reduce the disparities of income and wealth within the U.S. (not to mention the world), but until that happens it seems quite reasonable to argue that those making and enforcing other public policies, like antitrust enforcement, should, to the degree manageable, take into account the distributional implications of their actions. And this would seem to argue in favor of a standard for merger and other antitrust enforcement focusing on consumer surplus rather than total welfare, as the latter is generally applied – that is, in favor of a merger standard centered on the effect of the merger on (quality-adjusted) price.

Ross and Winter (2005) point out that, while in the Williamsonian tradeoff a total welfare standard implies a weighting of increases in producer surplus equal to the weighting of increases in consumer surplus and a consumer surplus standard implies a weight of zero for producer surplus, one can imagine intermediate weighting schemes as well. They argue, however, that antitrust should give no greater priority to income redistribution than other government policies do, and that, based on their analysis, the policies of the Canadian government – the focus of their case study – favor redistribution

⁸ Correspondingly, as Schwartz points out, we do not expect suppliers to monopolists to benefit from the high monopoly prices charged to the customers of the monopolist; rather, the suppliers suffer from the monopolistic output reduction.

⁹ See, for example, Gilbert (2005).

only on behalf of the very poorest members of society, as opposed to generally from the richer half (for example) to the poorer half. When they translate this policy into the weighting of transfers from consumers to producers generally, it does not much change the equal weighting scheme implied by a total welfare standard.

The main problem with this line of thinking may be that the introduction of a weighting between zero and one for producer surplus reduces the predictability of enforcement by allowing enforcer discretion in the choice of weights.¹⁰ Ross and Winter report some success in Canada with a methodology of solving for the weight which would cause an enforcement decision to change and then considering whether that weight seems reasonable, but that strategy certainly does not eliminate the problem. The more comprehensive answer from the Ross and Winter paper – that a proper weight for producer surplus would not be all that different from one, anyway – seems completely specific to the authors’ analysis of broader Canadian distribution policies; I know of no comparable analysis for the U.S. or other countries.

The *Horizontal Merger Guidelines* of the U.S. Department of Justice and Federal Trade Commission use a standard that is close to a consumer surplus standard – favoring, for example, the inclusion of efficiencies into the analysis when said efficiencies are likely to be

sufficient to reverse the merger’s potential to harm consumers in the relevant market, e.g., by preventing price increases in that market. (Guidelines at §4)

However, they make at least a nod in the direction of total surplus in the stated willingness of the agencies to consider, “in their discretion”, significant efficiencies that are not likely to be passed along in the form of lower prices for the affected product, including both efficiencies in different markets and savings in fixed costs. In the latter case, the agencies note that “consumers may benefit from [these reductions in fixed costs] over the longer term even if not immediately”.¹¹ Carlton (2007) bases his case for total welfare on the longer term benefits of cost savings, especially as these lead to technological improvements.

It may be worth noting here that Williamson (1968) himself expresses some reservations about ignoring distributional concerns – though, to be sure, in the end he does come down in favor of doing just that. He begins by making the “division-of-labor” in government policy argument himself, suggesting that “income distribution objectives ... [fall] more clearly within the province of taxation, expenditure, and transfer payment activities.” Nevertheless, he also argues that

The transfer involved could be regarded unfavorably not merely because it redistributes income in an undesirable way (increases the degree of inequality in the size distribution of income), but also because it produces social discontent. This

¹⁰ I thank Dennis Carlton for suggesting this point to me.

¹¹ U.S. Department of Justice and Federal Trade Commission, *Commentary on the Horizontal Merger Guidelines*, March 2006, at §4.

latter has serious efficiency implications that the ... [traditional] analysis does not take explicitly into account.

He concludes this portion of his paper with the observation that “distinguishing social from private costs in this respect may ... be the most fundamental reason for treating claims of private efficiency gains skeptically.”

2. How Much Deference Should One Give to the Assumption that Mergers Are (at least) Privately Profitable?

“Assume a virtue, if you have it not.”

Hamlet

The economist’s natural reaction to a proposed merger goes something like the following. If a company proposes a takeover, or two companies propose a merger, we can assume that this transaction will be at least privately profitable.¹² This assumption will of course not turn out to be correct every time, but given information asymmetries and private incentives, we can assume that it will be profitable more often than not, and certainly more often than if the government second-guessed such private decision-making. Enforcers should then examine the likely effects of the merger on customers, but with the assumption that the fact of the merger itself implies a positive effect on at least the producer surplus portion of total welfare.

Unfortunately, the support from the empirical literature for this set of benign assumptions about merger motivations and outcomes is not particularly strong. There is by now a fairly extensive literature examining merger outcomes: a smaller industrial organization literature that relies mostly on accounting data, a much larger finance literature that relies mostly on stock market data. A surprisingly large number of studies in both areas come to the following conclusions:

- The stockholders of acquiring firms on average do not benefit, or do not benefit much, from mergers.
- The stockholders of acquired firms tend to enjoy significant gains from mergers.
- The balance of these two forces is probably a small overall efficiency gain from mergers – though even this is uncertain.
- These patterns vary, to some degree systematically, with the types of merger transactions.

¹² Heyer (2006): “Certainly the merging firms believe that they will be better off, as evidenced by the fact that they have chosen to merge, presumably, voluntarily.” See also Farrell and Shapiro (1990) (“Since any proposed merger is presumably privately profitable, it will also raise welfare if it has a positive external effect [on consumers and on nonparticipant firms].”) and Kaplow and Shapiro (2007) (“The law implicitly presumes mergers to be advantageous to some degree....Setting the threshold of anticompetitive effects significantly above zero may be rationalized by the view that mergers typically generate some synergies, so they should not be prohibited unless the reduction in competition is sufficiently great.”).

The first result alone should give us pause concerning deference to the forecasts and incentives of acquiring firms: presumably even if the net effect ends up positive, it was not the intention of the (stockholders of the) acquiring firm to hand over most or all of the value of this gain to the (stockholders of the) acquired firm. And yet this seems to be the dominant empirical finding.

Among the studies reporting this outcome are Mandelker (1974), Varaiya and Ferris (1987), Bruner (2002), and Moeller, *et al.* (2004).¹³ (Dissenting voices include Andrade, *et al.* [2001] and Kaplan [2006].) Andrade, *et al.* (2001) express well the problems raised by these findings:

A ... challenge to the claim that mergers create value stems from the finding that all of the gains from mergers seem to accrue to the target firm shareholders. We would like to believe that in an efficient economy, ... mergers would happen for the right reasons, and that their effects would be, on average, as expected by the parties during negotiations. However, the fact that mergers do not seem to benefit acquirers provides reason to worry about this analysis.

The first, third and fourth results together raise the obvious question, why would firms engage in mergers that on average fail to increase profits? One answer may be the same as the answer to the classic microeconomic question as to why rational consumers would buy both lottery tickets and insurance: even if lottery tickets are on average a losing proposition, the small possibility of a very high return may act as an incentive for participation. Correspondingly, even though – for example – the AOL/Time Warner and Daimler-Benz/Chrysler combinations turned out badly, the parties may have been betting on the small possibility of a transformationally successful outcome.

A number of more specific explanations have been proposed in the literature and found to have empirical support, many relying on the classic problem of the separation of ownership and control that goes back to Berle and Means (1932). Roll (1986) suggests a “hubris” hypothesis, with managers (and, possibly, their shareholders) overestimating the degree to which they can improve the operations of acquired assets. Shleifer and Vishny (1988) suggest an “empire building” hypothesis, noting that the remuneration of top managers is more closely related to the size of the assets that they manage than the return that those assets earn. Gorton, *et al.* (2005), noting the empirical regularity that larger firms are less often acquired, suggest a motive of acquiring a smaller competitor in order to make the firm too large to be easily acquired by a larger competitor, while Fridolfsson and Stennek (2005 and 2006) suggest a motive of acquiring the assets of a smaller competitor before one’s competitors can acquire those assets.¹⁴

¹³ See also Ravenscraft and Scherer (1987), and the general discussion in Scherer (2006).

¹⁴ Incidentally, this theory suggests a weakness in the common assumption that a decline in the stock price of competitors following a merger announcement indicates that the merger will result in efficiencies. Fridolfsson and Stennek argue that this effect may simply reflect the market’s reaction to the failure of the competitors to successfully purchase the acquired firm themselves.

The fact that returns to mergers vary systematically with characteristics of the transaction seems to support these or related hypotheses. Gondhalekar, *et al.* (2004) show that “free cash flow” in the acquiring firm is associated with overpaying for the acquired firm, while Barger, *et al.* (2007) show that publicly held firms are more likely to overpay than privately held firms. Andrade, *et al.* (2001) show that acquirers who issue stock to finance an acquisition lose money on average, though they argue that this is largely due to the information disclosed by the issuance of the stock rather than to the acquisition itself. (Amihud, *et al.* [1990] suggest that this difference in returns to stock-financed acquisitions may be limited to those firms with low managerial ownership.) Rau and Vermaelen (1998) show that acquirers that are “glamour” firms (low book-to-market) systematically lose money with their acquisitions, in contrast to “value” acquirers (high book-to-market) that systematically gain. Porter (2005) cites the “strategy literature” as demonstrating that “smaller, focused acquisitions are more likely to improve productivity than mergers among leaders.” Other studies have found a “negative correlation between acquirer announcement returns and both acquirer size ... and the size of the merger transaction ... as well as ... worse acquirer returns in defensive acquisitions...” (Gorton, *et al.*, 2005).

Again, the idea here is decidedly not that enforcement agencies should second-guess the decisions of firms to merge; if firms do not forecast the profitability outcomes of mergers well, enforcement agencies would do much worse. Nor is the point that enforcement agencies should be systematically more inclined to challenge those types of acquisitions that have been shown on average not to create value for the acquired firms – though it might be worth considering such a policy, especially if its likely effect were on average to discourage deals that reflect the furtherance of manager utility rather than the increase of shareholder value.

Rather, the idea is that, if firms do not in fact forecast the profitability outcomes of mergers well, the agencies should not adopt the default assumption that a merger would enhance the producer surplus portion of total welfare simply because the firms have proposed it; nor should the agencies put much stock in the existence or magnitude of efficiencies claimed by merging parties in their negotiations with the agencies. As Porter (2005) summarizes, “We cannot assume that a merger will be efficient and profitable just because companies propose it.” And this leads us to the conclusion that if the analysis of the impact of a merger on competition and consumer surplus is what agencies and courts do best, that analysis is what they should rely on in deciding whether to challenge a merger.

3. Is a Total Surplus Agency Goal the Best Way to Achieve a Total Surplus Process Outcome?

“By indirections find directions out.”
Hamlet

As noted above, there is a growing literature that examines the issue of the best standard for antitrust enforcement in the context of the process of enforcement – in

particular, in merger enforcement, the clear and clearly relevant facts that a) firms choose which mergers to propose and b) agencies (and courts) are in some ways at a significant information disadvantage as compared to the merging firms. Among the most important papers, Besanko and Spulber (1993) and Lyons (2002) – both ably discussed by Farrell and Katz (2006) – emphasize the incentives of the firms to choose among merger possibilities on the criteria of producer surplus only, so that a corresponding bias on behalf of consumer surplus at the enforcement agencies may be the most likely strategy to achieve an outcome favoring both producer and consumer surplus. (There may be some parallel between the advantage of the firms in proposing the merger and the advantage gained by the member of a committee or legislature who controls the agenda; see, *e.g.*, Mueller [2003].) Fridolfsson (2007) explicitly outlines a scenario in which a consumer surplus bias at the agencies leads firms to consider alternative merger partners and/or strategies that they would have not considered otherwise.

Unfortunately the existing literature on the topic of how the U.S. antitrust agencies choose which mergers to challenge – as well as other enforcement actions – is not very satisfying. Masson and Reynolds (1977) point out the methodological flaws in the literature of the pre-*Guidelines* period, and my own paper (1992a) argues that the more recent literature claiming to demonstrate significant political influences on micro-level enforcement decisions of the agencies is badly flawed. More recently, Baker and Shapiro (2007) present data suggesting that the U.S. agencies – and the Antitrust Division in particular – have been considerably less likely to challenge mergers under the George W. Bush administration than under the Clinton and George H.W. Bush administrations.

But consider two potentially simpler issues: the internal structure of an enforcement agency, and the fact that, for the most part and for most of the past quarter century, the heads of the agencies have sought to act as neutral judges rather than as aggressive prosecutors. I believe that these two factors act to bias the decisions of the agencies against merger challenges and other enforcement actions – which may suggest, as with Besanko and Spulber (1993) and Lyons (2002), that some countervailing bias, such as a focus on consumer surplus rather than total welfare, is appropriate even if the object is an outcome maximizing total welfare. I will focus here on the Antitrust Division of the U.S. Department of Justice.

Within the Antitrust Division there are sections of lawyers organized either by economic sector (*e.g.* the Telecommunications and Media Enforcement Section, the Transportation, Energy, and Agriculture Section), by type of investigation and violation (the National Criminal Enforcement Section), or by geography (the seven Field Offices). These “legal sections” are in turn supported by three “economic sections”, groups of economists who work with the lawyers as part of investigative teams but who report their analyses and recommendations to their own (economist) section chiefs.

Section chiefs of legal and economic sections report to Deputy Assistant Attorneys General (“deputies”), who are assisted by “directors of operations”. Deputies report to the Assistant Attorney General for Antitrust (the AAG), who makes the enforcement decisions.

An argument to challenge a proposed merger is, by its nature, a somewhat frail creature within the Antitrust Division jungle. A judgment by both the legal and economic staffs that a proposed merger should not be challenged is rarely overruled by the two section chiefs involved. A decision by both the legal and economic section chiefs that a proposed merger should not be challenged is rarely overruled by the legal and economic deputies. And a decision by both the legal and economic deputies that a proposed merger should not be challenged is rarely overruled by the AAG. For the most part, “no challenge” is the default outcome.

Public Choice economists and students of bureaucracy will respond that Antitrust Division lawyers are not random draws from the population. Lawyers who apply for work at the Antitrust Division are more likely to believe in its mission than those who do not. (Though in fact the majority of new Division attorneys have applied for a position at only the Department of Justice rather than a particular Division thereof, still a) one could argue a general pro-enforcement bias on the part of applicants to the Department, and b) there remains the issue of which young attorneys offered jobs by the Division choose to accept.) Furthermore, Division lawyers arguably advance their careers and increase their human capital by getting a case into a courtroom. (I suggest elsewhere [Pittman, 1992b] that it is difficult to argue seriously that Division economists – or, for that matter, FTC economists – are biased in favor of challenging mergers.)

However, I would maintain that this (arguable) bias at the staff level is far outweighed by the notable lack of bias (arguably) at the section chief level and (reliably) at the deputy and AAG levels. This is a point apparently not much addressed in the literature. Coate, et al. (1990) and Coate (2005) demonstrate the importance of perceived objective factors such as concentration and entry barriers in leading to FTC merger challenges; these findings seem consistent with a lack of bias at the decision-making level of the sister agency of the Antitrust Division. (See also the discussion in Leary [2002], arguing for an intertemporal continuity of basic enforcement decisions at the two agencies.) In related literature, Glaeser, et al. (2000) suggest that *both* public interest and career furtherance are factors in certain decisions of federal drug enforcers, and this seems consistent with Posner’s (2003) observation that the “aspirations for higher office or well-paying private employment” of the heads of administrative agencies “are enhanced if they earn a reputation for efficiency”.

I think most experienced observers would agree that at the Antitrust Division, both deputies – legal and economic – and AAGs typically think and reach decisions in the mode of adjudicators rather than prosecutors. If they decide to go to Federal district court to challenge a merger, they want to win the challenge, but they challenge only those mergers that they believe, on the merits, *should* be challenged.

But note what all of this means for the outcome of the Division’s decision-making process. Even if Division attorneys are biased towards a merger challenge – even if Division attorneys and legal section chiefs together are biased toward a merger challenge – they are certainly no more so biased than the lawyers of the merging companies are

biased against a challenge. (The rare formal and organized complaint by a competitor of the merging companies does not change this larger picture.)

But if, as I argue, the deputies and the AAG are not biased, this means that a recommendation to challenge at the staff level that is a close call on the merits has only about a 50% chance of making it past the deputies, and then only a $50\% \times 50\% = 25\%$ chance of making it past the AAG to an actual challenge. An unbiased Federal district court judge reduces the chances of the merger being successfully blocked to $50\% \times 25\% = 12.5\%$. (The reader can do the math regarding appeals.)

The broader point is a straightforward one. If deputies, the AAG, and the judiciary constitute three sequential decision makers seeking to maximize total welfare, if there is little appeal from a first or second level decision not to challenge but a strong appeal to a decision at any level to challenge, then the system is going to be biased in the direction of not blocking mergers, including mergers that would reduce total welfare. Some may argue that this *laissez-faire* sort of bias is appropriate. Others may respond, with Porter (2002), that existing accounting and tax conventions already provide artificial incentives for mergers. In any case, if the desired *outcome* is one that maximizes total welfare, the analysis in this section suggests – in the same spirit as Besanko and Spulber (1993) and Lyons (2002) – that the best *process* to achieve that goal is more likely one where the enforcer seeks to add to the mix a bias in favor of consumer surplus. This is of course *a fortiori* the case if, as I have argued above, the desired outcome should be one of the maximization of consumer surplus rather than total welfare as traditionally applied.

4. Conclusion

Mergers have a significant impact on the U.S. economy. When mergers are horizontal, they may reduce competition in such a way as to transfer large sums of money to the merged firm (and its competitors) from their customers. Conventional neoclassical economics treats these transfers as welfare-neutral, but I have argued that as a whole they are quite likely to be regressive and thus (arguably) welfare-harmful. This does not mean that enforcement agencies and courts should seek a detailed analysis of the distributional consequences of each horizontal merger. It does suggest, however, that enforcers and courts may assume that, on balance, such transfers are harmful rather than neutral (or “potentially” neutral), and use a consumer surplus standard in evaluating mergers, seeking to block those likely to result in price increases to customers. Note that this does not mean that estimates of efficiencies must always be ignored; a consumer surplus standard inherently includes any marginal cost reductions that are passed along to customers.

As noted above, the *Horizontal Merger Guidelines* of the U.S. Department of Justice and Federal Trade Commission elaborate an enforcement standard that is arguably close to a consumer surplus standard, focusing on the effect of a merger on the prices paid by customers, emphasizing the desirability of efficiencies lowering marginal costs so that they may have a direct impact on post-merger prices, and examining claims of efficiencies presented by the merging firms with great care. Thus the argument in this

paper is not really for a change in the *status quo*, and I do not argue strongly against the taking account of efficiencies in limited circumstances that is favored by the *Guidelines* and the recent *Commentary* thereto. However, several recent papers have called for the adoption of a total welfare standard rather than (close to) a consumer surplus standard, emphasizing in part the desirability of treating transfers as welfare neutral. It is this proposed change – which would, all else equal, lead to less stringent U.S. merger enforcement – against which I am specifically arguing.

Furthermore, it is clear from the finance literature that acquiring firms are poor predictors of the impacts of mergers on their shareholders. On average, acquiring firms in certain categories – and perhaps acquiring firms in general – do not benefit from the deals – though of course the managers who instigated the deals may benefit. This suggests strongly that, on average, the estimates of efficiencies prepared for the agencies by the acquiring firms are not to be trusted, even if the firms themselves believe them. (As noted above, Williamson urged “skepticism” regarding these estimates, especially the degree to which they reflect public rather than private efficiencies.) And this means that even agencies seeking to maximize total welfare should focus on the impact of the merger on customers, without trying to factor in the inherently unreliable firm forecasts of cost reductions, except perhaps in very special circumstances.

Finally, the structure of the Antitrust Division – and, I suspect, the FTC – is biased against merger challenges. At each level, a recommendation not to challenge is likely to prevail, while a recommendation to challenge faces a strong appeal from the parties in front of generally neutral top agency management. Under these circumstances, an attempt by the agencies to maximize total welfare will lead to the challenge of too few mergers. A decision rule that seeks to maximize consumer surplus is more likely to lead to decisions to challenge at a level maximizing total welfare.

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