

Competition Policy: Theory and Practice

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Massimo Motta

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Preface

Recently, competition policy (or anti-trust, as it is more often called in the US) has often made the first pages of newspapers. High profile cases both in the European Union and in the US have attracted the attention of society at large. Among the possible examples, there are *US v. Microsoft* (see chapter 7 for a discussion), where the Department of Justice at one point asked for such a drastic measure as the split of the software giant into two separate companies; a few cartel cases with an international dimension (such as those involving the producers of lysine, vitamins, or the famous auction houses Sotheby's and Christie's), and that resulted in prison sentences for some of the firms' managers involved; some EU merger cases, such as *General Electric/Honeywell* (see chapter 6), which was followed by public opinion on both sides of the Atlantic (and few people were not surprised when eventually the European Commission blocked the deal between the two American companies).

What competition policy is, and why we need it Rather than starting by defining competition policy in abstract terms, in the book I will first provide the reader with an idea of what competition policy is about through a historical approach (see chapter 1). Only after having briefly described competition laws in the US and in the EU, will I give a formal definition of competition policy (see chapter 2) 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 this definition there are probably two elements to be underlined. The first is that firms might restrict competition in a way which is not necessarily detrimental (for instance, this is the case for most vertical restraints, that is restrictive clauses between a manufacturer and a retailer, see chapter 6). The second is that economic welfare, a standard concept for

economists (see chapter 2) is the objective that competition policies should pursue. In this book I will assess the anti-competitive potential of business practices, and the desirability of particular competition rules, according to this definition.

Still, a reader might ask why we need competition policy at all. Let me delay for the moment the case where market failures would require the regulation of the sector (see below), and think instead of an industry where there exist no barriers to entry. One might think that market forces, and in particular the threat of new entrants, will eliminate monopolies (or dominant positions) and reduce prices. Yet, firms might resort to anti-competitive actions that create or strengthen a monopolistic (or dominant) position and, more generally, to actions that increase their profits, but reduce welfare: collusive agreements (see chapter 4), anti-competitive mergers (see chapter 5), and exclusionary behaviour (see chapters 6 and 7) are cases in point. For these reasons, competition laws and competition authorities that enforce these laws are necessary.

Competition policy and regulation In general, competition policy applies to sectors where structural conditions are compatible with a normal functioning of competition (whether the market functions well in practice or not is of course another matter). Instead, regulation applies to special sectors, whose structure is such that one would not expect competitive forces to operate without problems. Regulation would usually concern markets where fixed costs are so high that no more than one firm would profitably operate (a so called *natural monopoly*): examples might be electricity (transmission phase), telecommunications (local loops), railways (the network). Other industries subject to regulation might be industries that are in a transitory phase, for instance because they used to be legal monopolies (perhaps state-owned) and they were then liberalised. Since it would be unlikely that entrants could compete on an

equal footing with an established incumbent, a regulatory body usually supervises the industry to try and ensure a smooth transition towards a regular functioning of competition in the market.ⁱ

There are several differences between competition policy and regulation (see e.g. Rey, 2000: 44-47). While competition authorities generally limit themselves to checking the lawfulness of firms' activities, industry regulators have more extensive powers (they might impose or control firms' prices, investments, and product choices). While competition authorities usually intervene ex-post (for instance, checking the legality of a certain business practice after it has already been taken), regulators act ex-ante (for instance, authorising a certain business practice or not). Regulators' involvement with an industry is long-run and continuous, whereas competition authorities' interventions tend to be occasional.ⁱⁱ Such differences are also mirrored in the theoretical frameworks adopted to deal with these two issues. While competition policy issues can mostly be analysed with oligopoly theory (that is the main tool used in this book), regulatory issues are more naturally addressed by so-called "principal-agent models", where the principal is the regulatory authority and the agent is the regulated firm, with the former having to devise incentives in order for the latter to take the actions that would achieve the principal's objectives.

This book will deal only with competition policy, not with regulation.ⁱⁱⁱ

Objective of this book, and how to use it Previously the domain of lawyers, competition policy today is a field where lawyers and economists work together, and both judges and competition authorities have to master sophisticated economic concepts and theories (and likewise, economists have to understand the legal and institutional framework of anti-trust).

The main objective of this book is to provide a guide to all those who have an interest in competition issues, and to offer them the possibility to understand what modern advanced economics teaches us on these issues.

The book deals with both the theory and the practice of competition policy. It draws on the literature of industrial organisation, and on original analyses, to explain the likely effects that firms' practices have on welfare, and formulate policy recommendations which are of practical use for antitrust authorities.

The interaction between theory and practice is to be regarded as one of the main features of the book, and to this purpose it also contains frequent references to competition policy cases (mostly, from the EU and the US), and a few fully developed case studies.

The book is written to appeal to competition policy practitioners as well as students, to lawyers as well as economists. It is also designed to be used as a textbook in economics (first year graduate or advanced undergraduate courses), or as a book for those who want to approach competition issues in a clear and rigorous way.

Since the book is meant to be accessible also to readers who are not familiar with modern economics, the formalisation of the material covered in the main non-technical sections is relegated to separate "technical" sections. These sections, that are marked with one or two stars, according to their level of difficulty (* for undergraduates, ** for graduates), can be skipped without loss by the readers who are not familiar with modern, quantitative economics (or who are not interested in formal models).

Having followed an introductory course in industrial organisation will make reading the technical undergraduate (*) sections of the book easier, but students who have received a basic training in microeconomics should be able to understand them as well. The (*) sections

require familiarity with little more than basic calculus, simple game theory (the concepts of Nash equilibrium and sub-game perfect Nash equilibrium) and oligopoly models (Bertrand competition, Cournot competition).

Nevertheless, to help students and provide them with the necessary background if needed, chapter 8 offers an introduction to basic monopoly and oligopoly theory (as well as to the fundamental concepts of game theory). An instructor who wants to teach a self-contained undergraduate course on the economics of competition policy (or economics of anti-trust as it would be called in the US), without requiring any pre-requisite course, might want to devote a few lectures to chapter 8 before teaching the material contained in the rest of the book.

The book could also be used as a textbook for a course in “applied” industrial organisation at the undergraduate level, as opposed to a traditional course in the theory of industrial organisation. In this case, one could first teach the material contained in chapter 8 and then select material from the other chapters according to one’s priorities.

Each chapter also contains exercises, both at the undergraduate and graduate level, and essays, which instructors might find a useful complement to their teaching. Solutions for the exercises are also provided.

Preface Footnotes

ⁱOther regulatory problems are related to the existence of informational asymmetries between consumers and firms, and call for the setting of environmental, health and safety standards.

ⁱⁱIn some cases, the border between competition policy and regulation is blurred. Merger control, for instance, usually a task carried out by competition authorities, shares several features with regulatory problems. The analysis of the merger is to be done ex-ante rather than ex-post, and when conditions are imposed on the merging parties (see chapter 5), they might involve re-designing the structure of the market (structural

remedies), or limit the parties' freedom of choosing contracts or business practices (behavioural remedies), thereby making the competition authorities take actions more typical of a regulator.

ⁱⁱⁱFor an introduction to regulation with an undergraduate level treatment, see Viscusi et al. (1995). For an advanced treatment, see Laffont and Tirole (1994).

Acknowledgements

My first encounter with anti-trust law dates from 1989-1990, when I was at the London School of Economics. John Sutton devoted the classes of his course on Industrial Organisation to the presentation and discussion of anti-trust cases, so I owe him not only guidance through my first attempts at doing research, but also introduction to this fascinating topic. However, I can now confess that I was often very puzzled after class: was that firm really guilty? Was that particular business practice really anti-competitive? And which model was really relevant in that particular case? Some of these questions still accompany me today when I look at anti-trust cases: the interaction between the theory and a complex reality, and the necessity to capture the essential facts of a case and analyse them with the help of models we know, make anti-trust analysis often very difficult.

My curiosity about this topic increased when I met Kai-Uwe Kühn in Barcelona. Given the common interest, we taught a course on competition policy together, at Universitat Pompeu Fabra (UPF). I have learned a lot from Kai-Uwe, and discussing with him has shaped my way of thinking about anti-trust. The idea of writing a book on competition policy was also conceived together, and for a long time the book was meant to be a common project. Eventually, a Continent in between (he moved to Michigan), two small kids each, different research projects, and many other engagements made coordination more difficult and time scarcer, and Kai-Uwe unfortunately withdrew from the project.

Since that first course in 1995, I have taught competition policy to undergraduate and graduate students, to law and economics students, in Barcelona, in Florence, and elsewhere. The questions, comments, and reactions of all these students (many of whom are now colleagues, friends, and sometimes co-authors) have constantly pushed me to understand more

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