

Vertical Merger Guidelines: Interpreting the 1982 Reforms

Oliver E. Williamson†

Fourteen years separate the original Justice Department Merger Guidelines of May 30, 1968, the last day of Donald Turner's term as head of the Antitrust Division, and the Merger Guidelines of June 14, 1982, which were issued in the second year of William Baxter's tenure. Because merger policy plays an essential role in antitrust enforcement, the promulgation of new Merger Guidelines provides an important means of assessing changes in that area. Inasmuch as a decade appears to be a useful interval for evaluating antitrust developments,¹ a comparison of the recent with the earlier Guidelines should help to disclose what kinds of progress in antitrust enforcement (if any) have occurred within the interval.

In addition, an examination of the recent Guidelines may help to evaluate the proposition that ideas drive outcomes in antitrust law.² Economic scholarship has considerably reshaped the economic rationale for vertical integration during the past decade.³ A comparative ex-

† Charles and William L. Day Professor of Economics and Social Science, University of Pennsylvania. S.B. 1955, Massachusetts Institute of Technology, M.B.A. 1960, Stanford University, Ph.D. 1963, Carnegie-Mellon Institute of Technology.

1. For an argument that a decade is a useful interval in which to measure changes in antitrust law, see Williamson, *Antitrust Enforcement: Where It Has Been; Where It Is Going*, in *INDUSTRIAL ORGANIZATION, ANTITRUST, AND PUBLIC POLICY* 41 (J. Craven ed. 1982).

2. Williamson, *On the Political Economy of Antitrust: Grounds for Cautious Optimism*, in *THE POLITICAL ECONOMY OF ANTITRUST* 77 (R. Tollison ed. 1980). This viewpoint is disputed by Stigler, *The Economists and the Problem of Monopoly*, *AM. ECON. A. PROC.*, May 1982, at 1, 7 ("Economists have their glories, but I do not believe that the body of American antitrust law is one of them.").

3. The main developments and contributions have been summarized as follows:

The most popular [argument for vertical integration] has been that if economies of scope between successive stages due to technological or organizational interrelationships are strong enough, these activities should be provided under joint ownership (*e.g.*, Chandler (1966)). Other arguments for Vertical Integration have been the avoidance of factor distortions in monopolized markets (*e.g.*, Vernon and Graham (1971), Warren-Boulton (1974), Schmalensee (1973)); uncertainty in the supply of the upstream good with the consequent need for information by downstream firms (Arrow (1975)); and the transfer of risks from one sector of the economy to another (Crouhy (1976), Carlton (1979)). Furthermore it has been pointed out that transaction costs might create important incentives for vertical integration (*e.g.*, Coase (1937), Williamson (1971, 1975)).

Kleindorfer & Knieps, *Vertical Integration and Transaction-Specific Sunk Costs*, 19 *EUR. ECON. REV.* 71, 71 (1982).

My emphasis here is mainly with the transaction cost ramifications of this literature. For specific references to the relevant literature in this area, see *infra* notes 33-34.

amination of the 1968 and 1982 vertical Merger Guidelines should therefore be instructive in determining whether antitrust enforcement policy follows antitrust scholarship.

I

THE 1982 VERTICAL MERGER GUIDELINES

A. Main Provisions

The 1982 Guidelines distinguish between two broad classes of mergers, horizontal and non-horizontal. The latter category includes both conglomerate and vertical mergers. This is a change from the classification in the 1968 Guidelines, which distinguished horizontal, conglomerate, and vertical mergers.

The main antitrust problem posed by conglomerate and vertical mergers is that they may reduce actual or perceived potential competition. The Justice Department evidently believes that potential competition problems are insubstantial unless the Herfindahl-Hirschman index (HHI) in the acquired firm's market exceeds 1800⁴ and the market share of the acquired firm exceeds 5%.⁵ The threshold for challenging conglomerate and vertical mergers is thus set at these levels.

The Department, in my judgment, would have been better advised to maintain the conventional three-way classification of mergers—horizontal, vertical, and conglomerate—rather than dividing mergers only into horizontal and non-horizontal types. To be sure, conglomerate and vertical mergers are troublesome in antitrust respects mainly in the degree to which they pose potential competition problems.⁶ But this is little more than incidental. Much more important to an understanding of the antitrust concerns posed by these mergers are the *sources* of the competition difficulties they can create. Conglomerate and vertical mergers differ substantially in this respect—as the Guidelines effectively, if obscurely, concede. Thus, the operational content of the non-horizontal Merger Guidelines exists less in the common threshold levels than it does in the subsequent two-part breakdown of non-horizontal mergers, which distinguishes between “elimination of specific potential entrants” and “competitive problems from vertical mergers.”⁷

4. An HHI of 1800 corresponds roughly to a four-firm concentration ratio of 70%. U.S. Dep't of Justice, Merger Guidelines § III(A), 47 Fed. Reg. 28,493, 28,497 (1982), *reprinted in* 71 CALIF. L. REV. 649, 655-57 (1983) [hereinafter cited without cross-reference as Guidelines].

5. *Id.* § IV(A), 47 Fed. Reg. at 28,499-500, 71 CALIF. L. REV. at 660-62.

6. Vertical mergers can also pose problems if they increase the price in the downstream market, although this is not a likely outcome. Moreover, conglomerate organization may facilitate reciprocal buying—though again, this is a slender reed upon which to rest a case against conglomerates.

7. Guidelines § IV(A), (B), 47 Fed. Reg. at 28,499, 28,500, 71 CALIF. L. REV. at 660, 662.

The former subsection presents issues relevant to the evaluation of conglomerate mergers, while the latter deals with vertical merger issues.

The Guidelines associate three possible adverse effects with vertical mergers: increasing barriers to entry, facilitating collusion, and evading rate regulation. These will be considered separately.

1. *Entry Barriers*

Vertical integration of a firm can create entry barriers by making it more difficult for nonintegrated rival firms⁸ that are otherwise qualified to compete to remain effective competitors. These entry barriers include greater difficulty of contracting, adverse effects of scale economies, and increased cost of capital.

The ease with which a rival firm at one stage of an industry (stage I) can contract for its requirements⁹ in another stage (stage II) depends upon whether nonintegrated capacity at stage II is large (or can easily be increased). If ample nonintegrated stage II capacity is not in place and will not appear without special effort, the stage I rival firm must contemplate simultaneous entry at both stages. The acquisition by merger of previously nonintegrated stage II capacity can thus force an otherwise qualified stage II rival to choose between integrated entry and no entry at all. Whether integrated entry is significantly deterred will then depend upon cost of capital and scale economies.

To its credit, the Justice Department observes that the need for additional capital, by itself, does not constitute a barrier to entry into the primary market (here, stage I), as long as the necessary funds are available at a cost commensurate with the level of risk in the secondary market.¹⁰ But the Department correctly recognizes that integrated entry that includes an unfamiliar stage is apt to carry a risk premium. This is because lenders may "doubt that would-be entrants to the primary market have the necessary skills and knowledge to succeed in the secondary market and, therefore, in the primary market."¹¹ The Guidelines note that this problem is exacerbated when a high percentage of the capital assets in the secondary market are long-lived and specialized to that market, and are therefore difficult to recover in the event of failure.

The Department also acknowledges that scale economies could create an entry barrier if a firm is forced to enter at two stages simultaneously because another firm has vertically integrated into the second-

8. Throughout this Article, the term "rival" will refer to either an actual or potential rival.

9. Such contracting might be backward into earlier stages of production, laterally into other components required at a given stage, or forward into fabrication and distribution of the product.

10. Guidelines § IV(B)(1)(b)(i), 47 Fed. Reg. at 28,501, 71 CALIF. L. REV. at 663.

11. *Id.*

dary market. It posits a situation in which the capacities of minimum-efficient-scale plants in the primary and secondary markets differ significantly. For example, if the capacity of a minimum-efficient-scale plant in the secondary market were greater than the needs of such a plant in the primary market, entrants would have to choose between inefficient operation at the secondary level and a larger scale than necessary at the primary level. The secondary level inefficiency would result because the firm would be either operating an efficient plant at an inefficient output, or producing an efficient level of output from an inefficiently small plant. If the firm chose instead to be efficient at the secondary level, it would oversupply its primary level needs. Either effect, the Department concludes, could cause a significant increase in the entering firm's operating costs.¹²

To this, however, the Department adds in a footnote that "this problem would not exist if a significant outside market exists at the secondary level. In that case, entrants could enter with the appropriately scaled plants at both levels, and sell or buy in the market as necessary."¹³

2. *Collusion*

Vertical integration is most likely to facilitate collusion in conjunction with forward integration into retail distribution. Thus, the Department's concern is that collusion in the upstream market is most likely to result because of the integrated firm's ability to monitor price.¹⁴ This is troublesome if vertical integration into retail distribution is extensive and the upstream market is concentrated—where 1800 HHI is the level above which concentration is believed to pose a collusion concern.¹⁵

3. *Rate Regulation*

Acquisition of a supplier by a regulated utility might permit the utility to evade rate regulation, because "[a]fter the merger, the utility would be selling to itself and might be able arbitrarily to inflate the prices of internal transactions."¹⁶ These practices should be difficult for regulators to monitor. Thus, although the Department is sensitive to "genuine economies of integration," it will "consider challenging mergers that create substantial opportunities for such abuses."¹⁷

12. *Id.* § IV(B)(1)(b)(ii), 47 Fed. Reg. at 28,501, 71 CALIF. L. REV. at 663.

13. *Id.* n.47, 47 Fed. Reg. at 28,501 n.47, 71 CALIF. L. REV. at 663 n.47.

14. *Id.* § IV(B)(2)(a), 47 Fed. Reg. at 28,501, 71 CALIF. L. REV. at 664.

15. The recent Guidelines should, but do not, elaborate on why collusion becomes a serious concern at an HHI of 1800.

16. Guidelines § IV(B)(3), 47 Fed. Reg. at 28,501, 71 CALIF. L. REV. at 664-65.

17. *Id.*, 47 Fed. Reg. at 28,502, 71 CALIF. L. REV. at 665.

B. Comparison and Interpretation

In the 1968 vertical Merger Guidelines, the Justice Department indicated that it would examine the market shares of both upstream (supplying) and downstream (purchasing) firms. The Department stated that it would ordinarily challenge mergers between a supplying firm that accounted for at least 10% of sales in its market and one or more purchasing firms totalling at least 6% of purchases in the market.¹⁸

The 1982 vertical Merger Guidelines make no such upstream-downstream distinction. Instead, they focus entirely on the *acquired* firm's market. Vertical acquisitions are subject to challenge only in a concentrated market, i.e., where the HHI in the acquired firm's market exceeds 1800. Where this occurs, the acquisition of a 5% firm may be challenged.

The presumption that a vertical merger poses antitrust problems only if the acquired firm is operating in a concentrated market constitutes a substantial shift in vertical merger policy. It is grounded on the proposition that in markets where concentration is low or moderate, nonintegrated rivals will be able easily to contract for their requirements and hence will not be disadvantaged. The vertical Merger Guidelines are thus in accord with recent economic scholarship on contracting and strategic behavior that indicates that efforts by established firms to discipline actual competition and discourage potential competition are troublesome only in highly concentrated industries where entry is difficult.¹⁹

More generally, the recent Guidelines place emphasis on the ease of contracting, which is to say that transaction cost considerations are implicitly assigned a key role.²⁰ This is especially evident in the discussion of the cost of capital analyzed above.²¹

18. U.S. Dep't of Justice, Merger Guidelines—1968, para. 12 (May 30, 1968), reprinted in 2 TRADE REG. REP. (CCH) ¶ 4510, at 6886 (1982).

19. See Joskow & Klevorick, *A Framework for Analyzing Predatory Pricing Policy*, 89 YALE L.J. 213, 245-49 (1979); Ordover & Willig, *An Economic Definition of Predatory Product Innovation*, in STRATEGY, PREDATION, AND ANTITRUST ANALYSIS 301 (S. Salop ed. 1981); Williamson, *Assessing Vertical Market Restrictions: Antitrust Ramifications of the Transaction Cost Approach*, 127 U. PA. L. REV. 953, 960-66 (1979); Williamson, *Predatory Pricing: A Strategic and Welfare Analysis*, 87 YALE L.J. 284, 292 (1977). Although this literature is mainly concerned with predatory pricing, the same reasoning applies to strategic behavior generally.

20. See Guidelines § IV(B)(1)(b), 47 Fed. Reg. at 28,500-01, 71 CALIF. L. REV. at 662-63. See *infra* text accompanying notes 32-46.

21. Lenders may raise capital costs for potential entrants if they "doubt" that such entrants are fully qualified because prior competence has been demonstrated at only one of the stages. This may occur even though a potential entrant may be objectively qualified to enter at two stages of an industry because of the competence of its employees and management. The problem here is that it can be prohibitively costly for qualified entrants who lack a track record at the secondary stage to show their qualifications.

Such an objectively qualified firm would still be financed on low-risk terms in a world of

Rather than incurring these cost-of-capital penalties, firms that have demonstrated qualifications only at stage I may attempt to satisfy their stage II requirements by contract. The question then becomes whether the stage II product will be made available on competitive terms. The structure of the industry plainly has a bearing on this. If economies of scale are large in relation to the size of the nonintegrated fringe and if integrated firms are few and supply principally or exclusively their own needs, the would-be stage I entrant can anticipate difficulties in securing his second-stage requirements on parity terms.

The recent Guidelines also make the sophisticated point that investments in the secondary market are risky in the degree to which "capital assets in the secondary market are long-lived and specialized to the market."²² This point is also in accord with recent developments in transaction cost economics in which asset specificity plays a key role. The issues here are developed somewhat more fully below.

II

ANTECEDENTS

The 1982 vertical Merger Guidelines differ significantly from the 1968 Guidelines' counterpart. If, as I argued at the outset, antitrust enforcement follows antitrust scholarship, a change in the economic interpretation of vertical integration should have occurred during this interval. It will therefore be useful to compare the pre-1968 and post-1970 interpretations of vertical integration in the industrial organization literature.

A. Pre-1968 Views on Vertical Integration

The period 1950 to 1970 has been described by Coase as the applied price theory era in industrial organization.²³ The leading texts²⁴ were preoccupied with "the study of pricing and output policies of firms, especially in oligopolistic situations (often called a study of market structure)."²⁵ The firm, for these purposes, was essentially viewed

complete information. In the real world, however, the potential two-stage entrant would face high costs for acquiring knowledge of the technology and the operating skills associated with secondary stage activity. Were the relevant information easily accessible (from blueprints, manuals, and the like), and were it easily digested rather than embedded in the experienced work force (in which workers are costly to move in team configurations), the potential entrant would not be at a disadvantage to existing two-stage rivals in the secondary market.

22. Guidelines § IV(B)(1)(b)(i), 47 Fed. Reg. at 28,501, 71 CALIF. L. REV. at 663.

23. Coase, *Industrial Organization: A Proposal for Research*, in POLICY ISSUES AND RESEARCH OPPORTUNITIES IN INDUSTRIAL ORGANIZATION 62 (V. Fuchs ed. 1972).

24. J. BAIN, *INDUSTRIAL ORGANIZATION* (2d ed. 1968); G. STIGLER, *THE ORGANIZATION OF INDUSTRY* (2d ed. 1968).

25. Coase, *supra* note 23, at 62.

as a production function.

Such a technological approach conceded merit to vertical integration where successive stages were joined by a "physical or technical aspect."²⁶ The integration of stages where such a technological linkage was missing, by contrast, was considered to create antitrust problems. Where technological cost savings were not apparent, anticompetitive purpose was arguably the driving force. It was easy, therefore, to conclude that public policy concern was warranted whenever vertical integration involved an "appreciable degree of market control at even one stage of the production process."²⁷ Specifically, Stigler stated that when a firm has at least 20% of an industry's output, its acquisition of more than 5% of the output capacity of firms from which it buys or to which it sells can be presumed to violate antitrust laws.²⁸

The 1968 vertical Merger Guidelines, which set the limits at 10% and 6%, are plainly in this spirit. They were either informed by and reflected this line of scholarship, or the correspondence between the two is a remarkable coincidence.

B. Post-1970 Developments

Although the technological orientation toward vertical integration predominated among industrial organization specialists, there were dissenters who viewed vertical integration in transaction cost terms. Coase first promulgated such a view in 1937.²⁹ In principle, according to Coase, any transaction can be accomplished through either market or internal procurement. Whether a firm should produce for its own needs or purchase turns largely upon the transaction costs associated with each alternative. Specifically, Coase stated that transactions for which the administrative costs of internal organization were less than the costs of mediating an exchange by contract would be removed from markets and organized internally. Otherwise, market mediation would be observed.

This nontechnological approach to vertical integration remained outside the mainstream of operational microeconomics for two rea-

26. Bain explicitly made this technological argument. J. BAIN, *supra* note 24, at 381. Stigler advanced a life cycle view of vertical integration, but the contractual benefits of unified ownership over market exchange are nowhere developed in transaction cost terms. The main argument instead turns upon technological economies of scale, and attention then focuses upon the use of integration to evade sales taxes and defeat quota schemes and other methods of nonprice rationing. Stigler, *The Division of Labor is Limited by the Extent of the Market*, 59 J. POL. ECON. 185, 190-91 (1951).

27. Stigler, *Mergers and Preventive Antitrust Policy*, 104 U. PA. L. REV. 176, 183 (1955).

28. *Id.* at 183.

29. Coase, *The Nature of the Firm*, 4 ECONOMICA (N.S.) 386 (1937), reprinted in READINGS IN PRICE THEORY 331 (G. Stigler & K. Boulding eds. 1952).

sons.³⁰ First, most economists were still unpersuaded of the merits of transaction cost economics. Second, those who recognized merit in Coase's formulation could only acknowledge post hoc that transactions were consistent with the formulation. They were unable to use it to predict which transactions would be organized internally and which would be subject to market mediation.³¹

During the past decade, however, transaction cost economics has gained widespread use, and is now an effective means of predicting how transactions will be structured. The next Section will describe transaction cost economics and its methods for analyzing problems of industrial organization. It will then explain the transaction cost ramifications for vertical integration, and will finally assess the correspondence between these developments and the recent vertical Merger Guidelines.

1. Operationalizing Transaction Cost Economics

a. Premises of Transaction Cost Economics

Transaction cost economics is a comparative institutional assessment of alternative means of contracting. Coase believed that a deeper understanding of industrial organization would result from concentrating on what activities firms undertake, and from discovering the characteristics of the grouping of activities within firms. He also thought that because market arrangements are the alternative to intra-firm organization, it would be beneficial to study contractual arrangements between firms, such as long-term contracts, leasing, and licensing arrangements of various kinds.³²

The basic transaction cost mechanics for assessing a firm's decisions of whether to produce or purchase its requirements were first set out in 1971.³³ They have been refined and elaborated since.³⁴

Transaction cost economics rests on three propositions. First, the study of economic organization requires that social scientists come to terms with what might be called "human nature as we know it."³⁵ Sec-

30. Coase lamented some 35 years after its publication that his original article was "much cited and little used." Coase, *supra* note 23, at 63.

31. Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 783 (1972).

32. Coase, *supra* note 23, at 73.

33. Williamson, *The Vertical Integration of Production: Market Failure Considerations*, 61 AM. ECON. A. PROC. 112 (1971).

34. O. WILLIAMSON, *MARKETS AND HIERARCHIES* (1975); Klein, Crawford & Alchian, *Vertical Integration, Appropriate Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978); Teece, *Economics of Scope and the Scope of the Enterprise*, 3 J. ECON. BEHAV. & ORG. 233 (1980); Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233 (1979).

35. F. KNIGHT, *RISK, UNCERTAINTY, AND PROFIT* 270 (1965).

ond, transactions need to be "dimensionalized," i.e., the relevant dimensions with respect to which transactions differ must be identified, and their bearing on transaction costs must be determined. Third, carefully matching governance structures (generally, firms and markets) with the attributes of transactions can result in transaction cost economies.

The rudimentary behavioral assumptions for describing human nature owe their origins to organization theory (Herbert Simon) and to political science (Niccolo Machiavelli). Although Simon acknowledges that human agents are "intendedly rational," which is the prevailing assumption throughout economics, he also insists that human competence is limited. Where human cognitive limitations are severe in relation to the complexity of the problems being faced, a condition of "bounded rationality" occurs.³⁶ Machiavelli describes a phenomenon that might be called "opportunism" when he advises his prince that "a prudent ruler ought not to keep faith when by so doing it would be against his interest, and when the reasons which made him bind himself no longer exist."³⁷

Bounded rationality and opportunism place great strain on the convenient fiction of comprehensive market contracting. Nonmarket forms of governance—nonstandard forms of contracting, specialized mediation (such as arbitration), and complex hierarchical structures (administrative organization)—arise in response to these limitations.

b. Determining Governance Structures

Neoclassical analysis fails to consider either bounded rationality or opportunism.³⁸ In contrast, transaction cost economics makes explicit provision for both. Accordingly, whereas neoclassical analysis generally takes the organization of economic activity as given, thus ignoring the comparative institutional assessment of alternative modes of contracting, transaction cost economics expressly focuses upon assigning governance structures to transactions which will economize on transaction costs.

Comparative institutional analysis not only requires that transactions be dimensionalized, but that ex ante and ex post supply conditions be distinguished. Conventional microtheory focuses strictly on the former. Market contracting is said to be efficacious if large numbers of qualified suppliers tender bids at the outset. Transaction cost

36. H. SIMON, *MODELS OF MAN* (1957).

37. N. MACHIAVELLI, *THE PRINCE* 92 (Mentor ed. 1952).

38. See Diamond, *Comments*, in 1 *FRONTIERS OF QUANTITATIVE ECONOMICS* 29 (M. Intriligator ed. 1971) (response to Arrow, *Political and Economic Evaluation of Social Effects and Externalities*, in 1 *FRONTIERS OF QUANTITATIVE ECONOMICS* 3 (M. Intriligator ed. 1971)).

economics, by contrast, examines both *ex ante* and *ex post* supply conditions. If production of the item necessitates significant investments in transaction specific assets,³⁹ a contractual asymmetry develops between the initial winning bidder and all other bidders. The contractual relationship between buyer and seller is then transformed into a relationship of bilateral exchange during contract execution and at each time of renewal. Bilateral transactions are predictably beset with problems related to opportunism during contract execution, such as performing only to the letter of the contract or agreeing to efficient adaptations only upon renegotiation of terms. Internal organization (unified governance) often supplants autonomous contracting (market governance) for this reason.

Moreover, the influence of asset specificity on economic organization is not uniform. Different types of asset specificity have different ramifications for governance. Four types of asset specificity include:⁴⁰

i. Site specificity. When successive stages are located in close proximity to one another, common ownership generally results. This occurs because of an asset immobility condition, i.e., the setup or relocation costs of a station are great. Thus, once the assets are placed, their owners are operating in a bilateral exchange relation for the useful life of the assets.

ii. Physical asset specificity. If the assets are mobile and their specificity is attributable to their physical features (e.g., specialized dies), market procurement may still be feasible if the buyer owns the assets and solicits production bids. Lock-in problems are avoided because if contractual difficulties develop between buyer and seller, the buyer can reclaim the dies and reopen the bidding.

iii. Human asset specificity. Conditions that give rise to this type of asset specificity, such as learning-by-doing or problems of moving human assets in team configurations, favor common ownership. Integrated ownership coupled with a long-term employment relationship, rather than autonomous outside contracting, will generally govern such transactions.

iv. Dedicated assets. Investment in dedicated assets involves expanding an existing plant on behalf of a particular buyer. Buyers are understandably reluctant to make earmarked investments in the physical plant of their suppliers, and unified ownership is thus rare. The

39. Transaction specific assets are durable investments that are specialized to the contracting parties. Their value in best alternative uses (or by alternative users) is much lower than in their intended use. General purpose assets, by contrast, are diverted to alternative uses or users at little sacrifice of value.

40. See O. Williamson, *Vertical Integration—and Related Variations on a Transaction Cost Economics Theme* (1982) (unpublished manuscript) (University of Pennsylvania Center for the Study of Organizational Innovation Discussion Paper No. 129).

trading hazards to which suppliers are exposed are often mitigated by expanding the contractual relation to effect "equilibration." Nonstandard contracting, such as reciprocity or barter, sometimes appears for this reason.

Technology thus has a bearing on transaction cost reasoning, but only to the extent that it contributes to an asset specificity condition. Contracts that are supported by asset specific investments are ones in which the parties have an interest in maintaining the continuity of the exchange, lest the productive value of these assets be sacrificed by premature contract termination. Vertical integration plainly helps preserve the continuity of a complex contracting relationship, and is best understood as a response to these underlying continuity needs. It is thus wrong to conclude that vertical integration presents antitrust problems unless attended by the "physical or technical aspects" to which earlier scholarship referred.⁴¹ Such technological aspects are neither necessary nor sufficient for vertical integration to yield valued transaction cost economies.

2. *Public Policy*

A transaction cost approach shows that vertical integration can yield cost savings over a wider range of circumstances than the earlier technological/market-power approach indicated. Thus, a more permissive view of vertical integration is warranted in light of recent transaction cost scholarship. The 10% and 6% limits of the 1968 Guidelines find no support at all when the issues are framed in transaction cost terms.

Vigilance with respect to possible anticompetitive effects of vertical integration nevertheless remains important. But these effects also have transaction cost origins. If the leading firms in a highly concentrated stage I were to integrate into an otherwise competitive stage II activity, the nonintegrated sector of the market may be so reduced that only a few firms of efficient size can service the stage II market. Then, entry would be deterred by the potential entrant's having to engage in small-numbers bargaining with those few nonintegrated stage II firms. Furthermore, the alternative of integrated entry will be unattractive because prospective stage I entrants that lack experience in stage II activity would incur high capital and start-up costs were they to enter both stages themselves. But if stages I and II were of low or moderate concentration, a firm entering either stage can expect to strike competitive bargains with either integrated or nonintegrated firms in the other stage, because no single integrated firm can enjoy a strategic advantage

41. See *supra* text accompanying notes 26-28.

in such transactions, and because it is difficult for the integrated firms to collude. Thus, anticompetitive effects are likely to exist in highly concentrated industries; but because vertical integration in low or moderately concentrated industries is likely to promote efficiency, it will rarely pose an antitrust issue.⁴²

3. *The 1982 Guidelines*

The 1982 vertical Merger Guidelines correspond in three significant respects to the developments in transaction cost economics discussed above. First, the Guidelines express concern over the competitive consequences of a vertical merger only if the acquired firm is operating in an industry in which the HHI exceeds 1800. The presumption is that nonintegrated stage I firms can satisfy their stage II requirements by negotiating competitive terms with stage II firms where the HHI is below 1800. The Guidelines thus focus exclusively on the monopolistic subset, which is congruent with transaction cost reasoning. Second, the anticompetitive concerns in the Guidelines regarding costs of capital, (contrived) scale diseconomies, and the use of vertical integration to evade rate regulation are all consonant with

42. The full argument can be found in O. WILLIAMSON, *supra* note 34, at 115-16:

Except for the rather special case where a regulated firm has integrated backward into equipment supply, which needs to be assessed in the context of the regulatory milieu, vertical integration poses antitrust issues of two kinds: price may be adversely affected and the condition entry may be impaired. It needs, however, to be appreciated that adverse effects of neither kind will obtain unless a nontrivial degree of monopoly exists. Accordingly, the enforcement of antitrust with respect to vertical integration ought to be restricted to the monopolistic subset. Elsewhere, the maintained hypothesis ought to be that vertical integration has been undertaken for the purpose of economizing on transaction costs

Entry impediments of two types can arise where the leading firms in stage I integrate (backward or forward) into what could otherwise be a competitively organized stage II activity. For one thing, the residual (nonintegrated) sector of the market may be so reduced that only a few firms of efficient size can service the stage II market. Firms that would otherwise be prepared to enter stage I may be discouraged from coming in by the prospect of having to engage in small-numbers bargaining, with all the hazards that entails, with these few nonintegrated stage II firms. Additionally, if prospective stage I entrants lack experience in stage II related activity, and thus would incur high capital costs were they to enter both stages themselves, integrated entry may be rendered unattractive. The integration of stages I and II by leading firms is then anticompetitive, in entry aspects at least, if severing the vertical connection would permit a competitive (large-numbers) stage II activity to develop without loss of scale economies.

Vertical integration in industries with low to moderate degrees of concentration does not, however, pose these same problems. Here a firm entering into either stage can expect to strike competitive bargains with firms in the other stage whether they are integrated or nonintegrated. The reasons are that no single integrated firm enjoys a strategic advantage with respect to such transactions and that collusion by the collection of integrated firms (in supply or demand respects) is difficult to effectuate. Vertical integration rarely poses an antitrust issue, therefore, except as the industry in question is highly concentrated or, in less concentrated industries, collective refusals to deal are observed. But for such circumstances, vertical integration is apt to be of the efficiency promoting kind.

transaction cost reasoning.⁴³ Finally, the Guidelines make express reference to the importance of asset specificity, although the analysis is less fully developed than it might be.

Despite this striking correspondence, the Guidelines are not fully consonant with transaction cost reasoning. The transaction cost rationale for challenging a 5% acquisition whenever the HHI exceeds 1800 is not self-evident. Furthermore, the Guidelines make no provision for an economies defense, even where asset specificity is demonstrably great. It is true that there are hazards in allowing an economies defense, especially if economic evidence must be presented in court.⁴⁴ These hazards can be mitigated, however, if the Justice Department declines to bring cases where economies are clearly driving organizational outcomes.⁴⁵

CONCLUSION

The 1968 vertical Merger Guidelines reflected the then-prevailing technological orientation toward vertical integration. Because the requisite "physical or technical aspects" were commonly missing and transaction cost economies were disregarded, severe limits on vertical mergers were thought to be in the public interest. The acquisition of a 6% downstream firm by a 10% upstream firm was thus presumptively unlawful.

In the 1970's, the technological orientation toward vertical integration gave way to the comparative institutional assessment of contracting inherent in transaction cost economics. This approach focused on the purposes vertical integration can serve. Vertical integration realizes transaction cost economies where the parties are, in effect, reduced to bilateral trading because of an asset specificity condition. The transaction cost approach also identifies anticompetitive abuses of vertical integration. Such abuses can arise because of strategic preemption (fringe markets are reduced, resulting in rivals being forced to sell or secure supplies on bilateral terms), and because implicit contracts to collude are easier to enforce if rivals are identically integrated. Backward vertical integration may also be suspect in regulated industries if

43. The concern is that the regulator will be unable to evaluate the reasonableness of the costs incurred and prices charged by an integrated supplier because the relevant information is costly to obtain and difficult to evaluate. Such concerns would vanish were regulators comprehensively knowledgeable (not subject to bounded rationality) or if regulated firms would disclose all relevant information candidly (not subject to opportunism).

44. Some of these are discussed in Williamson, *Economies as an Antitrust Defense Revisited*, 125 U. PA. L. REV. 699, 701-03 (1977).

45. General Motors' acquisition of Fisher Body after a contracting relationship experienced strain is described by Klein, Crawford, & Alchian, *supra* note 34, at 308-10.

regulators are unable to evaluate underlying cost conditions except at great expense.

That the 1982 vertical Merger Guidelines are much more permissive than the 1968 vertical Merger Guidelines arguably reflects an appreciation for a wider set of efficiency benefits than had previously been recognized. The recent Guidelines are also much more precise in identifying the problems that vertical mergers in dominant firm or highly concentrated industries can present. I doubt that the recent Guidelines would read as they do had there not been a shift from market power to efficiency analysis in the intervening years. Accordingly, although I do not want to make too much of "one observation," the evidence is consistent with the hypothesis that ideas drive outcomes in antitrust law.⁴⁶

46. For related arguments and evidence, see *supra* notes 1, 2. See also R. BORK, *THE ANTI-TRUST PARADOX* (1978); Liebel, *Market Power and Competitive Superiority in Concentrated Industries*, 25 U.C.L.A. L. REV. 1231 (1978); Muris, *The Efficiency Defense Under Section 7 of the Clayton Act*, 30 CASE W. RES. L. REV. 381 (1980); Posner, *The Chicago School of Antitrust Analysis*, 127 U. PA. L. REV. 925 (1979); A. Fisher & R. Lande, *Efficiency Considerations in Merger Enforcement* (unpublished manuscript; forthcoming in 92 YALE L.J.).