

# Chapter 1: Competition Policy: History, Objectives and the Law

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## **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 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 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 I also provide the definition of competition policy that I will use in the book. Section 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.

## **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.

### **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.<sup>1,2</sup>

**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 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*.<sup>3</sup> 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.<sup>4</sup> 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 (1873-78 and 1883-86) and created instability in several sectors. But most of the price instability was of course 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

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<sup>1</sup> According to West’s Law & Commerce Dictionary (1985), “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 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.”

<sup>2</sup> 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), Scherer (1994).

<sup>3</sup> 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.

<sup>4</sup> See Chandler (1990), in particular chapter 3, for a rich and fascinating account of the changes taking place in the US economy in the second half of the 19th Century.

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 characterized 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.<sup>5</sup> 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 in 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.<sup>6</sup> 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, at-

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<sup>5</sup> However, price wars might be just one of the phases in the life of a cartel. See Green and Porter (1983) and Porter (1983). I defer discussion of this issue to chapter 4.

<sup>6</sup> Note that “[s]mall 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: 78-79. See also p.72.) Consumers’ interests are often too fragmented to have an impact on government policies. See also section 3.

tempts 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 imprisonment up to three years (recently jail sentences for anti-trust have been given more often).<sup>7</sup>

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 as 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.<sup>8</sup> The prohibition of price agreements among competitors is a very strong principle which is still valid, and which has known very few exceptions.<sup>9</sup>

In *Dr. Miles v. Park & Sons* (1911), the Supreme Court applies 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.<sup>10</sup> This prohibition has never been reversed since.<sup>11</sup>

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.<sup>12</sup> 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

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<sup>7</sup>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).

<sup>8</sup>See also Posner (2001: 35-36).

<sup>9</sup>However, exceptions to anti-trust rules in the US have been formally granted to many sectors such as insurance, agriculture, fisheries, professional baseball, labour organizations. There also exist 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).

<sup>10</sup>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.

<sup>11</sup>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.

<sup>12</sup>See chapter 7 for a brief discussion of the case in the context of the analysis of predatory pricing.

purchasing minor 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.<sup>13</sup>

**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, and it was probably the Sherman Act itself that led to a sharp increase in the number of mergers in the US.<sup>14</sup>

“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 financiers 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 (1899), 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)<sup>15</sup>

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 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).

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<sup>13</sup> This case is still mentioned nowadays in discussions related to essential facilities and refusal to supply. See chapters 6 and 7.

<sup>14</sup> See also Bittlingmayer (1985) for a well documented study.

<sup>15</sup> 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.

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).<sup>16</sup>

The Clayton Act has subsequently been amended. The *Robinson-Patman Act* of 1936 amended its provisions on price discrimination.<sup>17</sup> Later, the Celler-Kefauver Act of 1950 amended instead 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 that price discrimination 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 it 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.<sup>18</sup> This Supreme Court decision can be understood only considering the historical perspective. The Great Depression was having important consequences on many industries, and one such industry which suffered the hardship of the crisis was the coal mining industry. Facing a severe reduction in demand, and intent on avoiding 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

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<sup>16</sup>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.

<sup>17</sup>In recent years, provisions against price discriminations have rarely been used, though.

<sup>18</sup>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. 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.

response to protect the market from destructive practices.<sup>19</sup>

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.<sup>20</sup>

**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 though which was consistent with the dominant economic thinking of the period.<sup>21</sup>

*International Salt* (1947) establishes a *per se* rule prohibiting tie-in sales, that is 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, that is clauses that assign a particular distributor a territory in which other distributors cannot sell the same manufacturer's product.<sup>22</sup>

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 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).<sup>23</sup>

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

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<sup>19</sup> 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.

<sup>20</sup> 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 will discuss at length the issue of the standards of proof in collusion cases. I will argue there that hard evidence of communication among firms should be necessary for convicting firms.

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

<sup>22</sup> 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.

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

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.<sup>24</sup> 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 (1981-88), which brought a "hands-off" approach, in the conviction that market forces should be left free to select the more efficient firms.<sup>25</sup>

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.<sup>26</sup> As 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.<sup>27</sup>

**Recent events** It is more difficult to identify trends when looking at the very recent past. Probably, apart from some very visible events determined by

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

<sup>25</sup>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 the chapter 2 for a discussion).

<sup>26</sup>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 only get anesthesiologist services provided by a medical corporation on an exclusive basis) had unreasonably restrained trade.

<sup>27</sup>See Viscusi et al. (1995) and Comanor (1990: 47-48).

a change in the government,<sup>28</sup> agencies and courts lie somewhere between the interventionism of the 60s and the *laisser-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).

## 2.2 Competition laws in the European Union

In this section I will briefly review 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 will have a cursory look at them.

### 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.<sup>29</sup> This idea, coupled with the feature that the freedom of contracting was one of the governing principles of competition laws, implied that in Germany not only price agreements were permitted, but also that they were enforceable in courts. Anti-cartel action was taken only in certain extreme cases, for instance where the cartel could lead to a complete monopoly or to extreme exploitation of consumers (Scherer, 1994: 24). As a result, cartels proliferated in the years around the turn of the century. By 1905 there were 385 cartels involving 12000 firms, and the number increased steadily. By 1923 there were 1500 cartels in Germany (Kühn, 1997: 116.).

It is only in 1923 that a Cartel Law was introduced, mainly as a reaction to hyper-inflation, as it was feared that price agreements might contribute to the escalation of prices. But even then, the law did not prohibit cartels; it merely required registration with a new agency in charge of ensuring that cartels would

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<sup>28</sup>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 Bush Jr., the Department of Justice changed completely attitude and looked for a settlement, which was finally approved by a Judge in November 2002.

<sup>29</sup>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.

not abuse their market power. Apparently, not many abuses were pursued and the new law did not have much impact on cartels, whose number continued to rise. New economic conditions soon obviated the desire to limit the power of cartels, and prompted a move in the opposite direction. Indeed, in 1930, under the effect of the Great Depression and the bankruptcy of many firms, participation in cartels was made compulsory for firms operating in vulnerable sectors. Compulsory participation in cartels was made even more extensive under the Nazi regime, with the aim of controlling the national industry and strengthening the sectors involved in the war apparatus, on the grounds that it would be stronger if firms were tightly coordinated.

The idea that allowing firms to cooperate closely or to merge their operations would make them stronger and create some sort of “national champion” which would outperform foreign rivals is a widespread one. After World War II, the Allies wanted to impose anti-trust laws upon both Germany and Japan, not only to promote economic progress but also to break up excessive concentration of economic power, which represented a possible future threat. Accordingly, cartels, syndicates and trusts were forbidden by occupation authorities.<sup>30</sup> But the de-concentration programme of the Allies was soon put to an end, since the US and British governments now perceived the threat of the Soviet Union and decided that Germany represented a useful force which could help to counter-balance the strength of the Soviet Union. A similar development also occurred in Japan (see Scherer, 1994: 28-32).

Germany passed a strict competition law in 1957, after a long debate.<sup>31</sup> The Federal Cartel Office (Bundeskartellamt) is the main institution called to enforce the rules against price-fixing agreements and other anti-competitive practices. Germany has had a procedure for merger control since 1973, and this procedure has been enforced relatively strictly, leading not only to a considerable number of merger prohibitions but also to frequent modifications of merger proposals and the abandonment of many others. It has been noted, however, that one of the main principles behind competition policy in Germany still is the protection of economic freedom.<sup>32</sup> So, mergers are scrutinised because they could lead to the formation of dominant agents which could then limit the economic freedom of competitors. Provisions against the abuse of a dominant position should be seen in the same perspective.<sup>33</sup>

The strict opposition to practices such as resale price maintenance, which is *per se* illegal in Germany since 1973,<sup>34</sup> is also consistent with this philosophy,

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<sup>30</sup> The breaking-up of the German chemical firm IG Farben into BASF, Bayer and Hoechst dates from this period.

<sup>31</sup> See Amato (1997: ch. 3) for a discussion of the *ordo-liberal* school and its influence on the German competition law.

<sup>32</sup> See Kühn (1997), also for a discussion of Court decisions which privilege the contractual freedom of agents to the detriment of economic efficiency.

<sup>33</sup> German competition law tends to protect smaller competitors. For instance, the practice of large supermarket chains of selling some products below cost is forbidden because it would damage smaller stores. See the recent decision (11 November 2002) by the German Supreme Court on the Wal-Mart case.

<sup>34</sup> The only sector which is exempted from this prohibition of resale price maintenance is

to the extent that the imposition of resale prices by a manufacturer is seen as restraining the liberty of the retailers to set their own price.<sup>35</sup>

## 2.2.2 Competition law in the United Kingdom

One of the first pieces of legislation introduced in the UK to deal with competition matters was the Profiteering Act 1919, whose main concern was to avoid excessive prices after World War I. Towards the end of World War II, the introduction of new competition rules was discussed, with a different motivation. Indeed, unemployment was a major issue then, and the Monopolies and Restrictive Practices (Inquiry and Control) Act 1948 appears to be motivated by the idea that competition in the marketplace would help attain full employment. Since then, a number of changes have been introduced in the UK, until the Competition Act 1998 brought the UK competition law almost in line with the EU's.

The UK system until the recent major changes was principally based upon the Restrictive Trade Practices Act 1956 (RTPA), which was extended among others by the Resale Prices Act 1964 and by the Monopolies and Mergers Act 1965, and amended by a number of other laws. Rather than adopting a system of prohibitions, under the RTPA agreements had to be registered and they could be challenged in court if found against the public interest. It is debated whether the Act had a real impact on firms' pricing behaviour or not.<sup>36</sup>

Several features of the UK competition legislation prior to the 1998 reform are worth mentioning. First of all, its objectives were never clearly specified. Under the wording "public interest" many different considerations can be made. The central role played by the Secretary of State of Industry - who had discretion on whether to accept or reject both the Office of Fair trading recommendations for referrals of merger cases to the Monopolies and Mergers Commission, and discretion on whether to accept the latter body's recommendations, witnesses the role that political considerations may have on competition cases.

Second, the UK legislation lacked a system of penalties and tools of enforcement. Until the 1998 Reform, unlike their European counterparts, the UK competition authorities were not entitled to search firms' headquarters and seize documents.<sup>37</sup> This is clearly a serious limitation when it comes to fighting collusive or predatory practices. Further, competition authorities could not impose fines on firms which had been found engaging in practices against the public interest. Penalties could be given only to recidivists: only if a firm had been

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the publishing sector.

<sup>35</sup> According to Kamecke (1998: 147), however, resale price maintenance was prohibited because it was damaging small shop owners. Large chain stores had enough bargaining power to be able to disregard manufacturers' price choices without being challenged, whereas small shops had not. As a result, retail price maintenance had - somewhat paradoxically - the effect of harming small shops.

<sup>36</sup> See Utton (2000, pp. 272-275) and Symeonidis (1998).

<sup>37</sup> The Director General of the OFT could only ask a company for information if there was suspicion of a restrictive agreement, as well as apply to the courts to have cross-examinations on oath. See Whish (2001).

found guilty by a court of breaching an order of the Secretary of State and was later caught breaching this court order, could penalties be given, for “contempt of court” (a serious offence). It does not surprise then, that people have been wondering about the effectiveness of the UK competition system in deterring anti-competitive agreements.<sup>38</sup>

The authority of having search power, to impose fines up to 10% of the firms’ UK turnover, and the possibility of seeking recovery of damages by third parties through private actions, along with provisions which are clearly derived from the Treaty of the European Community, align the new UK competition policy as designed by the 1998 Act with the EU’s.

One of the main differences still existing is that the UK system keeps the possibility to investigate a “monopoly” (defined as a firm having more than 25% market share) or a “complex monopoly” (a group of firms which hold together more than 25% market share) and to make recommendations such as seeking changes in the firms’ business practices, imposing price controls and even divestment. This introduces the possibility of a structural interventions which is more typical of regulatory regimes than competition policy.

### 2.2.3 Competition law in the European Communities

The starting point of supra-national competition law in Europe was the series of pro-competitive measures adopted by France, Germany, Italy and the Benelux countries in the 1951 Treaty of Paris, which created the European Coal and Steel Community (ECSC). This Treaty prohibits trade barriers as well as discriminatory and other restrictive practices capable of distorting competition among the six countries which were later to become the founding members of the European Economic Community.

There are probably two main reasons behind the introduction of competition policy measures in the Treaty of Paris. The first one is again related to the desire of diminishing the danger of German power by making available to the other European countries such (at the time) essential inputs as coal and steel. The prohibition of discriminatory practices might also be seen as a way to guarantee equal access to these basic resources. The second reason is that the principle of free competition was beginning to be appreciated as the only viable way to attain an efficient functioning of the market, also in view of the success of the US economy which had continuously relied upon anti-trust rules (Goyder, 1992: 19). Free competition was thus preferred to a centralised organisation of markets, even though the High Authority (the body in charge) was authorised

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<sup>38</sup>Other critiques have been made about the quality and variability of the decisions taken. For instance, both Utton (2000) and Symeonidis (1998) mention contradictory judgments (which, incidentally, have also the effect of not giving firms legal certainty about the actions they should take) as well as (early) decisions which are today hard to understand. I found particularly curious two arguments made by the court in two separate cases. The first that a cartel might benefit consumers because it would save them time wasted in shopping around; the second that a cartel reduces uncertainty and therefore the return on capital required by firms in the industry, ultimately lowering prices. See Symeonidis (1998:58 and footnote 3) and Utton (2000: 279).

to intervene in case serious market imbalances arose.

Some of the key points of current competition law in Europe can be traced back, at least in their basic elements, to the articles dealing with competition issues in the Treaty of Paris. Article 65 of that Treaty prohibits agreements and concerted practices between firms or associations of firms which tend directly or indirectly to prevent, restrict or distort normal competition within the Common Market, and this provision is clearly the model upon which Article 81 of the Treaty of Rome is based.<sup>39</sup> Article 66(7) deals with the abuse of a dominant position by firms which use such a position to pursue objectives which are contrary to the Treaty, and is therefore the close correspondent of Article 82 of the Treaty of Rome.<sup>40</sup>

Article 66 also deals with mergers and concentrations between firms in the coal and steel industry. Consent to such mergers could be given only by the High Authority, which granted approval only where the concentration did not give to the new entity the power to control prices, restrict production and distribution, distort trade among Member States, or create an artificially privileged position in the markets. Attention to prospective mergers in these sectors can be understood by the fear of concentration of economic power in the hands of a few firms, a fear which had already justified the process of de-cartelisation in Germany. It is noteworthy, though, that the treatment of mergers is not mentioned in the Treaty of Rome. Mergers were not made the explicit object of European competition policy until the adoption of the Merger Regulation in 1989, after a debate which lasted for years, witnessing basic differences in the approach to competition and industrial policy among the different countries. In particular, Germany and the UK wanted mergers to be judged only on the basis of competition issues, whereas France wanted also to consider criteria of industrial policy and social issues. Eventually, the former approach prevailed.<sup>41</sup>

The Treaty of the European Communities deals with competition issues in articles 81 to 89.<sup>42</sup> However, the logic of free competition is enunciated by article 3(1)(g), which calls for the institution of “a system ensuring that competition in the internal market is not distorted”. Furthermore, one of the major reasons behind the adoption of competition rules under the Treaty of Paris was to avoid discrimination on national grounds. Article 12 confirms that this is also one of the basic principles in the Treaty of the European Communities (the “Treaty”), and it has applications well beyond the rules on competition alone (Goyder, 1993: 26). Therefore one of the main objectives in European competition policy is the elimination in the economic system of any discrimination based on national

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<sup>39</sup> Previously Article 85. The Treaty of Amsterdam, which entered into force on 1 May 1999, has renumbered the articles of the Treaty of Rome.

<sup>40</sup> Previously Article 86.

<sup>41</sup> See Goyder (1998: ch. 18(1)). However, this does not imply that other public policy considerations will never play any role in the EU merger policy. Article 13 of the Merger Regulation states that the EC must assess mergers “[...]within the general framework of the achievement of the fundamental objectives referred to in Article 2 of the Treaty, including that of strengthening the Community’s economic and social cohesion.”

<sup>42</sup> In the Treaty of Rome the relevant articles were numbered 85 to 94.

grounds.<sup>43</sup> This explains in particular the strong position taken by the European Commission - and upheld on several occasions by the European Court of Justice - with respect to price discrimination across countries. Indeed, the Commission has without exception condemned firms which have tried to segment markets across national borders, and practices such as forbidding parallel imports have basically a status of *per se* prohibition within the EU.<sup>44</sup>

It is difficult to see exactly what the objectives of competition policy were for those who drafted the Treaty of Rome. It is probably safe to say that competition was not an end in itself, but was intended as a way to promote economic progress and the welfare of European citizens, the latter being one of the objectives of the EC as stated by Art.2.<sup>45</sup>

Today, the main objectives of competition policy as enforced by the EC are most probably economic efficiency and European market integration:

“The first objective of competition policy is the maintenance of competitive markets. Competition policy serves as an instrument to encourage industrial efficiency, the optimal allocation of resources, technical progress and the flexibility to adjust to a changing environment. In order for the Community to be competitive on worldwide markets, it needs a competitive home market. Thus, the Community’s competition policy has always taken a very strong line against price-fixing, market sharing cartels, abuses of dominant positions, and anti-competitive mergers. It has also prohibited unjustified state-granted monopoly rights and state aid measures which do not ensure the long-term viability of firms but distort competition by keeping them artificially in business. The second is the single market objective. An internal market is an essential condition for the development of an efficient and competitive industry. [...] The Commission has used its competition policy as an active tool to prevent [erecting private barriers to trade], prohibiting, and fining heavily the parties to, two main types of agreement: distribution and licensing agreements that prevent parallel trade between Member States, and agreements between competitors to keep out of one another’s ‘territories’.” (European Commission, 2000: 6)

Social reasons are also taken into account in European competition policy. Indeed, the Commission has granted exemptions from competition rules for so-called *crisis cartels* - namely, agreements where firms engage in reciprocal reductions in capacity and output - provided such reductions in over-capacity are permanent, favour specialisation and are implemented in such a way that

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<sup>43</sup> This is also clearly stated in recent EC publications, such as European Commission (1996: para 2).

<sup>44</sup> Firms would not be able to charge different prices in different European countries if consumers and retailers made parallel imports, that is, if they engaged in arbitraging by buying cheap in one country and selling at a higher price in another. See chapter 7 for a discussion.

<sup>45</sup> That competition policy is a way to achieve the optimal allocation of resources, promote technical progress and adapt to a changing environment is stated clearly in European Commission (1995: para. 1). The Commission also emphasises that competition helps European firms by pushing them to be more competitive and efficient. More generally, it is Art. 3 of the Treaty which refers to competition as a way to achieve the objectives stated in Art. 2.

they minimise the social costs of the unemployment which results from the cutback of production (Goyder, 1993: 162-165). Here it is clear that social and political considerations influence the way in which competition policy is implemented: competition can be sacrificed when the social costs of it might be too high, since many firms might exit an industry under conditions of over-capacity, which would result in considerable job losses. Even if in the long-run a restructuring of the industry would be beneficial, in the short-run there might exist considerable costs that a government might want to avoid for political and social reasons.

A decision which shows that the EC considers arguments other than economic efficiency when deciding on horizontal agreements is *Ford/Volkswagen*, where it exempted a joint-venture for the development and production of a multi-purpose vehicle (that is, a mini-van) between the two major automobile manufacturers. On pure competition grounds, it is very doubtful that this joint-venture should have been cleared (it is likely that the two firms had enough skills and resources to develop and produce independently this type of vehicle). However, the Commission noted that:

“the project constitutes the largest ever single foreign investment in Portugal. It is estimated to lead, inter alia, to the creation of about 5 000 jobs and indirectly create up to another 10 000 jobs, as well as attracting other investment in the supply industry. It therefore contributes to the promotion of the harmonious development of the Community and the reduction of regional disparities which is one of the basic aims of the Treaty. It also furthers European market integration by linking Portugal more closely to the Community through one of its important industries.” (*Ford/Volkswagen*: para. 36)

The possible consideration of reasons other than efficiency was re-affirmed in *Nestlé-Perrier* case, in which the Court of First Instance ruled that, although the Merger Regulation is concerned primarily with questions of competition, this does not preclude the European Commission from taking into account the social effects of a concentration if they affect the level or conditions of employment (European Commission, 1996: 60).

Another element which affects competition policy in Europe is the importance accorded by the Commission to small and medium-sized enterprises (SMEs).<sup>46</sup> These firms often receive favourable treatment. For instance, the EC looks favourably upon State Aid given to SMEs in the form of subsidised loans, R&D support, financial guarantees and other assistance.<sup>47</sup> Further, the European Court of Justice has taken the view that article 81(1) - that deals with agreements among firms, see section 4 below - is not applicable where the impact of an agreement between firms on intra-community trade or on competition is not appreciable (the so-called *de minimis* doctrine). The European Commission has

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<sup>46</sup>The EC defines a SME as an enterprise which has a turnover up to 40 million euro, a balance sheet of 27 million euro, and a maximum number of employees of 250. See Commission recommendation of 3 April 1996 published in OJ L 107, 30.4.1996, p.4.

<sup>47</sup>See OJ L 107, 30.4.1996: 4. See also European Commission (1996: para. 201).

since set two quantitative criteria specifying when such agreements are deemed of minor importance: (1) a market share criterion; (2) a firm's size criterion.<sup>48</sup>

(1) Two different *aggregate* market share thresholds have been set by the EC. A 10% threshold for an agreement between competitors; a 15% threshold for an agreement between firms which are not actual or potential competitors in any of the relevant markets affected by the agreement. However, a "black list" exists: if horizontal agreements involve price-fixing, restraints on outputs, market-sharing, or sharing of sources of supply; and if vertical agreements involve resale price maintenance or territorial protection, then article 81(1) can still be applied.

(2) Even if the above market share thresholds are exceeded, the Commission will not apply article 81(1) to agreements among SMEs, since they are rarely capable of affecting trade and competition within the Common Market, and would not in any case be of sufficient Community interest to justify its intervention. Only exceptions are agreements which might significantly impede competition in a substantial part of the relevant market, or which restrict competition by the cumulative effect of parallel networks of similar agreements between several producers or dealers.

The favourable treatment accorded to small and medium firms finds its rationale in the *de minimis* rule, namely that little harm can be done by firms which are of limited size. Accordingly, it is not efficient for the EC to use resources on agreements which are likely to have little impact on competition and welfare.<sup>49</sup> This has also inspired the recent reform on vertical restraints that allows the EC to focus more on cases that deserve scrutiny (see section 4.1 below).

The European Commission has also looked with favourable eyes at SMEs since the big fall in employment caused in the 70s by the crisis of large firms operating in heavy industries: "the Commission continues to acknowledge the important contribution of SMEs in terms of job creation, innovation and economic development on the one hand and the difficulties SMEs have in raising capital and their insufficient access to information on the other hand."<sup>50</sup>

As the previous quote indicates, a further reason for a more favourable treatment might balance disadvantages that SMEs have in the markets because of their smaller dimensions.

### 3 Objectives of competition policy, and other public policies

The previous short historical review of competition policy illustrates that anti-trust and competition laws are often influenced by social and historical reasons,

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<sup>48</sup> See *De Minimis Notice*.

<sup>49</sup> See also Neven, Papandropoulos and Seabright (1998).

<sup>50</sup> EC Competition Policy Newsletter, 2(1), Spring 1996: 34. Similarly, on state aid policy, the EC states: "In general the Commission takes a favourable view of aid to small and medium-sized enterprises, given their structural handicaps as compared with large undertakings and their potential for innovation, job creation and growth." (European Commission, 2000: §245)

and might respond to quite different objectives. In what follows, I first briefly discuss a number of objectives which have been indicated in different circumstances and in different jurisdictions, as the ones competition policy should pursue. I then deal with some public policy considerations which have at different times influenced the enforcement of competition policy.

### 3.1 Objectives of competition policy

A number of objectives have inspired competition policies. After introducing the concept of economic welfare, I briefly mention some other objectives, and comment upon the possible contradictions between them and the welfare objective.

#### 3.1.1 Welfare (total surplus)

Economic *welfare* is the standard concept used in economics to measure how well an industry performs. It is a measure which aggregates the welfare (or surplus) of different groups in the economy (see chapter 2 for a more detailed discussion). In each given industry, welfare is given by *total surplus*, that is the sum of consumer surplus and producer surplus.<sup>51</sup> The surplus of a given individual consumer is given by the difference between the consumer's valuation for the good considered (or her willingness to pay for it) and the price which effectively she has to pay for it. *Consumer surplus* (or consumer welfare) is the aggregate measure of the surplus of all consumers. The surplus of an individual producer is the profit it makes by selling the good in question. *Producer surplus* is therefore the sum of all profits made by producers in the industry.

From these definitions it follows that, other things being equal, an increase of the price at which goods are sold reduces consumer surplus and increases producer surplus. It turns out, however, that in general as the price increases, the increase in profits made by the firms does not compensate for the reduction in the consumer surplus (see chapter 2 for a graphical representation). Hence, welfare is the lowest when the market price equals the monopoly price (the highest price firms might want to charge), and the highest when it equals marginal costs of production.

It is important to notice that this concept of welfare completely overlooks the issue of income distribution among consumers and producers. This is not because economists think it is an irrelevant issue, but rather because it is a different issue. The welfare measure is a summarising measure of how efficient a given industry is as a whole and does not address the question of how equal or unequal income is distributed, which can be dealt with by other measures. Note also that the rationale for not considering distributional issues is that in principle it is possible to operate redistribution schemes such that consumers

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<sup>51</sup> More complete measures of welfare might also take into account externalities, taxes paid, subsidies received, government revenues and so on. Some of these items might cancel out. It is also possible to construct measures of welfare which assign different weights to consumer and producer surplus.

and producers are *both* either better off or worse off.<sup>52</sup> Imagine for instance a situation where, as a result of a change in the economy, welfare increases as the net effect of an increase in consumer surplus and a decrease in producer surplus. In theory, it is possible to redistribute gains from consumers to producers in such a way that both groups are at least as well off as they were before the changes took place.<sup>53</sup>

Finally, the concept of welfare should not only be interpreted in a static sense but also in its dynamic component. In other words, future welfare matters as well as current welfare. The two things do not necessarily coincide, as we shall discuss in chapter 2. Imagine the hypothetical case where firms in the industry have already paid their fixed costs and that a competition authority were systematically able to impose price equal to marginal cost. This being the lowest possible price, it would maximise welfare in a static sense. However, one would not have the firms in the industry make any investment in such a situation, as they would anticipate that at price equal to marginal cost they would not make any profit and hence they would not be able to recover any fixed cost associated with an investment. As a result, in such a hypothetical situation future welfare will be reduced, as new products would not be introduced, innovations would not be made, quality levels of goods and services would not be improved. (See chapter 2 for further discussion of this point.)

### 3.1.2 Consumer welfare (consumer surplus)

Although in most circumstances practices that decrease total welfare also decrease consumer welfare and vice versa (this being the case for cartels, for instance), this is not always necessarily the case. For instance, perfect price discrimination by a monopolist (a situation where each consumer is made to pay exactly its willingness to pay) maximises welfare to the detriment of consumers (see chapter 7); or, more important since perfect price discrimination belongs to the theoretical realm only, but perhaps not a very frequent case either, a merger that allows the merging firms to decrease significantly their fixed costs might increase total welfare (due to larger profits) while increasing prices and thus decreasing consumer welfare (see chapter 5).

**Consumer v. total welfare standard in different jurisdictions** It is difficult to say whether competition authorities and courts favour in practice a consumer welfare or a total welfare objective. In the EU, Art. 81(3) allows any agreement, decision or concerted practice “which contributes to improving

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<sup>52</sup>The difference between consumers and producers as two completely different groups of citizens should not be overstated either. In most countries, consumers are also owners of the firms either directly (as shareholders) or through pension and investment funds.

<sup>53</sup>See Tirole (1988: 7-12) for a discussion of the measures of consumer surplus and welfare. In particular, it should be emphasised that in a partial equilibrium framework (that is, when a sector is considered in isolation from the rest of the economy) such measures are valid as long as consumers are spending in that sector’s products just a small fraction of their total incomes. Otherwise, income effects should be taken into account and the consumer surplus measure cannot be relied upon in computing approximations of welfare.

the production or distribution of goods or to promoting technical or economic progress, *while allowing consumers a fair share of the resulting benefit*" (emphasis added). Furthermore, Art. 2.1 of the Merger Regulation accepts in principle an efficiency defence "provided that it is to consumers' advantage". These provisions might indicate that consumer welfare is among the ultimate objectives of competition law.<sup>54</sup> However, I am not aware of any statement of the ECJ on this point, nor of any (Commission or Court's) decision where reliance on either standard has made a difference in practice.

In the US, both the courts and the anti-trust agencies seem to tend for a consumer welfare standard too, at least as far as mergers are concerned. Indeed, the last revision of the US merger guidelines state that "the Agency considers whether cognizable efficiencies likely would be sufficient to reverse the merger's potential to harm consumers in the relevant market, e.g., by preventing price increases in that market."

In other jurisdictions, such as in Canada, Australia and New Zealand, competition authorities seem instead to lean towards a total welfare standard (Lyons, 2002: 3).

**Consumer v. total welfare standard for economists** Although I believe that consumer and total welfare standards would not often imply very different decisions by anti-trust agencies and courts, there remains the question of which of the two should be the appropriate objective for competition policy. While economists generally prefer total welfare, arguments have also been raised in favour of a consumer welfare objective.<sup>55</sup>

Consider the following argument (which takes a "political economy" perspective). Very often consumers are not willing (or able) to exert their aggregate power since the effect upon consumers of a given market situation is likely to be dispersed among many of them while it is much less dispersed for producers. Imagine, for instance, that a certain consumer good is usually bought by 100,000 consumers per year, each of which buys only one unit, usually sold at a price of 100 euro. If the two firms producing this good were able to influence the government to enforce a regulation which increases the price by 10% (for instance, through protection from foreign competition, or through authorization of a collusive agreement), this would bring about huge collective losses for the group of consumers as a whole, but individual losses (10 euro) are probably not large enough for consumers to decide to stand up to defend their position. On the contrary, the two producers would have large individual gains from such a move, and so they would be ready to employ considerable resources to lobby the

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<sup>54</sup> But the Guidelines on Vertical Restraints, at para. 7, state: "The protection of competition is the primary objective of EC competition policy, as this enhances consumer welfare and creates an efficient allocation of resources."

<sup>55</sup> A different question, which pertains to politicians rather than economists, is whether - if a total welfare standard is chosen - profits of foreign firms should be included in the measure of producer surplus or not, and in which proportion. The issue is of some importance in European merger policy, since mergers analysed by the EC often involve firms and consumers of different countries.

government into adopting the regulation. The competition authority might then have a role to play if it contributes to balancing the different lobbying powers of the two groups of economic agents in question. Therefore, the argument goes, attaching a heavier weight to consumer surplus than to producer surplus might help redress the balance towards consumers.

Similar arguments in favour of a consumer welfare standard have been made in discussions of merger policy. For instance, Besanko and Spulber (1993) argue that merging firms enjoy information advantages (particularly on the efficiency gains associated with the merger) over the competition authority, and that the adoption of a consumer welfare standard (that is, accepting the merger only if it increases consumer welfare, no matter the effects on profits and therefore on total welfare) might counter-balance this asymmetry. Neven and Röller (2000) suggest that competition authority officials might be exposed to the lobbying of firms that can offer them personal reward, and claim that a consumer welfare standard might counter-balance the bias resulting from such lobbying.<sup>56</sup>

Another argument that is sometimes mentioned in favour of the consumer welfare standard is that it might simplify decisions by the anti-trust authorities in merger cases. Suppose for instance that a merger entails some fixed cost savings, but it will likely increase prices. A total welfare standard would entail a difficult exercise of quantification of the changes in consumer surplus and in profits, in order to arrive at a final estimate of the net effects on total welfare. A consumer welfare standard, instead, would not need such an exercise, since it could limit itself to the (relatively) simpler assessment of the effects on prices.

Although these arguments might have some merit, it would not be wise for Competition Authorities to adopt a consumer welfare objective, for several reasons. First, consumer welfare by definition does not take into account the gains made by the firms. However, in today's advanced economies consumers often own (partly or fully) firms, directly or through pension and investment funds. Accordingly, dividends are distributed to a vast number of citizens who would be hurt if profits were reduced. If the adoption of a consumer welfare standard were intended to favour "citizens" as opposed to "firms", it would not be clear that such a goal would be achieved.<sup>57</sup> Second, if one took literally the objective of maximising consumer surplus, this would lead to pricing at marginal costs, with firms exiting the industry in the long-run or having to be subsidised to cover fixed costs, not a reasonable idea, since the market should then be replaced by across-the-board regulation. Third, and of great importance, lower prices and profits would have the effect of depriving firms from the necessary incentives to innovate, invest, and introduce new products.<sup>58</sup> Therefore, at the very least one should consider the objective as that of maximising consumer surplus over time (i.e., in dynamic terms), otherwise by helping consumers today

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<sup>56</sup> See Lyons (2002) for a brief discussion on the merits of these papers, as well as for another economic model which indicates that under certain circumstances a consumer welfare standard might be superior to a total welfare standard when dealing with mergers.

<sup>57</sup> And if one wanted to pursue redistributive goals, for instance favouring labour over capital, it would be more efficient and less distortive to use fiscal policies than anti-trust laws.

<sup>58</sup> See chapter 2 for a discussion of market power and profits as incentives for firms to invest.

one would hurt consumers tomorrow. But then, it would not be clear to which extent the distinction between consumer and total surplus matters.

Like most economists, I also prefer the welfare standard. Therefore, in this book the different practices will generally be assessed according to this standard, but their effects on consumer welfare will also be made explicit. In most cases, however, the policy recommendations would not differ if one chose the latter objective over the former.

### 3.1.3 Defence of smaller firms

The defence of small firms has often been one of the main reasons behind the adoption of competition laws. The most famous instance is given by antitrust laws introduced in the US at the end of the 19th Century, which were initiated from the complaints of farmers and small firms against the large trusts, but this motivation probably lies behind the restrictions to discriminatory practices introduced by many pieces of legislation.

The favourable treatment of small firms is not necessarily in contrast with the objective of economic welfare if it is limited to protecting such firms from the abuse of larger enterprises, or giving them a small advantage to balance the financial and economic power of larger rivals.

However, artificially helping small firms to survive when they are not operating at an efficient scale of production is in contrast with economic welfare objectives. Indeed, this would encourage inefficient allocation of resources and would contribute to keep high prices in the economy.

The European Commission seems to have taken the view that small and medium-sized enterprises (SMEs) are more dynamic, more likely to innovate and more likely to create employment than large firms. This would be an additional argument to promote SMEs. However, the empirical evidence is quite ambiguous. It would seem difficult to state that small firms make a larger contribution to growth and innovation than large firms.<sup>59</sup>

As a conclusion, it makes sense that the competition authorities do not use their scarce resources to monitor agreements and mergers which involve smaller firms,<sup>60</sup> but there is little rationale behind a systematic use of competition policy towards helping SMEs.

Smaller firms are often hurt by the lack of proper infrastructure and imperfect markets (larger firms might be able to overcome problems owing to their size, financial means or internal market mechanisms). Such difficulties had better be dealt with by government interventions at the root of the problems, rather than instruments such as competition policy, whose purpose lies elsewhere. The risk is of creating additional distortions in the competition sphere, while giving only a very imperfect answer to the source of the problems.

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<sup>59</sup> Think, for instance, of the very old issue of whether large firms are more conducive to innovation than the small firms. The vast literature on the subject is far from conclusive.

<sup>60</sup> The practice of granting exemptions to small firms is also useful in that it does not oblige them to spend resources in dealing with administrative matters, such as filling forms to notify agreements or mergers.

### 3.1.4 Promoting market integration

As we have seen, *promotion of market integration* is one of the key objectives of EU competition policy as stated by the Treaty, enforced by the EC and endorsed by the courts. This is a political objective which is not necessarily consistent with economic welfare. EU competition law *de facto* forbids price discrimination across national borders. There is no economic rationale for such a different treatment.

*A priori*, it is difficult to say whether price discrimination has a positive or negative impact over welfare, as the following example shows. Imagine that the same good is sold in two countries, say Germany and Portugal. Germans have on average a higher income and willingness to pay for the good than Portuguese. If price discrimination is allowed and it is feasible (arbitrage does not occur, or it occurs only to a limited extent), a monopolist would sell in Germany at a price  $p_h$  (where  $h$  stands for “high”) and in Portugal at a lower price  $p_l$ . By making consumers pay according to their different willingness to pay, the firm is able to increase its profit.

Consider now what happens if the monopolist was obliged to set an identical price on the two markets. A possible option is to set an intermediate price  $p_m$  (such that  $p_l < p_m < p_h$ ). Hence, Germans would be better off, while Portuguese would be worse off. To judge the overall welfare effect of market integration, three aspects should be accounted for: the consumer surplus of the two groups (Germans would gain, Portuguese would lose) and the profit earned by the monopolist (which is lower when price cannot be segmented). *A priori*, the welfare effect is therefore ambiguous.<sup>61</sup>

However, there is also another option available to the monopolist. This is to continue to charge the price  $p_h$  it was charging in Germany for both markets. It would lose completely the Portuguese market but it would keep the highest profit in the German market, so that this strategy might well be more profitable than selling at an intermediate price in both markets.

If the second strategy prevails, then the prohibition of price discrimination across countries achieves precisely the opposite effect than intended at first sight: differences in the market conditions between Germany and Portugal end up with being much more pronounced than before.

It is not easy to draw simple and practical policy implications on price discrimination (see chapter 7). However, as this simple example shows, a *per se* rule which forbids firms from price discriminating across countries is not justified on economic welfare grounds, and in some circumstances might even work (paradoxically) against the objective of market integration.

### 3.1.5 Economic freedom

As we have seen, to guarantee economic freedom is probably the main rationale behind competition laws in Germany. The possible contradictions between such an objective and the objective of economic efficiency have been discussed in

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<sup>61</sup> See chapter 7 for a simple formal analysis.

detail and with reference to specific cases by Kühn (1997). Probably the most obvious source of contrasts arises in vertical restraints, for instance in contracts and clauses imposed by a manufacturer upon the retailers of the good it produces. While territorial restraints, resale price maintenance and other practices often find strong justification in economic efficiency terms (for instance, by stimulating the efforts of retailers, or by making sure that they would not set prices above those which are optimal for the manufacturer), it is straightforward that they limit the economic freedom of the retailers.<sup>62</sup>

### 3.1.6 Fighting inflation

Our brief historical excursus has also illustrated how macroeconomic events might affect the implementation of economic policy. Fighting inflation, for instance, has been indicated as one reason for introducing control over cartels in Germany. However, it seems doubtful that competition law might efficiently be used to attain such purposes. If firms are colluding, then breaking a cartel would give a one-time reduction of prices, rather than contributing to a permanent decrease of inflation. Further, in an environment where all prices are continuously increasing, it is likely that firms would react to a common shock on the prices of inputs by simultaneously and independently increasing prices, even in the absence of any collusion.<sup>63 64</sup>

### 3.1.7 Fairness and equity

Competition laws might also incorporate objectives such as fairness and equity, forcing firms to behave in a certain way both with respect to customers and to rivals.<sup>65</sup>

As for fairness towards customers, the law might prevent dominant firms from charging excessive prices (as in Art. 82 in the EU, see below). From an economic point of view, price controls by authorities are unlikely to be a desirable policy in markets with free entry, apart from exceptional cases. In general, a firm should be free to charge the prices it wants, and if it enjoys market power because of its merits (be they investments in R&D, advertising, or whatever other business strategy) there is little reason to oblige it to give discounts to consumers who are willing to pay a high price for its goods or

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<sup>62</sup>For the relationship between restrictions on commerce and restrictions on the freedom of contract, see Amato (1997).

<sup>63</sup>Nor would it be reasonable to limit price movements of the firms in a situation where all input prices increase.

<sup>64</sup>However, if price shocks were not perfectly anticipated by the firms, that is, if inflation was highly correlated with price uncertainty, it might be possible that colluding firms (which are able to monitor each other's behaviour and share information) immediately increase prices every time there exists a price increase of inputs, whereas firms which are not colluding are more hesitant to raise prices. I have never seen this argument analysed in formal terms.

<sup>65</sup>Several competition laws refer to terms such as "fairness", "fair", "unfair". Definitions of such concepts are (understandably) rare, and their use is left to the discretion of competition authorities and courts.

services.<sup>66</sup> If the market is one where entry is free, and the goods or services under discussion are valuable for consumers, chances are that sooner or later competition from new entrants will appear and prices will move downwards. There are two qualifications to this reasoning, however. The first is that the market in question might be one where entry is not free. If this is the case, for instance because there exists a legal monopoly, then price intervention would be justified. Usually, such markets should be subject to regulation, but if for some reason sector regulators do not exist or fail to intervene, intervention by competition authorities (if allowed by the institutional setting) might be justified.

The second is that although entry is free on paper, in practice the market does not work well because the monopolist has set up practices which allow it to preserve or reinforce its monopoly position. However, in this case, it would be preferable if antitrust authorities intervened so as to restore market competition (which is the cause of the problem), rather than to set a ceiling to prices (whose high level is the effect of abusive practices).

This brings us to the next issue, which is fairness and equity in the marketplace. Let me consider first a case where a particular interpretation of the concept of fairness would collide with an economic welfare criterion. Take for instance the politically-sensitive issue of small shopkeepers v. large supermarket chains. In many countries, concern is often voiced that the supermarket chains exploit their bigger volumes so as to have bargaining power and buy from manufacturers much cheaper than small shops. This allows the former to sell at lower final prices than the latter. As a result, small shops have economic difficulties and could be forced to close down. Some people would argue that this is unfair, and that small shops should accordingly be protected.<sup>67</sup> If from the point of view of fairness this claim is justified, I do not know. Certainly, such a reasoning would be at odds with basic efficiency principles. Whenever there exist economies of scale in a market, larger firms will have lower costs and will be more competitive. Small firms which fail to reach the minimum efficient scale of production (or distribution) will either have to content themselves with lower profits or exit the market. This process of rationalisation whereby only the most efficient firms will stay in the market is beneficial for a community as a whole, as it will bring market prices down to the benefit of consumers. Interfering in this process by limiting the ability of larger firms to charge lower prices would damage welfare.<sup>68</sup>

Note, however, that fairness and efficiency are not always in contradiction.

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<sup>66</sup> See also chapter 2 on the need to let firms appropriate the fruits of their investments.

<sup>67</sup> An Italian law approved in 2001 (l. 62 of 9-3-2001) established the prohibition to sell books at a discount higher than 10% of the cover price. (The law was later modified, prohibiting discounts higher than 15% and for the period of one year only.) This is an example of a law which distorts competition in the marketplace to protect smaller firms (bookshops in this case) from the competition of more efficient and larger firms (in this case, supermarkets and internet bookstores).

<sup>68</sup> If - for whatever reason - it was really felt that small shops have to survive, then rather than using competition policy it would be better to implement this objective through a redistributive policy, for instance by reducing taxes on the personal income of shop-keepers.

Consider a variation of the previous example, and suppose that in a given market a supermarket chain which already has a very high share of the market (say, 70%) systematically charges below costs with the aim of forcing all small rivals out of the market (they could not cover their costs at the prices charged by the supermarket). In this case, this practice (that is called *predatory*) is both unfair and welfare detrimental. Indeed, after small shopkeepers have been forced to exit the market, the supermarket chain will start to charge monopoly prices. Therefore, consumers pay low prices during the period in which the supermarket is acting in a predatory way, but they will have to pay much higher prices ever after.<sup>69</sup>

More generally, *ex ante* equity (that is, the fact that firms have the same initial opportunities in the marketplace) is compatible with competition policy, which should guarantee a *level-playing field* for all the firms. Instead, *ex post* equity (that is, equal outcomes of market competition) is unfortunately not something which necessarily coincides with competition policy, since the way in which markets work is that firms which invest more, innovate more, or simply are luckier than others will be more successful and reap higher profits.

### 3.2 Other public policy factors affecting competition

A number of public policy considerations often affect competition laws and their enforcement. Indeed, the brief historical account above shows that often competition authorities and courts adopt weaker stances on competition issues than economic considerations alone would have suggested, due to social, political, or strategic reasons.

#### 3.2.1 Social reasons

Competition rules have sometimes been relaxed to smooth social tensions. US laws were implemented in a more lenient way in the times of the Great Depression, with the view that some price agreement would help firms to avoid bankruptcy, thus easing social tensions caused by unemployment. If capital markets were imperfect, then a policy trying to reduce bankruptcies might be of help. However, allowing firms to collude to solve the problem is likely to be a remedy worse than the problem itself. This would introduce further distortions in the economy: it would be better to intervene directly with other measures in the banking and financial sphere.

For the same reason, “crisis cartels” are sometimes tolerated by the EC. Although pursuing such objectives might be understandable, it is not clear that the means adopted achieve their purpose. A more favourable treatment for certain firms in bad times might have adverse consequences upon other groups already hit by a recession, like consumers or even other firms using inputs or intermediate goods. As for allowing agreements between firms in a declining

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<sup>69</sup>Of course, it is not always easy to distinguish predatory behaviour from low prices due to higher efficiency. See chapter 7 on monopolisation for an analysis of how competition authorities should behave in such cases.

sector (often concentrated in a given geographical area), it might have medium- and long-run adverse consequences. Actually, this might allow less efficient firms to stay on to the detriment of more efficient firms which would have survived anyhow. A misallocation of resources might be the result of such a policy.<sup>70</sup>

### 3.2.2 Political reasons

Political reasons might also justify some competition policy positions. When the Allied Forces decided to break up industrial groups in Germany and Japan, one of the reasons might also have come from the danger of having economic concentration of power being used for political purposes. Indeed, the close connection between political and economic power during the Nazi regime played a role in the attempt of increasing the dispersion of power. More generally, it might be feared that democracy could be put at risk when a few citizens and groups dominate a large share of resources. From a different point of view, calling for a less concentrated distribution of resources can be justified on fairness grounds. Indeed, to reduce inequality in income distribution has also been one of the reasons invoked by the advocates of anti-trust laws in the US, as a reaction to the excessive power accumulated by some large firms and trusts and to the epidemic of bankruptcies of small firms at the end of the 19th Century.

### 3.2.3 Environmental reasons

Environmental reasons might also be taken into account in the enforcement of European competition law, according to articles 6 and 174 of the Treaty. In a recent decision (*CECED*), for instance, the Commission has approved an agreement among producers and importers of washing machines which together account for more than 95% of European sales (Martinez Lopez, 2000a). The agreement aims among other things at discontinuing production and imports of the least energy-efficient washing machines, which represent some 10-11% of current EC sales. The agreement removes one of the dimensions along which sellers compete, and as such it might negatively affect competition and increase prices (as a general rule, the most polluting machines are also the least expensive ones). However, the Commission considered that the agreement will benefit society in environmental terms,<sup>71</sup> allowing to reduce energy consumption, and that such an objective would not have been attained without the agreement. This is because consumers do not properly take into account all the externalities involved in their purchase and consumption decisions, and firms would not give up a tool of market competition unless bound by an agreement.<sup>72</sup>

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<sup>70</sup> However, it is not always the case that market forces left alone would bring about the exit of less efficient firms before the more efficient ones. See e.g. Dierickx et al. (1991). The existence of different financial situations might also explain the permanence in the market of more inefficient firms.

<sup>71</sup> Private energy-saving benefits for consumers should be already properly taken into account by consumers when taking their purchase decisions. It is the environmental externality that the consumers might not take into account.

<sup>72</sup> One could possibly interpret this situation as one where firms play either a coordination game or a prisoner dilemma game. In the absence of the agreement, they would end up

Of course, whenever competition policy is used for other purposes than efficiency, one has to wonder whether this is the optimal solution.<sup>73</sup> In this particular case, the same (or more advanced) objectives might be attained through a number of other public policies, such as the imposition of taxes which discriminate against more environmental damaging machines or even the imposition of a minimum environmental standard adopted at a European-wide level. However, it might well be that such alternative instruments are politically difficult to attain, and that competition policy might help the environmental objectives. Of course, it is important in these cases to ensure that this use of competition policy does not introduce additional distortions. In this particular case, however, competition among producers did not seem deeply affected, as the agreement did not remove many other competitive instruments at the firms' disposal (prices, technical effectiveness, brand image, advertising, and adoption of energy-saving levels above the threshold imposed by the agreement are still available).

### 3.2.4 Strategic reasons: industrial and trade policies

Supporting *national champions*, or breaking up foreign champions, has also played a role in competition policies. Lax competition policies in some countries can sometimes be explained by the willingness of national governments to allow domestic firms to “go bigger” in the belief that this will help them be more successful *vis-à-vis* foreign rivals. This might for instance explain why France wanted to include social and industrial policy considerations in the Merger Regulation, and *a contrario* inspired the policy of de-cartelisation forced upon Germans after World War II. This means that strategic trade policy considerations might lurk behind competition laws or behind implementation methods.

An example of using competition laws to allow domestic firms to extract rents in foreign markets may be observed in the exception given by US law to *export cartels*.<sup>74</sup> The Webb-Pomerene Act exempts export associations from the antitrust laws where their sole purpose is to engage in export trade and if their actions: (1) do not interfere with or restrain trade in the US; and (2) do not restrain the export trade of domestic competitors.<sup>75</sup> The Export Trading Company Act provides for the issuance of a “certification” of immunity by the Department of Commerce (with the agreement of the DOJ). The certification issues where the export activity: (1) does not result in a substantial reduction of competition in the US or with an export competitor; (2) does not unreasonably affect prices in the US; (3) does not amount to an unfair method of competition against rivals in the export market; and (4) does not engage in the sale or resale

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selling to a certain part of the market energy-inefficient machines at low prices, whereas the agreement allows them to sell more efficient machines at no less profit.

<sup>73</sup> See also Martinez Lopez (2000b).

<sup>74</sup> I am grateful to Mel Marquis for the following discussion.

<sup>75</sup> The export association must file reports on its activities with the Federal Trade Commission (FTC). Based on US case law, the association is not permitted to join a foreign cartel, nor may it establish a foreign subsidiary. Finally, it may not join with non-members to restrict competition and price. If the association violates these prohibitions, the FTC refers the matter to the DOJ for prosecution.

of goods in the domestic market.

More generally, competition policy instruments can also be used to achieve *protectionist* goals. A case in point is the use of *anti-dumping laws*: these are laws that in theory aim at avoiding that foreign firms sell below their costs (i.e., that they *dump* their goods) in the national market, to the detriment of national firms. The existence of such laws is justified on fair trade grounds (if dumping coincides with below cost pricing, it might be indicating predatory behaviour), but that often is used as a way to protect domestic firms from more efficient foreign firms. For instance, anti-dumping laws are often implemented in such a way that it is very easy to prove that there has been dumping by foreign firms, that are being penalised even when they are simply more efficient.<sup>76</sup>

Industrial policy and trade policy considerations have often been an obstacle to the enforcement of competition policy.<sup>77</sup> My view is that competition policy is the best possible industrial policy: it is unlikely that firms in a particular industry are able to grow healthily if sheltered from competition, subsidised, or exempted from anti-cartel laws.<sup>78</sup>

Of course, the clearest case where strategic trade policies are at work is when a country's government subsidises domestic firms. This distorts competition in the marketplace and has detrimental effects, since it might allow inefficient firms to survive at the expenses of more efficient ones. Although in the EU it is the Competition Directorate that is in charge of *state aids*, and that such aids do have an effect on competition, I take the view that they pertain more to the domain of trade policy than of that of competition policy. Accordingly, I do not deal with subsidies in this book.

### 3.3 Competition policy: a definition

To define *competition policy* (or *antitrust policy* as it is more often called in the US) is not an easy task. A possible definition might be as follows: “the set of policies and laws which ensure that competition in the marketplace is not restricted in a way that is detrimental to society”. This definition admits the possibility that some restrictions might not necessarily be detrimental. For instance, some agreements between a manufacturer and a retailer which limit competition by other retailers often improve economic welfare (see chapter 5). The definition is also empty though, unless one specifies what “detrimental to society” means. In turn, this calls for a specification of the objectives of competition policy.

In section 3 I have argued that *economic welfare* is the objective competition authorities and courts should pursue. This brings me to define competition policy as “the set of policies and laws which ensure that competition in the marketplace is not restricted in such a way as to reduce economic welfare”. In

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<sup>76</sup>On anti-dumping, see chapter 7. On the possibility that competition policy instruments are used as a protectionist device, see Motta and Onida (1997).

<sup>77</sup>See Gual (1995) on the conflicts among competition, trade and industrial policies in the EU.

<sup>78</sup>See chapter 2 on the role of competition to promote productive efficiency.

this book I will assess the anti-competitive potential of business practices, and the desirability of competition laws, according to this definition.

This does not imply that objectives or public policy considerations other than economic efficiency are not important, but more simply that if a government wanted to achieve them, it should not use competition policy, but resort to policy instruments that distort competition as little as possible. Furthermore, as an economist my role is to stress which measures are aligned with the objective of increasing economic welfare and which are instead in contrast with it. It will be up to others, be they politicians or judges or sociologists, to decide whether to give priority to economic or other considerations when conflicts arise.

## 4 The main features of European Competition Law

This section gives a short introduction to European competition law, whose main provisions are contained in articles 81 and 82 of the Treaty of the European Communities and in the Merger Regulation.<sup>79</sup>

Articles 81 and 82 of the Treaty are characterized by “direct applicability”: this means that they are part of the law of each Member State and are directly enforceable by national courts. As directly applicable provisions, articles 81 and 82 are enforced by the European Commission (EC), or more precisely, by the *DG Comp* (the Directorate General for Competition that acts following the directives of the European Commissioner responsible for competition law) at the Community level and by National Competition Authorities at the Member States’ level.

At the Community level, the Court of First Instance (CFI) has, since 1989, jurisdiction in all actions brought against the decisions of the EC by any natural or legal person in competition law matters.<sup>80</sup> The European Court of Justice decides on appeal actions brought against the judgments of the CFI.

At the National level, national courts decide according to the different system provided by each Member State against the decisions of National Competition Authorities.

### 4.1 Article 81: horizontal and vertical agreements

Article 81(1) prohibits

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<sup>79</sup> Articles 83 to 89 of the Treaty also deal with competition issues, but either contain procedural norms or deal with issues such as public enterprises and state aids, whose detailed analysis goes beyond the scope of this work. For a better understanding of the legal aspects of European competition law, see e.g. Bellamy and Child (2001), Goyder (1998), Korah (1994), Ritter et al. (2000), or Whish (2001).

<sup>80</sup> Actions brought by Member States against other Member States or community’ institutions and actions brought by any community institution against any other community institution are, however, heard only by the European Court of Justice.

“all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market, and in particular those which: (a) directly or indirectly fix purchase or selling prices or any other trading conditions; (b) limit or control production, markets, technical development, or investment; (c) share markets or sources of supply; (d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at competitive disadvantage; (e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts”.

Article 81(2) declares that “[a]ny agreements or decisions prohibited pursuant to this Article shall be automatically void”.

Article 81(3) states that such prohibition does not apply to any agreement, decision or concerted practice

“which contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not: (a) impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives; (b) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.”

Whereas a full discussion and interpretation of this article is not possible here, a few remarks are needed. First, article 81 deals with both horizontal and vertical agreements. This is a source of potential problems, as economics shows that one should generally expect these agreements to have quite different competitive effects. Horizontal agreements, that is agreements among competitors, usually restrict competition and thus reduce welfare (see chapter 4) and should therefore be prohibited apart from very specific cases (such as, for instance, co-operative agreements in R&D). Instead, vertical agreements, that is agreements between firms operating at different stages of the production processes (for instance, between a manufacturer and a retailer) are often efficiency enhancing and pose problems to competition, if any, only when they are undertaken by firms which enjoy considerable market power (see chapter 6). To treat agreements which have such a different nature and such different expected competitive effects with the same legal provision is therefore unlikely to be efficient.

Recently, the EC perceived this problem and adopted an approach on vertical restraints which is more in line with economic thinking. Regulation 2790/1999 introduces a block exemption from article 81(1) on vertical restraints, subject to (i) a market share criterion and (ii) a “black-list” of clauses which are not exempted.<sup>81</sup> (i) The block exemption is limited to vertical agreements in which

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<sup>81</sup> Adopted on 22 December 1999 and published in OJ L 336, 29.12.1999, this regulation replaces three expired block exemptions regulations, on exclusive distribution, exclusive purchasing and franchise agreements. For a better understanding of this regulation, see also the Commission Notice “Guidelines on Vertical Restraints”.

the market share of the supplier is below 30% (in case of agreements containing an exclusive supply obligation, it is the buyer's market share which may not exceed 30% in order for the block exemption to hold).<sup>82</sup> (ii) However, there are some types of restraints which are considered so harmful by the Commission that the block exemption does not apply to them even if the market share threshold of 30% is not attained.<sup>83</sup> These so-called "hard-core" practices mainly relate to resale price maintenance (clauses which fix, directly or indirectly, resale prices) and (some types of) territorial restrictions which might lead to market partitioning by territory or by customer,<sup>84</sup> and are more justified by the desire to promote identical prices and sales conditions in the EU than they are based on an economic rationale.

Second, note that agreements need not be written or be formal agreements for them to be prohibited, as the reference in article 81 to the term of *concerted practices* makes clear. However, the term itself leaves space for interpretation. Today pure market "parallel behaviour" without any attempt from the firms involved to communicate with each other or establish practices which help sustain collusion would probably not be judged by the Court of First Instance and the European Court of Justice as a concerted practice within the meaning of article 81 (see chapter 4 for a discussion).

Third, for different reasons such sectors as agriculture, defence, and (road, rail, inland waterways, air and maritime) transports, have been granted block exemptions from article 81(1). In other words, agreements between firms in such sectors are not subject to the same prohibition.

Fourth, article 81(3) clearly states that even agreements among competitors do not fall under a *per se* rule of prohibition. Some horizontal agreements have been covered by so-called "block exemptions". The EC has adopted over the years a number of regulations which specify the conditions under which specialisation, research and development, or technology transfer agreements are not subject to the prohibition of article 81(1). The block exemptions have been extremely useful in saving time in dealing with agreements that the EC thought would pose few competition problems. Otherwise, firms could still apply for an individual exemption from article 81(1). In such cases, until 2002 they had to notify of their agreement the EC, which could (implicitly or explicitly) clear them if the conditions indicated by article 81(3) were met.<sup>85</sup>

The recent reform of Regulation 17 of 1962 (due to come into effect May 1, 2004) has modified the implementation of article 81, and introduced a "directly

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<sup>82</sup> See Article 4(b) of the Vertical Block Exemption.

<sup>83</sup> However, the *de minimis* rule (discussed above in section 3) may still apply.

<sup>84</sup> However, this does not mean that exclusive territory agreements are illegal: a supplier is allowed "to restrict *active* sales by its direct buyers to a territory or a customer group which has been allocated exclusively to another buyer or which the supplier has reserved to itself." (See Guidelines, §50) A supplier is not normally allowed to restrict passive sales, i.e. sales to satisfy unsolicited requests from individual customers, but can prevent its distributors from actively approaching customers located in territories assigned to other distributors.

<sup>85</sup> The Commission did not have enough resources and personnel to review in depth each notification. More than 90% of cases were closed informally by so-called "comfort letters" which probably did not have binding legal value. See European Commission (2000: §25).

applicable exception system”.<sup>86</sup> There have been two main changes. First, the authorisation arrangement system and the notifications which are its corollary would be abolished, passing to a system of ex-post control. Second, the EC has given up some of its “monopoly power” over article 81(3): national authorities and judges could also give exemptions.<sup>87</sup> This new system, will - in the intention of the EC that proposed it - lead to a more efficient application of article 81, allowing it to focus on the most important agreements rather than having to review hundreds of minor ones. Nevertheless, due to the decentralisation of competition policy, the system might lead to heterogeneous enforcement, with some national agencies and courts being more lax than others.

## 4.2 Article 82: abuse of a dominant position

Article 82 states:

“Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States. Such abuse may, in particular, consist in: (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions; (b) limiting production, markets or technical development to the prejudice of consumers; (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at competitive disadvantage; (d) making the conclusion of contracts subject to acceptance by other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.”

The list of possible abuses is not exhaustive and it is included just to give possible examples. In general, article 82 is related to exploitative behaviour (excessive pricing) and such exclusionary practices as predatory pricing, exclusive dealing, refusal to supply, and tying (see chapter 7).

It is important to stress that for an abuse of a dominant position to exist, *first* it must be established that a *dominant position* exists, *then* that this dominant firm has engaged into an *abusive behaviour*. I look at these two elements in turn.

**Dominance** In one of the first article 82 (then article 86) cases, *Hoffmann-La Roche*, the European Court of Justice gave the definition of market dominance which is still used nowadays:

“The dominant position [...] relates to a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of

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<sup>86</sup> “Regulation implementing Articles 81 and 82 of the Treaty” of 26 November 2002.

<sup>87</sup> For an economic analysis of these changes, see Bergès, Loss, Malavolti and Vergé (2002), who focus on the implications of ex-post rather than ex-ante control regime, and Barros (2001), who focuses on the decentralisation aspects.

the consumers. Such a position does not preclude some competition, which it does where there is a monopoly or quasi-monopoly but enables the undertaking which profits by it, if not to determine, at least to have an appreciable influence on the conditions under which that competition will develop, and in any case to act largely in disregard of it so long as such conduct does not operate to its detriment.”

It is difficult to translate into economic terms the precise meaning of the legal expression “the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of the consumers.”<sup>88</sup> For sure, dominance relates to a situation where a firm enjoys a very high degree of market power, but the jurisprudence has made it clear that a firm with 40% of the relevant market - far from being a monopolist - might well be a dominant one.<sup>89</sup> In practical terms, the analysis of dominance by the Commission and the Courts coincides with the economic analysis of market power. A firm will be judged dominant when it has a high degree of market power, and the process of finding dominance involves the study of those factors that are relevant for the determination of market power (see chapter 3).

**Abuse of dominance** As for the concept of abuse of a dominant position, *Hoffmann-La Roche* defined it as follows:

“[a behaviour] which, through recourse to methods different from those which condition normal competition in products or services on the basis of the transactions of commercial operators, has the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition.”

Abusive behaviour mainly consists of exclusionary practices. A possible exception is price discrimination across member states, which occupies a special place in view of the economic integration objective of the European Union.<sup>90</sup>

Another possible exception is an “exploitative abuse”, that consists of charging excessive prices to buyers (or extorting too low prices from suppliers). This is an area where European competition law differs from US law, that does not provide the competition agencies with the power to intervene in case of “too high” prices.<sup>91</sup>

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<sup>88</sup> In modern industrial economics terms, one could perhaps say that behaving independently of competitors might be formalised as a situation where the (dominant) firm maximises its profits taking into account the best replies of its competitors (which simply best respond).

<sup>89</sup> The threshold of 40% comes from one of the early cases of abuse of dominance, *United Brands*, and it is still considered as a relevant threshold for the purpose of the determination of dominance, although the market share possessed by a firm is neither a necessary nor a sufficient condition to prove its dominance.

<sup>90</sup> Note that predatory price discrimination would be an exclusionary practice.

<sup>91</sup> See section 3.1.7 above and especially chapter 2 for why price controls are not a good idea. For cases where the EC and the courts have applied article 82 for excessive pricing, see Ritter et al. (2000: 357-360). The most famous case is *United Brands*, where the ECJ found that the EC had not proved the allegation of excessive pricing.

One important point to emphasise is that European law does not punish the creation of a dominant position, but just its abuse. In other words, if a firm builds market power - however strong - through innovation, investment, marketing activities, this is perfectly legal. It is only the abuse, not the creation, of a dominant position which is forbidden. This makes sense from the point of view of economic efficiency. One does not want to punish firms just because they are better, more successful, or even luckier, than others, as this would reduce incentives for firms.

However, in the practice of European law, a dominant firm might not be entitled to engage in the same practices as non-dominant firms. Aggressive competitive practices might be allowed to competitors, but not to a dominant firm, which has a “special responsibility”.

As we shall see in chapter 7, proving that a firm has engaged in exclusionary practices is not an easy task. This is an area of competition law where it is difficult to adopt simple rules and where each case is often a special one. Not surprisingly, article 82 cases are much rarer than article 81 cases, and often controversial.

### 4.3 Mergers

Both horizontal and vertical mergers are regulated by the Merger Regulation 4064/89 and successive modifications. This regulation, that as seen above has been adopted after many discussions and much time after the Treaty of Rome, consists in an authorisation procedure with strict time deadlines. Each project of *concentration* (the law uses this term to encompass both mergers and takeovers and refers to all situations where the operation allows a firm to take *de facto* control of the operations of another firm) should be notified to the Merger Task Force (MTF), a special unit of the Competition Directorate of the European Commission, within seven days of the agreement or the announcement of the public bid. The MTF has then one month to carry out a first round of investigation.<sup>92</sup> At the end of it, it might either decide to allow the merger or that such a merger “raises doubts as to its compatibility with the Common Market”. In the latter case, the MTF has four additional months at its disposal to decide on the concentration proposal, during which it will engage in deeper investigation of the possible effects of the merger. In the end, there are mainly three possible outcomes to this process. The merger might be allowed, prohibited, or allowed subject to certain conditions, or *remedies* (see chapter 5 on the distinction between behavioural and structural remedies).

The fact that the EC decides on mergers within strict time deadlines is a notable feature of the Merger Regulation, and one which should be praised. Indeed, firms and the markets need to know as quickly as possible if a merger can be carried out or not. The uncertainty related to long regulatory processes is always very costly but it is especially so for mergers, where firms need to deeply

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<sup>92</sup> Under special circumstances, for example the submission of a remedy, the one-month limit can be extended.

restructure and reorganise their production, distribution, research and marketing activities. It is crucial that this uncertainty is over as quickly as possible. The preventive authorisation system also responds to efficiency criterion. It would simply be wasteful to carry out the merger first and then rule that firms should return to the original situation.<sup>93</sup> Forced spin-offs would be extremely inefficient. It is precisely for this reason that the European legislators decided to introduce the Merger Regulation. In *Continental Can* and *Philip Morris*, the European Court of Justice had ruled that article 81 and 82 might have been used *ex-post* to deal with merger operations. It is to avoid this danger that the Merger Regulation was introduced in 1989.<sup>94</sup>

The Merger Regulation does not deal with all merger proposals in the EU, of course. Rather, it provides a good example of the *subsidiarity principle* whereby decisions should be taken at a decentralised level (i.e., by the national authorities) unless there are good reasons to take them at a centralised one (i.e., by the supra-national administration body which is the EC). The EC has jurisdiction on a merger if certain thresholds are met (see Art. 1). Such thresholds ensure that the mergers reviewed by the EC are mergers among large firms which have an important presence in several EU countries.<sup>95</sup> Mergers between “small” firms, and mergers which mainly interest a single country will be dealt with by national authorities and not by the Commission. Note that this regulatory rule is to the advantage of the firms, since it spares them from asking for an authorisation in each of the countries in which they operate, a process which might involve a considerable waste of time and legal expenses (this is known as the *one-stop shop* principle of regulation).

The substantive aspects of the merger regulation and merger practice will be discussed in chapter 5. For the time being, however, note that Article 2(3) of the Merger Regulation states that:

“A concentration which creates or strengthens a dominant position as a result of which effective competition would be significantly impeded in the Common Market or in a substantial part of it shall be declared incompatible with the Common Market.”

In other words, only mergers which create or reinforce a dominant position will be prohibited. This is a crucial feature of the Merger Regulation, and to anticipate the discussion in chapter 5, it is a feature at odds with economic principles, since there may well be mergers which do not create a dominant position but still decrease welfare (in markets with few firms, a merger might

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<sup>93</sup> Article 7(1) of the Merger Regulation states that no merger may be put into effect before being declared compatible with the Common Market. However, in some special circumstances firms might want to take the risk of a merger being undone. Article 7(4) allows for derogation from the suspensory provisions of Article 7(1) if certain conditions apply.

<sup>94</sup> On the events preceding the Merger Regulation, see Goyder (1998: 379-385).

<sup>95</sup> Notice that merger projects by firms which are non-Europeans also fall within the scope of the Merger Regulation, as long as the thresholds above are met, that is, as long as a merger has effects in the EU. Two well-known merger operations among non-EU firms that were blocked by the EC are *Gencor/Lohmro* and *General Electric/Honeywell*.

result in considerable price increases and diminished competition even if does not establish or reinforces a dominant position).

## 5 Exercises

**Exercise 1** *Describe the concepts of consumer surplus (or consumer welfare) and total surplus (or total welfare). What are the arguments in favour and against using consumer surplus rather than total surplus as the objective of competition policy?*

**Exercise 2** *In which competition law jurisdictions that you know can competition authorities intervene in case of excessive pricing by a firm? Briefly discuss whether such intervention should be welcome.*

**Exercise 3** *To what extent might trade policy and competition policy be in conflict with each other?*

**Exercise 4** *Large firms sometimes have advantages over small ones, for instance because of economies of scope, stronger bargaining power with suppliers that allow them to buy inputs at lower prices, better financial resources and access to credit. As a consequence of these advantages, competition between large and small firms is not on equal grounds. Should competition policy intervene, and if so in which way, so as to balance these asymmetries?*

**Exercise 5** *What other policies might be pursued by competition policies? What are some advantages and disadvantages of distorting competition to achieve these ends?*