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POLICY BRIEF

Prioritizing Innovation in Antitrust Merger Analysis

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The Biden administration has taken a more interventionist and Neo-Brandeisian "Big Is Bad" approach to antitrust enforcement, and one way this has manifested itself is through heightened skepticism of mergers at the Department of Justice (DOJ) and Federal Trade Commission (FTC). However, now and into the future with potential Trump or Harris administrations, these enforcement agencies should exercise caution when assessing the competitive effects of potential mergers, especially with regard to *innovation competition*. A merger policy that presumes innovative harm is likely to block and deter many economically beneficial mergers, thereby eliminating potential efficiencies and innovations that would increase consumer welfare. Efficiencies, both static and dynamic, must be empirically assessed in merger analysis, and innovation competitiveness is key among those dynamic efficiencies.

A sensible framework for innovation competition in merger analysis, the *innovative delta*, returns to a "rule of reason" approach and can be applied to horizontal, conglomerate, and vertical mergers, plus the acquisition of startups and entrants.[1] Under the rule of reason, a proposed merger is condemned only if its likely anticompetitive effects outweigh its procompetitive benefits.

The Guidelines

Innovation competition—the competition for new products, production processes, and transaction methods—has increasingly become just as important as conventional price competition in many industries. As a result, antitrust enforcement agencies have given greater consideration to the potential innovation effects of mergers in their analysis.

Some of this analysis has sought to block mergers on the basis of two innovative theories of harm. The first is a market structure theory of harm, which argues that mergers increase concentration, potentially causing firms in a market to invest less in innovation. The second is a cannibalization theory of harm, which argues that one of the two merging parties will innovate less post-merger to avoid cannibalizing the business of the other merging party. Neither theory sufficiently justifies

a presumption of innovative harm from a merger, and the theories' application has arguably, on multiple occasions, wrongfully condemned potentially beneficial mergers.

The joint DOJ and FTC 2023 Merger Guidelines recognize that innovation and technological development broaden the scope of market definition in merger analysis, as well as the role that economic analysis can play in understanding innovation competition.[2] However, the guidelines are problematic for innovation competition because they are too permissive of speculation on the innovative impacts of a merger, and they seem to endorse a view that increased concentration and mergers are per se bad for innovation. On top of heightened skepticism of mergers, the guidelines take a hostile approach toward any innovation efficiency defense that merging parties might offer as justification for a merger. Lastly, the guidelines either selectively apply or disregard relevant developments over the past four decades in both industrial organization and Supreme Court jurisprudence.

Antitrust authorities should strongly reconsider merger policies that start from a presumption of illegality, allow needless room for speculation in merger analysis, or both. Enforcement agencies need not speculate on potential innovation effects; there are economic tools better suited to estimate these effects. One such tool is the *innovative delta* framework,[3] which applies a rule of reason approach to innovation competition that is based on economic analysis and theory. The basis of the innovative delta is the observation of the introduction of new innovations and the subsequent adoption of those technologies by consumers and firms in the relevant market. This simple framework estimates economic welfare in the absence of a potential merger, represented by W, and the effects of the merger on welfare owing to changes in innovation competition, represented by Δ. Estimated post-merger welfare is thus equal to $W + \Delta$, where welfare can decrease or increase depending on the innovative delta analysis. The key point of this framework is that there should be no presumption that any merger will necessarily improve or harm innovation competition, which is consistent with developments in industrial organization and Supreme Court jurisprudence regarding mergers.

Horizontal and Conglomerate Concerns

The FTC and DOJ's recent approach to innovation competition for horizontal and conglomerate mergers largely stems from the market structure theory of harm, which itself is a byproduct of the structure-conduct-performance (SCP) paradigm. This paradigm argues that the extent of competition in a market is directly a result of the amount of concentration in said market. Applied to innovation, a concentrated market leads to monopolistic conduct in innovation competition, which decreases the total amount of innovation in a market. On this basis, concentrated markets will fail to be dynamically efficient and any merger that threatens to increase market concentration should therefore be rejected.

This approach to innovation competition for horizontal and conglomerate mergers should be rejected in favor of a return to a rule of reason approach, such as the innovative delta analysis. The market structure theory of harm and SCP intuitively might seem plausible, but there is a lack of evidence that concentration actually lowers the incentive to innovate. Firm strategy can lead to intense innovation competition even in industries with only a few firms, and entry or just the threat of entry can consistently discipline dominant firms. Reviews of economics literature find little consensus on whether market consolidation discourages innovation.[4] In fact, one line of economic reasoning suggests that concentration might actually increase innovation. With fewer firms in an ordinary monopolistically competitive market, there may be less intense competition, which could lead to higher prices and greater output for each firm. Higher individual price-setting ability and expanded output would increase the incentive for each firm to reduce costs through product, production process, and transaction method innovations.

One case that illustrates the flaws of a merger policy that presumes innovative harm for horizontal or conglomerate mergers is Amgen, Inc., and Horizon Therapeutics plc. In that case, the FTC challenged a conglomerate merger between two pharmaceutical companies, Amgen and Horizon Therapeutics, on the basis of an "entrenchment theory" of harm.[5] The FTC claimed that Amgen's acquisition of Horizon Therapeutics would "hamstring innovation in life-saving markets," through potential future cross-market tying arrangements.[6] However, there were several problems with the FTC's argument. It could not be claimed that competition would be reduced, given that this wasn't a merger of competing products, nor could it be said that Amgen was foreclosing on its competitors by purchasing a key input. Additionally, not only was the tying and entrenchment theory of harm based on speculation of future behavior but, as antitrust practitioners and scholars William MacLeod and David Evans assessed,[7] what the FTC alleged was harmful for competition and innovation was actually a welfare-enhancing efficiency of the merger. They explained, "Ultimately, the commission's argument is there will be more demand for Amgen's product after the transaction because Amgen will have a better line of products to sell. This is an efficiency."

Vertical Concerns

Deviating from decades of federal jurisprudence, the 2023 Merger Guidelines also take a mistakenly skeptical view toward innovation efficiencies that can arise from "vertical" mergers. Those mergers involve a union of firms at different levels of the supply chain in an industry. Specifically, in a vertical merger, the "upstream" firm supplies a good or service that is obtained by a "downstream" firm. For example, it might involve the union between a manufacturer and a distributor, between the producer of a final product and the maker of parts that are incorporated into that product, or between a service supplier (such as accounting services) and a business that previously purchased those services (such as a chain of hospitals).

The guidelines again based this skepticism around market structure theories of harm, most notably foreclosure of competing downstream firms from crucial upstream inputs they need for

innovation. Firms choose to vertically integrate, merging an upstream firm with a downstream firm, to lower costs, and this cost-saving can arise from preventing hold-up problems, improving intra-firm coordination, preventing free riding, and other things.[8] These cost efficiencies from vertical integration spill over into innovation as well, as companies innovate through combinations of in-house and outsourced research and development. If separate components necessary for a firm's innovation are partly in-house and partly outsourced, a merger between an upstream and downstream firm can generate innovation efficiencies through better coordination, communication, and exchange of technology within one firm.

Another aspect of vertical merger policy that enforcers should keep in mind with respect to innovation is that the incentive to vertically integrate can be driven by two factors: strength of intellectual property (IP) protection and the complexity of innovations. Comparatively stronger IP protections for new technology might make market contracts preferable to vertical integration, as strong IP laws lower the transaction costs of market contracts. In addition, as innovations become more and more complex and specialized, no individual firm has the required subject matter expertise and patent rights to realize innovations. As a result, firms will increasingly both provide and procure new technologies through market transactions with other firms. Increased reliance on market transactions over vertical integration should suggest that proposals for vertical mergers could be driven by innovation efficiency considerations. With these factors in mind, antitrust policy should favor strengthening IP protections and should not support a general presumption of foreclosure harm to innovation.

The relatively recent vertical merger between Microsoft and Activision Blizzard highlights why a general presumption of foreclosure in merger policy is mistaken. The FTC alleged in its complaint that the acquisition would result in Microsoft having both the incentive and the ability to foreclose on its competitors in multiple developing markets by withholding Activision's (the upstream firm's) content.[9] This, the FTC argued, would create artificial barriers to entry, which would harm consumer welfare and discourage innovation by making Activision a captive supplier of inputs.

The FTC's flawed presumptive approach to this merger seems to have prevented the agency from appropriately assessing market conditions and the competitive effects of this merger. In fact, the Ninth Circuit Court of Appeals rejected the FTC's request for a preliminary injunction to halt the merger, stating that "the FTC has not shown a likelihood it will prevail on its claim this particular vertical merger in this specific industry may substantially lessen competition."[10] Ultimately, the FTC's predicted harm to innovation and welfare owing to foreclosure did not come to fruition. After the courts allowed the merger to go through, both merged firms have continued to offer new products, and Microsoft has not foreclosed access to its popular products, even to its biggest competitor, Sony. Merger policy that would seek to block mergers like Microsoft/Activision on the

basis of a presumption of innovative harm could discourage innovation competition and prevent efficiency- and welfare-enhancing mergers.

Entrants and Startups

Recent merger policy proposals also focus on innovation competition with respect to the acquisition of entrants and startups, but whereas vertical and horizontal merger policies are aimed at market structure, these proposals focus on a cannibalization theory of harm from mergers. This approach will harm innovation competition by lowering the incentive for innovative entry and by restricting technology transfer. As stated previously, the cannibalization theory of harm argues that one firm in a merging party will innovate less to reduce the possibility of cannibalizing the business of the other merging firm.

There are two versions of the cannibalization theory of harm: *killer acquisitions* and *the kill zone*. The killer acquisition version argues that an incumbent firm may look to acquire a highly innovative entrant to stifle future competition.[11] The kill zone version argues that multisided platforms, such as Amazon or Facebook, with the advantage of network effects and consumer switching costs, might acquire potential competitors to discourage future entry,[12] thereby eliminating the competitive threat to continually innovate.[13] More specifically, the theoretical argument is that "[t]he prospect of an acquisition by the incumbent platform undermines early adoption by customers, reducing prospective payoffs to new entrants. This creates a 'kill zone' in the start-up space, as described by venture capitalists, where new ventures are not worth funding."[14]

There are multiple problems with both versions of the cannibalization theory. This theory prematurely presumes that the acquisition of an entrant or startup will necessarily diminish product innovation and product variety. There is little empirical evidence to support this presumption, because many incumbent firms across many industries have grown through mergers and acquisitions of startups and entrants and have continually innovated and offered wide varieties of products. Unilever, Nestlé, Kraft Heinz, Cisco Systems, and Stellantis are some examples. Another issue with cannibalization theories of harm with respect to mergers and acquisitions is that they require antitrust authorities to distinguish between a possible cannibalization strategy from the acquiring firm and a product diversification strategy, and determining that intent isn't always a straightforward analysis.

Some economic research further contradicts a killer cannibalization theory of harm. Ivaldi, Petit, and Unekbas studied a sample of European merger acquisitions and showed "that one could not observe a disappearance of the target's products, a weakening of competing firms, and/or a post-merger lowering or absence of entry and innovation."[15] One last issue with cannibalization approaches is that they assume firms are isolated islands of innovation and that firms do not interact both horizontally with competitors and vertically along the supply chain with respect to

innovation. This is an incorrect assumption, because firms generally do not create all the necessary technology in-house to innovate.

Conclusion

In sum, antitrust merger policy with regard to innovation competition should not be based on presumptions of harm like the market structure theory or the cannibalization theories and should instead consider using the innovative delta framework. The innovative delta framework provides an empirical and economically sound approach to analysis. It returns merger enforcement back to a rule of reason approach that is consistent with developments in the economic understanding of mergers and antitrust jurisprudence. This is not to say that these novel theories of harm are necessarily incorrect, but there is very little empirical evidence so far to support them. Thus, merger policy should not run the risk of prematurely or wrongly condemning potentially efficiency-enhancing and welfare-enhancing mergers on the basis of mere beliefs.

About the Authors

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Notes

1. *Horizontal mergers* are mergers between direct competitors in a market—for example, two manufacturers of steel bars. *Vertical mergers* are mergers between firms at different levels of the supply chain, such as manufacturers and distributors of a particular product. *Conglomerate mergers* involve tie-ups between firms in unrelated markets (for example, a merger between a steelmaker and a casino). Modern antitrust analysis has viewed horizontal mergers as presenting the greatest threat to competitive harm and conglomerate mergers, the least threat.
2. US Department of Justice and Federal Trade Commission, "Merger Guidelines," December 18, 2023, https://www.ftc.gov/system/files/ftc_gov/pdf/2023_merger_guidelines_final_12.18.2023.pdf.
3. Alden F. Abbott and Daniel F. Spulber, "Antitrust Merger Policy and Innovation Competition," *Journal of Business and Technology Law* 19, no. 2 (2023): 265–329.
4. Wesley M. Cohen, "Fifty Years of Empirical Studies of Innovative Activity and Performance," in *Handbook of the Economics of Innovation*, vol. 1, ed. Bronwyn H. Hall and Nathan Rosenberg, 129–213 (Amsterdam: North-Holland, 2010).

5. Deborah Platt Majoras, "Merger Enforcement at the Antitrust Division" (speech to the KPMG/Chicago Graduate School of Business Mergers and Acquisitions Forum, September 27, 2002).

6. Federal Trade Commission, "FTC Sues to Block Biopharmaceutical Giant Amgen from Acquisition That Would Entrench Monopoly Drugs Used to Treat Two Serious Illnesses," news release, May 16, 2023.

7. William MacLeod and David Evans, "Looking for Plausibility in FTC's Amgen Merger Challenge," *Law360*, May 26, 2023.

8. A *hold-up problem* occurs when two or more parties who could benefit through cooperation refuse to cooperate because of fears of increasing the future bargaining power of the other party and likelihood of unexpected renegotiation of terms. The *free-rider problem* occurs when a party reaps the benefits of investments made by another firm without having to pay for them.

9. Federal Trade Commission in the matter of Microsoft Corp. and Activision Blizzard, Inc., Administrative Part 3 Complaint, docket no. 9412 (redacted public version), December 8, 2022, https://www.ftc.gov/system/files/ftc_gov/pdf/D09412MicrosoftActivisionAdministrativeComplaintPublicVersionFinal.pdf.

10. Federal Trade Commission v. Microsoft Corp., 23-cv-02880-JSC (N.D. Cal. Jul. 10, 2023).

11. Colleen Cunningham, Florian Ederer, and Song Ma, "Killer Acquisitions," *Journal of Political Economy* 129, no. 3 (March 2021): 649–702.

12. Sai Krishna Kamepalli, Raghuram Rajan, and Luigi Zingales, "Kill Zone" (NBER Working Paper 27146, National Bureau of Economic Research, Cambridge, MA, May 2020, revised June 2022).

13. *Network effects* is a phenomenon in which the value of a platform or product increases as the number of people who use it increases.

14. Sai Krishna Kamepalli, Raghuram Rajan, and Luigi Zingales, "Kill Zone" (Working Paper No. 2020-19, Becker-Friedman Institute, University of Chicago, March 2020), abstract, https://bfi.uchicago.edu/wp-content/uploads/BFI_WP_202019.pdf.

15. Marc Ivaldi, Nicolas Petit, and Selçukhan Ünekbaş, "Killer Acquisitions: Evidence from EC Merger Cases in Digital Industries" (TSE Working Paper no. 13-1420, Toulouse School of Economics, last revised January 30, 2024).