

Agenda

Advancing economics in business

The economist in court: guilty of ex post rationalisation?

Economists are not always viewed favourably by judges. One accusation, made by the Competition Appeal Tribunal in *Napp Pharmaceuticals* (2002), is that economists rationalise business behaviour after the events have taken place. Is this fair on the profession? This transcript of a (fictitious) hearing with an economist presents the case for the defence

- JUDGE** I now summon the defendant in this case, the Economist. Can you confirm that you are indeed a competition economist by training?
- ECONOMIST** Well actually competition economics is not taught as such at universities. Most of us are trained in the fields of microeconomics and IO (which stands for industrial organisation), and some in econometrics.
- JUDGE** So competition economics is not a separate field in economics? And yet economists are increasingly being used in proceedings under competition law.
- ECONOMIST** Antitrust law in the USA has been influenced by economists throughout its history, and particularly influential were the law and economics ideas of the Chicago School in the 1960s and 1970s. In the UK there is also a long tradition of using economists in these matters. At the EU level this is a relatively new development, to some extent in response to the European Court of First Instance, which in 2002 overturned three European Commission decisions, in part because of the apparent lack of economic evidence to support the Commission's theories.¹ Many, not just economists, view this as a positive development. I think economic theories and empirical techniques can help judges and policy-makers come to more informed decisions.
- JUDGE** Well, we'll have to see about that. Let's focus on the reason why you are here today. You stand accused of dreaming up rationalisations of business behaviour after the events have taken place. I take it you are familiar with the *Napp Pharmaceuticals* judgment?²
- ECONOMIST** Yes I am. This was the Competition Appeal Tribunal's very first judgment in an appeal under the UK Competition Act 1998.
- JUDGE** Indeed. And perhaps to send out a signal to future experts, the CAT stated very firmly that the defendant's justification for its behaviour did not flow from its internal documents, but from the work done by its economic advisers for the purpose of that particular case.³ In other words: ex post rationalisation. The CAT essentially rejected this expert statement outright. What do you have to say in your defence?
- ECONOMIST** I was not directly involved in that case, but I can say the following. Economics emerged in the late 18th century. Commerce and business have probably existed for 10,000 years, if not longer. So there is no chicken and egg confusion here: it is almost inevitable that much of what economists have done is provide ex post rationalisations of business behaviour and market mechanisms that have existed for ages. And even though many prominent IO economists nowadays teach at business schools, so there may be some cross-fertilisation, I think business practices will continue to come before economic theory (ie, a form of ex post rationalisation). Take the recent example of the so-called 'two-sided markets', which now seems to be a buzzword both in economics and competition policy. Two-sided markets are 'platforms' that sell services to two types of user, with 'network externalities' between those types—for example, a credit card network, which is more attractive to retailers the more consumers hold the card in

their wallet, and more attractive to consumers the more retailers accept the card for payments in their store. Other examples are Yellow Pages (externalities between advertisers and consumers) and video game consoles (externalities between game writers and players) ...

JUDGE Please get to the point, and use a bit less jargon if you will ...

ECONOMIST What I'm getting at is this. Economists, and with them the competition authorities, have got all excited about two-sided markets in recent years, with a whole new body of literature being produced, in part triggered by the ongoing credit card interchange cases across Europe. Now, owners of nightclubs—another example of a two-sided market—probably realised decades ago that it makes commercial sense to let women in for free, so as to make the place more attractive to men, who can then be charged a nice price. In economists' speak, the nightclub sets its charging structure such that it brings both types of user (men and women) on board. The important point I want to make is this. The fact that economists discovered this phenomenon years or decades after the business people did does not mean that they have nothing useful to say and should be disregarded outright. Even ex post, economists can provide useful insight into the effects of such business practices—for example, on competition and economic welfare.

JUDGE Even if we accept, for the moment, what you say on the ex post issue, you still haven't addressed the other fundamental part of the accusation: that what you say often bears no resemblance to what is in a businessperson's mind. I quote from the CAT in Napp:

Napp does not strike us as a naïve or badly managed company. If its pricing policy had in fact been set by Napp in the way that its economic consultants suggest, we would have expected the company's internal documents to demonstrate that.

ECONOMIST Without knowing the details of this particular case, and with all due respect to judges, I think this statement by the CAT does not fully hold. Please let me explain. Even the butcher, the brewer and the baker in Adam Smith ...

JUDGE Adam Smith?

ECONOMIST Yes, Adam Smith, the Scottish scholar of moral philosophy, whose work, *Wealth of Nations*, 1776, established the field of economics. Adam Smith also brought us a basic idea behind antitrust law, with his famous insight that when people of the same trade meet, they inevitably start conspiring against the public to raise prices. I would highly recommend Adam Smith to any non-eco...

JUDGE Please get on with the butcher and the baker.

ECONOMIST Adam Smith provided a fundamental new insight into how markets operate. He saw that if economic agents, such as the butcher and the baker, all pursue their own self-interest (making money), this is actually a good thing, because there is what Adam Smith refers to as an 'invisible hand' that ensures that, in the economy as a whole, the right business decisions and opportunities are taken such that markets work efficiently by themselves, making us all better off. Importantly, Adam Smith made it clear that such efficient market functioning arises despite the fact that the butcher and the baker are neither intending to achieve that efficiency nor are they necessarily conscious of the fact that they are doing this. May I quote from *Wealth of Nations*?

It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages ... As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual value of society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it ... And by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of society more effectually than when he really intends to promote it.⁴

This insight of Adam Smith continues to fascinate anyone who studies economics, and still underpins the way we think about markets today. Therefore, I think it is to some extent irrelevant whether any internal documents of the defendant confirm the theory put forward by the economist. The fact that the defendant's commercial people are not aware of the economic theory according to which they behave does not mean that this economic theory cannot provide any insight into the effects of that behaviour. Companies involved in competition proceedings are like the butcher and the baker seeking their own self-interest (profit maximisation), and economists have much to say about the consequences of such behaviour.

JUDGE That's a complicated argument, but I can begin to see what you're getting at.

ECONOMIST Perhaps a sports analogy might help. Take snooker. Just because a snooker player does not sit there with a protractor, calculator and a list of formulae before playing every shot doesn't mean that the laws of physics don't apply to the shots played. Likewise, many in business may have mastered the art of trade without being aware of the broader market mechanisms they are part of.

JUDGE All right. But let's take this logic a bit further. Are you implying that judges should accept any economic theory or analysis in a competition proceeding, even if it is completely removed from the business reality?

ECONOMIST Well no. On the one hand, I'm saying that the criticism by the CAT is somewhat unfair, but on the other hand ...

JUDGE Aaah, the two-handed economist.

ECONOMIST Ahem ...

JUDGE Not to worry. We all know one-handed economists are hard to find. Continue with your other hand.

ECONOMIST While on the one hand the CAT's criticism is somewhat unfair, given what I have said about the butcher and the baker, on the other hand I do think that we economists ought to make sure that our theories and empirical evidence contain a good dose of realism. In this respect I cannot but have sympathy for the CAT's criticism expressed in *British Horseracing Board* that the arguments presented by one of the parties, in this case the competition authority, were 'a triumph of theory over commercial reality'.⁵ Perhaps an example of good practice in using economics is the 1997 *Staples/Office Depot* merger case in the USA.⁶ This was probably the first court case that was almost entirely decided on the relative merits of the econometric analyses by both sides, which may well have set a good precedent for cases over here as well ...

JUDGE I dread the day.

ECONOMIST Anyway, this case was noteworthy in two respects (and I refer to a speech by Jonathan Baker, the Federal Trade Commission's Economics Director at the time, for a more detailed description⁷). First, the econometricians on both sides had full access to the same data, so there was no dispute on that. Second, and of importance here, what made the FTC's case against the merger more convincing was the fact that the results of its econometric analysis were consistent with the way the merging parties operated commercially, as revealed, indeed, in those parties' internal documents. This merger concerned two retail chains of large office supply and stationery stores. There was one other large chain in the market. The FTC had found evidence in internal documents that the two chains saw each other as direct competitors, and that they generally endeavoured to set lower prices in those cities in which both chains had a presence than in cities where only one of them had a store. The econometric analysis by the FTC neatly confirmed this, showing a statistically significant price difference of close to 10% between cities with just one of these stores and cities with both (after controlling for any other factors that may cause the price difference). The FTC concluded from this that the merger would lead to a unilateral price increase, and its decision prevailed in the court case. The use of economists in this case can be regarded as an example of good practice.

JUDGE Thank you, Competition Economist, for pleading your case. To sum up, we have heard today that there can be a valid role to play for economists in competition proceedings. It is now for the jury to form their own judgment.

¹ Case T-342/99, *Airtours v. Commission* (June 6th 2002); Case T-5/02, *Tetra Laval v. Commission* (October 25th 2002); and Case T-310/01, *Schneider Electric v Commission* (October 22nd 2002).

² *Napp Pharmaceuticals Holdings Ltd and Subsidiaries v. DGFT*, Case 1001/1/1/01, January 16th 2002.

³ *Ibid*, para 254.

⁴ Adam Smith (1776), *An Inquiry into the Nature and Causes of the Wealth of Nations*.

⁵ *British Horseracing Board v. OFT*, Case 1041/2/1/04, August 2nd 2005, para 170.

⁶ *FTC v Staples Inc.*, 970 F. Supp 1066 (DDC 1997).

⁷ Baker, J. (1997), 'Econometric Analysis in *FTC v Staples*', remarks prepared for the ABA's Antitrust Section Economics Committee, July 18th.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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