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**Working Paper**

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AEI Economics Working Paper, No. 2019-18

**Provided in Cooperation with:**

American Enterprise Institute (AEI), Washington, DC

*Suggested Citation:* Jamison, Mark (2019) : Applying antitrust in digital markets: Foundations and approaches, AEI Economics Working Paper, No. 2019-18, American Enterprise Institute (AEI), Washington, DC

This Version is available at:

<https://hdl.handle.net/10419/280607>

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# Applying antitrust in digital markets: Foundations and approaches

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AEI Economics Working Paper 2019-18

November 2019

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# Applying Antitrust in Digital Markets: Foundations and Approaches

November 4, 2019

By MARK JAMISON \*

*This paper analyzes conflicts that arise when trying to apply traditional antitrust principles in the context of digital markets. Antitrust has both political and economic foundations. The political approach emphasizes populist themes that ultimately harm economic development, while economic approaches focus on characterizations of and remedies for market power. Digitization of markets thwarts current antitrust tools by adding complexity and rapid change. A number of authors suggest populist approaches for antitrust in digital markets, but these lack rigor and fail to address central challenges. This paper suggests that antitrust should return to its earliest roots and directly address features in the economy that create market power.*

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Digitization of information is affecting all aspects of life. A growing number of college graduates have never stepped foot on their alma maters' campuses. Business-to-business e-commerce in the US totaled more than \$1 trillion in 2018 (Digital Commerce 360 2019), and PWC Global reports that 80 percent of US CEOs expect that artificial intelligence will significantly change the way they do business by 2024 (PWC 2019). Although retail e-commerce made up only 10 percent of US retail sales in 2018, it was up nearly 70 percent over five years earlier (Statista 2019a). The United Nations scores 58 percent of countries as high or very high in their e-government development (United Nations 2018).

These changes are affecting business regulation and antitrust. The growing use of unprecedentedly large and constantly updated databases—called big data—to study behavior has led to concerns that the lowering of computing and data storage costs will result in consumer harms. People worldwide were startled by the revelation that Cambridge Analytica used information collected about Facebook users in violation of Facebook's policies.

The US Congress and the US Federal Trade Commission (FTC) have responded to big data, data security, and privacy concerns with hearings and investigations, which may result in greater enforcement of existing laws or the creation of new laws. The European Union (EU) recently adopted a General Data Protection Regulation (GDPR) that creates “digital rights” for EU citizens, requiring companies that collect or use personal data to ask for user consent.

Digitization has also given rise to technology backlashes and new interindustry rivalries. This has been evident in the debates over net neutrality. What apparently began as a desire to retain traditional telephone regulations in an internet age morphed into a competition in the regulatory arena between internet service providers and content providers over how regulation might be used to affect how these different types of companies might or might not get into each other's business (Jamison 2019a).

Digitization has also enabled the emergence of what has become known as Big Tech: Google (whose parent company is Alphabet), Facebook, Apple, Microsoft, and Amazon. The sizes and perceived influence of these companies has prompted populist calls for antitrust action to decrease their size and scope. Adherents to this populist approach refer to it as neo-Brandeis and apply the approach to all sectors, not just digitized industries. One of the adherents, Wu (2018), advocates expanding the role of antitrust in the US to limit business size and scope, a view echoed by Sen. Elizabeth Warren (2019). Focusing on Amazon, Khan (2017) argues for greater antitrust enforcement or common carrier-like regulations. Following similar themes, Furman et al. (2019) call for more aggressive antitrust and suggest imposing a code of conduct and data-sharing regulations on digital businesses.

These authors are correct that digitization creates problems for accepted antitrust tools, but their analyses and remedies are based on a simplified view of history and of the challenges of digitization. Today's antitrust approach emphasizes identifying market power by analyzing specific markets and firms' abilities to raise prices, and it advises remedies when the exercise of market power might harm consumers (Baker 2007; Farrell and Shapiro 2010). Khan (2017) argues that firms like Amazon seek market control rather than profits and so frustrate traditional views of

firm conduct. Eisenach (2012, 2017) identifies dynamics, systems competition, and network effect characteristics of the information technology sector that present challenges for antitrust. Hauge and Jamison (2016) explain that constant change in digital markets causes the validity of antitrust market analysis to rapidly decay, calling into question both the bases for decision-making and the propriety of antitrust action.

Neo-Brandeis adherents hold that antitrust was built on anti-bigness views and had meaningful success until the 1980s when a more economics-oriented ideology took hold and turned antitrust to emphasize consumer welfare. They are correct that Brandeis' anti-bigness view shaped the initial practice of antitrust, but wrong in their views of the roots of consumer welfare. The scholarly emphasis on how monopoly affects consumers dates back to Smith (1776) and Mill (1848) and was a central theme in economic analysis of antitrust as early as 1934 (Lerner 1934). Furthermore, Stigler (1966) and Crandall (2019) show that early antitrust cases based on anti-bigness were ineffective.

This paper assesses current calls for more extensive application of antitrust by examining antitrust's foundations, reviewing the challenge of digitization, and assessing recent proposals for change. It also extends Hauge and Jamison (2016) to suggest that the challenges that digitization creates for antitrust are best addressed by returning to the roots of the economics of monopoly and market power.

This paper proceeds as follows. The next section describes the political, legal, and economic debates that led to current antitrust policies and how these policies are reflected in current practices. The second section describes the natures of digital markets and the conflicts with current antitrust practices. The third section examines some recent proposals for applying antitrust to digital markets. The fourth section describes a way forward for antitrust in the presence of digitization. The last section is the conclusion.

## **I. Foundations and Practices in Antitrust**

This section begins with the political motivations and economic foundations for antitrust and then examines the economic investigations into monopoly and market power. It ends with a description of current practices.

### *A. Impetuses for Antitrust*

The purpose of antitrust has been debated in the US at least since the inception of the associated laws and policies. Gordon (2002) and Demsetz (1974) explain that the debate is largely between political motivations for antitrust and economic analysis. Louis Brandeis' work provided much of the energy and many of the notions stirring the political motivations. His ideas appear to have carried sway in the early years of antitrust and animate a current populist movement (Wu 2018). But Brandeis' economic arguments were often poorly formed and contradictory (McCraw 1984), so early antitrust activities had little positive impact for the economy (Stigler 1966).

Two primary drivers for Brandeis' antitrust views were his preference for autonomous individualism and his animosity toward large institutions, both business and government. He advocated for an economy comprised of small businesses because he viewed individualism as important for personal development and that it is lost if people work in large businesses rather than run their own (*Whitney v. California* 1926; McCraw 1984). In his private law practice and political activities, Brandeis pursued large business with aggressive personal attacks. This ad hominem approach to law and regulation carried into his political roles with Presidents Woodrow Wilson and Theodore Roosevelt and into his writings, where he villainized large banks and other businesses (Brandeis 1913; Brandeis 1914; Brandeis, Fraenkel, and Lewis 1934; McCraw 1984). This appears to be part of a larger theme for Brandeis—namely, that he was generally suspicious of other people's motives, but not his own (Laski 1930).

Brandeis' economic reasoning was flawed in part because he believed that breaking up large businesses lowers costs. He thought that small businesses are inherently more efficient than large businesses because business management must ultimately be overseen by a single person, and no one has the mental capacity to oversee a large enterprise. Although he recognized that there are economies of scale, he thought they are quite limited so that large businesses are generally wasteful. In his view the only way a business can become large and endure is by buying rivals, colluding with rivals, or dropping prices to drive out rivals that cannot be bought or bought off. But he did allow for rare exceptions, such as in the cases of public utilities. He viewed customers as being duped into being attracted to low prices because prices rise once rivalry is gone (US Senate 1912; Brandeis, Fraenkel, and Lewis 1934; Brandeis 1913).

But concern over prices was not a primary motivation for Brandeis wanting to break up large firms. Indeed, he viewed low prices as a problem and pressed for laws that would exempt small businesses from antitrust so they can collude. Price competition is wasteful, in his view, because it hurts small company profits, and customers have more important things to do than compare prices (Brandeis 1913; McCraw 1984).

Although the political motivations for antitrust are generally associated with populist sentiments and fears (McCraw 1984), economists such as Mason (1957) and Bain (1949, 1956, 1968) provided economic arguments for the political view with case studies and models of monopoly that argued that the fundamental economics of certain industries and consequent firm behaviors made the industries bend toward monopoly and market power. Based on a paradigm that industry structure drives firm conduct, which in turn drives sector performance, they emphasized scale economies, barriers to entry, and collusion. While Mill (1848) was one of the first to identify barriers to entry as a source of monopoly, he held that barriers need to be absolute, such as the case in which uniquely situated land was necessary for supply of particular products. Mason and Bain took more expansive views of entry barriers than Mill did.

Many economic scholars have been skeptical of politically motivated antitrust, holding that economic incentives make markets naturally arc toward competition. Two founders of modern economics, Smith (1776) and Mill (1848), view competition as emerging naturally from people's normal tendencies and identify government barriers to competition as primary causes of monopoly

or market power. Smith and Mill write of situations in which consumers suffered because political power was used to protect enterprises from competition. They also describe how collusive agreements can harm consumers by allowing firms to avoid competition, but this strategy requires that the colluding businesses prevent other firms from entering in response to supranormal profits. Government protections were often key to enabling collusion. Stigler (1959) explains that economists continued to favor markets and remained skeptical of many forms of regulation from the times of Smith and Mill to the time of Stigler's article. He explains that economists were concerned about monopoly, but later adds that antitrust had done little to decrease industry concentration, although it did appear to decrease instances of collusion and of horizontal mergers (Stigler 1966).

Implicit in the dispute between political and economic views on antitrust is a disagreement over purpose. Smith (1776) explains that the purpose of a market economy is to serve customers and warned against government interventions to satisfy businesses. This view was carried by many economists over the years and eventually became the driving force behind US antitrust in the 1980s. But long before the 1980s, Lerner (1934) emphasizes consumer harm as central to defining market power, and his approach has dominated economic analyses. Simon (1934) agreed that the population's economic welfare is a primary concern of economic policy, but he was troubled that the large firms of his day might become permanent fixtures with market power that would threaten democracy. The emphasis on consumer harm as the motivating factor for antitrust grew over time and is now the primary school of thought. As Shapiro (2018) explains, modern "*antitrust is about protecting the competitive process so consumers receive the full benefits of vigorous competition*" (emphasis in original).

Despite economists' emphasis on the need for economic foundations for antitrust, political motivations persist for some people and perhaps drive some antitrust cases. Gordon (2002) argues that political motivations explain some aspects of the US antitrust case against Microsoft in the 1990s. Recent populist views of antitrust reflect political motivations in that they replicate the theme that business success reflected in the size of a business, and especially enduring business success, are problems for the economy and democracy (Wu 2018). Shapiro (2018) counters that nothing in legitimate empirical analyses of market power in the US supports the notion that the goal of antitrust should be expanded beyond concern for consumer welfare.

### *B. Sources of Monopoly*

The economic views of antitrust rest on ideas of monopoly and market power. Demsetz (1974) explains that two schools of thought in economics have battled to explain monopoly: the interventionism theory—which holds that monopoly power largely derives from government interventions that protect companies from competition—and the self-sufficiency theory, which holds that monopoly power emerges from the fundamental economics of an industry or the behavior of the market participants. The theories are not mutually exclusive, so the disagreement is over which theory better explains the majority of market power that people believe they observe over time. Indeed, Smith (1776) and Mill (1848) reflect both these ideas. Both authors identify

government barriers to competition as primary sources of monopoly, but they also describe how collusive agreements can allow firms to avoid competition.

According to Stigler (1959), economic scholars since the founding of modern economics have been skeptical that markets naturally arc toward monopoly and market power, as the self-sufficiency theory holds. Smith and Mill viewed competition as emerging naturally from profit motives. Simon (1934) was concerned with enduring monopoly in the self-sufficiency sense, but his concern was largely on how monopolists might gain political power that would then protect their economic interests. Demsetz (1974) holds that the interventionism theory has a better intellectual foundation than the self-sufficiency theory because it is consistent with empirical evidence and can explain how economic rents can be used to benefit the government officials that restrict competition. He states that the self-sufficiency theory doesn't provide adequate explanation of how existing firms can restrict entry absent government help or control an essential supply input.

Tullock (1967) expands on the idea of government as a primary source of monopoly by describing how people seek benefits for themselves in the political arena, leading to government-created barriers to competition. This might take the form of seeking a subsidy or a tariff on something the businesses produce or obtaining regulations that hamper competitors. Krueger (1974) provides the term "rent-seeking" and explains that it is a major hindrance for economic advancement in developing economies. Peltzman (1976) and Posner (1974) identify rent-seeking as a major motivation behind the regulation of business.

In support of the self-sufficiency theory, Mason (1957) and Bain (1949, 1956, 1968) argue that the fundamental economics of certain industries and firm behaviors in those industries made the industries arc toward monopoly and market power. Mill (1848) was more skeptical and held that the barrier must be absolute, such as situations in which essential skills or supply inputs are subject to natural limits. This parallels with the grain warehouses in the 1876 case *Munn v. Illinois*,<sup>1</sup> in which the US Supreme Court found that competition was physically impossible because certain Illinois grain elevators were situated uniquely between a river harbor and railroad tracks. This case was critical in the formation of the concept of public utility in the US (Jamison 2013).

In contrast to Bain's structure-conduct-performance paradigm, Stigler (1942, 1964, 1968) finds government intervention as a major determinant of limited competition. He challenges common assumptions about capital market imperfections, identifies practices previously thought to hinder competition as actually indicating healthy competition, and explains how competition is constrained by regulation, patents, and tariffs.

Natural monopoly and entry barriers became the standard economic explanations for monopoly. Natural monopoly is thought to arise out of production economies in which a single firm is the least-cost means to provide a product. Baumol (1977) establishes that this occurs if

<sup>1</sup> *Munn v. Illinois*, 94 US 113, 130-132 (1876).



production costs are subadditive,<sup>2</sup> but Jamison (1999) adds that a firm must have dominant cost subadditivity.<sup>3</sup>

Applying the technology-based natural monopoly concept has at least four challenges. One is that it does not explain why there are no close substitutes. A second is that the theory fails to explain why a firm should be defined by technology. Coase (1937) holds that firm boundaries are determined by the economics of contracting. A third problem is that empirical analyses of production economies can only be done on existing firms. Sharkey (1982) points out that firms often organize themselves in ways that give appearance of such economies, but that does not mean the chosen technologies are those that would be used in a different market structure. Finally, production economies are measured in terms of products and markets for which antitrust authorities can obtain data. This means that application of the concept is inherently backward looking.

Rohlfs (1974) launches a body of economic literature that addressed demand-side scale economies—that is, situations in which customers add value to other customers, either directly or indirectly. These are now called platform markets, and the synergies are called network effects. His work and subsequent research find that such markets tend to tip, resulting in a monopoly or near monopoly and customer lock-in.

### *C. Practices*

The US Department of Justice (DOJ) began formally following economic-based considerations in its thinking on antitrust in 1968 when it developed its first merger guidelines, but the roots are much earlier as the guidelines appear to derive from Kaysen and Turner (1959). Turner was head of the DOJ's Antitrust Division at the time. Shapiro (2010) notes that although these first guidelines reflected primarily a dislike for large enterprises, the notion of delineating markets has a longer history in both economics and law. The early economics literature defined markets as boundaries in which pricing arbitrage was possible (Stigler 1942; Marshall 1920). Bane (1952) holds that substitutability defined market boundaries, and Machlup (1952) adds cross-elasticity of supply as a delineating factor.

The merger guidelines evolved so that now assessing a firm's market power generally occurs in two steps: defining "market" and then finding "power." Baker (2007) observes that market definition is the critical step because, throughout history, that issue has determined case outcomes more than any other. The US approach for defining the market—the "relevant market" in antitrust jargon—has remained essentially the same for several years, but it is not without controversy (Baker 2007). The DOJ and FTC 2010 Merger Guidelines (DOJ and FTC 2010) also offer methods for assessing market power without first defining markets, such as Upward Pricing Pressure

<sup>2</sup> Costs are subadditive when it is less costly for a firm to produce a given level of output than for all possible combinations of two or more firms to produce that output (Sharkey 1982).

<sup>3</sup> Dominant cost subadditivity exists when a firm's economies of joint production are greater than the economies that could be provided by all other forms of organization that might produce some portion of the monopoly's output  $o$  in conjunction with products and/or markets that the monopoly does not supply (Jamison 1999).

Analysis (Farrell and Shapiro 2010). All the approaches currently being practiced rely on boundaries of firms and markets being sufficiently stable and understandable to guide antitrust decision-making (Jamison and Hauge 2015). As the next section explains, this belief is unsupportable for digital markets.

## II. The Challenge of Digitization

Digitization causes some economic features of markets that used to receive scant attention to now rise to such prominence that they appear new and surprising. For example, seaports have existed for centuries and often exhibit the characteristics of multisided markets, but these features failed to attract scholarly interest until Rohlfs (1974) encountered them when trying to specify demand functions for telecommunications services. This section identifies some features of digital markets and how these features affect antitrust.<sup>4</sup>

Multisided markets—also called platforms—are economic environments that bring together two or more groups who value each other in some way. Examples include Uber (bringing together riders and drivers), Facebook (bringing together users and advertisers), and the Windows system (bringing together PC users, software developers, and device manufacturers). It might be that similar users value each other, such as in the case of communications networks, or different types of users do so, such as game producers and game users. The platform brings the participants together and enhances the value of the relationships by, for example, applying artificial intelligence to improve matching.

Demand-side scale economies can create tipping effects—the situation in which a single platform serves all or most of a market. Tipping is more likely when the platform also exhibits supply-side scale economies. This is likely in digital markets when the platform is largely software and the cost of adding a user is nearly zero. The Windows operating system is like this in that, once the software is produced, the only costs of an additional user are those of having sufficient network capacity to provide online updates.

The nearly zero marginal production costs do not mean that the costs for a 100-member platform and a 100 million-member platform are the same. In many situations, creating software for a platform that provides a sufficiently high-quality experience so as to attract 100 million users is likely to be more costly to produce than one that can attract only 100 users. So while the marginal cost of attracting the additional users looks like a fixed production cost, it is not truly fixed unless the higher- and lower-quality software are the same product.

Network effects can lead to user lock-in, which is when platform participants would have to incur costs—called switching costs—to move their platform activities to another platform. Lock-in can also occur when users would need to engage in costly coordination to move to another platform and retain the network value. Users can reduce lock-in by engaging in multihoming,

<sup>4</sup> This section is not comprehensive in its description of digital markets and how they affect antitrust. See Jamison (2019b) on how digitization affects traditional concepts of market power.

which is when individual platform participants use more than one platform for similar things, such as particular social media users using Facebook, Snapchat, and Twitter to share content.

Evans (2003) explains the complications that multisided markets create for traditional antitrust.

The economics of two-sided markets differ from the economics of one-sided markets in important respects. First, the individual prices charged on either side of the market do not track costs or demand on that side of the market. Indeed, the fact that benefits and costs arise jointly in the two sides of the market means that there is no meaningful economic relationship between benefits and costs on either side of the market considered by itself. It takes two to tango. Second, one cannot talk about the individual prices in isolation. Any change in demand or cost on either side of the market will necessarily affect both prices along with the sum of those prices. Third, products in two-sided markets cannot come into existence and cannot remain in existence unless firms in those markets get “both sides on board.” This gives rise to pricing and investment strategies that differ from those taken in one-sided markets and seem odd unless considered in the context of competition in a two-sided market. Fourth, any analysis of social welfare must account for the pricing level, the pricing structure, and the feasible alternatives for getting both sides on board. It must also account for the extent to which not-for-profit institutions manage those aspects of the network that could give rise to supra-competitive profits.

He further explains these features affect market definition, the examination of how and whether firms can hold prices significantly above marginal cost, the existence of barriers to entry, and how getting and keeping both sides on board affects ideas of predation.

Modularity is the situation in which there are strong complementarities among services. For example, there is strong complementarity among the Android operating system, devices designed to use it, and apps that are built for the Android platform. As Eisenach (2017) explains, complementarity creates demand for compatibility. And competition occurs within platforms, such as between some apps in the Android platform, as well as between platforms, such as between Android and Apple’s iOS.

Digitization also allows firms to undergo rapid change. Substantial change is normal in a market economy. As Bourne (2019) shows, four of the 10 largest US companies (in terms of market capitalization) in 1980 were not on the 1990 list, six firms on the 1990 list did not make the 2000 list, six on the 2000 list did not make the 2010 list, and five on the 2010 list did not make the 2019 list. Digitization increases the rate of change because of (1) modularity; (2) Moore’s law (Moore 1965), which states that the number of transistors in a dense integrated circuit doubles approximately every two years; and (3) Bell’s law (Bell 2007), which states that a new computer class forms roughly each decade, establishing a new industry. The lists of the 10 largest US

companies illustrate this greater rate of change: In 2000, three of the top 10 firms were focused on digital markets (Cisco Systems, Microsoft and Intel), four of the top 10 in 2010 were digital (Apple, Microsoft, Google, and IBM), and the top five in 2019 were digital (Microsoft, Amazon, Apple, Google, and Facebook). Only Microsoft persisted through the 20-year period.

Gilder (2018) argues that the business models of many of today's large tech firms have run their course. The reasons include an overreliance on artificial intelligence, the diminishing returns to big data, the rise of distributed data with blockchain and similar technologies, the reliance on zero prices for key services, and an antiquated security architecture. Business models that rely heavily on artificial intelligence fail to leverage the nonsequential qualities of the human mind; rely on big data, whose economics are changing; and are overly deterministic, which makes their conclusions vulnerable to factors outside the system. The reliance on zero prices limits the enterprises' abilities to learn from consumers expressing their willingness to pay because the businesses are essentially relying on barter, and the cost and value of what consumers are giving up—primarily information about themselves—is not front of mind when consumers engage in the barter. Also, the barter makes the economic relationship between the tech firm and the user unclear because arguably the firm may be under no specific obligation with at least some aspects of its service since the consumer has not explicitly paid for them. Lastly, the server farms that make up the cloud computing that large tech firms use centralizes data storage and processing. The economics of cloud computing is being challenged by distributed systems such as blockchain, which have security built into their architectures and alter the opportunities for big data analytics.

The vulnerability of some companies' value propositions and the demand-side economies make head-to-head competition with similar products a quickly passing phase at best. For example, in 1998 *Fortune* ran an article titled "How Yahoo! Won the Search Wars" (Stross 1998). But Google formed in 1997 and by the end of 1998 was attracting accolades for the quality of its search results. Seeing this, Yahoo made Google its default search engine two years later but dropped the relationship in 2004. But by then Google was surpassing Yahoo in consumer use. Although Google has maintained its lead in search for over a decade—US consumers use Google 700 percent more than they use Bing and Yahoo combined—these consumers value Bing and Yahoo only 10 percent less than they do Google in consumer satisfaction scores (Statista 2019b). This implies a quality elasticity of demand of 70, which is substantial relative to price elasticities and would imply intense quality competition and a fragile market share.

Because of this difficulty in profitably competing in markets where products are nearly identical, companies compete aggressively to create the next generation of product. The dynamism occurs within a system of complementary products and between competing systems. For example, companies making hardware and software for PCs in the 1980s and 1990s engaged in dynamic competition within the overall system whose standards were largely overseen by Microsoft and Intel. This system competed with Apple's Macintosh system. Some manufacturers and developers competed in both systems but had different rivalries within the systems. Evans (2017) illustrates the dynamism in today's digital markets by showing how companies' market mixes evolve quickly.

Competition through innovation (Eisenach 2012, 2017) and the vulnerability of some tech business models (Gilder 2018) make it futile to base antitrust on market definition and price sensitivities (Hauge and Jamison 2016). The practices used to define markets and examine upward pressure on prices rely on stable products and demand and historical data that are directly relevant to making decisions about the future. This reliance is misplaced, as rapid change makes the present and past poor representations of the future. Hauge and Jamison call this “decay,” by which they mean that as time passes, facts about the past decline in relevance for regulatory action.

Even if antitrust could define “market” in a digital world, many firms are rivals even if they are not in the same markets. Marketline (2018) finds that Amazon provides competitive pressure to Microsoft even without market overlap. Facebook and Alphabet provide competitive pressure to each other for online advertising, but also for next-generation uses of artificial intelligence. Jamison (2018) describes these relationships further.

Gordon (2002) explains that the complexities of information industries demand that economic models used to examine antitrust issues also be complex. This makes the analytical results sensitive to modeling assumptions. For example, assumptions about information providers’ business models and the demand for information products caused some economic papers to find that net neutrality regulations are valuable to consumers, while other papers found that the regulations would harm consumers (Jamison 2019a).

Not only are the analytical findings sensitive to model design, but there is no assurance that the critical features are stable in the real world. For example, if research were to find that most video content providers negotiated contracts with internet platforms based on an assumption that some platforms are better able to attract users than others, who can say with confidence that there will not be software in the near future that makes it easy for consumers to move seamlessly across platforms?

Another challenge for traditional antitrust is that market power is hard to observe with validity, and traditional definitions of market power seem to not fit. Antitrust analysts and writers in the populist antitrust tradition often look for supranormal accounting profits as indicators of market power. Shapiro (2018) explains why accounting profits are at best deceiving as indicators of economic profits. Jamison (2019b) explains that focusing on a particular firm’s profits to find market power is inappropriate in digital markets because relatively high current profits for highfliers are needed to attract capital to the sector. Indeed, the returns to the sector overall appear normal taking into consideration the high number of failed ventures and early financial losses (Jamison 2015).

### **III. Recent Proposals for Antitrust in Digital Markets**

A number of people and groups have made proposals for changing antitrust to address digitization. This section examines some of these.

One of the proposals to make the academic literature is Khan (2017). She holds that digitization affects the profit motive. Focusing on Amazon, she argues that the company’s years of financial losses imply that it has predatorily subsidized its business line expansion. She holds

that these acts contradict the profit-maximization assumption of the economic approach to antitrust. She also holds that Amazon built an e-commerce infrastructure that is a barrier to entry and that can be used for anticompetitive purposes.

Khan's argument that digitized businesses are not profit maximizing is flawed in its premises and logic. Her core evidence of Amazon's indifference is a letter from the Amazon CEO to shareholders. The letter is undated but appears to be written in 1998, as it focuses on Amazon's 1997 financial results (Bezos n.d.). Khan quotes Bezos as saying:

We believe that a fundamental measure of our success will be the share-holder value we create over the *long term*. This value will be a direct result of our ability to extend and solidify our current market leadership position. . . . We first measure ourselves in terms of the metrics most indicative of our market leadership: customer and revenue growth, the degree to which our customers continue to purchase from us on a repeat basis, and the strength of our brand. We have invested and will continue to invest aggressively to expand and leverage our customer base, brand, and infrastructure as we move to establish an enduring franchise.

The quote is incomplete, as evidenced by the ellipsis. The missing text is:

The stronger our market leadership, the more powerful our economic model. Market leadership can translate directly to higher revenue, higher profitability, greater capital velocity, and correspondingly stronger returns on invested capital. Our decisions have consistently reflected this focus.

The missing text clearly states that Amazon's focus on growth is a step to achieve profitability. So rather than being the evidence of "Amazon's lack of interest in generating profit" as Khan claims, the quotation actually supports the standard assumption of profit maximization.

Even if Khan had not committed this factual error regarding Amazon's priorities, she committed an error in logic: If Amazon were in effect buying customers using money from shareholders who didn't care that they would not get their money back, there is nothing that would stop another company from competing by losing money for investors that seek to do so.

Khan's concern that Amazon is behaving predatorily in adding lines of business and building an e-commerce infrastructure to economically serve multiple lines is misplaced. That a company combines formerly separately produced lines of business onto a common platform that is more economical than separate production processes is simply an example of economies of scope. If Khan and Amazon are right that this is a way of improving productivity, then it should be applauded. If they are wrong, then once the subsidizing shareholders run out of money or decide to move on, the system will fold.

Lastly, Khan believes that Amazon has used profits from some lines of business to subsidize others. She argues that this is *de facto* predation that would be missed under traditional antitrust

analysis. Her mistake is that she believes that economic analysis requires that losses from below-cost pricing be made up from the same product. This isn't true.<sup>5</sup>

Wu (2018), Jarsulic et al. (2016), and Lande (2019) argue that firms are becoming larger, that antitrust is rooted in an anti-bigness philosophy, that the adoption of a consumer welfare standard for antitrust was part of a conspiracy by corporate interests and libertarians, and that antitrust was successful in controlling market power before adoption of the consumer welfare standard. This is an incorrect reading of history. Section I describes the historical debate regarding antitrust. Consistent with Stigler's (1966) finding, Crandall (2019) explains that the cases that the neo-Brandeis adherents cite as antitrust success stories—Standard Oil, American Tobacco, AT&T, and Microsoft—are far from that. In general these antitrust cases did not result in more competition, lower profits, or lower prices. The oil industry did become more competitive a few years after the case against Standard Oil, but that result came from new oil discoveries in the Midwest and Gulf states. The three-firm oligopoly that emerged after the breakup of American Tobacco maintained its market position after the breakup, real cigarette prices did not decline, and the return on assets for the three companies did not decline. The AT&T breakup resulted in years of costly court and regulatory proceedings. Furthermore, the industry boundaries assumed in the breakup proved to be uneconomic, resulting in costly regulations, mergers, and divestitures (Jamison and Sichter 2010). The Microsoft case did not affect the competitive landscape of the industries providing computer operating systems and internet browsers.

Wu, Jarsulic et al., and Lande hold that antitrust regulators should place arbitrary limits on firm size, mergers, and vertical relationships. Their remedies are arbitrary because their concerns lack rigor and so provide no foundations for decision-making. They also fail to appreciate that, absent government-imposed restrictions on competition or physical limits on access to the means of production, firms are large because customers choose to buy from them. Customers do so because they believe it is in their best interests.

It can be argued that customers make errors in these choices, and the arguments are certainly correct in some instances as all people make mistakes. But the argument fails to be persuasive for at least four reasons. One is that there is no evidence that government regulators are less error prone than customers, which would be necessary for it to make sense to transfer decision-making authority from customers to regulators. Also, customers know more about their individual circumstances than do government regulators and so are in better positions to make optimal decisions, all other things being equal. A third reason is that consumers are highly motivated to make optimal decisions, but government regulators have conflicting motivations, including career considerations (Kahn 2002). Finally, if government regulators know something that customers do not, they can make that information available to customers so that they can give it the appropriate weight in their decision-making.

Wu, Jarsulic et al., and Lande fail to demonstrate that giving government greater control of business would not empower greater rent-seeking. Rent-seeking is a plausible outcome because,

<sup>5</sup> For summaries of the literature on inter-product cross subsidies, see Sharkey (1982) and Jamison (1999).

once a regulatory mechanism is in place that can bind some firms, the cost of risk-seeking is lower for these firms' rivals. And as Kahn (2002) observes, once regulatory institutions are in place, regulatory practitioners sustain them to pursue their own ideological and economic interests.

Addressing antitrust in the UK, Furman et al. (2019) make similar errors. They suggest that the government form a digital markets unit that would specialize in applying antitrust to digital businesses. The unit would develop a code of conduct that would apply to large businesses but not small ones. It would also adopt and enforce two types of rules—rules for individuals to port data about themselves between platforms and rules for open, nonpersonal data—to weaken the effectiveness of companies building unique databases. The unit would also promote open standards for platforms, presumably to promote more intra-system competition and a platform ladder of investment, such as was done in telecommunications networking by requiring network unbundling. In addition to forming the digital markets unit, Furman et al. recommend more restrictive merger policies.

There are three fundamental weaknesses in the Furman et al. recommendations. One is that they are based on questionable premises—namely that artificial intelligence and big data represent the key to enduring success in platforms, that the value of each increases monotonically with scale, and that the value of distributing these assets to those who did not build them is more important than providing incentives to create them. Section II explains the vulnerability of current data-based business models: There is no doubt that these businesses have created value for billions of people, but believing that they represent enduring, unassailable advantages appears to be an end-of-history illusion (Quoidbach, Gilbert, and Wilson 2013). Taking this together with the understanding that most innovation comes in recombining known technologies rather than creating new technologies (Gilder 2018) and the understanding that new computing architectures are poised to remake the tech sectors (Gilder 2018; Bell 2007), it is highly probable that the current tech leaders will be replaced by firms that use entirely new approaches to information technology services.

This leads to the second weakness—namely, that the proposals favor rivalry within the current platform structures. If the regulations are successful in helping companies that rely on current big data models and that, in some sense, represent plug-and-play approaches to the current platform architectures, then entrepreneurs will find competing within the current systems less risky and costly than challenging them. This would tend to protect current platform leaders.

Finally, the proposals seek to extend the use of today's merger analyses, which data decay and other aspects of dynamism make quite problematic.

Feld (2019) takes a different approach. He proposes that such regulations should come into play when the value of the service being provided is sufficiently high relative to the next best alternative that consumers or businesses suffer greatly if they do not obtain the service in question. He calls this the cost of exclusion. He rejects breaking up tech companies as being too costly and impractical and instead suggests a regulatory tool kit that would be at the disposal of a specialized regulatory agency. The tool kit would include at least nine items, such as consumer rights to data portability and data deletion, open software for application programming, licensing of essential intellectual property, limits on firm size and diversification, and unbundling.



Feld essentially recommends utility-style regulation, although he does not use that term. His cost of exclusion maps to beliefs that utility services are essential. His recommendations map to utility obligations to serve and to utility regulators' attempts to open some utility markets to competition.

Feld's proposal suffers from the same deficiencies of Furman et al. and adds another problem: He fails to solve contradictions that utility regulators have long struggled with—namely, that the tools of utility regulation assume the utility is a government-sanctioned monopoly and the tools of opening markets to competition assume that the government is opposed to monopoly. Kahn (1998, 2002) explains that regulators and policymakers are unsuccessful in resolving the contradiction. He shows through case studies that regulatory efforts in such contexts are biased toward producing immediate results and toward favoring new competitors. He explains that genuine deregulation is needed to produce real competition and that it takes time, which means it takes strong political will. He holds that regulation should establish preconditions for efficient competition and then get out of the way. Absent doing so, the regulatory system's "inbred tendency to micromanage everything and to proclaim great consumer benefits, publicly, while doing everything they can to conceal the costs" will cost consumers and the economy (Kahn 1998).

#### **IV. A Way Forward**

To address the challenges of digitization, the study of monopoly and market power should return to its roots of examining causes and differentiating between causes that are legitimate, those that improve economic performance, and those that are neither. It should also address current regulatory interventions that are limiting small firms.

##### *A. Returning to the Roots of Monopoly Analysis*

Since Lerner (1934), most antitrust work appears to assume that market power exists when a firm faces downward-sloping demand resulting in profits exceeding zero and that prices exceed marginal cost. But this was not the approach of two founders of modern economics, Smith (1776) and Mill (1848). They focused on resources for production rather than on firms, understanding that firms are the consequences of resource availability, laws and regulations, human decision-making, and demand over time. These determinants are exogenous at any point in time, but endogenous over time as firms' decisions affect resources, institutions, the economics of production, product evolution, and buyer preferences. Indeed, the more dynamic a sector, the more its resources are endogenous.

This dynamism foils conventional and neo-Brandeisian views of profits indicating market power. As Jamison (2019b) explains, observing a successful firm's profits deceives antitrust regulators: It encourages an end-of-history illusion that the future will be much like the present. It encourages regulatory and rival opportunism in that investors had provided capital and endured periods of negative returns without being warned that the regulator would take action against the firm to confiscate through fines or redistribute through regulations the positive returns that they

had anticipated. And it encourages regulatory naivete in that the regulator is incented to act against this firm without consideration as to how the confiscatory policy affects competition.

Figure 1 illustrates some of investors' considerations when deciding whether to invest in startups in a sector.<sup>6</sup> In Figure 1, about 90 percent of startups fail (a typical estimate for Silicon Valley), and the red triangle represents their losses. The black triangle represents the profits of the 10 percent of startups that succeed. The profits and losses in Figure 1 are not the firms' actuals, but rather the expectations of investors based on their experiences with firms of these types, current and expected laws, anticipated demand, and other economic factors.

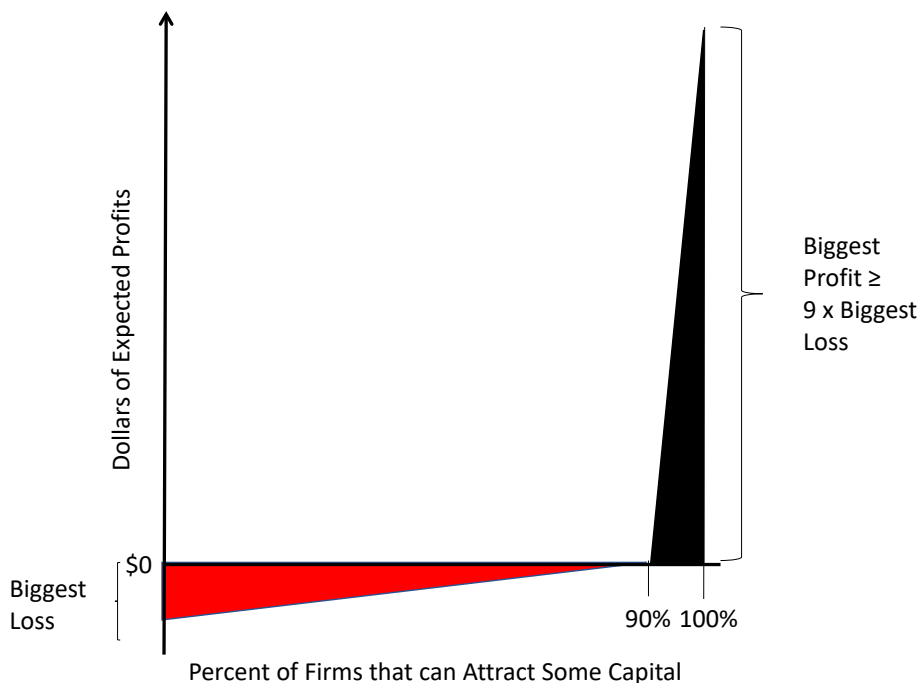


Figure 1. Expected profits and losses from pool of firms that investors are willing to fund, but that cannot identify ex ante which will be profitable over its lifetime beginning at the current time period.

Investors are unable ex ante to identify which firms will be successful and which will not. So investors often fund a portfolio of firms and anticipate that the portfolio will include both winners and losers. Figure 1 represents such a portfolio.

For an investor to fund the portfolio of firms in Figure 1, the area of the black triangle must be greater than or equal to the area of the red triangle. So if indeed the expected profits and losses are triangles, the expected profit of the most profitable firm must be nine times the expected loss of the biggest loser. Again, these are investor expectations, not achieved profits and losses. But for investors to have such expectations, they need experiences that support them. So observed profits of established, successful firms must be of sufficient magnitude to create such expectations. If

<sup>6</sup> See Jamison (2019b) for a more rigorous treatment of this issue.

investors observe that profits of the magnitudes in the black triangle attract attacks from antitrust regulators or politicians, they will adjust their expectations for the area of the black triangle downward and, as a result, fund fewer startups.

As Jamison (2019b) explains, the analysis in Figure 1 is useful for identifying market power. If investors believe a firm has market power, they will view the firm's profits as being unassailable and so will be unwilling to invest in actual or potential rivals. This includes rivals that could take the firm's customers even without being in the same market. For example, platforms such as Google and Facebook have diminished the profitability of traditional news organizations. But the platforms did not do so by entering the market for news. Rather, they attracted consumers' time and attention by providing a richer and more economical experience than do the providers of broadcast and print news, whose traditional business models depend on occupying people's attention. So the platforms and traditional media compete for advertising revenue, but by being in different product markets rather than the same markets.

But the presence of market power isn't the only reason that investors might not fund actual or potential rivals. The existing, profitable firm might have capabilities that investors believe cannot be matched. So regulators should examine if there are barriers that prohibit the flow of resources to actual or potential rivals and that give an existing firm the ability to control its market (Jamison 2019b).

### *B. Barriers to Resources Flowing into Markets*

An antitrust approach focusing on resource fluidity—that is, resources' abilities to be directed toward areas where they can create and receive their greatest value—would directly address the factors that limit firms' abilities to compete. There are several regulatory initiatives that are decreasing incentives for firm creation and growth. Pierce et al. (2014) and Bordo and Duca (2018) show that Dodd-Frank banking regulations following the 2008 recession decreased lending to small businesses. Jia et al. (2019) demonstrate that Europe's GDPR has slowed the development of small digital businesses in Europe. Similar effects are likely to be felt in the US as US regulators adopt similar regulations (as in the case of California) and as smaller US firms find it costly to expand into Europe.

Regulations such as Dodd-Frank and GDPR make it more likely that startup firms will seek to merge with larger, established digital businesses than to compete with the larger firms. The larger businesses will have lower financing costs (because of Dodd-Frank) and greater regulation-induced scale economies (because of GDPR), which are artificial economies of scale resulting from a larger firm being able to spread costs of regulation over more units of sale.

To appreciate the dynamics of startups, it is important to understand that innovation is a multistep process and few firms can accomplish all the steps. The steps include creating an idea, designing a product based on the idea, and taking the product to market. The steps are complex and blur together in practice. Isaacson (2014) observes that for information technology businesses, innovation requires the work of scientists, psychologists, and sometimes artists, generally working in teams. Turning the idea into an actual product is generally the work of engineers, who would

normally have back-and-forth interactions with the creators. Successfully taking the product to market is the work of marketers, operations managers, financial managers, and the like. Often startups bring in professional business managers to conduct this work.

But even then, not all startups can make it. As Cusumano et al. (2019) observe, developing a successful platform is complex and subject to timing and chicken-and-egg challenges, and a successful business model emerges only with experimentation. When the innovation, design, and business phases are completed for an idea, the idea has a chance to become successful, but only a chance: The new product must still provide customers with a better value proposition than do existing and emerging products. So many startups that develop good ideas and products may never develop the right business model. Established firms can sometimes provide the product synergies and expertise that are needed for success. This could be why Instagram and WhatsApp had success as stand-alone products but achieved greater and more sustained success once they were purchased by Facebook. Proposals such as those by Furman et al. (2019), Jarsulic et al. (2016), and Lande (2019) that would make it more difficult for new firms to be bought by established firms would necessarily decrease the financial prospects of small firms and decrease their creation.

Antitrust authorities should refuse to act against business challenges that some might consider barriers to entry or exit. These might include existing firms' possession of big data, temporal and intertemporal network effects, so-called first mover advantages (although moving first is often a disadvantage), and brand recognition. These make it hard for others to compete in the same business space, but a hands-off antitrust approach to them benefits consumers because it encourages creating new product space.

This understanding contrasts with the overly static views demonstrated in some antitrust investigations of large tech companies. These cases appear to fixate on a present moment. The EU has explicit policies that a firm must adopt less profitable business models once it is labeled as dominant, which means it has achieved a 40 percent market share as defined by EU regulators. EU regulators have fined US tech companies billions of euros based on this policy. As of this writing, a number of state attorneys general are launching investigations of large tech companies. In press statements, the state officials hold a tautological view that the companies have reached such prominence that they affect innovation, marketing, and the like of companies that use the large companies' platforms.

These EU and state perspectives reflect a flawed view of the industry. The firms' platforms are influential because people choose to use them. Just as people entering a courtroom are required to behave according to certain protocols to help the legal system function, a platform provider creates conventions and rules that it hopes create value that will attract and retain participants. As Cusumano et al. (2019) explain, this is complex, involves trial and error, and often ends in failure when platforms do not get the features, balance of interests, timing, and other business decisions right.

The antitrust authorities see none of this. They only see the business at a point in time when it is successful and with rivals struggling to provide customers a better value proposition. This leads to illusions, such as (1) the end-of-history illusion that the future is a lot like the present, (2)

a simplification illusion that is ignorant of the narrow differences between business models that provide large success and those that provide failure, (3) a closed-system illusion that antitrust actions have no impacts beyond the entities involved in the immediate case, and (4) an engineering illusion that persons with no particular expertise in business can design a business model that creates more value than what investors, innovators, business managers, and customers jointly develop through competitive processes. Falling for these illusions threatens the value current platforms provide and the creation of new platforms that could in the future replace the current ones by providing superior value.

Two papers relating to tech antitrust cases illustrate these illusions. Crémer, Rey, and Tirole (2000) examine market power in the internet backbone and conclude that embedded customer bases are a source of market power leading to discrimination in connectivity. Carlton and Waldman (2002) examine generations of software and conclude that an embedded customer base provides a software provider with a competitive advantage that can lead to market power. These analyses assume that customer bases are endowed and so neglect consideration of how regulation might affect incentives to create valuable product space that then provides network effects. If policies extract value once it is created, then service providers will learn and likely limit their investments for the future.

Rather than attack firms for business practices that are at best difficult to understand because the antitrust view lacks context, antitrust regulators should look for and address unearned barriers or advantages that prohibit or distort the flow of economic resources that firms need to compete. There are several government actions that limit competitive processes and should be of interest to antitrust regulators. One is the grant of monopoly. The telecommunications industry in the US was allowed to operate as a government-endorsed monopoly through most of the 20th century even though experiences in the late 1800s and early 1900s had demonstrated that competition was workable, even if messy. The regulated monopolies were often inefficient, lacked innovation, and discriminated against rivals, and breaking up the monopoly was costly and time-consuming. Antitrust regulators should have opposed the sanctioning of monopoly instead of participating in it.

Because the government had encouraged the monopoly, extraordinary measures were taken to undo it, including breaking up AT&T, imposing business line restrictions on the monopoly remnants of AT&T, and forcing network access and unbundling for competitors. Researchers have struggled to demonstrate that these regulatory actions benefited consumer. But at the time the actions were being taken, they appeared necessary for overcoming the entrenched monopolies that the government had a hand in creating.

Antitrust should also address government subsidies that benefit some companies to the harm of consumers. The numerous subsidies given out in the wake of the 2008 recession provide examples as many of these were targeted to specific companies that then used the money to advantage themselves over rivals. That these advantages were undeserved is evidenced by the lack of voluntary investor interest and the number of subsidy recipients that eventually failed.

Favorable access to government resources would be another example. Historically governments have granted radio spectrum rights, for example, based on political considerations. This has been partially resolved in the US with the introduction of radio spectrum auctions, which enable firms to obtain limited government resources based on their ability to pay for them from future profits. It could be argued that the Coase Theorem would resolve such access gifts because the recipients could sell the rights to the highest bidder. But the Federal Communications Commission's (FCC) recent incentive auction demonstrates that market frictions have limited the Coase Theorem's effect: The FCC's incentive auction released millions of dollars of value by moving scarce radio spectrum into the hands of businesses that could use it more efficiently than could those that had received the gift.

Governments sometimes hinder efficient competition by forming their own enterprises and giving them an economic advantage over rivals. For example, state-owned and partially state-owned telecommunications providers in Europe were given favorable terms for interconnecting their networks with rivals. City-owned telecommunications networks in the US rarely make positive economic impacts and often fail financially, but not before harming consumers and privately owned rivals.

In investigating barriers to resource flow, antitrust regulators should focus on the key resources that firms need to arise and compete. A digital economy relies largely on energy, manufacturing, construction, transportation, and talent as basic inputs drawn from other economic sectors, with capital being the critical resource for importing these basic inputs. Digital businesses also need knowledge, ideas, critical masses of users and suppliers, and business acumen, but these are developed within the digital economy rather than imported by it. Indeed, these intermediate digital goods and institutions are often created by the digital businesses that ultimately use them. For example, Amazon has created knowledge for managing a transaction e-commerce platform and developed a critical mass of consumers, and it uses both in providing its retail services.

A legitimate area for antitrust investigation is whether there are restrictions to capital availability. The Dodd-Frank restriction is one example. The rise of the token economy is another. It came about in part because some entrepreneurs found traditional, regulated capital markets too costly and rigid for their business ideas. Antitrust should have taken a leadership role in investigating how traditional capital markets—that were designed for non-digital businesses—made it hard for new business models to emerge and challenge the status quo. Instead the FTC largely stood with the US Securities and Exchange Commission in protecting traditional financial regulations, with the predictable result that some entrepreneurs skirted regulations and used the new low-cost methods for raising capital. The lack of a legal framework enabling a token economy for low-cost business creation provided opportunities for illegitimate enterprises to imitate the honest firms and engage in scams that triggered regulatory backlashes, raised capital costs, and increased risk.

## V. Conclusion

This paper analyzes the application of antitrust in digital markets. It explains how digitization thwarts some premises of antitrust practices and how current proposals—mostly emanating from neo-Brandeis adherents—intellectually collapse because of weak foundations and failing to address the features of digital markets, their rapid pace of change. It is no longer legitimate to (1) use historical data to define markets or determine firms’ abilities to raise prices; (2) analyze firms’ current situations as indicators of market power; (3) consider mergers as largely about changing the number of rivals in a market rather than opportunities to develop temporal and intertemporal network effects, combine assets to create new products, implement new business models for emerging products, and learn; and (4) consider competitive advantages that firms have developed as barriers to competition rather than assets that improve the economics of current and future products.

The study of monopoly and market power should return to its roots of examining causes and differentiating between those that are legitimate, those that improve economic performance, and those that do neither. This paper’s analysis implies a more stringent measure for consumer welfare in antitrust: Regulators should examine the industry-suppression impacts of their policies. For example, the possible consumer benefits of expanding rival access to a platform should be weighed against the suppression of innovations in this platform and the discouragement of new platform formation.

Further research is needed. One area of focus should be how to identify barriers to resource flow. Another area would be legal avenues for providing remedies, especially when the entity creating the barrier is government.

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