Competition Policy

Theory and Practice

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CAMBRIDGE
UNIVERSITY PRESS

PUBLISHED BY THE PRESS SYNDICATE OF THE UNIVERSITY OF CAMBRIDGE
The Pitt Building, Trumpington Street, Cambridge, United Kingdom

CAMBRIDGE UNIVERSITY PRESS
The Edinburgh Building, Cambridge CB2 2RU, UK
40 West 20th Street, New York, NY 10011-4211, USA
477 Williamstown Road, Port Melbourne, VIC 3207, Australia
Ruiz de Alarcón 13, 28014 Madrid, Spain
Dock House, The Waterfront, Cape Town 8001, South Africa

http://www.cambridge.org

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First published 2004

Printed in the United States of America

Typeface Minion 10.25/12.75 pt. *System* LaTeX 2ε [TB]

A catalogue record for this book is available from the British Library.

Library of Congress Cataloging in Publication Data

Motta, Massimo.

Competition policy : theory and practice / Massimo Motta.

p. cm.

Includes bibliographical references and index.

ISBN 0-521-81663-7 – ISBN 0-521-01691-6 (pb.)

1. Competition. 2. Competition, International. 3. Competition – Government policy.
4. Antitrust law. 5. Industrial policy. I. Title.

HD41.M68 2004

338.6′048 – dc21 2003046268

ISBN 0 521 81663 7 hardback
ISBN 0 521 01691 6 paperback

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List of Abbreviations

art.: article
CFI: Court of First Instance
CS: consumer surplus
DOJ: Department of Justice (in the United States)
EC: European Commission (that is, Commission of the European Communities)
ECJ: European Court of Justice
ET: exclusive territories
EU: European Union
FF: franchise fee
FOCs: first-order conditions
FTC: Federal Trade Commission (in the United States)
HHI: Herfindahl–Hirschman Index
JV: joint-venture
LHS: left-hand side
OFT: Office of Fair Trading (in the United Kingdom)
OJ: Official Journal of the European Communities
para.: paragraph
PS: producer surplus
R&D: research and development
RHS: right-hand side
RPM: resale price maintenance
s.to: subject to
W: welfare

1

Competition Policy: History, Objectives, and the Law

1.1 INTRODUCTION

Rather than starting with a long and abstract discussion of what competition policy is, this chapter aims at introducing the reader to competition issues by using a historical approach. Section 1.2 briefly describes the main features that competition policies have exhibited in the past in the US and in Europe. The historical review also shows that in the practice of competition policy a number of public policy considerations and objectives have been (and still are) used. Section 1.3 briefly discusses them, and indicates the possible conflicts between economic and non-economic objectives. Armed with this discussion, at the end of the Section 1 also provide the definition of competition policy that I use in the book. Section 1.4 describes the main features of competition law in the European Union (EU), to provide the reader with further insight of what competition policy is about.

1.2 BRIEF HISTORY OF COMPETITION POLICY

This section briefly reviews the main historical events in the development of competition (or anti-trust) laws in the US and in the European Union. The purpose here is not to have a complete description of the history of competition laws, but rather to help understand the circumstances in which competition laws were created and enforced, as well as the objectives, which they purported to attain.

1.2.1 Anti-Trust Law in the United States

The origins of modern competition policy can be traced back to the end of the 19th century, mainly as a reaction to the formation of trusts in the United States.[1,2]

The Events Leading to the Sherman Act In the second half of that century, the United States experienced a number of events, which resulted in the transformation

[1] "The 'trust' was originally a device by which several corporations engaged in the same general line of business might combine for their mutual advantage, in the direction of eliminating destructive competition, controlling the output of their commodity and regulating and maintaining its price, but at the same time preserving their separate individual existence, and without any consolidation

of manufacturing industries. Perhaps the most important events were the dramatic improvement in transportation and communication. The railways extended rapidly throughout the US territory, as did the telegraph lines and the telephone services. This entailed the formation of a large single market, which in turn gave a powerful incentive to firms to exploit *economies of scale* and *economies of scope.*[3] Along with other technological innovations in several fields (e.g., metallurgy, chemicals, energy), the formation of more advanced capital markets and new managerial methods, this created the possibility for the expansion of the size of the firms.[4] Legal innovations such as the "liberalization of state incorporation laws also contributed [to the creation of larger firms], permitting the acquisition of other firms' stock (e.g., in mergers) and the delegation of stockholders' decision-making power to full time managers" (Scherer, 1980: 492). It is not by chance that the US experienced an impressive merger wave in the 1880s and 1890s.

The last part of the 19th century was characterised by low and unstable prices. This was due in part to macroeconomic factors which gave rise to many recurrent and persistent economic crises (1873–8 and 1883–6) and created instability in several sectors. But most of the price instability was due to the very same factor, which allowed for the creation of larger market opportunities. Indeed, the fall in transportation and communication costs led not only to a large single market for many industries, but also to a rise in competition, since firms now had to compete with more distant rivals, located both in the other American states and abroad (shipping rates fell in this period as well).

Further, the large investments made by firms so as to enjoy scale and scope economies caused lower costs and lower prices. In the words of Chandler (1990: 71), "Increasing output and overcapacity intensified competition and drove down prices. Indeed, the resulting decline of prices in manufactured goods characterised

or merger. This device was the erection of a central committee or board, composed, perhaps, of the presidents or general managers of the different corporations, and the transfer to them of a majority of the stock in each of the corporations, to be held in 'trust' for the several stockholders so assigning their holdings. These stockholders received in return 'trust certificates' showing that they were entitled to receive the dividends on their assigned stock, though the voting power of it had passed to the trustees. This last feature enabled the trustees or committee to elect all the directors of all the corporations, and through them the officers, and thereby to exercise an absolutely controlling influence over the policy and operations of each constituent company, to the end and with the purposes above mentioned". (West Group, 1998.)

[2] To write this section, I have consulted a number of sources that describe US anti-trust laws in a historical perspective. Among others Amato (1997), Comanor (1990), Fox (2002), Kovacic and Shapiro (2000), Lin et al. (2000), Mueller (1996), Posner (2001: ch. 2), Scherer (1980), and Scherer (1994).

[3] There are economies of scale when unit costs of production fall with the total quantity produced; economies of scope when unit costs fall because two or more goods are produced jointly.

[4] See Chandler (1990), in particular ch. 3, for a rich and fascinating account of the changes taking place in the US economy in the second half of the 19th century.

the economies of the United States and the nations of Western Europe from the mid-1870s to the end of the century".

Also, firms had to make large investments to reorganise their production and distribution activities, to buy new machines or to enter new markets (think for instance of the huge investment railways had to make). In the attempt to operate at full capacity so as to cover the large fixed costs, firms were tempted to decrease prices, giving rise to price wars.

Firms often tried to respond to price wars and market instability by way of price agreements which enabled them to maintain high prices and margins.[5] The organisation of cartels and trusts (railroad and oil companies are the best known examples of these) had exactly this purpose. But the advantages of price stability for the members of cartels and trusts did not come without detriment to other groups in the economy. Final consumers were hurt by higher prices, and so were producers, such as farmers and small industrial firms, which used products of cartelised sectors as an input. Both groups suffered from the low sales prices brought about by the aforementioned crises (the latter also by a less efficient scale of production), and found themselves squeezed in between low sale prices and high input prices (above all, railways and energy). Furthermore, small firms complained of unfair business practices adopted by their large rivals, which allegedly wanted to drive them out of business.

Farmers and small businesses had enough political force and public sympathy to lead to the creation of anti-trust laws in many US states.[6] However, such laws could do very little against agreements, which involved more than one state. But soon there was enough consensus for a federal law and in 1890 the *Sherman Act* was adopted. This is probably the best known example of anti-trust law in the world, although it is not the earliest: Canada, for instance, adopted a similar law in 1889, but enforcement of that law was to be much weaker.

The Sherman Act and Its Early Enforcement For our purposes, the relevant sections of the Sherman Act are Sections 1 and 2. Section 1 prohibits contracts, combinations and conspiracies which restrain trade, and prescribes imprisonment and fines for violators. Section 2 prohibits monopolisation, attempts to monopolise and conspiracies to monopolise "any part of the trade or commerce among the several states, or with foreign nations" (but note that having a monopoly position is not by itself illegal). The Act carries its own criminal penalties, which might include

[5] However, price wars might be just one of the phases in the life of a cartel. See Green and Porter (1984) and Porter (1983b). I defer discussion of this issue to Chapter 4.

[6] Note that "small businessmen included not only manufacturers whose small operations gave them a cost disadvantage, but also wholesalers, manufacturers' agents, and other middlemen who were being driven out of business as the volume-producing manufacturers moved forward and the mass retailers moved backwards into wholesaling". (Chandler, 1990: 78–9. See also p. 72.) Consumers' interests are often too fragmented to have an impact on government policies. See also Section 1.3.

imprisonment up to three years (recently jail sentences for anti-trust enforcement have been given more often).[7]

During its first decade of life, enforcement of the Sherman Act was not very strict. It was not until 1897 that a Supreme Court decision on a trust of 18 railways, which fixed the fares for the transport of goods (*Trans-Missouri Freight Association*) clearly established that price agreements were illegal. Indeed, in this decision and in *Addyston Pipe and Steel,* judges refused arguments aimed at justifying price-fixing on the grounds that the rates charged were "reasonable" and that price-fixing was a way to prevent "unhealthy competition". The Supreme Court took the view that, with the Sherman Act, the Congress intended to outlaw all price agreements, and that it was not up to judges to decide which agreements are reasonable and which ones are not.[8] The prohibition of price agreements among competitors is a very strong principle which is still valid, and which has known very few exceptions.[9]

In *Dr. Miles v. Park & Sons* (1911), the Supreme Court applied the Sherman Act's prohibition of price restrictions to vertical relationships as well. The Court established there that a resale price maintenance clause, whereby the manufacturer obliges retailers to sell above a minimum price that it sets, is *per se* illegal.[10] This prohibition has never been reversed since.[11]

This tough stance was then confirmed by the judgments against two of the most important trusts, namely the *Standard Oil Company* (which was split into 34 separate companies in 1911) and *American Tobacco.*

Standard Oil is still one of the most famous cases in the history of anti-trust policy.[12] The trust, a creation of Rockefeller, had engaged in a series of monopolisation practices – such as localised price cuts deemed to be predatory and a number of acquisitions of minor firms – which were judged against Sections 1 and 2 of the Sherman Act. In *American Tobacco,* five tobacco manufacturers had merged into the American Tobacco Company, and engaged in a campaign of purchasing minor

[7] Note that EU competition law does not allow imposing criminal penalties in anti-trust violations, although certain EU countries' laws do (for instance, Austria, France, Germany, Ireland, whereas the UK is in the process of introducing them).

[8] See also Posner (2001: 35–6).

[9] However, exceptions to anti-trust rules in the US have been formally granted to many sectors such as insurance, agriculture, fisheries, professional baseball, labour organisations. There also exists a "state action" doctrine which represents another exception. In particular, horizontal agreements (such as price-fixing), which would otherwise be deemed anti-competitive are allowed insofar as they are promoted by a state regulation. For a discussion see Inman and Rubinfeld (1997).

[10] If a business practice is *per se* illegal, no argument can justify it: it is prohibited without exceptions. Under a *rule of reason* approach, instead, a firm might convince the court that the business practice it adopted does not harm welfare in its particular instance.

[11] Such a *per se* prohibition is not justified on economic grounds: see Chapter 6. Note that only in 1997 did the Supreme Court rule, in *State Oil v. Kahn,* that a firm might impose a *price ceiling* on its dealers.

[12] See Chapter 7 for a brief discussion of the case in the context of the analysis of predatory pricing.

competitors, controlling stock interest in other corporations, and starting price wars to increase its power and drive other manufacturers out of business. The trust was condemned and dismantled.

Another important monopolisation case was *Terminal Railroad* (1912), which prohibited several railways that controlled the terminal facilities of the main bridge in the city of St. Louis to discriminate against competitors, and obliged the former to give access to the latter on reasonable terms.[13]

The Clayton Act and the Federal Trade Commission Act Note that the Sherman Act covers price fixing and market sharing agreements between independent firms, as well as monopolisation practices by individual companies, but not mergers (which were legal unless formed with the intention to monopolise the market using unfair methods of competition). Therefore, firms wishing to coordinate prices had the option of merging into a single firm and, by so doing, they put themselves beyond the reach of the Sherman Act. The *Clayton Act* of 1914 was therefore introduced to extend anti-trust legislation to cover mergers capable of reducing competition; it was probably the Sherman Act itself that led to a sharp increase in the number of mergers in the US.[14]

> After 1897 began the largest and certainly the most significant merger movement in American history. It came partly because of continuing antitrust legislation and activities by the states, partly because of the increasing difficulty of enforcing contractual agreements by trade associations during the depression of the mid-1890s, and partly because the return of prosperity and the buoyant stock market that accompanied it facilitated the exchange of shares and encouraged bankers and other financers to promote mergers. The merger boom reached its climax between 1899 and 1902, after the Supreme Court had indicated by its rulings in the Trans-Missouri Freight Rate Association case (1897), the Joint Traffic Association case (1889), and the Addyston Pipe and Steel case (1899) that cartels carried on through trade associations were vulnerable under the Sherman Act. (Chandler, 1990: 75, footnote omitted.)[15]

The Clayton Act also explicitly forbids other practices, such as price discrimination, which lessens competition and interlocking directorates among competing firms. Very important is also the possibility of recovering *treble damages:* introduced by Section 4 of the Clayton Act for private anti-trust suits, and which has given rise

[13] This case is still mentioned nowadays in discussions related to essential facilites and refusal to supply. See Chapters 6 and 7.

[14] See also Bittlingmayer (1985) for a well documented study.

[15] The extent to which mergers to monopoly were covered by the Sherman Act is unclear. In *US v. Knight* (1895) the Supreme Court did not find against the Sugar Trust, which had gained control of 98% of the US sugar refining capacity through a series of mergers. However, in *Northern Securities v. US* (1904), it blocked the combination of the Northern Pacific and Great Northern railroads, that would have monopolised the industry.

to important transfers of money from offenders to victims of unlawful commercial conduct (the latter can ask a compensation equal to three times the damage they have received, plus attorney's fees).

The *Federal Trade Commission Act* also dates from 1914. It created the FTC, an independent agency that should regulate unfair trade practices, and that shares with the Department of Justice (DOJ), a government agency, the responsibility to enforce anti-trust law in the US at the federal level (at the state level, attorneys general can act on behalf of those injured by anti-trust violations).[16]

The Clayton Act has subsequently been amended. The *Robinson-Patman Act* of 1936 amended its provisions on price discrimination.[17] Later, the Celler-Kefauver Act of 1950 amended the Clayton Act provisions relating to mergers, by extending the cross-ownership prohibition among competitors to asset transactions (before, only stock transactions were covered). Another important piece of legislation is the *Hart-Scott-Rodino Act* of 1976 that amends the merger provisions of the Clayton Act by giving the DOJ and the FTC the power to review all mergers of firms above a certain size threshold.

The Inter-War Period The period between the two World Wars is marked by a less strong enforcement of anti-trust laws. During World War I, it is the coalition between business and politics that governs the economy, rather than market forces, and this model continues to have its advocates even when the war ends. The Great Depression of 1929 reinforced such views and resulted in some price controls and other regulatory initiatives. The Robinson-Patman Act, which aims at avoiding price discrimination that may put small stores out of business to the benefit of large chain-stores, is a product of such an environment.

In the same line is the arguably most noticeable decision of this period, *Appalachian Coals v. US* (1933). This marks one of the very rare exceptions to the *per se* prohibition of price-fixing.[18] This Supreme Court decision can be understood considering only the historical perspective. The Great Depression was having important consequences on many industries, and one such industry which suffered

[16] The division of labour between the two agencies is not determined in a precise way. In merger cases, it is typically along sectoral lines that can change over time. However, only the DOJ has enforcement power in criminal cases.

[17] In recent years, provisions against price discriminations have rarely been used.

[18] The *Board of Trade of Chicago* case (1918) might appear an exception to the *per se* prohibition of price-fixing, but it is probably not. The object of the decision was a rule that fixed the price for all the transactions taking place after the normal operating hours at the level set at closing time. The Court decided that the *per se* rule did not apply here because the Chicago Board did not have control over the prices of the transaction and because to judge a restraint one should consider the specificity of the industry, the nature and the effects of the restraint. This seemed to introduce a rule of reason for price-fixing cases, but in *US v. Trenton Potteries* (1927) the Court made it clear that naked agreements to set price among competitors should be under a *per se* prohibition, with a rule of reason assessment being reserved only in exceptional circumstances.

the hardship of the crisis was the coal mining industry. Facing a severe reduction in demand, and intending to avoid further losses, 137 producers located in the Appalachian Mountain region formed a company which was to find the best prices and to allocate outputs among members. The Court found that this agreement was not unlawful since it was to be considered as a reasonable response to protect the market from destructive practices.[19]

This is probably one of the best examples of how competition laws and their enforcement are to be understood in the political, economic, and historic context in which they are made. In *Socony-Vacuum Oil* (1940), when the economic conditions were already very different, the Supreme Court (which in the meantime had changed some of its judges) was to re-establish the principle of the *per se* prohibition of price agreements by declaring unlawful a practice also dating from the time of the Great Depression to counter the price decreases caused by the dumping of gasoline into the market by refiners panic-stricken by the crisis.[20]

Until the Mid-70s: The Activism in Anti-Trust Case Law After *Socony-Vacuum Oil* and until the mid-70s, there is a period of intense anti-trust activity, characterised probably more by the desire to restrain large firms than by the objective of increasing economic efficiency, an attitude which was consistent with the dominant economic thinking of the period.[21]

International Salt (1947) establishes a *per se* rule prohibiting tie-in sales – situations where a producer sells a given product (or service) only if the customer also purchases another product (or service). In *Schwinn* (1967) the Court rules against exclusive territorial clauses – clauses that assign a particular distributor to a territory in which other distributors cannot sell the same manufacturer's product.[22]

In *Alcoa* (1945), the Circuit Court of Appeals overruled a lower court judge and found Alcoa guilty of monopolisation in the aluminium ingot market although

[19] The anti-competitive effect was also considered to be less strong since there existed many other producers in the industry not taking part in the agreement.

[20] In *Interstate Circuit* (1939), and *American Tobacco* (1946) the Supreme Court took the view that a conspiracy could be found even in the absence of hard evidence: There was no evidence of an explicit agreement or of direct communication among the firms, they simply followed a similar behaviour which had the effect of increasing prices. However, in *Theatre Enterprises v. Paramount* (1954) the Court ruled that conscious parallelism without any additional factor would not be a proof of an unlawful agreement. Chapter 4 discusses at length the issue of the standards of proof in collusion cases. I argue there that hard evidence of communication among firms should be necessary for convicting firms.

[21] See Mueller (1996) and Kovacic and Shapiro (2000) for the relationship between economic doctrines and US anti-trust law over time.

[22] As we shall see in Chapter 6 exclusive territorial protection is generally an efficient practice that encourages retailers to provide services: including it among vertical restraints that were *per se* prohibited is telling of an approach that looked suspiciously at restraints and disregarded efficiency reasons. As for tying (see Chapter 7), it is a practice that might in some circumstances be anti-competitive but often has good efficiency justifications.

there was no intent of monopolisation. The mere fact that Alcoa had monopoly power (as determined by its holding of a 90% share of the market) and that it took actions to increase its business (such as building new capacity) was enough to prove monopolisation (and the intent of it).[23]

Merger decisions of that period also appear to show a similar trend. In *Brown Shoe* (1962), the Supreme Court ruled against a merger that would have given the merging firms a market share of 5%. In *Philadelphia National Bank* (1963), a key issue in the assessment of the merger between two Philadelphia banks was whether the market was to be defined as the Philadelphia metropolitan area or as the New York–Philadelphia region. The Court opted for the narrower market definition and disallowed the merger because it would have created too concentrated a market, and it dismissed the banks' claim that the merger would have allowed them to compete with larger banks by claiming that anti-competitive effects in one market could not be justified by pro-competitive effects in another. In *Procter & Gamble* (1967), the Court ruled in favour of the FTC although the proposed merger was a conglomerate one (but it attached great importance to the fact that P&G might have entered the market), and despite the claim of efficiency gains.

From Sylvania Onwards: Chicago School and the Reagan Years Several authors related to the University of Chicago heavily criticised the interventionism of the anti-trust authorities and courts, and stressed instead the efficiency rationale behind vertical restraints and mergers.[24] These views started to have an impact on judges and commentators during the 70s.

The joint effect of the Chicago School critique and of the loss of competitiveness of US firms abroad, that directed attention to the efficiency effects of business practices, causes a change in the enforcement attitudes of anti-trust law in the US. The turning-point is certainly *GTE-Sylvania* (1977), in which the Supreme Court decided that non-price vertical restraints should be subject to a rule of reason.

The new trend became a major change during the years of the Reagan administration (1981–8), which brought a "hands-off" approach, in the conviction that market forces should be left free to select the more efficient firms.[25]

The focus on efficiency also meant that it was more difficult to win a case against a firm, especially in cases involving vertical restraints and monopolisation.[26] As

[23] Other monopolisation decisions which have been criticised for not taking into account possible efficiency arguments are *United Shoe* (1953) and *Utah Pie* (1967).

[24] For a view of the so-called Chicago School arguments, see for instance Bork (1978) and Posner (1976).

[25] As a result, important anti-trust investigations carried out by the previous administration, such as the one on IBM, were abandoned. This policy shift was also supported by new theoretical developments such as the "contestable markets theory" (see Chapter 2 for a discussion).

[26] See for instance *Jefferson Parish Hospital* (1984), where the Supreme Court decided that there was no evidence that a tying arrangement (patients of the hospital could get anesthesiologist services only provided by a medical corporation on an exclusive basis) had unreasonably restrained trade.

a consequence, the number of private anti-trust cases filed in US District Courts declined steadily in the 1980s. At the 1977 peak there were 1611 such cases, whereas in 1989 there were only 638.[27]

Recent Events It is more difficult to identify trends when looking at the very recent past. Apart from some very visible events determined by a change in the government,[28] agencies and courts lie somewhere between the interventionism of the 60s and the laisse-faire of the 80s. An important fact is the renewed strength in the fight against cartels, signalled by some prison sentences given in some high-profile international cartel cases, and helped by the introduction of a successful *leniency policy* that grants amnesty to managers that provide proof of the existence of cartels (see Chapter 4 for a detailed discussion).

1.2.2 Competition Laws in the European Union

This section briefly reviews the main historical development of competition laws in the European Union, where there are two different levels of jurisdiction: national and supra-national. The latter is more interesting, as most European countries have not had proper competition laws until very recently, and such national laws are to a large extent reproducing the same features as the laws introduced by the Treaty of Rome and its successive modifications. Therefore, I will devote attention mainly to EU competition policies. However, I find the history of German and British competition laws interesting under several respects, and for this reason I have a cursory look at them.

1.2.2.1 Competition Law in Germany

We have seen that the economic changes in the second half of the 19th century in the US created incentives for the formation of cartels and trusts which were soon to be outlawed by the Sherman Act. In Germany, however, the prevailing view was that cartels were an instrument to control the instability created by cut-throat competition and price warfare.[29] This idea, coupled with the feature that the

[27] See Viscusi et al. (1995) and Comanor (1990: 47–8).

[28] The most important and publicised case in recent years was the investigation on the alleged monopolisation of *Microsoft,* started under the Democratic Clinton administration. Under President George W. Bush, the Department of Justice changed attitude completely and looked for a settlement, which was finally approved by a judge in November 2002.

[29] Many of the comments referring here to current German competition law might also apply to other Central European countries such as Austria, Czech Republic, Switzerland, Hungary and Holland. In all of these countries, competition law was inspired by the principle of economic freedom. This might also explain the favourable treatment to cartels accorded in the past by most of the countries mentioned.