By Steven Pearlstein, Published: March 10

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As a general rule, we don’t prefer monopolies. We know that, over the long run, monopolists tend to raise prices, reduce choice and stifle innovation. But are monopolies so bad that we might want to tolerate a little price-fixing by customers or suppliers in order to break them? Could a little anti-competitive behavior actually be pro-competitive?

That is what five leading book publishers are arguing in explaining why they simultaneously accepted an offer from Apple, just before the release of the iPad, to change the way e-books are priced and distributed. Their actions moved the industry from a “wholesale” model, in which they sold e-books to retailers and let them set the retail price, to an “agency model,” in which the publishers set the retail price and pay the retailers a fixed commission on every sale. In the process, they managed to break up Amazon’s e-book monopoly and raise the price of online books by 30 to 40 percent.

Now you might ask at this point why breaking up a monopoly would raise prices rather than lower them.

The answer has to do with how Amazon went about building its e-book monopoly in the first place — namely, by setting a price that was lower than what Amazon was paying publishers for the book. What looked to consumers like a great bargain at $9.99 a book looked to others in the industry suspiciously like predatory pricing, or selling below cost today in order to gain a monopoly and raise prices in the future.

So which is better: a market in which Amazon uses low prices to maintain its e-book monopoly and drive brick-and-mortar bookstores out of business, or one in which the major book publishers, in tacit collusion with Apple, break Amazon’s monopoly and raise prices?

For the moment, the government has come down on the side of lower prices. Under threat that they will be taken to court for conspiring to fix the price of e-books, the book publishers are trying to work out a settlement with Justice Department’s antitrust division.

The talks largely focus on two provisions of the publishers’ contract with Apple: one that prohibits the publishers from entering into “wholesale” arrangements with Amazon or any other major distributor, and a second that guarantees that no other distributor will be allowed to sell books for less than Apple. It was those provisions, ostensibly imposed by Apple but greatly welcomed by the publishers, which allegedly gave the publishers the incentive and the confidence to challenge their biggest customer, threatening a cut-off of books if Amazon did not accept the new arrangement.

It’s not just the government that is after Apple and the publishers, however. Even if they are able to settle this case, they face a class-action lawsuit, filed on behalf of all e-book customers, that is pending in federal court. At stake are several billion dollars in compensation and punitive damages, along with hundreds of millions of dollars in legal fees.

It is certainly possible, as the plaintiffs’ lawyers allege, that executives of Apple and the publishing companies did conspire and collude with one another in meetings or e-mails or phone calls. The lawyers claim to have a “confidential” and “highly credible” source who has provided them with documentation of such direct communication. Even if there is no “smoking gun” document, however, it is possible that the publishers were able to
tacitly collude through separate conversations with Apple. It is also possible that the publishers did not collude in any illegal fashion, but simply went along with an offer from Apple that allowed them to do what they had long wanted to do: challenge an Amazon monopoly that was undermining its much larger and more profitable business in printed books.

After all, it’s not an illegal price-fixing conspiracy when, for example, American Airlines announces it is charging $25 for checked baggage just hours after United has announced the same thing. So why, argue the publishers, should their near-simultaneous decision to go with Apple be viewed as anything different than “parallel” actions by competitors facing the same market pressures?

One thing that makes it different is that it is happening in a high-tech sector that, by its nature, is prone to winner-take-all competitions. We saw that with IBM in the 1960s, Microsoft in the 1990s and more recently with Google and Facebook. Because of the “network” quality of such industries, customers prefer to do business with the firm that has the most customers. Moreover, once you decide to do business with one company, the cost and hassle involved in shifting to a competitor is sufficiently high that customers tend to be “locked in” to their original choice.

Antitrust regulators have come to believe that, in such industries, restrictive contracts between firms and their customers, or between suppliers and distributors, may not be as benign as free-market economists and judges once believed. Fiona Scott Morton, chief economist at the Justice Department’s antitrust division, recently dubbed them as “contracts that reference rivals” and warned companies that such provisions would now be viewed with heightened suspicion.

These restrictions can take the form of steep discounts for customers who do all or most of their business with a dominant supplier, such as Intel used to do with computer chips.

They can take the form of exclusive contracts prohibiting a buyer from dealing with any other seller, or seller with any other buyer, as when a dominant health insurer requires doctors not to participate in another insurer’s provider network.

They can take the form, as they did with Apple and the publishers, of “most favored buyer” clauses in which a customer is guaranteed that it will get as good, or better, price as any other customer.

And as with Apple and publishers, it can take the form of restricting sellers from using a different pricing or business model with other customers.

Certainly the government’s case and private ones against Apple and the publishers are greatly strengthened by the fact that we no longer buy e-books for $9.99. That’s something any judge or juror can understand and probably explains the instinct to settle.

But the danger of regulators and judges focusing solely on short-term price effects is that it can mean turning a blind eye to business practices that temporarily lower prices even as they drive competitors out of business, lock in customers or limit entry into the market by new firms with better products.

Or to put it another way, it’s great to be able to buy e-books for $9.99, but maybe not if the alternative is accepting an Amazon monopoly that drives Barnes & Noble and your local bookstore out of business.

The only really safe mechanism for setting price is open competition, says Andy Gavil, an antitrust expert at Howard University, and anything that prevents that ought to be viewed with suspicion. Sounds like good advice to me.