



Differences in Schools of Thought on Protecting Competition:

Chicago School vs. European School

US and EU competition law differ. State-aid rules are unique to EU competition law, while the US ban on monopolization finds no exact parallel in Brussels. The abuse-of-dominance standard in Europe is stricter and reaches further than American rules on exclusionary conduct. Excessive pricing can violate Article 102 TFEU, but never the Sherman Act. US law treats vertical restraints more leniently than EU competition law does.

These differences were addressed by FTC-Commissioner Ohlhausen in one of her most recent speeches¹ on

U.S. – E.U. Convergence: Can We Bridge the Atlantic?

In her speech, FTC-Commissioner Ohlhausen made (correctly) the point that various schools of thought can come into tension. This might be the case between US and EU competition law enforcement. But there is tension even within Europe. The online booking cases, significant market power concepts in Article 102 TFEU, the treatment of vertical restraints or big data are just a few examples.

Tension emerges in particular when economic scholars with a Chicago School background² advocate their school of thought and economic analysis in EU competition law cases. An application of the Chicago *laissez-faire* ideology to EU competition problems simply does not fit with the aims of EU competition law, which is embedded in the clearly pre-defined economic order of the Lisbon Treaty thereby integrating the values and objectives of the European society.

In the following we explain from an economic perspective why Chicago School insights and the related 'consumer welfare' story do not offer guidance in EU competition law.

The Chicago School and the 'consumer welfare' story

The two schools of thought, the Chicago School and the European School, have some values that are similar, some of them are conflicting.

¹ <https://www.ftc.gov/public-statements/2016/09/us-eu-convergence-can-we-bridge-atlantic>

² It has to be noted that Chicago School thinking is advocated by some scholars in Europe. In sharp contrast, Chicago School thinking is not well received in US antitrust enforcement at all.

Both, the European School and the Chicago School, agree that in a market the sum of producer and consumer surplus should be maximised.³ Thus, both schools prefer a system based on market economies while the interest in social equality diverges. The main distinction between the two systems is that within Europe the re-distribution of wealth gains within society is pre-determined by the legal order to assure that the benefits of the market are socially equitable and fairly shared. This is a normative approach which lacks an equivalent in the Chicago School.

In contrast to the European situation, Chicago scholars do not accept a pre-determination of how wealth gains should be equitably and fairly distributed between members of society. They argue that other public policies are better suited to deal with equity goals: 'Antitrust thus has a built in preference for material prosperity, but it has nothing to say about the way prosperity is distributed or used.'⁴ Thus, consumer welfare in the Chicago style is enhanced by the creation of efficiencies regardless of which market participant receives the actual wealth created i.e. social aspects are not valued. The result is that economic thinking based on the Chicago School focuses on the 'consumer welfare standard' only discussed further below. The Chicago School considers efficiency gains as politically neutral but regards wealth transfers as politicised: 'Wealth should go where it is the most appreciated.'⁵ In this Chicago view, the redistribution of income in Williamson's trade-off model (see graph below) is neutral, which is strange considering that producers get richer at the expense of consumers when Chicago School thinking is applied.

Another distinction relates to the role of the State. Posner's⁶ economic welfare and Bork's total consumer welfare concepts, based on a neo-liberal *laissez faire* approach, suggest that markets will manage any possible antitrust problems themselves. Therefore, intervention in market forces is rarely required. The Chicago School does not accept that government intervention to protect the competition process is necessary. Thus, Chicagoans believe in the functioning of markets, not competition.

We discuss in the following this economic model step-by-step for non-economists to enable a proper understanding of the issue. Our guess is that once the 'Chicago Trap' is properly understood, the language-use of 'consumer welfare' will considerably be reduced in Europe.

Williamson's trade-off model

In 1968, *Oliver Williamson* discussed the need to weigh the benefits of improved efficiency against the costs of allocative inefficiency ('deadweight loss'). His trade-off model⁷ shows that society is in most cases better off despite monopoly enhancement because of a merger.

As illustrated in the graph below, following a merger, market power increases: output is reduced from Q1 to Q2 and price increases from P1 to P2. The loss in allocative efficiencies is represented by the triangle A1 ('deadweight loss'). The merger generates cost savings from AC1 to AC2. However, the industry is now less

³ Total welfare and total surplus are used in the following as synonyms.

⁴ Bork, *The Antitrust Paradox: A Policy at War with Itself*, 1978, p. 90

⁵ Posner R., *The Economics of Justice*, 1981, p. 92

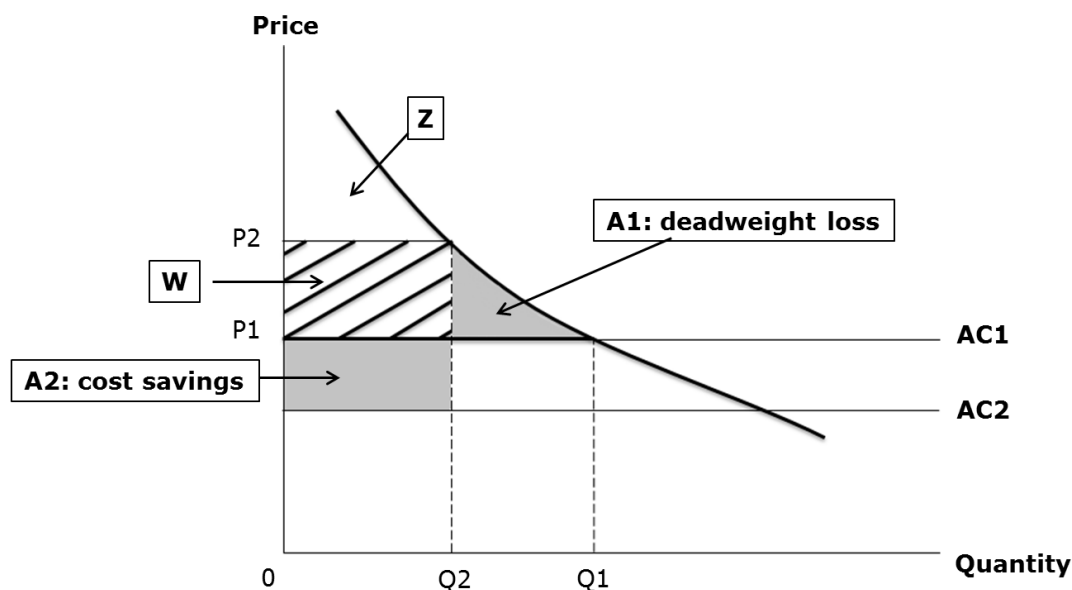
⁶ Posner R., *The Chicago School of Antitrust Analysis*, 1979

⁷ The model is based on strict assumptions: perfect competition, merging firms are duopolists, homogenous products, constant unit cost of production etc..

competitive. Since the firm is no longer a price taker, the price P_2 it charges is above the (now lower) unit cost AC_2 .⁸

The striped rectangle, W , represents a loss of consumer surplus (gain in monopoly profits) that the merger produces. Thus, income or wealth is transferred from consumers to producers. This means that the amount of consumer surplus, the area below the demand curve and above the price P_2 , Z , is lower post-merger. Previously consumer surplus was Z plus W plus A_1 (area above P_1).

Chart 1: Williamson's Trade Off Model



The total welfare standard asks whether additional producer surplus (which might accrue through an increase in productive efficiency⁹ created by the merger) is larger than any additional allocative inefficiency ('deadweight loss') that results from an increase in market power.

Williamson concluded that cost savings need not be very high to compensate for deadweight losses induced by price increases. The net allocative effect of the merger is assessed by comparing the triangle A_1 (deadweight loss) with the rectangle A_2 (cost savings) confirming that a merger quite often yields a net-efficiency gain. However, in this thinking income (or wealth) is transferred from consumers to producers.

When a consumer welfare standard is used, the merger assessment needs to focus on consumer surplus only. The consumer-surplus standard allows, in contrast to the total welfare standard, no disadvantages to the consumer. According to this approach, a merger that leads to increased consolidation, higher prices and

⁸ For a monopoly, the price will be set where the unit/marginal cost intersects marginal revenue.

⁹ Productive efficiency (or technical efficiency) describes the level of utilization of resources in the economy and is maximized with various combinations on the production possibility frontier (PPF) of the economy. It is a situation in which the economy could not produce any more of one good without sacrificing production of another good. Put simply, optimal productive efficiency exists where the economy utilizes resources in the least expensive way possible. See (OECD, Glossary of Industrial Organisation Economics and Competition Law, 1993)

negative effects for competition can only be approved if the consumer benefit increases post-merger. The achievable efficiency gains of a merger must be at least partly passed on to the consumer. This 'consumer pass on' of efficiency gains is mainly measured in prices. Accordingly, a merger that entails projected price increases would not be approved, independent of whatever advantages it may have for the total welfare.¹⁰

This means that depending on the welfare standard applied, results in the economic analysis differ. An antitrust standard which puts consumer interests on the forefront could never approve a merger without an increase in consumer surplus. Where price decreasing effects through efficiencies are smaller than price increasing effects through additional market power of producers but gains in productive efficiencies are larger than the additional allocative inefficiencies ('deadweight loss'), a consumer welfare standard leads to a negative assessment whereas total welfare would be increased.¹¹

To conclude, the Chicago position is that consumer welfare is another name for allocative efficiency or total welfare. This means that the Chicago School applies a total welfare standard and not a consumer welfare or consumer surplus standard as articulated by some contributors.

Deciding which welfare standard shall be applied cannot be reached through welfare theory itself, but must be decided normatively. Practically, this means that the decision over which approach to apply is a political one.

In EU competition law both goals - efficiencies as synonym for economic progress and a fair distribution of wealth gains between producers and consumers - are equally important. Moreover, EU competition law has a built-in preference how prosperity should be distributed. The European position is that welfare gains because of a merger should not be attributed mainly to one group (such as the producer in the *Williamson's* trade-off model) but distributed fairly and equitably between both groups, consumers and producers. Whereas the Chicago School believes that in the long run consumers will benefit anyway, the European School prefers a fair distribution at the time the worsening of the competition process takes place.

Returning to the *Williamson* graph above consumer surplus before the merger is the entire area above AC1 (the triangle A1, the rectangle W, and Z the white area

¹⁰ See also (Ahdar, 2002).

¹¹ Allocative efficiency: Every good or service is produced up to the point where the last unit provides a marginal benefit to consumers equal to the marginal cost of producing it. In the usual interpretation at the point of allocative efficiency, price is equal to marginal cost. In principle, at this point production equals consumer preferences by focusing on the consumer's willingness to pay. At this point surplus is maximized with no deadweight loss. Allocative efficiency can be referred to Pareto efficiency that occurs when resources are so allocated that it is not possible to make anyone better off without making someone else worse off. When referring to a situation as Pareto efficient, it is usually assumed that products are being produced in the most efficient (least cost) way. In antitrust economics, allocative or economic efficiency arises when inputs are utilized in a manner such that a given scale of output is produced at the lowest possible cost. An increase in efficiency occurs when an existing or higher scale of output is produced at lower cost. See (OECD, Glossary of Industrial Organisation Economics and Competition Law, 1993)

above W). Following the merger, consumer welfare/consumer surplus is reduced to Z alone. A1 is gone, a deadweight social loss, and W belongs to the producer.

In the Chicago view, the redistribution of income in *Williamson's* trade-off model is 'neutral'. This is a strange definition considering the fact that producers get richer at the expense of consumers. In the US, there is empirical evidence indeed supporting this observation and indicating that monopoly power, past and present, has contributed significantly to the above average wealth of the already wealthiest families.¹²

The 'Chicago Trap'

The confusion¹³ between 'consumer welfare' and 'total welfare'¹⁴ was introduced by Bork, probably unintentionally, and then he unwittingly called consumer welfare 'the wealth of the nation' a term economists refer to as 'social welfare'.

In *Bork's* view, consumer welfare is the greatest when society's economic resources are allocated so that consumers are able to satisfy their wants as fully as technological restraints permit. In his view, allocative efficiency and productive efficiency together make up the overall efficiency that determines the level of society's wealth.¹⁵ *Bork* further explained that consumer welfare is net social welfare, the sum of producer surplus and consumer surplus. '*Those who continue to buy after a monopoly is formed pay more for the same output, and that shifts income from them to the monopoly and its owners, who are also consumers.*'¹⁶ Thus, *Bork* qualified both monopolists and normal people as consumers. In *Bork's* view consumer welfare is in fact total welfare.

Bork's main contribution to the Chicago trap¹⁷ is the call for maximising consumer welfare as a dominant goal of antitrust.¹⁸ '*The whole task of antitrust can be summed up as an effort to improve allocative efficiency without impairing productive efficiency so greatly as to produce either no gain or a net loss in consumer welfare.*'¹⁹

To date, the US Supreme Court has not given clear guidance about which welfare standard should be applied, nor has it decided which school of thought should be used in US antitrust cases. In fact, the contributions of welfare economics in Chicago style to antitrust analysis in US case law are very, very limited.

¹² See also (Ahdar, 2002, p. 346)

¹³ In 1966, Bork analysed the legislative intent of the Sherman Act. He argued that economic efficiency i.e. total welfare should be the guiding principle, but he called it 'consumer welfare'. See Bork R., Legislative Intent and the Policy of the Sherman Act, 1966

¹⁴ Bork R., The Antitrust Paradox: A Policy at War with Itself, 1978, p. 90

¹⁵ '*These two types of efficiencies make up the overall efficiency that determines the level of our society's wealth, or consumer welfare.*' (Bork, The Antitrust Paradox: A Policy at War with Itself, 1978, p. 91)

¹⁶ (Bork, The Antitrust Paradox: A Policy at War with Itself, 1978, p. 110)

¹⁷ (Cseres, Competition Law and Consumer Protection, 2005, p. 332)

¹⁸ (Bork, The Antitrust Paradox: A Policy at War with Itself, 1978, p. 50)

¹⁹ (Bork, The Antitrust Paradox: A Policy at War with Itself, 1978, p. 91)

The Frame of the European School

In contrast to the Chicago School thinking, the European belief is that a prosperous, free and equitable society can develop only when the market is embedded in a constitutional framework. The framework is necessary to protect the process of competition from distortion, as a means of preventing degeneration of the competitive process itself and in particular assuring that the benefits of the market are equitably distributed throughout society thereby minimising governmental intervention in the economy. These 'rules of the game' are incorporated into EU competition law that functions as a pillar of the social market economy concept by putting economic policy on a par with social policy objectives.

In the European School, the well-being of people includes, besides price elements, a holistic perception of consumer utilities and preferences. Interests of the 'average consumer' or citizen lie at the heart of the European School. This is not the same objective as, for example, defined by the consumer surplus/consumer welfare/producer surplus discussion of the Chicago School discussed above. The European objective is broader and holistic.

In Article 101 TFEU, for example, if an agreement restricts competition but contributes to improving the production or distribution of goods or to promoting technical or economic progress it may escape the nullity provision if the pro-competitive benefits outweigh the anti-competitive effects from a consumer perspective.

Consumers need not receive the same amount of wealth gains as producers because producers need to be compensated, for example, for their innovation efforts and risks. However, the distribution needs to be 'fair'. The analysis in European style considers non-price related benefits a consumer might receive in compensation for an increase in market power too.

In this higher hierarchy canon of freedom, social fairness, equality and rule of law, economic efficiency is of lower importance. Benefits are shared between the two market sides equally. If consumers would not get a fair share, only producers would benefit. This would be single-sided thereby contradicting the equality and social fairness criteria of the concept of social market economies.

According to Article 102 TFEU firms are supposed to engage in performance competition or 'competition on the merits'. That is normal competition which improves the performance of a firm and is in the long-term interest of the consumer: better goods, lower prices, better services and an increase in innovation. This type of competition translates into benefits to the consumer. However, non-performance competition is not in the long-term interest of consumers but takes place for other reasons such as the hindrance of competitors or undue enrichment. The logic of equality implies that since non-performance competition is not a type of competition a firm would engage in as normal business conduct, a firm holding economic power should refrain from such a type of competition as well. This is consistent with the 'rules of the game', namely, that firms with and without economic market power need to behave equally.

Our next two CCRs will provide some examples on the actual implementation of the European School in EU competition law. We will discuss a merger case as well as horizontal/vertical agreements and an abuse case.