TESTIMONY OF ROBERT H. GERTNER

WALLACE W. BOOTH PROFESSOR
OF ECONOMICS AND STRATEGY
THE UNIVERSITY OF CHICAGO
GRADUATE SCHOOL OF BUSINESS
AND
LEXECON INC.

ON
POSSIBLE ANTICOMPETITIVE EFFECTS TO
RESTRICT COMPETITION ON THE INTERNET

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I welcome this opportunity to discuss the important issue of possible anticompetitive efforts to restrict competition on the Internet. I applaud the FTC for addressing this important policy issue with this conference as well its other activities in this arena.

The Internet has created and should continue create enormous value for Americans. E-commerce transactions continue to increase rapidly. The Census estimates that total e-commerce transactions in the second quarter of 2002 were $10.2 billion, a 24.2% increase from the second quarter of 2001. This despite tough market conditions for this sector and a struggling economy. And these numbers do not measure the enormous value to consumers from the information that consumers derive from the Internet that allows them to learn about goods and services and find the products they want.

The restrictions on e-commerce in the markets that this conference focuses on have limited the ability of e-commerce companies to provide consumers with the full potential of the Internet. The justification for these restrictions are typically weak and to the extent they respond to legitimate policy concerns, these concerns can likely be addressed with less onerous regulation than outright bans on transactions over the Internet and other existing restrictions.

The political economy of these restrictions is such that they exist in many of the markets where the potential value of e-commerce transactions is the greatest. They have arisen to protect the

rents that accrue to intermediaries that are threatened by competition from entrants on the Internet.

The Internet has enhanced the efficiency of many consumers markets. In its most obvious form, these efficiencies arise from disintermediation of traditional distribution channels. Airline ticketing has become more efficient because consumers are able to make reservations and access the information typically provided by travel agents at lower costs. Consumers are able to browse for, skim through, and purchase books that are not available at local bookstores.

Restrictions on e-commerce transactions limit the ability of consumers to reap these benefits in many markets. We will hear about two markets at this conference that are especially important. Housing and automobiles represent the two largest expenditures for many consumers. In 1999, sales of existing houses and condos exceeded $700 billion and annual new and used car sales are approximately $200 billion. If the Internet were to reduce standard real estate agent commissions from around 6% by one percentage point and reduce the costs of a new car by 2%, annual consumer savings would exceed $10 billion.[1]

The most obvious costs of regulations on e-commerce arise directly from the reduced competition for intermediaries created by restrictions on Internet-based sales. But these are not the only costs and in many markets they may not be the most important ones. The value of e-commerce extends well beyond enhanced efficiency of transactions.

Restrictions on e-commerce may also result in lower levels of upstream competition. For example, an automobile manufacturer without a dealer in a particular local market may be a more attractive choice if it could sell directly to consumers in that market. This could result in greater competition among manufacturers and thereby lower wholesale prices. Americans who do not live in densely-populated markets have limited retail choices for many types of products. Many travel large differences to meet anything other than day-to-day needs. Mail order is an

[1]These ballpark estimates are plausible and may be conservative. Economists have argued that real estate commissions exceed competitive rates. Fiona Scott Morton and Florian Zettlemeyer have estimated the value of Internet-based referrals for automobiles as approximately 2%.

important way that companies compete for these consumers. The Internet reduces the costs of competing for these customers and extends the benefits of mail order to many more products.

In many markets, the Internet is an attractive distribution channel for new small-scale entrants because of its low fixed costs. Internet-based distribution has been an essential part of the entry strategy for many new musicians, software designers, and computer equipment makers. In markets in which this distribution channel is blocked, there will be less entry, less competition, and less innovation. Recent economic research suggests that the long-run costs to consumers from reductions in innovation and the resulting reductions and delays in new product introductions can be very large. Therefore, restrictions that limit the ability of entrants to use the Internet for distribution may be very costly to society.

Consumers benefit directly from the increased choice among differentiated products that are available over the Internet. The Internet is an incredible resource for a consumer with uncommon preferences to find products that satisfy those tastes. E-bay is a testament to this fact. Today, consumers in most states, who visit a small winery in California while on vacation and love its wine, may simply have no practical way to purchase that wine for consumption at home. In contrast, a consumer who hears a local band on that same vacation has no trouble sampling the band's music and purchasing its CD over the Internet.

On the other side of the equation are a number of legitimate concerns of how consumers could be harmed by e-commerce in particular markets. Probably the strongest economic argument is that consumers will free ride on the services of traditional distributors by acquiring information and services from these distributors and then purchasing from the lower-priced and lower-service Internet provider. This is a legitimate concern in several of the markets that are the focus of later sessions at this conference. However, it is a very long way from this concern to a conclusion that government restriction on Internet sales is the appropriate remedy.

If free-rider problems are large, the upstream producer has a large private incentive to resolve them in an efficient manner. Bob Stillman and I have studied how apparel firms have responded to the Internet. Firms that were not vertically-integrated into retail sales were faced with significant challenges because their retailers were concerned with reduced sales and free-riding.

Some chose to not distribute their products on the Internet while others chose to place restrictions on how its products would be sold on the Internet. The key point, however, is that private firms have the incentive and ability to handle this problem themselves and are more likely to come up with better solutions than broad government-mandated policies. In general, market participants adjust relationships creatively to allow all parties to benefit from Internet sales and eliminate the inefficiencies from free-riding.

In some markets, the solution may involve a change in the pricing model so that consumers pay for the services provided by different distribution channels. For example, some full-service brokerage firms, that traditionally provide free research and investment advice subsidized by high commission fees, have adjusted their pricing in response to entry of Internet-based low-commission, low-service brokerages. They have switched to a subscription-based pricing structure that, in effect, charges customers for the additional services they provide. Analogous changes could occur in the way automobile dealers are compensated by consumers or manufacturers to reduce free-riding, but allow consumers to benefit from direct Internet sales. When faced with a demand for protection from Internet sales based on free-riding on services, policy makers should consider the ability of companies to adjust relative prices – the relative prices of contact lenses and optometrist visits or the relative price of caskets and other funeral services could adjust if the services not provided by Internet-based providers are valued by consumers.

A second legitimate concern that motivates restrictions on e-commerce is standard consumer protection against deceptive practices, fraud, and dangerous consumer behavior. The policy goal should be to come up with regulations that provide consumer protection with a minimal impact on competition. It strikes me that many of the regulations we see are too restrictive. There are and should be less costly ways to provide consumers with protection against fraud on the Internet. There may be an important role for innovative licensing, monitoring, and consumer complaint procedures to meet these consumer protection goals. The FTC may be able to play a valuable role in identifying best practices and disseminating this information to policy makers.