Policy Watch
Antitrust Goes to College

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Public policies are often made without much recourse to economic reasoning. Economists are often unaware of what is happening in the world of public affairs. As a result, both the quality of public decision-making and the role that economists play in it are often less than optimal. This feature will publish short articles on topics that are currently on the agendas of policy makers and provide nonspecialists with a better understanding of the role of economic analysis in illuminating current debates. Suggestions for future columns and comments on past ones should be sent to Isabel V. Sawhill, c/o Journal of Economic Perspectives, The Urban Institute, 2100 M Street N.W., Washington, D.C. 20037.

Introduction

It may have come as a shock to many economists, especially those in academia, to learn that the Antitrust Division of the U.S. Department of Justice (DOJ) has been investigating alleged price fixing and information exchange of financial aid among 23 prestigious east coast colleges and universities. In May

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1991, the DOJ signed a consent decree with the eight Ivy League colleges as discussed in the Afterword. These schools include the "Ivy overlap group"—MIT, Brown, Columbia, Cornell, Dartmouth, Harvard, University of Pennsylvania, Princeton and Yale—and the "Pentagonal/Sisters group"—Amherst, Barnard, Bowdoin, Bryn Mawr, Colby, Mount Holyoke, Middlebury, Smith, Trinity, Tufts, Vassar, Wesleyan, and Williams. (At least one private antitrust case also has been filed, against Wesleyan.) We have no specific knowledge concerning the possible validity of these allegations or expertise about their legality. Rather, in this article, we wish to present the potential applicability of current antitrust doctrines to colleges and their conduct and the possible defenses that they might raise to justify their actions.

U.S. antitrust laws are premised on the view that consumer welfare is maximized by competition, not by the joint decisions of sellers. The Sherman Antitrust Act has been called the Magna Carta of competition. At its core is the per se prohibition on joint price fixing by competitors; "per se" means that price fixing is illegal in and of itself, even in the absence of evidence of any effect on price levels. The Sherman Act also flatly rejects defendants' attempts to justify price fixing on the grounds that competition would be destructive or that competitive prices would be unreasonable. As the Supreme Court stated baldly in a 1940 price fixing case, *U.S. v. Socony-Vacuum Oil Co.* (310 U.S. 150, 221–23),

Congress . . . has not permitted the age-old cry of ruinous competition and competitive evils to be a defense to price fixing conspiracies. It has no more allowed genuine or fancied competitive abuses as a legal justification for such schemes than it has the good intentions of the members of the combination . . . Under the Sherman Act, a combination formed for the purpose and with the effect of raising, depressing, fixing, pegging or stabilizing the price of a commodity in interstate commerce is illegal *per se*.

Given this rule, consider some of the alleged actions of the colleges listed above in allocating financial aid.\(^1\) Until this year, when the meetings were canceled (under the pressure of the DOJ investigation), the admissions officers met each year to review the financial aid applications of potential students. (In 1990, following the DOJ investigation, Yale and Barnard did not attend.) At these meetings, the officers exchanged information about the family incomes and resources of applicants. They apparently stated their opinions about what the applicants' families could afford to pay. To this end, it is alleged that they agreed on a family contribution for college costs and offered financial aid.

\(^1\)There also have been allegations that groups of colleges may have fixed faculty salaries and that they exchanged information on future tuition levels, information that could facilitate coordinated pricing of tuition. See Putka (1989) for details. To focus the analysis, we have restricted ourselves to the issue of financial aid.
accordingly. Thus, if the admissions officers agreed that a student could afford to pay $4000 per year, then a college whose total annual costs were $20,000 would offer $16,000 in aid, while a college whose total costs were $25,000 would offer $21,000 in aid.

**Antitrust Analysis of Financial Aid Cooperation**

If we assume these are the facts, should this conduct be held to violate the Sherman Act? How might the colleges defend themselves?

The colleges first might claim that their agreement did not violate the antitrust laws because it did not effectively reduce competition. After all, colleges still could compete by reducing the fraction of aid given as loans or work-study and increasing the fraction given as outright grants. This defense could succeed, but it will be a tough road for the colleges. Lack of effect is no defense to a price fixing claim under the Sherman Act. Furthermore, in the antitrust case *Catalano v. Target Sales, Inc.*, 446 U.S. 643 (1980), where beer wholesalers agreed to offer similar credit terms to retailers, while continuing to compete on wholesale price, the Supreme Court held that there was an illegal price agreement.

The simplest defense for the colleges might be that the antitrust laws do not apply to them. Under this defense, the universities would claim that they are different from the enterprises that form the bulk of the private sector of the U.S. economy. Colleges and universities are nonprofit institutions involved in education, not commodities. They are institutions of higher education and scholarship, not commerce. Many are government-run or -subsidized.

But over the years, the courts clearly have stated that the antitrust laws, and the per se rule, govern all markets that have not been specifically exempted by Congress. Professionals such as doctors and architects are covered. Nonprofit entities like hospitals are covered, even those with religious affiliations. As for colleges, the NCAA college football network television contract was found to amount to an illegal agreement among NCAA colleges to restrict competition among themselves, though it was not declared per se illegal. Instead, it was found to be illegal under a “rule of reason” analysis, discussed below.

Further, it seems quite reasonable to apply standard models of industrial organization to higher education. In this model, a university is an enterprise offering educational services as its primary output. Large universities are

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2For example, insurance is exempted and left for the states to regulate, an exemption that currently is under heavy legislative attack. Labor is exempted to the extent that unions are permitted to bargain collectively with employers. Professional baseball was exempted from the strictures of the Sherman Act in 1922, by the Supreme Court in *Federal Baseball Club v. National League* (259 U.S. 200), on the grounds that it was local, not interstate commerce. Other professional sports have been unable to replicate this trick, however.
multi-divisional enterprises, offering various degrees and differentiated products—like degrees in economics, English, fine arts and so on. Colleges sell these services to its student customers at a tuition price.\(^3\) Colleges discriminate among their customers by offering price discounts in the form of scholarships and low interest loans of varying amounts.

Colleges and universities compete for student customers. There are a number of quality dimensions of this competition, including location, quality of professors, courses, fellow students, and social life.\(^4\) Price also is relevant to student choices. Any readers who doubt the relevance of price should ask themselves whether freshman applications would fall significantly at the college they attended (or now attend), if the college \textit{unilaterally} increased tuition by 10 percent.

Thus, higher education is not clearly outside the range of what normally is viewed as commerce. Moreover, the nonprofit, cooperative or governmental status of colleges does not make them unique. Hospitals, museums and other enterprises are ready examples elsewhere in the economy, as are mutually organized savings banks and insurance companies. Even nonprofits are concerned with revenue needs and competition, so they have an economic incentive to try to fix prices. Third-party payment of tuition has obvious parallels to health maintenance organizations and other forms of health insurance, and antitrust law clearly covers these services.

Thus, the relevant question becomes one of whether (and how) college financial aid, rather than college education, is different or special. In this view, the colleges might try to justify their joint actions as consistent with the goals of the Sherman Act. Joint pricing by competitors is permitted under the antitrust laws under certain circumstances. For example, when GM and Toyota formed a joint venture to produce subcompact automobiles, they also were permitted to price the car jointly (Kwoka, 1989). Similarly, thousands of composers are members of the two performing rights collectives, ASCAP (American Society of Composers, Authors and Publishers) and BMI (Broadcast Music, Inc.). Each of these collectives, acting on behalf of its members, licenses the performance rights to the songs of its members to networks and other users on an all-or-nothing basis. Under the "blanket licenses" offered by ASCAP and BMI to broadcasters, for example, licensees can play any song in the catalog of the respective group as often as desired, in exchange for the payment of a fraction of the licensee's advertising revenues.

These examples raise two questions. First, how can any joint pricing escape the \textit{per se} rule against price fixing? Second, what are the characteristics of the

\(^3\)Other outputs include research, housing and meals for resident students, spectator sports for students, alumni and others, and so on. Many of these outputs also carry explicit prices.

\(^4\)Colleges also compete in input markets, notably in the labor market for professors. This competition also is multi-dimensional, and some institutions may have market power.
exceptions? The Supreme Court's simple answer to the first question is perfectly circular. In an antitrust case against ASCAP and BMI (Broadcast Music, Inc. v. Columbia Broadcasting System, Inc., 441 U.S. 1 (1979)), the Supreme Court wrote, "As generally used in the antitrust field, 'price fixing' is a shorthand way of describing certain categories of business behavior to which the per se rule has been held applicable."

A clearer answer is that the per se rule applies to agreements that are virtually certain to be socially deleterious. One example of such an agreement is simple bid-rigging by competitors, where the price fixing is "naked"—that is, not accompanied by any other, pro-competitive activities. In this type of case, the per se rule means that the firms cannot defend "naked restraints" by claiming they did not have the market power to raise prices or by showing that there is no good evidence that prices actually were increased by their agreement. In such instances, where little or no good is likely to follow from the conduct, and the only issue is whether it caused significant harm, the per se rule economizes on legal process costs by foreclosing such a "no harm" defense. The "no harm" defense is permitted only under the "rule of reason," which applies to cases where the courts are convinced that some efficiency benefits are likely, and possibly could offset the harms from any market power caused by the conduct.

Courts have been willing to allow competitors to escape the per se rule by showing that joint pricing is not "naked," but rather is "reasonably necessary" to the creation of efficiency benefits, or pro-competitive effects. For example, in the case of ASCAP's and BMI's blanket licenses, the joint pricing was said to be necessary for the creation and marketing of a new product valued by purchasers. In particular, the blanket license gave licensees "unplanned, rapid and indemnified access to the entire repertory of compositions." Similarly, firms might show that joint pricing is procompetitive because it is necessary to increase production efficiency or otherwise reduce costs. For example, ASCAP captures scale economies by collectively monitoring and enforcing the copyrights of its members and collecting and distributing license fees. Not only is there a conventional scale economy, but if a licensee takes a blanket license (as opposed to licenses for a subset of individual composers), then there is no need to monitor that licensee at all for possible copyright infringement. If this type of efficiency claim is credible, then the courts will evaluate the practice under the "rule of reason," which balances the likelihood of the harm from the exercise of market power against the likely magnitude of any efficiency benefits. (The Supreme Court has never stated, however, what balancing test should be used to compare gains in production efficiency against market power.)

Given this, can the colleges credibly claim that their financial aid agreement is reasonably necessary to producing a better educational product? Consider one of the justifications offered by William R. Cotter, the president of Colby College and a former antitrust lawyer (Cotter, 1989). Mr. Cotter argues
that agreeing to equalize the cost of education at different colleges improves students' decision-making. He states that, absent these agreements, "many families would find the already difficult task of choosing a college distorted by the varied grant offers." The agreements thus aim "to increase students' freedom to choose colleges on the basis of the most appropriate academic program, not the cost to the family."

This justification, that removing price from the decision-making process is socially efficient, is unlikely to prevail in the courts. If the presidents of General Motors, Ford and other automakers tried to justify fixing the price of subcompact cars on these grounds, they likely would face stiff fines and treble damage suits, if not jail terms. According to antitrust doctrine (as well as standard microeconomic theory), it is generally efficient to have price included in buyers' and sellers' decisions. As for the possible confusion of buyers, it is a basic premise of a market system that competition leads to greater consumer welfare than collusion, even if consumer information is not perfect and decision-making is difficult and costly.

The colleges might claim that financial aid also is different because the universities have limited financial aid budgets. They should not, as Cotter put it, be forced to "be dragged in to a kind of 'bidding war' for the best students," because if that happened, colleges' expenditures "would have to be reduced or tuition would have to be raised to meet financial aid costs."

A bare claim of limited financial aid budgets cannot by itself be sufficient to carry the argument. If a bidding war ensued, financial aid budgets instead might be increased (that is, tuition "prices" cut to some students), at the expense of salaries or new buildings. Stated another way, do the colleges have proof that smaller scholarships for some students have led to lower tuition levels generally, rather than to fancier administrative offices or a new football stadium? The bald claim is simply too unbounded to be useful to a court. If it were accepted on its face, then a similar claim of limited salary budgets similarly could be used to justify jointly fixing faculty salaries. And suppose that tuition did not need to be raised. So what? Why should colleges be permitted to collude in order to benefit some students at the expense of others?

To go further, suppose that the automobile companies attempted to justify jointly fixing prices at elevated levels with the argument that they thereby could finance R&D on new technologies. Or, that they were fixing the prices of fleet sales to offer lower prices on entry-level models to (mostly lower income) regular retail customers. Would those arguments be credible? And if they were, how could courts decide which cross-subsidies were in the public interest, without turning the entire economy into a series of regulated (by the courts) industries?

The colleges might reformulate the previous argument as follows: A limit on financial aid competition allows a larger number of deserving students to attend elite colleges, by spreading the aid dollars more evenly, and this creates positive externalities for society, as well as for fellow tuition-paying students.
Similarly, positive externalities are created by increasing the income diversity of students attending these elite colleges.

This formulation of the colleges’ justification is stronger from an antitrust perspective—at least this argument has “output” increasing!—but this justification also suffers from potential unboundedness. Positive externalities are not unique to colleges. Forestry companies plant trees that prevent soil erosion, companies engage in R&D that enriches society, and architects sometimes design buildings that are handsome landmarks. To make this justification more defensible, the colleges would have to demonstrate the existence of a substantial market failure. For example, the colleges might claim that the source of the market failure is the fact that the quality of the educational experience depends on the mix of students at the college. Students want to attend the school that the most-desired students are attending. If colleges bid high for the most-desired students, they may be forced to raise tuition in a way that does not maximize welfare, or they may be unable to offer an optimal amount of aid to others.\(^5\) This is similar to insurance markets, where adverse selection means that the cost of insurance depends on the mix of purchasers (Greenwald and Stiglitz, 1986). In this case, unrestricted competition for the best students might lead to a suboptimal equilibrium, and collusive pricing may be necessary.

Whether this last justification is credible or not, it would at least have standing under the antitrust laws, because it directly links the price fixing to improved quantity and quality of the educational product sold by colleges. Of course, it would be more convincing if the colleges actually provided hard evidence that indicated both the significance of the market failure and the way in which their conduct directly addressed the market failure. For example, colleges might attempt to demonstrate that the quantity of students or the quality of education would increase from their joint conduct.

The colleges also would have to show how joint activity, as opposed to actions undertaken individually, was necessary to overcome that market failure. After all, any college can choose not to engage in financial aid competition and instead spread its limited financial aid budget more evenly. In all joint pricing cases, the defendant must show that the efficiency benefits could not be achieved without jointly fixing prices.\(^6\)

\(^5\)For example, suppose that there are two competing colleges and both want to increase racial diversity by attracting more black students who need financial aid. For concreteness, suppose there are four potential black candidates: two are brilliant “superstars” and two are just average. With collusion, the schools would offer a standard aid package to all four candidates and, say, two would attend each college. However, if the schools get into a bidding war for the two superstars, and each school attracts one, neither school may be able to afford sufficient aid to attract either of the average black candidates. Thus, competition may reduce diversity, which thereby may reduce the quality of the educational experience for the inframarginal non-aid students. Yet, if the perceived educational quality does not rise for the marginal non-aid students, it will be impossible to raise tuition to generate the additional aid needed.

\(^6\)In this journal, Shapiro and Willig (1990) discuss this point in the context of research, production and marketing joint ventures.
Conclusions

Based on this analysis, we think the colleges are likely to have a difficult time contesting these antitrust allegations. The externality argument seems to reflect the true views of the administrators and, if they can explain why cooperation is needed, holds some promise. However, because antitrust focuses on competition, arguments about externalities arising from a diverse student body may be difficult to prove convincingly to courts, even if they are true.

The colleges may do better by trying to persuade the Justice Department to use its "prosecutorial discretion" and not bring this case to court. (Although this would not automatically eliminate the threat of private suits, it would reduce their likelihood. Many private class action suits against price fixing follow on government cases, which allows the plaintiff's lawyers to benefit from the government's investigation and success in litigation.) The colleges could rest this plea to the DOJ on the social goals of educational policy. Current antitrust analysis focuses solely on competition, not fairness and equity. But, the colleges' strongest point might be that society's overall educational and social goals are better served by limiting the amount of financial aid to the most desired students to permit more poor students overall to attend college, given the competing demands on college budgets. In this way, society can fight poverty and improve overall human capital formation. In this formulation, college administrators might claim that they are doing the best they can in the face of severe state and federal cutbacks in aid to education.

Antitrust law does not create a blanket prohibition on colleges' efforts to achieve this goal. Instead, the antitrust laws say only that competing sellers—whether college administrators or automobile manufacturers—may not, on their own accord, decide among themselves to fix prices to achieve what they perceive as an important social goal. Instead, they must get explicit permission from the relevant governmental entities—here, the legislature and education department. Only then may they implement a policy that explicitly conflicts with the competitive goals of the Sherman Act. Moreover, their activities also should be actively supervised by the government, to ensure that they do not use the opportunities afforded by the process to engage in other anticompetitive activities, such as fixing tuition or faculty salaries. Oversight also can ensure that the benefits of competition are given proper weight.

A final word. As this article makes clear, antitrust analysis is based on a classical microeconomics foundation, notably that competition among profit-maximizing firms maximizes welfare. Antitrust expects non-profits to compete

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7 For example, college administrators may think it is unfair for some students to get aid that is not need-based. However, this type of "unfairness" is endemic in a competitive market economy and so is given no weight in modern antitrust analysis.

8 The colleges could get an explicit exemption by Congress, or the relevant state and federal educational agencies could direct the colleges' actions. The Supreme Court has recognized an exemption from the antitrust laws for state-directed actions. Parker v. Brown, 317 U.S. 341 (1943).
too. Antitrust either assumes non-profits effectively do choose prices and output to maximize profits, or it guides these entities to compete regardless of their underlying objective functions. This approach need not be the socially optimal one. A questioning of this approach might be supported by a welfare analysis of markets composed of nonprofit firms. Colleges may be a good market to study for this purpose. The economy does have for-profit insurance companies and hospitals, operating alongside nonprofit and publicly run institutions. However, except for vocational schools, there is no comparable for-profit college and university sector. Maybe there is something different about the educational enterprise.

Afterword

In May 1991, after this article went to press, the DOJ formally charged the eight Ivy League colleges and MIT with price fixing on scholarship levels (Barrett 1991; DePalma 1991). The civil antitrust suit, brought in Federal District Court in Philadelphia, was immediately settled by the eight Ivies with a consent agreement, in which the eight schools (while denying any guilt for past actions) promised not to collude in the future on financial aid, tuition levels, or faculty salaries. MIT declined to join the settlement and is likely to face trial.

In announcing the agreement, Attorney General Richard Thornburgh declared that “students and their families are entitled to the full benefits of price competition when they choose a college. This collegiate cartel denied them the right to compare prices and discounts among schools, just as they would in shopping for any other service.” In response, Daniel Steiner (vice president and general counsel of Harvard) said, “Our practices served the good social purposes of making sure that a limited amount of financial funds went to the neediest students.” And Harold T. Shapiro, president of Princeton, said, “Awards in excess of need either divert resources from needy students or require an increase in revenues or reductions in other programs to support aid above the level of need.” It appears that neither side has convinced the other.

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References


