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Competition Policies

Report by David Encaoua and Roger Guesnerie

EDITORIAL

In the case in point, history and geography lessons help shed light on the main choices made in competition policies, particularly those implemented in the European Union. But, where should one draw the line between competitive demand and consumer protection? What should the balance be between the logic of competition and that of cooperation? How must one fit together competition policy and R&D and innovation policy? The recommendations made in the report are rich, pragmatic and quickly operational. We draw your attention to the series of propositions to implement at community level. Not forgetting, of course, purely-French reforms required by the evolution of the general context and justified by the principle of subsidiarity.

Christian de Boissieu
Executive Chairman of the CAE

A market economy requires rules and regulations. Competition policy is one instrument of this regulation. This report presents the intellectual and historic foundations of these policies. It then details their areas of intervention, ranging from the control of market structures, through the control of merger transactions, to that of behavior through applying antitrust rules. Moreover, the report underlines and details the increasing importance of economic analysis both in the implementation of policies, and in regulatory and institutional shaping.

This report was presented to the Prime Minister on September 14, 2005. This letter, released by the Permanent Committee, reviews the authors' main conclusions.

Competition policies have experienced increasing importance in all western countries. This report details their origins and the different fields of intervention. It gives an educational and exhaustive overview of the optimal forms and intensity of competition, the complementarities of competition policies with other policies, the diversity of the areas and mechanisms of implementation and the internal coherence of these governance systems. It offers a certain number of recommendations, in particular to improve the coordination of competition policies with those policies promoting competition and innovation. It also recommends that the objectives assigned to these policies and to the authorities who implement them be clarified.

Origins and foundations of competition policies

In the first part, the authors put into perspective current competition policies with reference to the discipline's intellectual and historic foundations. Competition policies are firstly described as being historic products. The authors contrast the emergence of these policies at the end of the nineteenth century in the US and subsequently in the middle of the twentieth century in Germany.

The first North American laws saw light with the Sherman Act in 1890 and Clayton Act en 1914 to fight against trusts, while acknowledging the positive aspects of concentrating production means to capitalize on economies of scale. These first texts were federal laws aimed at prohibiting interstate trading restrictions. The authors describe the shift in the balance after the implementation of this law. After the dormant years between 1915 and 1936, which saw the promotion of the providence State, came the activist years of 1936 to 1972 under the influence of the structuralist school, Havard. Strong suspicions against large companies and the determination to simplify to extremes the burden of proof incumbent on competition authorities, led to the promotion and quest for small, highly fragmented market structures. 1973 to 1992 was a period of radical transformation, under

the influence of the School of Chicago, which demonstrated the possible positive impacts that certain restrictive competition practices could have on well-being. Emphasis was placed on efficiency gains and taking account of the need to promote innovation. These arguments were then developed more formally by the post-Chicago synthesis using game theory techniques.

The evolution of competition policy in Germany is rather different. After 1945, it was influenced by two factors. The first, of an intellectual nature, is associated with the ordo-liberalism doctrine. The second, of a political nature, reflects the pressure from alliance forces to dismantle the cartels regime. In 1958, the Restraint of Trade Law, known as GWB, was voted in the Federal Republic of Germany. In this text, competition is a rightful object which must be protected itself. The objective therefore differs from that prevalent in the US, that is the defense of economic efficiency. Suspicions regarding economic dominance therefore play a more important role in Germany than in the US. The authors then explain the different intellectual reasoning behind competition policy, emphasizing its complexity and relating it to developments in economic analysis. Even if increased economic reasoning has not stabilized the way in which competition policies are implemented, as past experience confirms, at least it will have favored a certain contemporary convergence of competition policies between two continents.

Areas and method of implementation

Secondly, the authors analyze the issues and limits of community competition policy by reviewing the main areas of implementation, that is antitrust and control of concentrations. This part recalls the constant tug of war between competition and cooperation, with a view to enhancing economic efficiency, which influences the implementation of competition policies. The mechanisms enable the implementation of *ex ante* control over market structures or contractual relations and *ex post* control over companies' behavior. The optimal policy should use at best a mix of both these methods. These controls are also subject to the delicate tug of war between a quest for greater legal protection provided by prohibition rules themselves or '*per se*' and improved efficiency by applying so-called 'rules of reason', which enable a case by case examination, with the inevitable uncertainty that this carries. The authors recall that since the Treaty of Rome in 1957 and until recent reforms implemented in 2004, the community competition policy has been characterized by the coexistence and juxtaposition of three objectives. The first objective, inherited from the German ordo-liberal concept, is defense of competition, designed as an object of law to be protected in itself. The second objective, which was initially predominant but still exists nonetheless, is that of common market integration. The third objective is that of efficiency, according to which only practices that reduce the well-being of consumers or in certain cases global well-being are reprehensible. This objective, more explicitly economic, is on a par with the American concept of competition policy.

Antitrust

The core issue of competition policy is then discussed: antitrust. The themes of fighting against cartels, exclusion practices and restrictive practices are dealt with successively. The battle against cartels and the examination of agreements draws a line between what is tolerated between competition and cooperation. The authors recall the differences in sanctions that exist on both sides of the Atlantic. In the US, cartelists are liable to a prison sentence, but not in Europe. The offenders expose themselves to fines equal to triple the amount of the damages. The materiality of proof necessary to penalize cartels is then examined. This leads to the distinction between tacit and explicit collusion. Explicit collusion designates agreements and practices of which material proof has been found. Conversely, the detection of tacit collusion depends on a range of evidence. The degree of materiality of the proof necessary to penalize cartels leads to cracking down solely on explicit agreements or also tacit agreements. This difficulty has been at the origin of the differences between the Commission's decisions and judgments on appeal at the Court of Justice. The Commission has often sought to condemn behavior it considered to be going against economic efficiency without material proof. In contrast, the Court of Justice has sought to further preserve economic freedom by demanding tighter standards on proof. The Commission has often used parallel behavior or prices as evidence of tacit collusion, the Court of Justice being more reticent to accept such arguments. Leniency programs, recently introduced at community and national levels are also detailed. They provide for granting amnesty to a member of a cartel for all or part of their fines in return for information that make possible to prove its existence. These programs illustrate optimal policy seeking to reveal and detect illicit practices at lower costs. In certain circumstances, cooperation between companies can prove beneficial from an economic efficiency standpoint. Such agreements are made possible through a legal exemption regime provided that two conditions are respected: to be beneficial to consumers and not to totally eliminate competition. This is notably the case of certain R&D, specialization or technology transfer agreements which can favor innovation. This also holds true for certain vertical restrictions between suppliers and distributors. Community legislation intensively introduced the mechanism called block exemption, based on business category. An agreement between companies that do not have excessive market power (generally market share of less than 20 or 30%) and that does not include competition restraints (specific to each business category) can benefit from block exemption. Until May 2004, when one of these conditions was not fulfilled, the regime of obligatory notification was applied and the Commission then decided on a case-by-case basis. Since May 2004, the regime in effect is that of legal exemption. These agreements are considered licit unless proved otherwise by the Commission. It is therefore down to the companies themselves to evaluate efficiency gains enabled by competition restrictions and therefore to bear the legal risk.

The authors then review the practice of fighting against exclusion strategies, or more generally the abuse of a dominant position. This domain is reputed for being one of the most delicate because evidence is difficult to provide. The use of excessively low prices or contractual clauses such as discounts, related sales or discriminatory prices are instruments which can be used as mechanisms of predation against competitors, but are not as such harmful to consumers, at least not in the short term. Competition authorities are faced with considerable information asymmetries as to the evaluation of pertinent costs or the purpose of such practices. The sequentiality of the burden of proof during the different phases of investigation can be optimized in order to limit these informational constraints. This is the purpose for drawing up the *structured rules of reason* that are under discussion as part of the reform of article 82 of the Treaty. Likewise, certain restrictive competition practices in vertical relations between suppliers and distributors remain prohibited *per se*. Yet, the economic theory suggests possible positive impacts of each of them. The rule of reason should therefore prevail over *per se* rules. In France, this concerns mainly the prohibition of reselling at a loss, which the authors would like to see removed.

The control of concentrations

The control of merger transactions is then discussed. This concerns a control of structures, which requires a prospective logic, as opposed to a retrospective or repressive logic, which overrides the previous implementation of competition rules. Until 2004, the Commission could prohibit a merger if the latter were to lead to the creation or the reinforcement of an individual's or collective's dominant position, thus creating a risk of anti-competitive practices. As mergers cannot be prohibited –which would increase the risk of cartels too much– the Commission used to implement a fragile concept (from an economic analysis standpoint), which is that of a collective dominant position. In several of its judgments, the County Court contested the Commission's decisions, not only on the issue of form but also substance. The County court has thus moved from playing a role of controlling manifest assessment errors to controlling the Commission's economic reasoning. The reform of May 2004 changes both the implementation of the control of concentrations and the assessment criterion. The new procedure is founded on stronger cooperation between the Commission and national competition authorities. Basically, the test of economic dominance has been replaced by the test of actual significant obstacle to competition, equivalent to the Anglo-Saxon so-called test of considerable reduction in competition. This test therefore substitutes a rule of reason –corresponding to what is known as the unilateral impact of a merger, which must be evaluated on a case by case basis– for the *per se* rule corresponding to the notion of individual dominance. It is more restrictive than the test based on dominance since a significant obstacle to competition can exist in the absence of individual economic dominance. Secondly, the new regulation introduces the concept of the coordinated aspect of a merger, implying increased chances of collusive behavior on the market after the merger. This depends on a certain number of factors supposedly facilitating the collusion. The efficiency gains generated by the merger could be taken into account and weighed up against possible competition restraints. This was not possible before because, on the contrary, the improved efficiency of the newly merged entity was seen as reinforcing its dominant position on the market. Finally, the authors examine the structural remedies (asset disposals) which can be imposed by a competition authority as a corrective measure for some merger transactions.

Competition policy and innovation policy

This report also pays particular attention to the problems in the interface of competition, innovation and intellectual property policy. These problems are of increasing importance in our contemporary societies, where immaterial assets play an increasingly decisive role, and raise the question as to whether the specificities of sectors, where innovation is dominant and permanent, demand special treatment with regard to the enforcement of competition law. According to the authors, greater coherence between legislation and the economy is necessary here: on the one hand, intellectual property appropriately granted is a great incentive to invest in research; on the other hand, intellectual property rights should not be excessive. The contrasting examples of the US and Europe testify to this tension. The excessive extension of patentable fields suggests a certain abuse of intellectual property in the US and this goes hand in hand with the increased rights of the holder and greater laxity in granting these rights. The situation is very different in Europe where even community unification of intellectual property rights is far from being attained.

State aid

Finally, the control of state aid is discussed. This is a sensitive and controversial area that covers certain aspects of industrial policy, notably through the aid granted to companies in difficulty. This aid can distort competition and considerably affect trading between EU member countries, or even maintain in the market (thanks to public aid) a company temporarily in difficulty. But in certain cases, this can be paradoxically pro-competitive. The report questions the criteria used to qualify for state aid (net advantage to the beneficiary, selective nature of the aid, public funds to finance the aid), the pertinence of these criteria given the objectives of the competition law, and the adequacy of the repayment obligation in the event of success. On these issues, the report pleads in favor of reinforced and controlled subsidiarity. The question is then widened to that of differences between member states in terms of tax, social or environmental standards, bearing in mind that such differences are the origin of increased competition asymmetries further to the expansion of the EU.

Recommendations

The third part takes a more global perspective and includes a certain number of recommendations. In the preamble, the report points to a certain indecisiveness regarding the objectives of competition policies which seem to be torn between consumer surplus and the well-being of the economic citizen, between the short and medium term. The recommendations are divided into two main categories.

The first consists of exploiting complementarities between competition policy and competitiveness and innovation policies. The gap between Europe and the US in terms of financial resources dedicated to research and innovation policy is considerable, while even competition policies are currently converging strongly between both continents. The first category refers to the imbalances caused by European preeminence of competition policy. This entails both giving back space and resources to competitiveness and innovation policies and making better use of complementarities with competition policy. The authors suggest that the European Council commits itself to boosting the community budget for research and innovation each year by an amount equivalent to the 'revenue' from the competition policy (i.e. collections from fines). They also suggest strengthening innovation incentive mechanisms, including intellectual property protection.

The second category consists in smoothing out certain tensions created when implementing competition policy. As regards future implementations, the tests carried out on the control of concentrations favor the short term, whereas emphasis should rather be on the medium to long term. To reduce tensions at community level, the authors suggest establishing coordination between the Competition DG, Enterprise and Industry DG and the Research DG to evaluate merger transactions involving significant industrial competitiveness issues. They also suggest that the commitments governing concentration authorizations should not be only of a structural nature, as is the case at present. Corrective measures leading to behavioral commitments may suffice, if they are accompanied by sanctions in the event of *ex post* non-compliance. As for France, the report recommends two alternatives to improve the control of concentrations. The first is calling into question the current regime for the control of concentrations: notification would be submitted to the Competition Council (Conseil de la concurrence) which would investigate, the final decision being made by the minister for considerations other than those of competition. This solution, consistent with the German regime, means that companies would no longer be

suspected of negotiating with the ministry departments rather than finding acceptable solutions with the Competition Council. The second solution would be to adopt a 'rationalized' status quo stance. A well thought out dualism would consist in separating the repression of fraud function from that of the control of concentrations and controlling the latter in a more systematic way taking account of the competition standpoint and elements of evaluation on other criteria.

In terms of repressive implementations, the report contains two suggestions. The first would be to reestablish a certain coherence between measures specific to competition and the plethora of legislative and regulatory measures governing, amongst other things, trading relations. The report suggests removing the ban on reselling at a loss, entrusting the competition authorities with the task of determining whether resel-ling at a loss does or does not constitute a predation strategy. The second suggestion involves the balance between legal protection and economic flexibility, demanding recourse to a structured rule of reason depending on the presumed abuse of each practice. The principles of such a rule should be specified in guidelines, explaining the successive stages of the examination, the allocation of the burden of proof at each stage and finally, the importance given to anti-competition and pro-competition arguments according to the presumed seriousness of the practice in question.

Comments

Michel Mougeot underlines the striking contrast between the meticulousness, subtlety and the nuanced character of the competition analysis discussed in the report and the simplistic, Manichean and often erroneous presentation of market issues in the media or in political speeches in France. Debates on the 2005 European constitution referendum showed how the French, often misinformed, fear the extension of the scope of competition. In light of this, the prime merit of the report is to recall that a market economy requires rules and regulations. Competition policy is one of the mechanisms of this regulation and the report gives a learned overview. The second merit of this text is that it highlights the different concepts of this policy and their ties with economic theory. Regarding competition as a process does not have the same implications as regarding it as a state of balance. The short and long-term concepts differ, especially regarding the pertinence of innovation policies. The forms of competition for the market can be substituted or, on the contrary, are complementary to competition in the market.

Hervé Lorenzi refers to the fact that competition policies have no particular objective. Is the objective to defend consumer surplus or social well-being in a broader sense? He underlines the importance given to the relation between competition and innovation. He raises questions about the possible stabilization of competition policies, the place of an industrial or competitiveness policy and the hierarchical organization of competition, industrial and trading policies within the European Union. Finally, he concludes that the evolution of modern economies today revolves around competition policies.

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