Brief History of Competition Policy - Part I

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Course material

- Motta, Massimo. Competition policy: theory and practice. Cambridge University Press, 2004
- Tirole, Jean. Economics for the Common Good. Princeton University Press, 2017.

- In this section, we will briefly review 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.
- Instead, our aim is to understand the circumstances under which competition laws were created and enforced, as well as the objectives which they purported to attain.

Anti-Trust Law in the United States

We can trace the origins of modern competition policy back to the end of the nineteenth century, mainly as a reaction to the formation of trusts in the United States.

- 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 (the act of joining together into one whole) or merger.

The events leading to the Sherman Act

In the second half of the nineteenth century, the US experienced a number of events, which caused a transformation of manufacturing industries.

- It can be argued that the most dramatic events were the improvements in
  - Transportation and communication
    - Rapidly expanding railways/telegraph lines, as well as telephone services
  - This resulted in a formation of a large single market, and gave a massive incentive to firms to exploit
    - Economies of Scale
    - Economies of Scope

- There are economies of scale when the unit cost of production fall with the total amount of quantity produced.
- There are economies of scope when unit costs fall because two or more goods are produced jointly.

The events leading to the Sherman Act

- The dramatic improvements in transportation and communication were complemented with
    - technological innovations in several fields (*e.g.*, metallurgy, chemicals, energy)
    - formation of more advanced capital markets
    - new managerial methods
- All these developments created the possibility for the expansion of the size of the firms

The events leading to the Sherman Act

Legal innovations also contributed to the transformation in manufacturing industries

- liberalization of state incorporation laws
  - permitting the acquisition of other firms' stock (*e.g.*, in mergers) and the delegation of stockholders' "decision-making power" to full-time managers

* It is not by chance that there was a massive merger wave in the US in the 1880s and 1890s.

The events leading to the Sherman Act

The last decades of the nineteenth century was characterized by low and unstable prices.

- Partially due to macroeconomic factors, leading to frequent and persistent economic crises (1873-8 and 1883-6), and causing instability in several sectors
- But most of the price instability was 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 large single market for many industries, but also to a rise in competition!
    - Now, firms had to compete with more distant rivals that are located both in other states in the US and abroad (shipping rates also fell in this period).

The events leading to the Sherman Act

- Large investments made by firms so as to enjoy scale and scope economies caused lower costs and prices. Indeed, the resulting decline in prices in manufactured goods characterized the economies of the US and Western Europe from the mid 1870s until the end of the nineteenth century.
- Firms had to make large investments to
  - reorganize their production and distribution activities
  - buy new machines
  - enter new markets
- To operate at full capacity (to cover the large fixed costs), firms were tempted to decrease prices, giving rise to price wars.

The events leading to the Sherman Act

So...

- Firms often tried to respond the price wars and market instability by way of **price agreements**,
  - which enabled them to maintain high prices and margins
  - *e.g.*, railroad and oil companies

But...

- **The advantages of price stability for the members of the cartels and trusts came with a cost to other groups in the economy**

The events leading to the Sherman Act

- Final consumers were hurt by higher prices,
- Producers, such as farmers and small industrial firms, which used products of cartelized sectors as inputs, were also hurt.
- Both suffered from low sales prices brought about by the aforementioned crises.
- As to the small industrial firms, they also suffered from a less efficient scale of production. They found themselves squeezed between low sales prices and high input costs (*e.g.*, railways and energy sectors).
- Small firms complained about unfair business practices adopted by their large rivals that wanted to drive them out of the market.

The events leading to the Sherman Act

- Farmers and small industrial firms and businesses had sufficient political power and public sympathy that led to the establishment of anti-trust laws in many states in the US.
- (Consumers' interests are often too fragmented to have an impact on government policies)
- Such laws could do very little against agreements, which involved more than one state.
- Soon, however, there was enough consensus for a federal law and in 1890 the Sherman Act was adopted.
    - Probably the best known example of anti-trust law in the world
    - Canada adopted a similar law in 1889 but its enforcement was much weaker when compared to the Sherman Act.

The Sherman Act and Its Early Enforcement

Our focus on Sections 1 and 2 in the act.

1. Section 1 prohibits contracts, combinations and conspiracies which restrain trade, and prescribes imprisonment and fines for violators.
2. Section 2 prohibits monopolization, attempts to monopolize and conspiracies to monopolize any part of the trade or commerce among the several states, or with foreign nations.
    - Note however that having a monopoly position is not by itself illegal.

The Sherman Act and Its Early Enforcement

- The Sherman Act carries its own criminal penalties, including imprisonment up to three years. In fact, jail sentences for anti-trust enforcement have been given more often.
- The first enforcement of the Act came in 1897.
- The Supreme Court decided that a trust of eighteen railways (Trans-Missouri Freight Association) fixed the fares for the transport of goods, and clearly established that price agreements were illegal.

The Sherman Act and Its Early Enforcement

- In this decision, as well as in *Addyston Pipe and Steel*, judges refused arguments aimed at justifying price-fixing on the grounds that
  - the rates were ‘reasonable’
  - and price fixing was a way to prevent ‘unhealthy competition’
- The Supreme court took the view that
  - all price agreements were outlawed
  - it was not up to judges to decide which agreement were reasonable and which were not.
- The prohibition of price agreements among competitors
  - is a very strong principle
  - is still valid
  - very few exceptions

The Sherman Act and Its Early Enforcement

- The Supreme Court applied the Sherman Act's prohibition of price restrictions to vertical relationships as well.
- Dr. Miles Medical Co. v. John D. Park and Sons
- The Court: resale price maintenance clause is **per se** illegal.

Resale (retail) price maintenance (RPM): a practice whereby a manufacturer and its distributors agree that the distributors sell the manufacturer's product

- at certain prices (resale price maintenance), at or above a price floor (minimum resale price maintenance) or
- at or below a price ceiling (maximum resale price maintenance).

- If a reseller refuses to maintain prices, either openly or covertly (see grey market), the manufacturer may stop doing business with it.

The Sherman Act and Its Early Enforcement

- This prohibition has never been reversed for a long time until 2007.
    - The Supreme Court overruled Dr. Miles, holding that such vertical price restraints as Minimum Advertised Pricing are not *per se* unlawful but, rather, must be judged under the "**rule of reason**."
- This marked a dramatic shift on how attorneys and enforcement agencies address the legality of contractual minimum prices and essentially allowed the reestablishment of resale price maintenance in the US in most (but not all) commercial situations.

The Sherman Act and Its Early Enforcement

That said,

- this tough stance taken by the authorities towards trusts and cartels was 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:* the trust was a creation of Rockefeller. It had engaged in a series of monopolization practices; *e.g.*, localized price cuts, which deemed to be predatory; a number of acquisitions of minor firms.
    - These practices were judged against Sections 1 and 2 of the Sherman Act.

The Sherman Act and Its Early Enforcement

- *American Tobacco:* five tobacco manufacturers had merged into the American Tobacco Company, and engaged in a campaign of purchasing minor competitors, controlling stock interest in other corporations, and starting price wars to increase its power and drive other manufacturers out of business. This trust was condemned and later dismantled.

The Sherman Act and Its Early Enforcement

- Another important monopolization case was *Terminal Railroad* (1912), which prohibited several railways and controlled the terminal facilities of the main bridge in the city of St. Louis to discriminate against competitors

Figure 1: St. Louis Bridge

The Sherman Act and Its Early Enforcement

- The Court concluded that *Terminal Railroad* (the fourteen defendant railroads) had deliberately brought about a monopoly at the St. Louis bottleneck by purchasing control of all competing alternate means of crossing the river
- The Court obliged these railways to give access on reasonable terms

The Clayton Act and the Federal Trade Commission Act

- The Sherman Act covers
  - price fixing and market sharing agreements between independent firms,
  - monopolization practices by individual companies
- Mergers were legal unless formed with the intention to monopolize the market using unfair methods of competition.
- As a result, firms that wished to coordinate prices had the option of merging into a single firm
  - By doing so, firms could put themselves beyond the reach of the Sherman Act.

The Clayton Act and the Federal Trade Commission Act

- The Clayton Act of 1914 was introduced to cover mergers capable of reducing competition.
  - The sharp increase in # of mergers following the Sherman Act was probably caused by the Act itself.
- The Clayton Act also forbids other practices, such as
  - price discrimination which lessons competition
  - interlocking directorates among competing firms

- *Interlocking directorates* is a common business practice where a member of a company's board of directors also serves on another company's board
- Under antitrust legislation, interlocking directorates are not illegal as long as the corporations involved do not compete with each other.

The Clayton Act and the Federal Trade Commission Act

Treble damages

- The possibility of recovering treble damages which also came with the Clayton Act is also very important.
  - Introduced by Section 4 of the Clayton Act for private anti-trust suits
  - Led to important transfers of money from offenders to victims of unlawful commercial conduct
  - The victims can ask a compensation equal to three times the damage they have received + attorney's fees.

The Clayton Act and the Federal Trade Commission Act

- The *Federal Trade Commission Act* also dates from 1914.
- The act created the FTC, an independent agenct that would regulate unfair trade practices
  - at the federal level FTC shares the reponisbility with the Department of Justice (DOJ) to enforce anti-trust law
    - DOJ is a government agency which takes the reponisbility to enforce anti-trust law in the US at the federal level
  - at the state level, attorneys general can act on behalf of those adversely affected by anti-trust violations

The Clayton Act and the Federal Trade Commission Act

- The Clayton Act was successfully amended.
    - *The Robinson-Patman Act* of 1936 amended the Clayton Act's provision
        - It aimed at avoiding price discrimination that might put small stores out of business to the benefit of large chain-stores
    - *Celler-Kefauver Act* of 1950 amended the Clayton Act provisions relating to mergers by extending the cross-ownership prohibition among competitors to asset transactions.
        - Before this, only stock transactions were covered
    - *The Hart-Scott-Rodino Act* of 1976 amended the Clayton Act's provisions relating to mergers by giving the DOJ and the FTC the power to review all mergers of firms above certain threshold.
        - at the state level, attorneys general can act on behalf of those injured by anti-trust violations.

The Inter-War Period

- The period between the two world wars is marked by a less strong enforcement of anti-trust law.
- During WWI, it was the business-government coalition that governed the economy
  - not the market forces
- This governance lasted even after the war.
- Great Depression of 1929 reinforced such views and resulted in some price controls and other regulatory initiative.
  - *The Robinson-Patman Act* was a product of such an environment

The Inter-War Period - *Appalachian Coals v. US* (1933)

- **Rare exception to the per se prohibition of price-fixing**
  - The Great Depression was having important consequences on many industries
    - *e.g.*, coal mining industry
  - The producers faced severe reduction in demand, and to avoid further losses, 137 producers found in the Appalachian Mountain region formed a company
  - This company sought to find the best prices and allocate outputs among its members
  - The Court found that the agreement was not unlawful
    - It was considered a reasonable response to protect the market from destructive practices.
- A great example of how competition laws and their enforcement are to be understood in the political, economic, and historic context in which they are made.

The Inter-War Period - *Appalachian Coals v. US* (1933)

- In US v. Socony-Vacuum Oil Co. (1940), when the economic conditions were already very different, the Supreme Court was to re-establish the principle of the *per se* prohibition of price agreements
- Some of the most widely quoted passages from *Socony* follow:
  - “Any combination which tampers with price structures is engaged in an unlawful activity. Even though the members of the price-fixing group were in no position to control the market, to the extent that they raised, lowered, or stabilized prices they would be directly interfering with the free play of market forces. The Act places all such schemes beyond the pale and protects that vital part of our economy against any degree of interference ...”

The Inter-War Period - *Appalachian Coals v. US* (1933)

- Another one...
  - "Nor is it important that the prices paid by the combination were not fixed in the sense that they were uniform and inflexible. Price-fixing . . . has no such limited meaning. An agreement to pay or charge rigid, uniform prices would be an illegal agreement under the Sherman Act. But so would agreements to raise or lower prices whatever machinery for price-fixing was used. . . . Hence, prices are fixed . . . if the range within which purchases or sales will be made is agreed upon, if the prices paid or charged are to be at a certain level or on ascending or descending scales, if they are to be uniform, or if by various formulae they are related to the market prices. *They are fixed because they are agreed upon.*"

Until Mid-70s: The Activism in Anti-Trust Case Law

- After *Socony*, and until the mid-70s, there was a period of intense anti-trust activity
- These activities were mainly focused on restraining large firms rather than increasing economic efficiency.
  - This was an attitude consistent with the dominant economic thinking of the time.
- *International Salt - 1947* - established a *per se* rule prohibiting tie-in sales
  - situations where a producer sells a given product (or service) only if the customer also purchases another product or service

Until Mid-70s: The Activism in Anti-Trust Case Law

- *Schwinn - 1967*
  - the Court ruled against exclusive territorial clauses
  - these clauses assign a particular distributor to a territory in which other distributors cannot sell the same manufacturer's product
- *Alcoa - 1945*
  - the Circuit Court of Appeals overruled a lower court judge and found Alcoa guilty of monopolization in the aluminum ingot market although there was no intent of monopolization.
  - The mere reason was Alcoa held 90% share of the market and took actions to increase its business, such as building new capacity.

Until Mid-70s: The Activism in Anti-Trust Case Law

- *Philadelphia National Bank -1963*
    - merger between two Philadelphia banks
    - a key issue in the assessment of the merger 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 and disallowed the merger
        - it would have created too concentrated a market
    - The Court dismissed the claims that the merger would have allowed the banks to compete with larger banks.
        - The Court added that the anticompetitive effects in one market could not be justified by pro-competitive effects in another.

Until Mid-70s: The Activism in Anti-Trust Case Law

- *Procter & Gamble - 1967*
  - the Court ruled in favor of the FTC although the proposed merger was a conglomerate one
    - A conglomerate is the combination of two or more corporations engaged in entirely different businesses that fall under one corporate group, usually involving a parent company and many subsidiaries.

From Sylvania Onward: Chicago School and the Reagan Years

- The Chicago School criticized the interventionism of the anti-trust authorities and courts
- The School stressed the efficiency rationale behind vertical restraints and mergers

- *Vertical restraints* are competition restrictions in agreements between firms or individuals at different levels of the production and distribution process.
- Vertical restraints can take numerous forms, ranging from a requirement that dealers accept returns of a manufacturer's product, to resale price maintenance agreements setting the minimum or maximum price that dealers can charge for the manufacturer's product.

From Sylvania Onward: Chicago School and the Reagan Years

- The joint effect of the
  - Chicago School critique,
  - the loss of competitiveness of US firms abroad,
- directed attention to the efficiency effects of business practices
- This necessitated a change in the enforcement attitudes of anti-trust law in the US.
- *GTE-Sylvania - 1977*
  - The Supreme Court: Non-price vertical restraints should be subject to a rule of reason
- The new trend became a major change during 80s, which introduced a "hands-offäpproach: market forces should be left free to select the more efficient firms.
- 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 monopolization.

Recent Events & Trends

- It is more difficult to identify trends when looking at the very recent past.
- Apart from some very visible events determined by a change in the government, agencies and courts lie somewhere between the interventionism of the 60s and the *laisse faire* of the 80s.
- An important fact is the renewed strength in the fight against cartels,
  - signaled by some prison sentences given in some high-profile international cartels cases,
  - helped by the introduction of successful leniency policy that grants amnesty (an official pardon) to managers that provide proof of the existence of cartels

Recent Events & Trends

- The digitization of society is at the heart of economic and social changes in the 21st century
- We increasingly
  - Shop and do our banking online
  - Read news on websites
  - Use Uber
  - Carpool using BlaBlaCar
  - Reserve accommodation through Airbnb
- ***Two-sided markets:*** there is a need for an increased focus on strategies of digital companies and how the two-sided markets can be regulated

Competition Laws in the European Union

- We will review the main historical development of competition laws in the European Union
- However, the history of German and British competition laws interesting in several respects
- The latter is also interesting because of Brexit

Competition Law in Germany

- Economic changes in the second half of the 19th century in the US created incentives for the formation of cartels and trusts soon to be outlawed by the *Sherman Act*.
- In Germany, the prevailing view was that cartels were an instrument to control the instability created by cutthroat competition and price warfare.
- Many of the comments here 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.

Competition Law 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
- As a result, cartels proliferated in the years around the turn of the century.
- By 1905 there were 385 cartels involving 12,000 firms, and the number increased steadily.
- By 1923 there were 1,500 cartels in Germany

Competition Law in Germany

- In 1923 a Cartel Law was introduced (mainly as a reaction to hyper-inflation)
  - It was feared that price agreements might contribute to the escalation of prices.
- The new law did not have much impact on cartels. Their number continued to rise.
- New economic conditions soon prompted a move (toward cartels) in the opposite direction.
- 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 became more extensive to control the national industry and strengthen the sectors involved in the war apparatus

Competition Law in Germany

- The widespread idea was that allowing firms to cooperate closely or to merge their operations would make them stronger and create some “national champion(s)” which would outperform foreign rivals

Competition Law in Germany

- After WWII, 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
- The deconcentration programme of the Allies was soon put to an end, since the US and British governments soon perceived the threat of the Soviet Union
    - Germany represented a useful force which could help to counter-balance the strength of the Soviet Union
- A similar development also occurred in Japan

Competition Law in Germany

- A strict competition law was passed in 1957
- The Federal Cartel Office (Bundeskartellamt) was the main institution called to enforce the rules against price-fixing agreements and other anti-competitive practices
- One of the main principles behind competition policy in Germany is still the protection of economic freedom.
- Thus, mergers are scrutinized because they could lead to the formation of dominant agents limiting the economic freedom of competitors.
- Provisions against the abuse of a dominant position should be seen in the same perspective.

Competition Law in the United Kingdom

- Several features of the UK competition legislation prior to the 1998 reform are worth mentioning.
- Its objectives were never clearly specified.
- The central role played by the Secretary of State for Industry
    - (who has discretion on whether to accept or reject 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)

  reflects the role that political considerations may have on competition cases.

Competition Law in the United Kingdom

- The UK legislation lacked a system of penalties and tools of enforcement.
- Until 1998, unlike their European counterparts, the UK competition authorities were not entitled to search firms' headquarters and seize documents (a serious limitation)
- The 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 found guilty by a court of breaching an order of the Secretary of State and was later caught again breaching this court order, could penalties be given, for "contempt of court"(a serious offence)
- Then, what can one say about the effectiveness of the UK competition system in deterring anti-competitive agreements?

Competition Law in the United Kingdom

- 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 (derived from the Treaty of the European Community)

  aligned the new UK competition policy as designed by the 1998 Act with the EU's
- This can, however, change soon.

Competition Law in the United Kingdom

- One of the main differences still existing is that the UK system keeps the possibility of investigating
  - 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 make recommendations such as,
  - seeking changes in the firms' business practices,
  - imposing price controls,
  - and even divestment
- This is more typical of regulatory regimes (than competition policy)