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Will *Ex Ante* Antitrust Remedies Be The End of Permissionless Innovation?

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Lawmakers and regulators are calling for blanket changes to longstanding antitrust regulations to counteract what some perceive to be market dominance by a handful of large technology firms. Some lawmakers are calling for the breakup of these firms and significant business restrictions, even if these actions invariably lead to a decrease in consumer welfare. While our system of jurisprudence stresses the presumption of innocence – "it is better that ten guilty persons escape, than that one innocent suffer" – these policymakers and regulators are willing to err on what may be good conduct upfront, rather than remedy bad conduct later. These actions, if implemented, will be very costly to consumers.

Guilt by Speculation

In reviewing potential antitrust violations, the Department of Justice, Federal Trade Commission (FTC), and U.S. courts have long relied on the "consumer welfare standard" to determine whether or not consumers are being made worse off by alleged restraint of trade, monopolization, and other anticompetitive conduct. By this standard, a merger, for instance, may or may not be approved, depending on whether the deal is empirically shown to lead to lower or higher consumer prices, respectively.

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However, the current FTC Chair, Lina Kahn, is working to change all of this, as she has moved to rescind the consumer welfare standard, redraft the current merger guidelines, and permit the collection of company documents and the initiation of investigations without the Commission's approval.[1] Moreover, the change would allow the FTC to investigate business practices that may harm some competitors, even when these business practices benefit consumers.

Similarly, a similar effort to undo the consumer welfare standard is underfoot in Congress, with legislative language that would specifically target only five companies – Apple, Amazon, Microsoft, Facebook (now Meta), and Google (Alphabet). To some extent, these companies operate in quite different markets, from an online retailer with a grocery chain to a computer software company. Yet, being large multinational businesses, they also tend to compete with one another from offering apps and mobile operating systems to cloud computing, social media, and online advertising.

The removal of the consumer welfare standard would mean the loss of a critical empirical test that provides objectivity to the process of investigating and adjudicating alleged antitrust violations. By removing the consumer welfare standard, the government will find it much easier to use the antitrust laws to target, investigate, and prosecute firms based on mere speculation, bias, or political ideology, even if such actions ultimately lead to the loss of consumer benefits.

Legislative approaches that target only five companies rely on an unsupported presumption that the costs of imposing *ex ante* regulations in a dynamic market environment outweigh the potential benefits.[2] While policymakers are right to

[1] Neil Chilson, "FTC Commission Chair Lina Kahn's Overreach is Bad for Consumers, Bad for the Economy," Americans for Prosperity, https://americansforprosperity.org/ftc-khan-consumer-welfare-standard/.
[2] *Ex ante* regulations are those based on predicted or forecasted results, rather than actual results (ex post). This will be discussed more in depth later in this *ConsumerGram*.

scrutinize questionable conduct, is it right to sanction or breakup companies without any presumption of innocence?

The absence of evidence will cast doubt on the veracity of antitrust claims. While market rivals may claim that another competitor is unfair, the purpose of the consumer welfare standard is to protect consumers and competition, not to protect one competitor from another.

Ex Post **v.** ***Ex Ante*** **Regulatory Remedies**

The argument in support of stricter antitrust regulations rests substantially in the faith that the power of government regulation outweighs the ability of free markets to act as the guarantors of consumer welfare. While some may believe in the wisdom of government regulators, subject to broad statutory guidelines and political pressure; others may place their trust in the private sector, the discipline of market competition, and consumers' ability to freely choose their products and services.

Recent legislative proposals have targeted a few large tech companies based on each firms' total revenue and total market capitalization, and little else. The allegations behind these efforts are based on a faulty political ideology or a belief that these firms are simply too large. These allegations are totally contrary to accepted economic thought, which shows that: scale economies can lead to lower per unit costs of production and lower consumer prices; and markets can have different minimal optimal scales of production. Moreover, none of the allegations claim that consumers have been negatively impacted.

The government versus market debate has morphed, in part, into a disagreement over the form and timing of government intervention. One camp may urge a presumption of the likelihood of bad conduct upon consumers and thus a need to resort to preventive government measures (*ex ante* regulation or anticipatory government intervention). Said differently, the government intervention camp may contend that if the government does not act now, eventually consumers could be harmed by these big tech giants.

Alternatively, the other camp urges regulatory restraint and government action only when bad conduct materializes (*ex post* regulation or remedial government intervention) because existing antitrust laws are generally sufficient.

Most consumer advocates should recognize that consumers could be harmed by either bad business conduct and by poorly conceived and executed government regulation. The balance should be an empirical matter to be considered case by case. It is a truism, however frequently ignored, that both markets and government agencies are imperfect and subject to various sorts of "failures." Thus, in choosing the mix between disciplines imposed by markets and government action, well-informed lawmakers and regulators should query about the real-world consumer costs and benefits of each.

Consumers are exposed to different potential harms resulting from market imperfections and flawed government processes. What follows is an attempt to frame the issue in general terms of costs and benefits.

To Err is Human, and Can Be Very Costly to Consumers Too

Scientists sometimes call attention to two kinds of errors: **Type I** and **Type II** errors or, in statistical contexts, false positives and false negatives. The two errors typically have different associated costs thus we generally have a basis for preferring one over the other if both cannot be avoided. A well-known example relates to our system of justice in which we prefer to find a guilty party innocent (false positive) to finding an innocent party guilty (false negative).

For example, in evaluating COVID medications, the FDA must weigh the harm from denying the benefits of "good" drugs against the risk of permitting those with bad side effects. The core of the problem is where to "give the benefit of the doubt" when outcomes are uncertain.

Similar dilemmas present themselves in various other contexts, including in the antitrust debate. Prescriptive approaches (*ex ante*) are recommended as strong in preventing "bad" behavior, but they also prevent good behavior – "tossing out the baby with the bathwater," as it were. Rather than predicting in advance what bad behaviors may occur, an *ex post* approach would use regulations to correct a problem or market failure after the fact.

An ex *post* approach has been crucial to establishing the U.S. as a world leader in technology, because that approach encourages permissionless innovation and experimentation with new business models and services. This had led the U.S. tech industry to move and innovate at a very rapid pace. On the other hand, government regulations move at glacier speeds. Having the government decide today (*ex ante*) what limitations should be placed on technology companies and their business models will unquestionably negatively impact future innovation and consumer welfare. That is the cost of *ex ante* antitrust regulations that are being proposed today.

Some of the proposed antitrust bills, if enacted, would end some beneficial services that consumes currently enjoy.[3] For example, Amazon Prime membership provides free delivery and sometimes free one-day delivery to its members on products it labels as "Prime." In order to assure that products are delivered on time, Amazon has its own fulfillment operations available to its products and the products of third-parties, provided these third-parties choose to use Amazon's fulfilment services and that they

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[3] For example, see Adam Kovacevich, "A Closer Look: How Senator Klobuchar's Bill Would Ban Amazon Prime," *Medium*, November 2, 2021, https://medium.com/chamber-of-progress/a-closer-look-how-senator-klobuchars-bill-would-ban-amazon-prime-aa57dd5d22c0.

meet Amazon's reliability standards. Third-party vendors may choose to deliver their products on their own and can sell their products on Amazon's platform, but without the Prime label, since Amazon cannot guarantee timely shipping by these vendors.

However, under some proposed antitrust provisions, Amazon's one-day free delivery may be deemed illegal, because not all third-parties are treated the same as it relates to Amazon's fulfillment services. If Amazon is forced to provide parity in fulfillment services, Amazon Prime services, as we know it today, will likely end.[4]

The end of Amazon Prime would mean an end to free shipping and free one-day shipping, and potentially limit some product choice. While Amazon Prime members pay a subscription fee, data show that the benefits of Prime membership leaves consumers tens of billions of dollars ahead in terms of savings.[5] In addition, the end of Amazon Prime will also mean the end of other Prime benefits, such as Prime Video, Prime Music, lost discounts at Whole Foods Grocery stores, and so on. In this example, a prescriptive antitrust approach would prevent good behavior, and it also creates a social cost that leaves consumers much worse off.

Remedial approaches (*ex post*) largely avoid the trap of preventing good behavior but are criticized as permitting some bad behavior. Consumers, of course, suffer the costs of both errors, though *ex post* regulations can still offset some of the costs. The current antitrust laws can already be used to remedy the potential for problems without first anticipating them.

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[4] Adam Kovacevich, "A Closer Look: How Senator Klobuchar's Bill Would Ban Amazon Prime," *Medium*, November 2, 2021, https://medium.com/chamber-of-progress/a-closer-look-how-senator-klobuchars-bill-would-ban-amazon-prime-aa57dd5d22c0. Under the Klobuchar bill, Amazon's services may be deemed as self-preferencing. The term "self-preferencing" will be addressed later, but (in this context) it generally refers to an online platform owner that promotes its own products and services over the products and services of other sellers on the same platform.

[5] Steve Pociask, "Regulators Wrong on Big Tech Benefits," *Townhall*, September 1, 2021, https://townhall.com/columnists/stevepociask/2021/09/01/regulators-wrong-on-big-tech-benefits-n2595137.

The relevant question is which is more damaging – errors caused by preventing consumer welfare enhancing good conduct (type I errors) or those caused by reducing consumer welfare by permitting bad conduct (type II errors). The table below summarizes these regulatory costs.

ERRORS IN PROACTIVE AND REACTIVE REGULATION

	Good Conduct	**Bad Conduct**
***Ex Ante* Regulation (Type I Errors)**	**Consumer Costs of False Negatives**	
***Ex Post* Regulation (Type II Errors)**		**Consumer Costs of False Positives**

Benefits and Costs of *Ex Ante* Antitrust Regulation

The benefits of *ex ante* regulation are almost exclusively a matter of conjecture, particularly since there is no systematic analysis of consumer benefits (welfare) or costs in the legislative record, and advocates will concede that it is impossible to estimate damages occasioned by conduct. If the proposed legislation passes, then these firms are guilty of being large and nothing more. However, in a world of network economies and high fixed costs, scale economies matter for production and can be necessary in keeping consumer prices low. As a result, consumers pay nothing even though Facebook and Google are large. Indeed, Amazon is the second largest retailer, only surpassed by Walmart, and is exempt from the legislation.

To date, the analysis of benefits by advocates has been limited to citing a handful of isolated "incidents" as omens of future harm in the absence of regulation. Irrespective of the consumer benefits of *ex ante* regulation, which have yet to be documented, the associated costs are just assured to be substantial. Here is what we do know about the costs of *ex ante* regulation:

- It invites litigation, gaming, rent-seeking, and general exploitation of regulatory processes by special interests, not consumer interests;
- It results in false negatives that prevent consumer welfare-enhancing conduct;
- It picks winners and losers in the marketplace;
- It creates uncertainty, delay, waste, and costs;
- It interferes with market forces that seek to compete and win consumer favor with innovative services and technological applications;
- By creating uncertainty and delay, it deters innovation, investment, and experimentation with new business models; and
- It creates ambiguous, overly restrictive, and discriminatory regulatory standards and benchmarks for market conduct and performance.

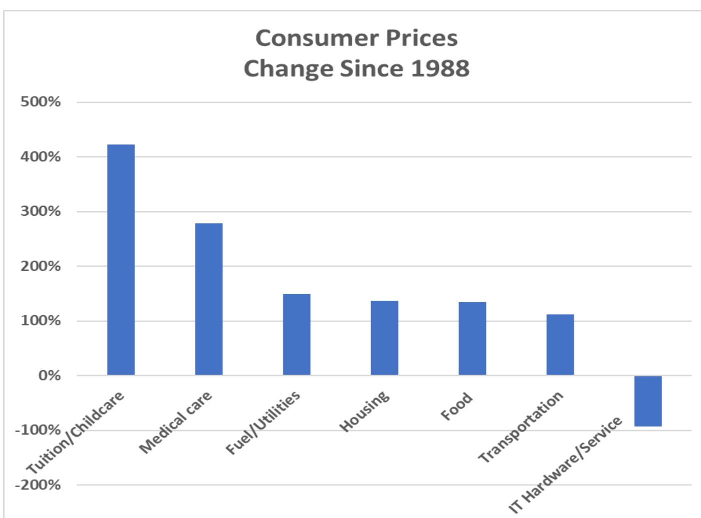
These characteristics of imperfect regulations are well documented. Remedial governmental actions manifest important externalities, transaction costs, and other indicators of institutional inefficiencies and government failure. More regulation is no antidote for consumer losses from poor regulation.

The Costs of Government Error are High

The evils of monopoly are well-known: high consumer prices, restricted output, and low levels of investment and innovation. However, none of these are present in the tech sector. For instance, the U.S. tech sector is the envy of the world when it comes to hardware and software technology, cloud computing, social media, and other innovative technologies. That is why the largest companies in the U.S. invest enormous resources in research and development. For example, among the world's publicly-traded corporations, Amazon and Alphabet (Google's parent company) spent more than $70 billion on research and development (R&D) in 2020, equivalent to about 12% of their revenue.[6] Together, these two companies were granted more than 4,000 patents in 2020 alone. Other major technology companies across the nation also heavily invest in R&D, which translates to new features, products, and services for consumers to enjoy.

What about consumer prices? Last year, President Biden issued an Executive Order aimed at promoting competition in the American economy, where he singled out a number of concentrated markets, including airlines, drug makers, banks, and big tech.[7] The Administration has also called attention to oil and poultry companies that are allegedly contributing to inflation.

Is there any evidence that the technology sector is responsible for higher prices? Not according to the Bureau of Labor Statistics' Consumer price indexes (see the chart below), which indicates that prices for hardware and software within the information technology sector fell in nominal dollars, compared to other consumer prices. In short, the tech sector exhibits all of the characteristics of a healthy, competitive market.



[6] Prableen Bajpai, "Which Companies Spend the Most in Research and Development (R&D)?, NASDAQ, July 21, 2021, https://www.nasdaq.com/articles/which-companies-spend-the-most-in-research-and-development-rd-2021-06-21.

[7] "Fact Sheet: Executive Order on Promoting Competition in the American Economy, White House news release, https://www.whitehouse.gov/briefing-room/statements-releases/2021/07/09/fact-sheet-executive-order-on-promoting-competition-in-the-american-economy/.

In the absence of any data showing that the market exhibits anti-consumer monopolistic conduct and without any quantitative analysis showing a negative impact on consumer welfare, there is no evidence of harm to warrant additional antitrust regulations. What is known, however, is that the resulting regulation will likely impose costs on these firms, the overall sector, third-party suppliers, and small businesses, as well as threaten U.S. leadership in the technology sector, and ultimately consumer welfare. Moreover, once in place, these costly regulations will be very difficult to reverse but easy to expand into other sectors of the economy.

As noted earlier, some of the legislative debate focuses on "self-preferencing," where large tech platforms direct its consumers to use its services over their competitors services. The idea of self-preferencing is pervasive in the market – such as when grocery stores offer discounts for private labeled products over name brand products. These calls for government intervention on the basis of "self-preferencing" may sound rhetorically appealing, but they ignore unanticipated costs to consumers of inevitable regulatory error. The consumer costs from government regulation will be very high.

Minimize Regulatory Errors and Maximize Consumer Welfare

The available record suggests that the costs of *ex ante* regulation outweigh conceivable consumer benefits. If and when *ex ante* regulation leads to type I errors, consumers will pay in the form of lower service quality, fewer options, higher prices, and reduced innovation. Consumers would likely be forced to forgo the benefits of market practices that firms otherwise would have performed, but for the threat of prosecution under well-meaning preventive regulation. That is not the case for what runs today's high tech sector of innovation, low prices, and increased output.

While *ex post* regulation permits mistakes to be made, the government can remedy these mistakes quickly and precisely after the fact. *As a result, ex post* regulation is widely regarded as sufficient, if imperfect, in matters of competition policy enforcement. The current antitrust laws accomplish this, and we have relied on them for the last century to prevent anticompetitive behavior across the entire economy and not just in the tech sector.

The tech sector moves and innovates at rapid pace, while government regulation moves at a glacier's pace. Having government decide today what limitations should be placed on technology companies and their business models will unquestionably create negative impacts on the future of innovation and put limitations on services that would otherwise have benefit consumers. That will be the cost of *ex ante* regulations that are unfortunately being proposed today.

Should antitrust policy be altered in a manner that would ultimately undermine America's position as a world leader in technology? Should antitrust laws and regulations place limitations on today's approach to permissionless innovation? If the proposed legislative and regulatory efforts to reform antitrust laws take effect, U.S. companies would be deemed guilty without a trial based on evidence.