Competition Policy

History, Theory and Practice

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Preface

Historically, competition policy can be traced back to medieval times. In fact, as put by the historian R.H. Tawney in his treatise *Religion and the Rise of Capitalism* (1926, p. 40), 'a great part of medieval industry is a system of organized monopolies, endowed with a public status, which must be watched with jealous eyes to see that they do not abuse their powers'. The modern history of competition policy took shape only during the later decades of the 19th century, when a free trade era was replaced by a stance of protectionist trade policy under the umbrella of which cartels and trusts began to proliferate. Whereas in the US the political response was antitrust in Europe cartels could develop unimpeded. It was only after World War II that competition policy was introduced in Europe, particularly in Germany, in Britain and at the EC level. More recently for two reasons, internationally, a remarkable convergence of principles and practices of competition policy has emerged. First, globalization of economic relationships gives rise to interdependencies which require a unified approach to face restraints of trade across national boundaries caused by collusion and mergers. Second, in economics a body of theories pertaining to industrial organization has been developed from which standards of evaluation were derived which have come to dominate the standards rooted in the legal tradition of individual countries. Still, because of diverging interests competition policy is subject to political controversies.

Whereas cartels have overwhelmingly been assessed critically, the attitude towards mergers are more ambiguous. In particular recent mega mergers, like mergers one hundred years ago in the United States, have given rise to both concern and admiration, as nicely exemplified toward the end of the nineteenth century in a parody of Finley Peter Dunne (cited in Nevins and Commager 1981, p. 276) 'Th' thrusts are heejous monsthers built up by th' inlightened intherprise ov th' men that have done so much to advance progress in our beloved counthry. On wan hand I wud stamp them undher fut; on the other hand, not so fast'. Frequently smaller competitors are scared by a powerful rival in their market which they do not dare to challenge. A good recent example is the case of Microsoft where only by the opening of antitrust procedures was the ban broken ('The Microsoft Factor', *Business Week* December 7, 1998, p. 64).

Since mergers affect the interests of different people in different ways,

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competition policy has been subject to political controversies. On one hand mergers and the formation of giant firms are welcomed as allegedly enhancing international competitiveness, and on the other hand the political clout they may wield gives rise to serious concern. The enlargement of markets following globalization seems to require firms to grow in size in order to withstand the challenge of more vigorous competition. Frequently, however, competition is visualized as a zero sum game holding the promise of large gains for a few and losses for many. The mixture of opposing views engenders the demand for industrial policy. However, as admitted by the former EC Commissioner Martin Bangemann, who had been in charge of EC industrial policy, such a hope will largely be in vain. Instead he suggested for internationally active firms to join a common code of behavior to moderate excessive competition, an astounding plead for establishing cartels.

In view of these controversial attitudes and uncertainties regarding the appropriate role of competition policy economic and legal expertise is called for. Whilst at the end of the 19th century legal arguments had taken the lead, more recently the debate has become more heavily influenced by economic reasoning. For competition policy to become effective it must be embodied in the law and has to be implemented by the government and courts. Thus economic and legal expertise must enter a symbiotic relationship. Therefore the present book is addressed at students of both economics and law, at practicing economists and lawyers. It aims first at elucidating the economic arguments pertinent to justifying the necessity of competition policy and second, by providing an overview of legal regulations in the US and Europe, to help acquire an understanding of the rationale and practice of competition policy.

In the first chapter the historical development of competition policy, as displayed in economic and political reasoning and in the development of government regulations, will be outlined. The challenges facing competition policy will be characterized by giving an account of the history of cartelization and industrial concentration in the US and Europe and the response of public policy. Furthermore, by expounding elementary models of economic theory, that is, perfect competition, monopoly and monopsony, the framework provided by economic theory will be set out. It will be elaborated in the second chapter which offers an overview of the present state of industrial economics, the centerpiece of which is the theory of oligopoly, that is, competition among the few. As theoretically-derived relationships are supported by empirical evidence, economic theory turns out to be a reliable foundation for evaluating restraints of competition politically. Competition policy derives its political relevance not least by showing that restraints of competition yield welfare losses which to a large extent can be avoided by adopting an effective competition policy. The third chapter is devoted to expounding the interplay between economic reasoning and the law concerning cartels, mergers, and vertical restraints of trade. Competition policy pertaining to these problems will be analyzed primarily for the US, Germany and the European Union by invoking the relevant law as displayed in legislation and applied by the government and courts. The comparative analysis reveals to what extent, following the impact of economic reasoning, a convergence of the standards of evaluation has developed between the US and Europe. The fourth chapter takes up various elements of the social framework and other policies to discuss how they relate to competition policy. It pertains to the role of property rights, to international trade policy, and to the impact of the prevailing financial system. The chapter closes with a discussion of the relationship between competition policy and the objectives of government policy at large.

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Manfred Neumann
Nuremberg

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1. Aims and Scope of Competition Policy

Competition policy is a cornerstone of economic policy in a market economy, founded on well-defined property rights and freedom of contract, supported by policies aiming at stable money, a high level of employment and social security. The objectives and means of competition policy have been subject to various controversies. On one side there are ardent followers of the gospel of economic freedom as exemplified by the slogan 'Laissez faire, laissez passer le monde va de lui même.' They consider economic freedom and the ensuing competition as ends in themselves. On the other side there are those considering competition policy as a constituent part of an interventionistic industrial policy aiming at establishing market structures and enticing enterprises to behave in a way conducive to the enhancement of economic welfare. Within this range of diverging opinions four objectives to be pursued by competition policy may be identified

- Establishing a competitive order as an end in itself to safeguard economic freedom
- Maintaining a competitive order to foster economic efficiency and technological and economic progress
- Providing for a level playing field of fair competition, which implies prohibition of deceptive and fraudulent practices, threat, extortion and blackmail as well as unfair advantages through government subsidies
- Maintaining a decentralized structure of supply because small and medium-sized enterprises are considered as the backbone of a democratic society.

Some of these objectives are rivalrous whilst others are mutually supportive. The latter is particularly true with respect to the two objectives listed first. The development during the last third of the 19th century gave rise to the conclusion that a laissez-faire stance of economic policy would lead up to undermining a competitive order by the formation of trusts and cartels and thus to the eventual elimination of economic freedom. Therefore maintaining a competitive order by prohibiting restraints of competition was deemed as an objective to be pursued irrespective of the impact on economic efficiency. According to this view, even though the enhancement of económic welfare

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through competition is welcome it does not in itself justify competition policy (Hoppmann 1966, Pitofsky 1979). At first sight, this view bears a close relationship to the preference for a decentralized structure of the economy, which has been propagated as the Jeffersonian ideal of a democratic society. However, followers of a laissez-faire stance of economic policy would frown upon such a policy aiming at some definite economic structure and criticize it as interventionistic regulation. Consequently, deregulation policies adopted in the US by the administration of President Ronald Reagan led up to a retrenchment of antitrust policy.

Reproaching competition policy as government regulation inhibiting economic freedom is not completely unjustified as far as it is conceived of as part of an interventionistic industrial policy. In fact, the borderline between a freedom-enhancing competition policy and interventionistic industrial policy is somewhat vague. Monopolistic market power is frequently considered as being on the same footing as market failure due to economies of scale, externalities and incomplete information. Attainment of a welfare optimum thus appears to require government interventions. However, in quite a few cases particular interests are coming into play. Interventions which would be justified as correcting for market failures come to be dominated by distributional issues and claims raised in the name of social justice. In the end, without correcting for market failures, government failures arise. For this reason competition policy should content itself with containing restraints of competition and thus establish a competitive order which embodies the rules of the game. Hence competition law assumes the role of a constitution. As put by the German economist Walter Eucken (1959, p. 156, my translation),

> Just as the constitutional state, the competitive order should establish a framework in which individual freedom of action is limited by preserving the sphere of freedom of others such that the individual spheres of freedom will attain an equilibrium.

The major advantage of competition policy can be seen in the role it plays in relieving the government from being burdened with a task it is unable to perform. An anonymous co-ordination of economic activities is substituted for a regulation performed by bureaucracy. As emphasized by Kaysen and Turner (1959, p. 14),

> Competition in this context is desirable because it substitutes an impersonal market control for the personal control of powerful business executives, or for the personal control of government bureaucrats.

Governance by command is replaced by governance by law. Rules are substituted for privileges. This brings economic theory into play. Instituting rules requires predictions of outcomes. Economic theory, however, is best suited for predicting long-run consequences of institutions and modes of behavior. It is less well suited for evaluating short-run relationships which may be analyzed by invoking game theory. Frequently multiple equilibria exist and thus unequivocal predictions are not possible. In the long run, however, some definite outcome may wind up to survive. For competition policy, seeking to establish rules holding in the long run, it is most important to ensure that welfare-enhancing developments are not blocked by restraints of competition. Thus private initiatives will be unleashed to enhance economic welfare.

For competition policy to assume a distinct profile and to emancipate it from political controversies it is necessary to be guided by a unique objective. Posner (1976) and Bork (1965, 1978) therefore suggest that competition policy should adopt welfare maximization as the sole objective. Economic theory allows unequivocal principles for competition policy to be derived from this objective. All the other aims of competition policy mentioned above are to be pushed into the background. Unless they are completely discarded, competition policy may proceed in two successive steps. First, the authorities entrusted with implementing competition policy should by guided by the aim of welfare maximization. In a second step auxiliary and possibly even competing objectives may be taken up. If a trade-off arises, a political decision is required. There is no conflict between maintaining economic freedom and maximization of welfare because a competitive order ensures the attainment of both.

1.1 COMPETITION IN A MARKET ECONOMY

Competition and economic freedom are like two sides of a coin. Philosophically John Locke (1690) propounded the idea that everybody has the unalienable right to pursue happiness and to define his or her interests. This idea gathered political momentum by its propagation in the famous Bill of Rights of Virginia, in the constitution of the United States of America and in the French Revolution of 1789. It finally became the core of all constitutions of the Western world. Individual freedom is deemed to be limited only insofar as the rights of other people must not be infringed. To be sure, as emphasized by Joseph Schumpeter (1942), competition entails 'creative destruction' by displacing existing products and methods of production by new ones. Hence, from day to day there are both winners and losers. Still, in the long run, all can become winners unless the right to participate in market activities is curtailed. Freedom to join the competitive process must therefore by safeguarded by law. In his popular essay *On Liberty* John Stuart Mill (1859, pp.

16f) has propounded this principle in admirable clarity,[1]

> The only freedom which deserves the name is that of pursuing our own good in our own way, so long as we do not attempt to deprive others of theirs or impede their efforts to obtain it.

Given economic freedom the scope of economic activity, the level of production and the distribution of income follow from autonomous decisions of individuals. As convincingly expounded by Hayek (1973, p. 41), individual freedom gives rise to a spontaneous order which has not been deliberately designed by anyone.

> Since a spontaneous order results from the individual elements adapting themselves to circumstances which directly affect only some of them, and which in their totality need not be known to anyone, it may extend to circumstances so complex that no mind can comprehend them all.

The spontaneity of individual behavior gives rise to an open-ended process, the outcome of which cannot exactly be predicted. There is no way to determine in detail what the objective of the economy is. Therefore a common weal is impossible to narrow down. It nevertheless remains true that economic freedom is best suited for safeguarding the individual welfare to be achieved. Even though a welfare maximum cannot be identified in advance, competition can be understood as a process approaching a maximum. The neoclassical theory of maximizing behavior of individuals which under competitive conditions yields a welfare maximum can be used as a paradigm of an evolutionary process. In fact the evolutionary process, characterized by survival of the fittest, is a process of groping for a superior outcome and can thus be understood as the equivalent to solving a maximization problem. Depicting it by setting up and utilizing a mathematical model amounts to simplifying matters, but at the same time helps to understand what is going on. Spontaneity, as alluded to by Hayek, implies that the outcome cannot be predicted because 'we cannot anticipate today what we shall know only tomorrow' (Popper 1957, p. x). Although the specific outcome is thus unknown, it is helpful to utilize a model as mentioned above to identify circumstances under which a maximum of economic welfare is attained. Theory thus gives guidance to devise the framework and the rules of the game to be applied. The choice of the rules must not be left to emerge spontaneously from the interplay of individual interests. That would amount to subscribing to the

[1] In *Utilitarianism* (1861, p. 22) Mill gave it a positive turn by citing the golden rule of Jesus of Nazareth (Matthew 7, 12) 'To do as you would be done' as being the ideal perfection of utilitarian morality.

principle of laissez-faire. Safeguarding economic freedom, as propounded by John Stuart Mill, must not be confused with laissez-faire. Laissez-faire provides scope for a dominant firm or a cartel to interfere with the liberty of other people and may eventually eliminate economic freedom altogether. Therefore competition policy must be geared to prohibit the abuse of economic power.

Competition as Institution Needs Protection

Although in a free economy the individual pursuit of profit is the engine of economic development, freedom alone does not suffice. For the pursuit of profit to be compatible with the advancement of economic welfare a competitive order must be established. Through competition variegated individual capabilities and powers are harnessed and put into motion to serving the common weal. Adam Smith illustrated the relationship between the pursuit of self interest and economic welfare forcefully by invoking the parable of the invisible hand. Provided competition exists, an entrepreneur following self-interest is 'led by an invisible hand to promote an end which was not part of his intention' (A. Smith [1776] 1950, vol. 1, pp. 477f). This is indeed a remarkable insight. For economic welfare to be enhanced, individuals need not pursue this objective. On the contrary, it would be presumptuous for individuals to claim that their command of knowledge and capabilities would enable them to act in the interest of the society. Moreover, frequently people in possession of power invoke the public interest only for being able to serve their own interest more successfully. To provide scope for the invisible hand to accomplish its task, competition policy must aim at securing undistorted competition. Since it involves creative destruction competition policy must not be concerned with protecting the individual competitor but with protecting competition as an institution.

The necessity of competition policy derives from the experience that everybody quite naturally strives for obtaining a position uncontested by competition (North 1981). Countless admonitions of churchmen from the Middle Ages and the Early Modern Times (Tawney 1926, passim) against greed and avarice, as revealed by exercising monopoly power, are convincing proof of the prevalence of the reprehended behavior. The experience with the economic practice of his time led Adam Smith ([1776] 1950, vol. 1, p. 144) to observe,

> People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.

In fact Ashton (1964, pp. 89–91), in his history of the Industrial Revolution in England, mentioned quite a few cartels in various industries and thus supports the evaluation to be found in Adam Smith. What was true in England of that time applied as well to other countries.

Cartels existed also in the United States (Kintner 1980a), and the last third of the 19th century saw the emergence of trusts. The trust used to be a legal form where the voting rights of shareholders of the participating firms were transferred to a trustee such that unified decision-making was ensured. Hence, trusts were tightly knit cartels. The start was made by John D. Rockefeller who founded the Standard Oil Company in 1882. By eliminating most of his competitors he created the largest monopoly of the country. His example was followed by the creation of other trusts pertaining to lead, whiskey, sugar, matches, tobacco and rubber. By 1904 there were 319 industrial trusts which 5300 formerly independent companies had absorbed (Nevins and Commager 1981, pp. 269ff).

In Germany, at that time, cartels were created first in coal mining and the iron industry, and later on in various other industries, as will be reported below in more detail. This historical experience as well as collusion repeatedly uncovered up to the present time proves that Walter Eucken (1959, p. 37) was right in suggesting a 'propensity to monopolize' exists which tends to undermine a competitive order. A competitive order must therefore be protected by an appropriate competition policy.

To elucidate the effects attributable to competition, and to confront them with the consequences following from restraints of competition, it is helpful to consider two opposing cases, namely perfect competition and monopoly. The analysis of these extreme cases, which themselves are hardly ever to be found in reality, allows for the development of standards of evaluation which also apply in the more realistic setting of an oligopoly to be treated in the next chapter.

Perfect Competition

Put most simply, competition and monopoly are distinguished by the presence or absence, respectively, of power to fix prices. Whereas a monopolist has the power to fix the price such that his own interest is served best, competition curtails this power to set prices, and in the extreme case of perfect competition there is no power at all. According to Frank Knight (1921) perfect competition prevails if buyers are perfectly informed about the quality of the product and the prices charged by competing suppliers, and if no barriers to entry exist such that actually or potentially the number of competitors is large, in the extreme infinitely large. Firms are assumed to be driven by self-interest. Since prices are given, firms choose the level of output such that profits are maximized. This requires marginal costs, that is, additional costs for an extra unit of output, to equal the price.[2]

Given perfect competition, in the long run, the price cannot exceed average costs of production. Otherwise profits would entice new firms to enter the market. Supply would increase and the market price would decline until it covers average costs and profits disappear. If demand for a commodity or service increases, at a given supply, the price goes up and profits arise. Following the entry of new competitors, during a period of adjustment existing firms can still earn profits, called quasi rents, but eventually they are eroded by the entry of new competitors.

The model of perfect competition has frequently been criticized for its static assumptions regarding demand and costs. As suggested by Schumpeter (1912) competition unfolds itself by innovations, that is, by the introduction of cost-reducing processes, new products and new ways to organize economic activity. At a close look, however, this criticism turns out to be unfounded. Starting from the model, as expounded above, to account for the facts emphasized by Schumpeter, innovations are easily incorporated. Between the notion of competition as rivalry unfolding in the dynamics of innovations and the ensuing change in prices on one hand, and the model of perfect competition, as suggested by Knight, on the other, a fundamental difference does not exist as frequently asserted (DiLorenzo and High 1988). Since competition entails profits to be eroded by the entry of competitors, each firm has the chance and an incentive to reduce costs or to elicit new demand by adopting process or product innovations and thus to improve profitability. Each enterprise is assumed to choose the level of output such that at a given price, which cannot be raised by an individual firm, profits are maximized. Following a cost-reducing innovation profits increase as long as marginal costs fall short of the given price. In this way total production increases which yields a decline in the market price. Firms that have failed to reduce their costs are coming under pressure and must eventually leave the market once the price falls short of their average costs. Schumpeter (1942) has called this 'creative destruction'. Old ways of doing things are displaced by new ones.

Still, not all firms with average costs exceeding the market price, which has fallen following innovations, are driven from the market immediately. At each time producers with different costs usually exist side by side because physical capital as well as human capital incorporated in organizational structures is long-lived and sunk. It cannot therefore be removed in the short

[2] Maximizing profits, $\Pi = pq - C(q)$, where p is price, q is output, and $C(q)$ are costs depending on the level of output, requires $d\Pi/dq = p - C'(q) = 0$, $d^2\Pi/dq^2 = -C''(q) < 0$, $C'(q)$ being marginal costs.

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