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+ Foreword

"Against the vertical discrimination presumption"

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Over the past several years, a growing number of critics have argued that big tech platforms harm competition by favoring their own content over that of their complementors. Over time, this "vertical discrimination presumption" has become the go-to argument for big tech's staunchest critics seeking to level novel charges of anticompetitive conduct against these platforms. Indeed, judging by the grandiose claim made by one critic at a recent Senate hearing—"*Digital platform self-preferencing threatens the American Dream*"[1]—the argument may be the very apotheosis of "populist antitrust."

According to this line of argument, complementors are "*at the mercy*" of tech platforms.[2] By discriminating in favor of their own content and against independent "*edge providers*," tech platforms cause "*the rewards for edge innovation* [to be] *dampened by runaway appropriation*," leading to "*dismal*" prospects "*for independents in the internet economy—and edge innovation generally.*"[3]

The problem, however, is that the claims of presumptive harm from vertical discrimination are based neither on sound economics nor evidence.

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The notion that platform entry into competition with edge providers is harmful to innovation is entirely speculative. Moreover, it is flatly contrary to a range of studies showing that the opposite is likely true. In reality, platform competition is more complicated than simple theories of vertical discrimination would have it,[4] and there is certainly no basis for a presumption of harm.

Consider a few examples from the empirical literature:

- Li and Agarwal (2017)[5] find that Facebook's integration of Instagram led to a significant increase in user demand for Instagram—and for the entire category of photography apps. The integration of Instagram increased consumer awareness of photography apps on Facebook, which benefited independent developers, as well as Facebook.
- Foerderer et al. (2018)[6] find that Google's 2015 entry into the market for photography apps on Android created additional user attention and demand for such apps generally. This had a positive spillover effect on complementors. Following Google's entry, complementors were more likely to innovate their photography apps and to release new apps in other categories, as well.
- Cennamo et al. (2018)[7] find that video games offered by console firms often become blockbusters and expand the installed base of the consoles. As a result, these games increase the potential for all independent game developers to profit from their games, even in the face of competition from first-party games.
- Finally, even though Zhu and Liu (2018)[8] are held up by vertical discrimination presumption proponents as demonstrating harm from Amazon's competition with third-party sellers on its platform, their findings are actually far from clear-cut. As one of the authors notes elsewhere: "[I]*f Amazon's entries attract more consumers, the expanded customer base could incentivize more third-party sellers to join the platform. As a result, the long-term effects for consumers of Amazon's entry are not clear.*"[9]

None of this should be surprising. The theory of vertical discrimination harm is at odds not only with this platform-specific empirical evidence, it is also contrary to the long-standing evidence on the welfare effects of vertical restraints more broadly.[10]

Proponents of the vertical discrimination presumption do sometimes begrudgingly acknowledge that only anecdotal evidence, at best, supports their claims.[11] But these begrudging acknowledgements do not dissuade them from proposing regulatory policies that would favor edge innovation over platform control, ostensibly rooted in "*innovation literature* [that] *suggests that 'external' innovation is more valuable.*"[12] In fact, as suggested above, this is not what the literature holds. Rather, the relationship between platform control and edge innovation is far more nuanced.[13]

> Mandating openness is not without costs, most importantly in terms of the effective operation of the platform and its own incentives for innovation

The notion that platforms should be forced to allow complementors to compete on their own terms, free of constraints or competition from platforms is a species of the idea that platforms are most socially valuable when they are most "open."[14] But mandating openness is not without costs, most importantly in terms of the effective operation of the platform and its own incentives for innovation.

Moreover, it is important to note that the appropriation of edge innovation and its incorporation into the platform (a commonly decried form of platform self-preferencing) greatly enhances the innovation's value by sharing it more broadly, ensuring its coherence with the platform, incentivizing optimal marketing and promotion, and the like. In other words, even if there is a cost in terms of reduced edge innovation, the immediate consumer welfare gains from platform appropriation may well outweigh those (speculative) losses.

Crucially, platforms have an incentive to optimize openness (and to assure complementors of sufficient returns on their platform-specific investments). This does not mean that maximum openness is optimal, however; in fact, typically a well-managed platform will exert top-down control where doing so is most important, and openness where control is least meaningful.[15]

But this means that it is impossible to know whether any particular platform constraint (including self-prioritization) on edge provider conduct is deleterious, and similarly whether any move from more to less openness (or the reverse) is harmful.

This is the state of affairs that leads to the indeterminate and complex structure of platform enterprises. Consider the big online platforms like Google and Facebook, for example. These entities elicit participation from users and complementors by making access to their platforms freely available for a wide range of uses, exerting control over access only in limited ways to ensure high quality and performance. At the same time, however, these platform operators also offer proprietary services in competition with complementors, or offer portions of the platform for sale or use only under more restrictive terms that facilitate a financial return to the platform. Thus, for example, Google makes Android freely available, but imposes contractual terms that require installation of certain Google services in order to ensure sufficient return.

> The appropriation of edge innovation and its incorporation into the platform (a commonly decried form of platform self-preferencing) greatly enhances the innovation's value by sharing it more broadly

The key is understanding that, while constraints on complementors' access and use may look restrictive compared to an imaginary world without any restrictions, in such a world the platform would not be built in the first place. Moreover, compared to the other extreme—full appropriation (under which circumstances the platform also would not be built…)—such constraints are relatively minor and represent far less than full appropriation of value or restriction on access. As Jonathan Barnett aptly sums it up: "*The* [platform] *therefore faces a basic trade-off. On the one hand, it must forfeit control over a portion of the platform in order to elicit user adoption. On the other hand, it must exert control over some other portion of the platform, or some set of complementary goods or services, in order to accrue revenues to cover development and maintenance costs (and, in the case of a for-profit entity, in order to capture any remaining profits).*"[16]

The problem arises when platforms navigating the middle ground after they have achieved success adopt a change from the status quo that entails an increase in control or a limitation on access by some users or complementors—as when a platform develops and prioritizes its own complementary services in competition with complementors. Too often the fact of such a change is seen as emblematic of the exercise of anticompetitive expropriation. But in reality, judged from the perspective of the value of the system as a whole—including innovation at the platform level—such a change may be at least as likely to increase consumer welfare.

Surely it is correct that edge providers will invest less in their businesses if their returns will be diminished by platform expropriation. But the massive size and enormous success of such platforms should raise eyebrows. Why would so many complementors continue to develop businesses in reliance on platforms if doing so entails a substantial risk of foreclosure and financial ruin? It can hardly be the case that a few competition scholars in Washington and Brussels have divined the "true" business realities of app development or online retailing that were otherwise invisible to the businesses, consultants, and analysts steeped in the industry.

Unless the argument is that independent complementors are improbably ignorant or repeatedly deceived, it must be the case that they develop their business models and operate their businesses in recognition of the risk involved. This implies either that the risk is not as substantial as critics contend (either because platforms are not likely to expropriate value or because complementors can protect themselves from it) or else that complementors are sufficiently compensated for it. In either case, the fact that platform ecosystems are so vast suggests that we should be careful before assuming that incentives to invest are inefficiently reduced by foreclosure or expropriation risks.

A complementor that makes itself dependent upon a platform for distribution of its content does take a risk. Although it may benefit from greater access to users, it places itself at the mercy of the other—or at least faces great difficulty (and great cost) adapting to unanticipated platform changes over which it has no control. This is a species of the "asset specificity" problem that animates much of the Transaction Cost Economics literature.[17]

But the risk may be a calculated one. Firms occupy specialized positions in supply chains throughout the economy, and they make risky, asset-specific investments all the time. In most circumstances, firms use contracts to allocate both risk and responsibility in a way that makes the relationship viable.[18] When it is too difficult to manage risk by contract, firms may vertically integrate (thus aligning their incentives) or simply go their separate ways.[19]

> The fact that Google creates an opportunity for complementors to rely upon it does not mean that a firm's decision to do so—and to do so without a viable contingency plan—makes good business sense

In some cases, however—as for Google and the sites linked in its organic results—the parties do not have a direct commercial relationship. This means that contractual risk allocation or compensation is unavailable.

This latter state of affairs is the one at issue in the European Commission's *Google Shopping* case. In its decision, the Commission asserts that Google's prioritization of its own shopping results harms competition because it reduces traffic to comparison shopping sites, potentially foreclosing them from minimum viable scale and causing them to under-innovate.[20] The decision does not identify actual consumer harm; it infers it from the reduction in traffic to comparison shopping sites, constituting an alleged impairment of an "*effective competition structure.*"[21]

But the fact that Google creates an opportunity for complementors to rely upon it does not mean that a firm's decision to do so—and to do so without a viable contingency plan—makes good business sense. In the case of comparison shopping sites, it was entirely predictable that Google's algorithm would evolve. It was also entirely predictable that it would evolve in ways that could diminish or even eviscerate their traffic. As one online marketing/SEO expert put it: "*counting on search engine traffic as your primary traffic source is a bit foolish to say the least.*"[22]

The problem with the superficial analysis that assumes harm from the diminution of traffic to independent competitors is this: Protecting complementors from the inherent risk in a business model in which they are entirely dependent upon another company with which they have no contractual relationship is at least as likely to encourage excessive risk taking and inefficient overinvestment as it is to ensure that investment and innovation are not too low.

That any given complementor succeeded in the past is no reason to assume it "should" succeed in the future, especially against competition from a platform's own, integrated product. Nor is it any reason to assume that, freed from the constraints of platform self-preferencing, it would provide any measure of innovation in the future. Indeed, the argument contains the seeds of its own demise:

If platform discrimination is rampant, the fact that a complementor previously succeeded under different discriminatory conditions offers no reason to think that that there was an "*effective competition structure*" in the first place and thus that its previous success was in any way "merited," either. Rather, under the terms of this argument, a complementor's previous success was just a byproduct of the platform's previous efforts to structure its ecosystem to advantage itself, and there is no basis for inferring a loss of competition simply because previously successful edge providers are harmed.

> Protecting complementors from the inherent risk in a business model in which they are entirely dependent upon another company with which they have no contractual relationship is at least as likely to encourage excessive risk taking and inefficient overinvestment as it is to ensure that investment and innovation are not too low

That enforcers and regulatory bodies are readily adopting the vertical discrimination presumption as a valid theory of harm is concerning. The UK's Furman Report, for example, proposes as one of three "*core principles*" for its recommended code of conduct that "*business users are* (…) *provided with access to designated platforms on a fair, consistent and transparent basis.*"[23] It later offers as an example of the application of this principle a provision holding that "*a platform with strategic market status giving undue preferential prominence on its webpages to its own integrated services*" is "*inconsistent with this principle.*"[24] The language is offered in the context of a theoretical case study, but it is a truly unfortunate choice. If consumer welfare is actually the objective of such regulatory efforts, such a principle finds no justification in economic theory or evidence. ■

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2 Id. at 4.

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5 Z. Li & A. Agarwal, Platform Integration and Demand Spillovers in Complementary Markets: Evidence from Facebook's Integration of Instagram, 63 Mgmt. Sci. 3438 (2017).

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10 See, e.g., F. Lafontaine & M. Slade, Vertical Integration and Firm Boundaries: The Evidence, 45 J. Econ. Lit. 629 (2007); J. C. Cooper et al., Vertical Antitrust Policy as a Problem of Inference, 23 Int. J. Indus. Org. 639 (2005).

11 See, e.g., K. Caves & H. Singer, When the Econometrician Shrugged: Identifying and Plugging Gaps in the Consumer-Welfare Standard, 26 Geo. Mason L. Rev. 395, 402 (2018).

12 L. M. Khan, The Separation of Platforms and Commerce, 119 Colum. L. Rev. 973, 1086 (2019), citing T. Wu, Taking Innovation Seriously: Antitrust Enforcement if Innovation Mattered Most, 78 Antitrust L. J. 313, 318 (2012).

13 See, e.g., K. Boudreau, Platform Boundary Choices & Governance: "Opening-Up" while Still Coordinating and Orchestrating, in Advances in Strategic Management: Entrepreneurship, Innovation, and Platforms, Furman et al., eds. (Emerald Publishing, 2017), 227, 323.

14 See, e.g., B. M. Frischmann, An Economic Theory of Infrastructure and Commons Management, 89 Minn. L. Rev. 917 (2005).

15 See generally, Hagiu & Boudreau, Platform Rules: Multi-Sided Platforms as Regulators, supra note 4; Barnett, The Host's Dilemma, supra note 4.

16 Barnett, The Host's Dilemma, supra note 4, at 1890.

17 See O. E. Williamson, The Vertical Integration of Production: Market Failure Considerations, 61 Am. Econ. Rev. 112 (1971); B. Klein, Asset Specificity and Holdups, in The Elgar Companion to Transaction Cost Economics, P. G. Klein & M. Sykuta, eds. (Edward Elgar Publishing, 2010), 120–126.

18 Klein, id. at 121.

19 Id. at 123–124.

20 Commission Decision No. AT.39740 – Google Search (Shopping) at ¶¶ 591–607.

21 Id. at ¶ 332.

22 A. Hoffman, Where Does Website Traffic Come From: Search Engine and Referral Traffic, Traffic Generation Café (Dec. 25, 2018), https://trafficgenerationcafe.com/website-traffic-source-search-engine-referral.

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