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The Dogmatic Posture of a Consumer Advocate: A Second Response to Mark Cooper

by

Richard A. Epstein*

In a previous Perspectives published by the Free State Foundation, I took to task the shoddy reasoning in Dr. Mark Cooper's statement in opposition to the Comcast-NBC Universal merger. In that piece, I explained that nothing he had said in opposition to that merger gave the slightest reason to think that the linkage of these two firms would cause any systematic harm to the overall telecommunications and entertainment industry, to its video segment, or to the larger economy as a whole. The explicit test I used in making that judgment was social welfare, which is equal to the sum of consumer and producer surplus generated by the transaction.

In recent testimony submitted to the United States Senate Commerce Committee, Dr. Cooper has responded to my comments as part of his ongoing opposition to the proposed merger on behalf of the Consumer Federation of America, the Consumers Union and Free Press. His criticisms are both general and specific. He first attacks the general approach to antitrust law of the Chicago School, of which I am a proud part. He then goes into some particulars of this transaction in order to support his own conclusion. Let me take his general points first and then turn to the particulars of this merger.

Efficiency and Restraint. Mr. Cooper (who has no visible qualifications in antitrust law) believes that the Chicago School represents an unflinching ideological commitment to the position that mergers produce efficiencies, even as they generate serious horizontal and vertical restrictions which are harmful to consumer welfare. He accuses me, and others like me, of harboring deep "ideological" commitments that stand in the way of clear analysis. He pays no attention at all to his own ideological blinders.

In launching this indiscriminate broadside, he is surely right that I did not speak about the specific efficiencies of this particular merger, as my purpose was to point out the economic weaknesses in his own arguments, none of which he responds to in detail. He makes similar mistakes in this recent testimony. Any sound economic theory shows that Dr. Cooper is surely wrong in denying, without any empirical evidence of his own, the existence of economic efficiencies unless they can be demonstrated in concrete economic fashion.

To see why, assume that under the proper definitions of the geographical and product market, there are some restrictive effects to many mergers, perhaps even to this one. The question is what does this indicate about the potential economic gains to these transactions. Here there are three possibilities. The first is that the merger would be so clunky that it would introduce extra layers of bureaucracy that disrupt sensible patterns of production. The second is that there are no organizational changes of note so that the efficiency remains the same. The third is that there are efficiencies that come from the merger which are evident to the insiders, even if they are not easily identifiable to outsiders like Mr. Cooper who know nothing about the internal operations of the new firm or its component parts.

The question is which of these three possibilities is the most likely to occur when the merger takes place. We can easily dismiss the first of them in virtually all cases, because any merger that created a firm with known inefficiencies would be surely less competitive than the two firms that it replaced. It is highly doubtful that the contraction of the industry, moreover, would allow it to regain through the exercise of market power the profits that it lost from its poor operations. The far more likely outcome is that other firms in the industry — for no one suggests that this merger would result in a 100 percent market control over any industry — would be able to take advantage of the high cost structure of a newly beached whale. Or that new entrants would help finish the job. It does not take empirical evidence to reach this conclusion. It only takes a rudimentary appreciation of basic economic theory. High-cost mergers are not planned in advance, even though they do arise in practice when business calculations go awry.

The second possibility — that all things should be expected to stay the same — can be dismissed with equal confidence. With respect to its internal operations, the merger of two large organizations will surely present some difficulties in the integration of different cultures, a point which is not likely to be lost on the parties to the merger. But at the same time, the decision to go forward with the synergy suggests that it would be wholly irrational to abandon any effort to eliminate duplication, streamline supply chains, combine research and advertisement facilities, engage in cross promotions, and open up new joint ventures that neither party could undertake itself. It follows therefore that the conventional model that evaluates mergers by asking about a trade-off between its efficiency properties and its restrictive implications is the correct trade-off.

It is not just a Chicago School artifact. It is also the standard view within the economic profession, which accordingly concentrates on this third possibility, ignoring all others. It is therefore intellectually irresponsible for Mr. Cooper to insist that the Chicago School just "waves a magic efficiency wand. . ." As should be evident, this derisive sentence could only be written by someone who has not tried to understand what the Chicago approach is about from the inside.

False Analogies. Being totally devoid of all theory, Mr. Cooper then seeks to bolster his general denunciations of my previous Perspectives piece by citing at great length a number of studies that have pointed out the flaws of a "free market" approach to financial regulation. But what he fails to do is to connect up that an analysis of market failure in other markets to the instant transaction. Thus in footnote 20, he makes the correct point that the great mistake of financial deregulation in the first decade of this century was its uncritical acceptance of a view (championed by Robert Rubin and Lawrence Summers, as well as Alan Greenspan) that counterparty scrutiny eliminated all need for government regulation of these transactions.

That criticism is in fact correct, and its most persuasive explanation comes from the sound application of the banking principles of the Chicago School. One problem with financial markets is that they dealt in newly created instruments that had a higher variability in value than traditional analysis suggested. Accordingly, the stress tests that are normally used to evaluate the soundness of financial arrangements understand the volatility of the financial deals, and hence the risk of widespread bankruptcy. Given the close interconnections between the parties and the rapid velocity of financial transactions, the counterparties bear only part of the overall social loss, which in turn suggests that their joint precautions will be insufficient to withstand the beating that they will take in times of stress. The result is that some form of regulation may well make sense. One sensible first step is retaining some overall reserve requirements.

It also bears mention that the financial markets were distorted by multiple *government* policies whose combined effect aggravated the risks of these voluntary transactions. First, the underlying mortgage securities were often mispriced, in part because of the active role that Fannie Mae and Freddie Mac played as a buyer and guarantor of these instruments. Second, the cheap money policies of the Federal Reserve resulted in a run-up in prices of the complementary goods, the real estate. Third, all players operating in these markets counted on an implicit federal guarantee that they would be bailed out from any economic failure, which in turn induced them to take high-risk, heads-I-win-tails-you-lose gambles, which ended in disaster. Fourth, imposing mark-to-market rules created the real risk of downward cascades that spread risk far further than should have been the case.

It has been said that free market advocates are supposed to believe in the privatization of gains and the socialization of losses. Nothing could be further from the truth. It is the height of government irresponsibility to create incentive structures that operate in this fashion. Whatever guarantees are given should be for a price that reflects the underlying risk, and, like ordinary private guarantees, contain explicit covenants on how banks and other financial institutions should operate in order to control against these risks. The intellectual blindness of Mr. Cooper in understanding the difference between financial and entertainment markets condemns his work to the lower levels of Dante's inferno.

Mr. Cooper shows a similar want of understanding about the ill-fated mergers under the Telecommunications Act of 1996. This statute was ballyhooed as introducing competition into the telecommunication industry, but it did nothing of the sort. Telecommunications is a network industry in which classical "wheat farm" textbook competitive solutions are not possible. The proponents of the 1996 Act oversold its supposed competitive effects because they ignored the simple fact that even after the statute was put into place the FCC and the state commissions had to figure out how to forge the appropriate integration of services of multiple carriers. Rejecting the old AT&T model of an end-to-end monopoly subject to regulation on matters of rates and access does not decide what should be put in its place.

The great disaster under the Telecommunications Act was again a *government* failure in the design of that new system. The 1996 Act allowed for either interconnection or for the purchase of "unbundled network elements" as the mode of integration. The FCC pushed the second approach at the expense of the first. In so doing it mispriced all the elements which led to excessive subsidization of new entrants and a litigation nightmare that lasted for about a decade. Many of the mergers that took place were driven by the desire to settle the unending litigation under the 1996 Act and to correct the bad guess of Judge Harold Greene that telecommunications was best organized with AT&T as a long lines carrier and the Regional Bell Companies as local exchange carriers to be treated as regulated local monopolists. Had the bill been passed five years later, it would have been clear that the so-called "last mile" monopoly of the incumbents had largely been overtaken by technology, and the Act would have assumed, hopefully, a very different form. But however these complications play out, it is again blinding economic ignorance to confuse the proposed Comcast-NBCU merger with the unfortunate escapades of the 1990s. The technology in telecommunications has so advanced that the prospect of single firm monopoly has been blunted by the multiple pathways into the home and office.

The Comcast NBC Universal Merger in Context. Mr. Cooper's fundamental misperceptions about how markets work leads him to make counterproductive proposals for the evaluation of this merger. Desirous of some - any - grand vision of how the telecommunications and entertainment industry should look, he bravely insists that the government ought to undertake "complete industry-wide proceedings" to resolve all underlying problems and to determine the proper institutional structure for the video industry insofar as it relates to both content and carriage. This recommendation is subject two fatal flaws. The first is that it presupposes that anyone could conduct a study on this fast-moving and complex industry that could be completed before some new technological or business model innovation rendered it obsolete. Yet that result would be ideal for Mr. Cooper because in the interim he could stymie this merger on procedural grounds without presenting any persuasive evidence that the merger is anticompetitive.

On this score, he surely disagreed with the glowing appraisal of the merger offered by Comcast and NBC-Universal. But he should find it more difficult to disagree with the assessment of the Congressional Research Service's February 2, 2010 report, authored by Charles B. Goldfarb, "The Proposed Comcast-NBC Universal Combination: How It Might Affect the Video Market," which is the antithesis of Mr. Cooper's jeremiad about this merger. Mr. Goldfarb's account of the video industry notes that there is "so much uncertainty" associated with the future development of the video market as to render it impossible to make any sound predictions of the industry's direction. More concretely, he properly tends to downplay the risks of vertical exclusion that Mr. Cooper trumpets in his report. Thus the CRS acknowledges that in "some unique circumstances" a distributor might be willing to pay a huge premium to foreclose distribution of certain content through other channels. But, in practice, this result is likely to be most uncommon, and if it does occur some narrow conduct rule that is directed to this risk of foreclosure is surely a far better way to deal with this problem than the total nullification of the merger. As a matter of general theory, Mr. Cooper shows no awareness of the critical role that tailoring limited remedies can play in an intelligent antitrust policy.

It should come as no surprise that the deep conceptual confusions in Mr. Cooper's recent presentation sheds no light on the empirical evidence that surrounds this merger. In his extended remarks he chides me for a fact-free presentation in my earlier paper. That criticism is largely beside the point because my purpose there was to discredit his own attack on the merger, not to mount a first-line defense of the transaction. His most recent broadside against the merger, however, does purport to be comprehensive. Yet it offers no detailed analysis, by name, of any particular geographical or product market that might induce someone to reject the merger. That omission is inexcusable in his case because his response wholly ignores the detailed presentation Comcast and NBC Universal have offered the FCC for their merger, which does mention a large number of competitors who compete in different ways for various segments of the video market. These major players include video rental operations like Wal-Mart, Blockbuster, Hollywood Video and Net Flix. It includes over-the-air satellite firms like EchoStar and DirecTV and online companies like Amazon, BlinkX, Clicker.com, Veoh, and the like, many of which I have never heard of. And of course there are content standbys like Walt Disney and Time Warner to contend with, plus many small players in this space.

It would be presumptuous of any academic to speak about the movements that are likely to take place in this industry. The principle of comparative advantage counsels against that foolhardy undertaking. But it is critical to note the clear implications of the constant level of new entry and new innovation throughout this sector. All of these devices are imperfect substitutes for each other, just as Skype is an imperfect substitute for cell phones, which in turn are an imperfect substitute for land lines and so on. What is clear, however, is that technological innovation always expands the boundaries of the relevant market, which thereby undercuts any claim of market dominance or monopolization by any player, big or small. Mr. Cooper offers vague speculation of unambiguous movements in price and quality without a shred of evidence as to how these trends will play out over the life of this proposed merger or any other.

It may well be that this merger will crater like the Time Warner/AOL deal. But that is not an antitrust concern, but a sober reminder that bigger is not always better, and that even sophisticated business parties can make mistakes in gauging the gains from trade and the future direction of markets. But it is precisely because all mergers face economic pressures of self-correction that we should regulate them with a light hand. The cumbersome Soviet-style review process that Mr. Cooper advocates does no good for the consumers who he purports to represent. It only shows how far out of touch he is with the basics of antitrust theory as they relate to the particulars of the telecommunication market.

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* Richard A. Epstein is the James Parker Hall Distinguished Service Professor of Law, The University of Chicago, The Peter and Kirsten Bedford Senior Fellow, The Hoover Institution, and a visiting professor at New York University Law School. He is also a Distinguished Adjunct Senior Scholar at the Free State Foundation and a member of FSF's Board of Academic Advisors.