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Mergers and dominant firms

Oceans apart

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Illustration by Phil Disley

Europe still seems to have less faith than America in the ability of the free market to tame monopolies

AMERICA fosters competition; Europe protects competitors. That jeer is tossed across the Atlantic pretty frequently. Watchdogs on both sides of the ocean play down the idea that the Europeans bite more often than the Americans. But although the gap is far narrower than it was a few years ago, it still exists. The commission (the European Union's antitrust authority) is much likelier than the American Department of Justice (DoJ) to fear that a merger of two big firms or the behaviour of a dominant one will force rivals out of business, raising prices and restricting choice. The Americans are more confident that if powerful firms abuse their strength, they may attract competition rather than crush it.

In March the commission began investigating the proposed purchase by Nokia, a mobile-phone company, of Navteq, a provider of digital maps. A similar deal between Tom Tom, a maker of portable navigation devices, and Tele Atlas, another digital-map firm, is also under scrutiny. Both transactions had been cleared swiftly in the United States. The commission is also examining the behaviour of other high-tech firms—notably Intel, the world's leading chipmaker—even though the companies in question have not perturbed the American authorities.

In one respect—the treatment of "horizontal" mergers, between competitors—Europe's policy has come to look more like America's. This change has come about largely because of setbacks in court. In 2002 an appeal court savaged the blocking by the commission of the merger of Airtours and First Choice, two British travel operators. The commission responded by drawing up guidelines for appraising horizontal mergers. These should now be permitted unless they would leave one company with uncontestable market power or allow the remaining companies to compete less vigorously.

The shift of policy was demonstrated last year when the commission blessed mergers that cut the number of large tour operators in Europe from four to two. The deal between Airtours and First Choice, blocked eight years earlier, would have left the market with three big suppliers.

However, a kindlier European view of "vertical" mergers (between customers and their suppliers) is harder to detect. American authorities have tended to judge that they add to efficiency and help cap prices. As long as there is competition for final sales, consumers will benefit both from cheaper production and from paying one fewer mark-up in the supply chain. The commission has been more wary: in 2001, notoriously, it blocked the merger of General Electric and Honeywell, an avionics firm, which American regulators had waved through.

The courts upheld the decision, but were nevertheless critical of the commission's reasoning. The commission responded to criticism by getting to work on guidelines for non-horizontal mergers, which were published last November. Although one competition regulator reckons there is a now just a "sliver of paper" between the EU and American approaches, the extra scrutiny given to the Nokia/Navteq and Tom Tom/Tele Atlas mergers suggests the EU is still cautious.

Differences in the treatment of dominant firms, especially in fast-changing high-tech industries, also remain—

and are if anything more plain. Article 82 of the EU treaty outlaws the abuse of a dominant position. Firms with a large share of a market are forbidden from using their muscle to set unfair prices, restrict output, force customers to buy related products or prevent other firms from challenging their dominance. Section 2 of the Sherman act puts the same restrictions on monopolies in America.

Applying these laws to technology industries is hard. The power of network effects in telecoms, computing and other digitised industries means it makes sense for firms to agree on an industry standard, so that gadgets and software are compatible. But this confers monopolies on the makers or patent-holders of standard kit, which in turn brings them into potential conflict with trustbusters.

Jorge Padilla, an economist at LECG, a consultancy, argues that in markets characterised by rapid innovation and modest barriers to entry, the costs of condemning a sound business strategy or merger are much greater than the harm caused by letting a monopoly slip through the net. In the first instance, efficiency gains are lost and incentives to innovate permanently blunted. In the second, market forces can help repair the damage.

American regulators seem to have become more convinced of this argument than their European counterparts have. The saga of Microsoft illustrates the difference. In 1998 the DoJ charged that by bundling Internet Explorer, its web browser, with Windows, its operating system, Microsoft sought to extend its desktop monopoly into browsers, freezing out Netscape, its main competitor.

The American courts ruled against Microsoft and in April 2000 ordered that the software giant should be split into two—one part owning the operating system and the other owning all other applications. The next year an appeals court said that Microsoft's actions did not warrant dismemberment. The DoJ settled for far more lenient remedies. These would stop Microsoft from bullying PC manufacturers into favouring its add-ons to Windows, but would leave the firm and its most important product intact.

The European authorities persisted with their own fight against Microsoft, which they eventually won last year. As well as paying fines totalling €1.4 billion ($2.2 billion), Microsoft has been obliged to supply a version of its operating system without its media player. It must also license parts of its code to rivals, to make it easier to dovetail their server-based software with Windows.

The commission is now monitoring some other high-tech companies too. It is investigating Intel for using discounts to maintain its dominant position. It claims that rebates paid to hardware manufacturers who buy most or all of their chips from Intel could be designed to squeeze AMD, its main rival, from the market. Intel is also suspected of more direct predation: selling chips below cost in order to secure clients in the server market. Another tech firm, Qualcomm, which owns the patent for chips used in mobile phones, is accused of overcharging for licences. The commission is also taking another look at Microsoft's past conduct, to see if it obstructed rivals' efforts to make their desktop applications work well with Windows.

The difference in approach is partly explained by economic philosophy. In America there is a greater faith that markets will fix the problem of monopolies and a belief that market leadership in high-tech is transient. A new product may make today's dominant technology redundant tomorrow. Firms compete for the market as much as in it: temporary monopoly is the reward for innovation.

Alongside this belief is another: that if regulators interfere they need to be sure that they are helping competition. That is not easy when behaviour that could bolster monopoly is indistinguishable from vigorous competition. Bundling, one of the sins for which Microsoft was punished, is common practice: every fast-food outlet charges more for separate items than for combined meals. And when a local print shop offers discounts or rebates for bulk orders—Intel's transgression—few imagine it is plotting against consumers.

But in a market where one firm is king, such practices can take on a sinister guise. Dominant firms might use loyalty rebates to stop others from becoming large enough to pose a serious threat. Bundling can be a tactic to compel consumers to buy several things from a firm with a monopoly in one product. It is hard to establish whether such strategies are pro-competitive or nefarious. Antitrust watchdogs have to gauge the tangible short-term benefits of lower prices and convenience against theoretical long-term harm.

America's agencies have tended to judge that too little action is less of a risk than too much. Intervention to protect weaker firms may serve only to blunt competition for the sake of highly uncertain benefits. Andrew Dick, a former DoJ economist now at CRA International, a consultancy, says that for these reasons American competition authorities put their faith in entrepreneurship to tackle monopolies. “Someone will always come along and build a better mousetrap,” he says.

This laissez-faire philosophy has fostered a permissive merger policy too. Two years ago the DoJ raised eyebrows when it approved the merger of Whirlpool and Maytag, even though the new firm would dominate the market for washing machines and clothes-dryers. The department considered that rival firms, at home and abroad, had strong enough brands and sufficient capacity to keep Whirlpool-Maytag in order.

Last month the DoJ sprang another surprise. It said it would not stand in the way of a tie-up between XM and Sirius, America's two satellite-radio providers. Its trustbusters said that "audio entertainment alternatives", such as AM and FM radio and MP3 players, would restrain the merged firm's prices. Ever since the XM-Sirius deal, lawyers have been wondering just what it would take to get a merger blocked.

Some lawyers see America's hands-off approach as a matter more of legal architecture than of economic creed. Joe Sims, of Jones Day in Washington, DC, reckons that the commission is likelier to bring cases because the European courts are a less powerful check on its discretion. Officials at the DoJ or the Federal Trade Commission (FTC) must make the initial case to a court if they want to halt a merger or challenge a monopolist. The means the courts can act quickly to thwart trustbusters if they decide a case lacks merit.

Last year, for instance, the FTC tried to prevent a merger between Whole Foods Market and Wild Oats Markets, two organic-food retailers. It saw each as the other's main rival in "premium natural and organic supermarkets". The courts, however, ruled this was too narrow a market definition: other grocers were offering more organic produce and redesigning stores to mimic upmarket outlets.

Europe's courts, by contrast, become involved in antitrust cases only in hearing appeals. Firms may make a legal challenge only after the competition authorities have delivered their verdict. Even then, the courts will overturn decisions only because of errors of reasoning or procedure: they may not rule on the technical details of each case.

More friction, less force

Perhaps the root of the divide between EU and America policy is not in philosophy or legal systems but in history and market structure. Janet McDavid, a lawyer at Hogan & Hartson in Washington, DC, points out that America has a far longer tradition of competition policy. It has had antitrust laws for more than a century: the Sherman act was passed in 1890. And America had a huge head start over the EU as a continental single market.

Europe's market is by far the more fractured. Infrastructure is organised around national boundaries, product markets are still highly regulated and many countries have state-owned or state-backed monopolies. This may justify a more intrusive antitrust policy: much of the commission's activity is aimed at battling unfair state support for companies.

Possibly, America's free-market zeal will fade. One Washington lawyer is advising clients that there is a small window between now and November to push through contentious mergers. A Democratic administration may be more willing to intervene.

But might the EU move closer to America in its treatment of dominant firms? It might—although it is yet to produce long-promised guidelines on Article 82 investigations, because, think some lawyers, regulators want to retain maximum discretion. The inquiry into Intel, which has also been taken up in Japan and South Korea, is one test. If the EU comes down hard on the chipmaker's rebates, it will confirm to many in America that Europe's competition watchdogs really do care more about protecting competitors than about promoting competition.

The intellectual tide favours America's laissez-faire approach. Mergers are now judged by whether they may hurt or harm consumers. Prior assumptions about what might be a desirable market structure play a diminishing role—even in Europe. In assessing horizontal mergers, regulators in Europe as well as America increasingly reason that rivals will emerge or respond if big firms try to gouge consumers. As for dominant firms, yesterday's giants—AT&T, IBM, General Motors—no longer cast such long shadows. Today's behemoths still need close watching, but in fast-moving markets, they have less scope to hold consumers to ransom.