

**Industrial economics:
SECOND PART**

Competition policy

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Economia e Gestione Aziendale (LMEGA)

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Competition Policy

A definition:

“Set of policies and rules aimed at ensuring that competition in the marketplace is not restricted in a way that is detrimental to society”.

We will study the economic theory (Oligopoly theory in particular) that is the basis and the rationale of these policies.

OUTLINE OF THE LECTURES

1. Competition Policy: history, objectives and rules
2. Market power and social welfare
3. Market definition and market power evaluation
4. Collusion and horizontal agreements
5. Horizontal mergers
6. Vertical restraints and vertical mergers
7. Predation, monopolization and other abusive practices

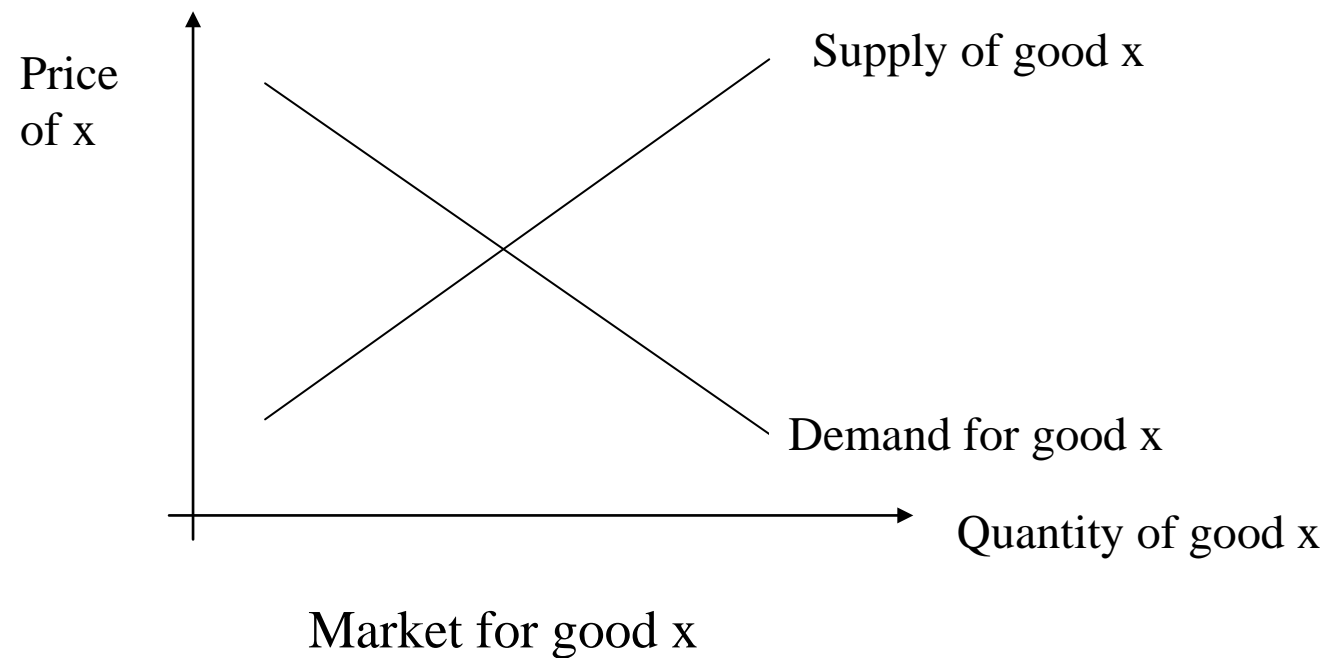
Textbook:

M. Motta, "**Competition policy. Theory and practice**", Cambridge University Press, 2004.

INTRODUCTION: WHY COMPETITION?

- Government plays a major role in all developed economies (beyond a certain threshold we call them “mixed economies”). Government interferes in the economy both for *efficiency and equity* reasons.
- You have just studied different market forms: perfect competition, monopolistic competition, oligopoly, and monopoly.
- Perfect competition is the baseline market structure for economists. The fundamental competition model deals with rational individuals aiming at their personal interest and with firms maximizing their profit, both interacting in (perfect) competitive markets.

DEMAND AND SUPPLY OF A GOOD IN A MARKET UNDER PERFECT COMPETITION



How to get demand and supply for a good?

- Consumers and firms are “rational” agents making efficient choices (Theory of consumption and Theory of the firm)
- **DEMAND:** aggregation of individual demand functions (each consumer decides how much to consume given his/her budget constraint and the price of the good).
- **SUPPLY:** aggregation of any single firm supply functions (each firm chooses the quantity of product that maximizes its profit).

- A perfectly competitive market reaches the equilibrium in a natural way.
- At equilibrium, the price level is so that offered quantity is equal to requested one: choices of buyers and sellers are compatible

WHICH CONCEPT OF EFFICIENCY?

Pareto Efficiency: *there's no universally preferred alternative.*

A Pareto optimal allocation is an allocation (x^{*1}, \dots, x^{*I}) so that it doesn't exist another allocation $(\tilde{x}^1, \dots, \tilde{x}^I)$ sustainable from an economic perspective and giving the same utility to all consumers and a higher utility to at least one of them :

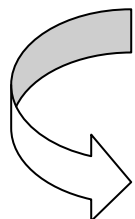
$$U^i(\tilde{x}^i) \geq U^i(x^{*i}) \quad i = 1, \dots, I$$

and it exists at least a i' such that

$$U^{i'}(\tilde{x}^{i'}) > U^{i'}(x^{*i'}).$$

Equilibrium property of a competitive market

- Resources allocation is Pareto efficient (no waste)



1st Welfare Economics Theory

This means that welfare of economic agents (buyers + sellers) is highest when each agent pursues his/her own objective (self-interest):

- Price is equal to the marginal producer's marginal cost
- Price is equal to the value marginal consumer attaches to the good



So Adam Smith was right:
the market is “the invisible hand”

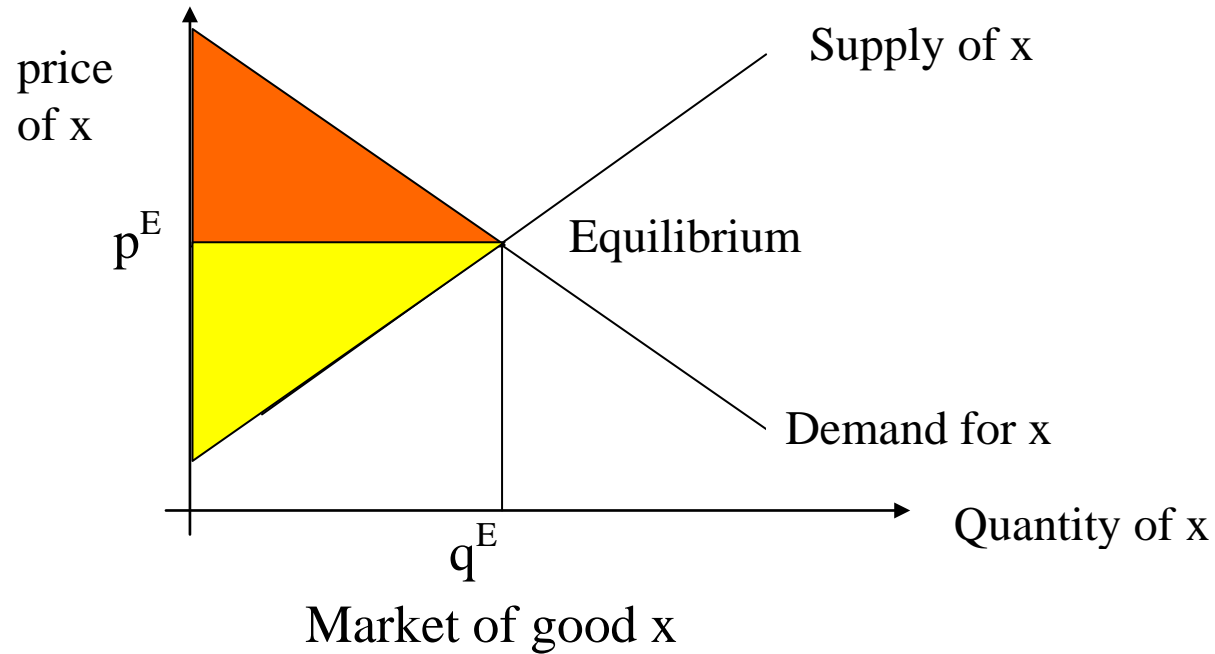
Due to prices allocation function, production and purchase choices are compatible in *any single market of the economic system* (general economic equilibrium).

- **Prices allocative function**

Prices allow economic agents to coordinate and to reach the equilibrium:

- Scarce goods are purchased by agents attaching them a higher value
- Productive resources are used in more profitable sectors (the ones with exceeding demand)

- How can we measure social welfare (benefits coming from trade)?
social welfare = consumer surplus + producer rent.



- At the equilibrium, benefits from trade are maximized.

Caveat: market equilibrium implies goods RATIONING (not all consumers have access to the goods or to the desired quantity). But all consumers have access to the quantity they want (possibly zero) GIVEN market price and GIVEN their budget constraint.

In a competitive market the price system leads to the final allocation of goods and services. Other methods to ration economy's scarce resources are:

- **waiting lists**
- **draws**
- **vouchers**

Even though all these methods are more equitable, they are less efficient (the good is not purchased by the agent willing to pay the most to own it)

- Prices communicate information on *goods scarcity* to economic agents.
- Price of good x is high when the available quantity of it is low: for instance, water price and diamonds price.
- Intervening on prices brings about high inefficiencies.
(pavements and ceilings)

Necessary Conditions for a perfectly competitive market

1. goods produced by different firms are perfect substitutes for consumers
2. Each firm produces a very small quantity with respect to total quantity exchanged in the marketplace (*many* price-taker firms): **no market power**, i.e. price = marginal cost, **mark-up is zero**
3. perfect mobility of factors (no sunk-costs = no recoverable costs)
4. perfect information for both firms and consumers
5. no network economies

It's very hard that all previous conditions are fulfilled (exception: agricultural goods markets). Nonetheless, perfect competition is an objective to pursue. As a matter of fact, in perfectly competitive markets, production is efficient (firms have incentive to minimize their costs) and consumers get a high surplus from purchase (because firms have no market power). Furthermore, firms have incentives to produce high quality goods and services.

When markets are not perfectly competitive we say that **markets fail**.

In the real world many MARKET FAILURES exist.

Those who are related to competition policies are the one concerning the supply-side of the market (firms and production).

They are:

1. sunk-costs,
2. market power,
3. natural monopolies,
4. network effects.

SUMMING UP: WHY ECONOMIES NEED A **COMPETITION POLICY**?

Because real firms have some MARKET POWER, even in markets with free entry and no natural monopolies. What determines firms' market power?

- *sunk costs*
- *lock-in and switching costs* effects
- *network effects*

Moreover, un-monitored, firms may resort to actions that increase their profits, but harm society, such as:

- Collusion
- Mergers which lessen competition
- Predatory behaviour
- Exclusionary behaviour

- Why do we need to restrict market power?
- Market power causes inefficiencies:
 - ALLOCATIVE
 - PRODUCTIVE
 - DYNAMIC
- **Public Policies role:** to avoid negative consequences deriving from firms' market power:
 - REGULATION
 - COMPETITION POLICY (ANTITRUST)

REGULATION vs COMPETITION POLICY (i)

Both are justified by market failures, but they differ by:

- *Procedures and control rights*
 - Regulation: more extensive powers (price, investments, products...), it can intervene on market structure
- *Timing of oversight*
 - Competition Policy: ex-post; regulation: ex-ante
 - continuous (regulation) vs. occasional (Competition Policy) intervention
- *Information*
 - more industry-specific for regulation

REGULATION vs COMPETITION POLICY (ii)

Despite these differences, the distinction between competition and regulation is less clear-cut. Antitrust Authorities intervene even in case of:

- Mergers: preventive authorization system
- Merger remedies: structural vs. behavioural remedies
- Exploitative abuses interventions (EU: article 82; not US)

Also: overlapping competence in several areas

A BRIEF HISTORY OF COMPETITION LAWS

THE US (i)

End of XIX Century in the US:

- Revolution in transportation and communication, which lead to a single US market
- Technological innovations, evolution of stock market, new managerial methods
- Mergers waves

→ economies of scale and scope to be reaped: firms' size increases

THE US (ii)

Market instability, due to macroeconomic crises and price wars, so:

Incentives to form cartels and trusts (Railways and Oil Companies), to get high and stable prices

- Negative effects on small firms (Transportations and energy as inputs) and farmers

1890: **Sherman Act** (monetary and penal sanctions)

- Section 1: it punishes trade restrictions (Conspiracies)
- Section 2: it punishes Monopolisation = exploiting Monopoly position

Objectives: (related to economics) minimizing social welfare losses due to market power \Rightarrow minimizing allocative inefficiencies.

(non-economics) protecting small firms, maintaining the same opportunities to all competitors

1914: **Clayton Act**

Prevents from entrepreneurial practice such as:

- art. 2, price discrimination;
- art. 3, exclusive dealing contracts (no deal with competitor), contracts for the whole consumption (all from the same supplier), contracts with restraint clauses (tying);
- art. 7, anti-competitive mergers

1914: **Federal Trade Commission Act**

It founds the Federal Trade Commission => Authority monitoring on unfair competition, consumers' protection and misleading advertising

THE US (iii): Competition laws enforcement

1897: first Supreme Court decisions against trusts

1911: Standard Oil broken into 34 firms

“*Per se*” prohibition of price agreements

(*per se / rule of reason*)

1950-60: active and hard enforcement

1970s: efficiency criteria begin to play a role

1980s (Reagan): low enforcement (*laissez-faire*)

A BRIEF HISTORY OF COMPETITION LAWS: EUROPE (i)

Before WW II: totalitarian regimes enforcing protectionist and interventionist policies

After WW II: US push Europe to accept Competition laws

- 1951 **Paris Treaty** (CECA = ECSC: European Coal and Steel Community) among France, Germany, Italy and Benelux: against trade barriers, price discrimination and restrictive practice potentially distorting trade in Europe
- Rationale: equal access to fundamental resources such as coal and steel (reducing German power), support to free markets (inspired to US)
- Before EU Competition Law were established, the treaty stated:
 - Art. 65: prohibits agreements that distort trade
 - Art 66: prohibits abuse of dominant position
 - Art. 66: concentrations

EUROPE (ii)

1957 **Treaty of Rome** accepts in art. 85, 86 what settled in Sherman Act (art. 1 and 2)

then become in **Treaty of Amsterdam** (1/05/1999): art. 81 and 82

- art. 81: prohibits all agreements, unless they allow to increase consumers' benefits from trade (see following list)
- art. 82: prohibits dominant position abuse (monopolisation), with a list of some practices
- art. 86: rules for legal monopoly firms

EU Competition Laws objectives:

- *Competition* as an intermediate objective, the primary objective being to help **economic progress and welfare of European citizens**
- To promote *European integration* (elimination of national discriminations in the economic system)

- art. 81, par.1: prevents from agreements (*conjoint exertion of market power*) aimed at:
 - fixing purchase or selling prices
 - limiting or controlling production, technical development, or investment
 - sharing markets or sources of supply
 - applying dissimilar conditions to equivalent transactions
 - make the conclusion of contracts subject to acceptance by other parties of supplementary obligations with no connection with the subject of such contracts
- art. 81, par.2: Automatically voids previous agreements
- art. 81, par.3: Exclusions for agreements such that:
 - improve production/distribution of goods
 - promote technical/economic progress

avoiding to

- impose not indispensable restrictions to the attainment of these objectives

EUROPE (iii)

1989, rule 4064

- it accepts what settled by Clayton Act with respect to concentrations
- furthermore, it institutes the **Directorate-General for Competition (DG IV)** a body aimed at defending competition (similar to FTC).

European Commission is in charge of norms enforcement (DG IV operates inside the European Commission).

Functions:

- Opens investigations autonomously or on request
- Declares illegal practices and enforces prohibitions
- Applies sanctions
- Communications and guidelines: “*economic analysis is important*”

Appeals against DG IV decisions: First degree court + European Court of Justice

Per se / rule of reason

- *Per se*: “conduct is prohibited if it fulfils the legal test regardless of other issues”
- *Rule of reason*: “conduct is prohibited if its negative consequences outweigh the positive”
- Art. 81 and 82 of the Treaty seem to point out a *per se* approach
- However, to demonstrate a firm abused of its dominant position, Authorities have to:
 - Show the firm took advantage of its dominant position in the market
 - Its conduct was abusive
 - In practice, Art 82 is close to the *rule of reason*
- In recent times Authorities are moving towards a *rule of reason* approach

ITALY

- *Delay* (almost 100 years after US) even with respect to other European countries. Reasons:
 - direct public presence within the economy (energy, telecommunications, ...)
 - previous existence of Treaty of Rome norms
 - propensity for a planned economic development with strong government intervention
 - scarce liberal culture
- end of 1980es: the previous economic system, deep rooted in State participation tumbles down, competition and private-oriented approach prevailed, Italian Antitrust Law is promulgated

Law 287/10 October 1990 *Rules for competition and market protection.*

Recovers completely European laws.

- **Objects:**
 1. Promoting productive efficiency and efficient allocation of economic resources
 2. Ensuring the same possibilities of economic action to all firms
 3. Controlling market power transmission
- Dominant position, agreements and mergers
- Subsidiarity with respect to European legislation
- Establishment of AGCM (Guarantee Authority on Competition and Market)

Art. 10: the **Autorità garante della concorrenza e del mercato** (AGCM) is established; it's an independent administrative authority committed to enforce antitrust laws. Competent on all economic sectors (involving bank sector with respect to competition issues). Bank of Italy nowadays only deals with commercial banks *stability*).

Tasks:

1. Autonomous investigations
2. On request by third parties
3. Studies on dubious markets
4. Decisions

- Law 287/90 **Title II**: establishment and tasks of AGCM
 - **Section I** : AGCM's features
 - **Section II** : powers agreements restricting competition and abuse of dominant position issues
 - **Section III** : powers in concentration issues
- Law 287/90 **Title III** : powers related to learning and advice

1.Preventing exclusionary vertical or horizontal dealings (agreements)

- Agreements are prohibited, but...
- Dispensation: AGCM may consent for a restricted time those kinds of agreements that produce **improvements in supply market conditions** and for the **benefit of consumers**.
 - Not even in such cases the removal of competition is admitted
 - AGCM may revoke a permission whenever the subject abuses of it or premises for the same permission vanish

2. Oversight on dominant position abuse

– Predatory pricing, refusal to supply, barriers to entry

- **Art. 3 c. 1**

– *A Firm with a dominant position, cannot benefit from the previous mentioned dispensation*

3. Prevention of the creation of a dominant position (CONCENTRATIONS)

- Art. 5: relevant cases
 - Two or more merging firms
 - A subject holding at least a firm, buys or take control of parts of one or more firms (acquisition)
 - Establishment of a joint firm (*joint venture*)
- In such cases, communication to AGCM is requested
- *Left out sectors*: public utilities provided in legal monopoly conditions
- AGCM may:
 - command to suspend temporary firm's activity until the end of the investigation
 - allow concentration, possibly prescribing measures to eliminate competition distorting effects
 - prohibit concentration fulfilling

COMPETITION POLICY

Back to definition:

- “Set of policies and rules aimed at ensuring that competition in the marketplace is not restricted in a way that is detrimental to **social economic welfare**”.
- From an economic point of view, the main objective is the maximisation of social welfare.

COMPETITION POLICY OBJECTIVES:

Which kind of welfare?

- Social welfare

Total Surplus = consumers surplus + producers surplus. With market power, if price lowers, total surplus increases.

⇒ It should neglect distributive problems

Dynamic aspects are relevant (innovation)

- Consumers Welfare

- *Political economy* argument (lobbying)

- Who owns the firms?

- Incentives to innovation

Often pursuing consumers welfare is, however, equivalent to pursuing social welfare

OTHER POSSIBLE OBJECTIVES

- Defence of smaller firms
- Promoting market integration
- Economic freedom
- Fighting inflation
- Equity
- Other public policy considerations affecting Competition:
 - social, political, environmental reasons
 - strategic reasons (trade and industrial policies)

⇒ From an economic perspective, driving criterion should uniquely be social welfare.

Summing up: Practices investigated by Competition Authorities

- **Agreements** on prices and/or market sharing
- **Predation** with different methods: Exclusive Dealings (a retailer agrees to carry only the brand of a certain manufacturer), fidelity rebates, refusal to deal (essential inputs and facilities)
- **Vertical Restraints** for instance Resale Price Maintenance (the manufacture sets constraints on how the retailer should choose the price of the good: price floor, price ceiling; or directly fixes the price), Exclusive Territories (only one retailer can sell a certain brand within a certain geographical area), Exclusive Dealing
- **Price discrimination** when detrimental to firms competition (for instance tying/bundling to extend a dominant position on different markets)
- **Mergers** among firms