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ARTICLE

It's Not Easy Being a Schumpeterian

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As all microeconomics textbooks teach, market power — the ability to raise price above marginal cost — generates a static inefficiency. Market power leaves gains from trade lying on the table, illustrated in blackboard diagrams as triangles of what economists picturesquely call deadweight loss. Competition, understood to mean increasing the number of sellers in the market, would eliminate the inefficiency and make society (notably including consumers) better off. Over the course of the twentieth century, these ideas filtered into antitrust enforcement. Enforcement agencies came to define the relevant market carefully and to look for market power by assessing market share. A federal court recently threw out the Federal Trade Commission's first attempt at a suit against Facebook, in significant part on the grounds that the commission had done a lousy job defining the relevant market and documenting the social network's market share.

The textbook view of economic efficiency as a guide to antitrust policy is not without its critics. The new chair of the FTC is abundantly on record that antitrust policy pays entirely too much attention to competition and consumer benefit. At the same time, an increasing number of critics fear that the textbook model misunderstands competition - in a way that pays *too little* attention to the genuine sources of consumer benefit. Arnold Harberger, whose name has become synonymous with the idea of deadweight-loss triangles, calculated in 1954 that, even starting with unreasonably high assumptions about the level of market power in the economy, the potential gains to eliminating *all* deadweight-loss triangles would amount to something like one tenth of one per cent of Gross Domestic Product, an order of magnitude less than a bad year's worth of annual growth in GDP. This suggests that, as Deirdre McCloskey puts it, the Great Enrichment of market societies in modern times "consists not of little efficiencies but of utterly novel betterments."

It was of course Joseph Schumpeter who most famously ridiculed the economist's focus on static price competition and the search for little efficiencies. In "capitalist reality as distinguished from its textbook picture," he wrote in a famous passage, "it is not that kind of competition which counts but the competition from the new commodity, the new technology, the new source of supply, the new type of organization (the largest-scale unit of control for instance) — competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives. This kind of competition is as much more effective than the other as a bombardment is in comparison with forcing a door, and so much more important that it becomes a matter of comparative indifference whether competition in the ordinary sense functions more or less promptly; the powerful lever that in the long run expands output and brings down prices is in any case made of other stuff."

Economists were not entirely unaware of Schumpeter's views, refractory though they were to the ingrained mindset of the profession. But they struggled to absorb them within the conventional schema. Schumpeter was quickly reinterpreted as having claimed that monopolies (or sometimes firms with market power or sometimes simply large firms) are better able to generate innovation than small firms. There ensued a massive and long-running, and in the end largely futile, research program to determine which kind of market structure was most innovative, usually measured in terms of R&D spending or patents generated. Schumpeter himself would have understood the futility of this exercise, since he did not make the claims attributed to him: far from maintaining that a particular market structure was most conducive to creative destruction, he was attempting to undermine the very idea of market structure as a valuable way of understanding competition.

In a fairly stable world of large oligopolistic firms, it was easy to think of competition in terms of market structure. At the end of the twentieth century, however, creative destruction was wreaking havoc on American industry, and it became increasingly difficult to maintain that the goal of antitrust should be the hunt for little efficiencies rather than the pursuit of rapid economic progress. Bedrock industries like steel, automobiles, and consumer electronics were succumbing to foreign competitors, who brought American consumers dramatically better products. Long-shackled industries like telephony, broadcast, rail, shipping, and air transport were being deregulated. Radically new high-technology industries were emerging overnight. It became increasingly hard to ignore Schumpeter; and a wide assortment of antitrust economists and legal theorists suddenly became eager to don the Schumpeterian mantle, even if they had very different conceptions of what that meant.

Yet we don't have a new Schumpeterian antitrust economics to replace the textbook story. Nor are we ever likely to have one. It's hard to be a Schumpeterian. I think the reasons for this are obvious, though worth restating. We can even dress them up in the robes of behavioral economics: humans have a cognitive bias in favor of the status quo. We find it easy to see the world staying more-or-less the way it is and moving along predictable lines. We are not cognitively designed to understand creative destruction.

Let me illustrate by retelling a familiar story: the Microsoft antitrust case. The litigants approached the case with two very different strategies. The government stuck to a focused script. It narrowly defined the relevant market as that for operating systems for Intel-compatible personal computers. Because Microsoft held some 95 per cent of that market, it was a monopoly. The government then pressed its case that Microsoft's contracting practices constituted anticompetitive exclusion that maintained its monopoly and thus violated Section 2 of the Sherman Act. By contrast, Microsoft waged what could only be called a Schumpeterian defense. The company denied all charges, and it portrayed its position as that of a dynamic competitor in an ever-changing market, perennially besieged by threats ranging from the dimly perceptible to the radically unknown. "In the future," one Microsoft executive was paraphrased as testifying, "users may simply plug their computers into cable outlets and get whatever programs cable providers offer. Small, handheld computing devices could wipe out the PC, just as the PC wiped out the mainframe." A graphical exhibit depicted these threats, many of them in the form of question marks, impinging as arrows upon the company. This elicited titters from the courtroom, and the argument was widely mocked in the press.

Ultimately, the Justice Department and the states agreed to a settlement with Microsoft on a set of detailed conduct remedies. This was essentially a regulatory solution: Microsoft's behavior would be overseen by a three-member panel of computer experts for five years. Perhaps little efficiencies were gained (or perhaps not), but the remedy did nothing to change the market in any fundamental way. Already in 1999, AOL had acquired Netscape, for its server-software business not its browser. In the view of the distinguished antitrust scholar Herbert Hovenkamp, "the Microsoft case may prove to be one of the great debacles in the history of public antitrust enforcement, snatching defeat from the jaws of victory." Writing in 2005, Hovenkamp envisioned an industry continuing along its same path, with Microsoft in control of a world dominated by the personal computer. Maybe another antitrust suit would soon be necessary.

Of course, that is not what happened. In the twenty-first century, everything Bill Gates feared would actually come to pass, including both streaming and the smartphone.

As we look out over today's antitrust landscape, we too are sure that the future will continue on in predictable ways with no surprises. We have already forgotten the creative destruction of the end of the twentieth century. We have even forgotten that, not so long ago, network effects and first-mover advantages assured the long-term dominance of AOL, Yahoo!, MySpace, Nokia, and Blackberry. We can't help it. It's just too hard to be a Schumpeterian.

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