Formal Rules Versus an Economic Approach in Dealing with Cartels: the Need for More Coherence in European Competition Law

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Abstract**: Cartelizing is today among the most hunted business conduct in the world. Competition authorities from the countries where these statutes were adopted embrace the wisdom that such agreements between competitors are unquestionably anti-competitive. As opposed to other business practices, cartel agreements seem to offer an undeniable proof of intent that confers comfort for those who are investigating and prosecuting them. A cartel is today qualified as per se illegal. No further proof is needed but the formal agreement and the shared intentions. They are, at least until now, the only business practice that has lead, in certain jurisdictions, to jail terms and criminal record for individuals who were engaged in their negotiation and implementation. However, cartels are business practices that do not fundamentally aggress against any property right. From a public policy perspective, the harsh attitude towards cartels is lacking a theoretical coherence. Today, when competition policies all over the world and especially in the European Union are gradually transiting towards a more economic approach to evaluating the welfare effects of business practices, reassessing cartels is a critical imperative in the effort for a more coherent and reasonable public policy.

**Keywords:** competition policy, cartels, per se rules, economic approach

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A cartel is an agreement among direct competitors to prevent or restrict competition. It is a horizontal agreement defined, from a legal perspective, in the Treaty of the European Union. It is the article 101 (former article 81), dealing with a larger specter of agreements between undertakings: „The following shall be prohibited as incompatible with the internal market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the internal market, and in particular those which:

(a) directly or indirectly fix purchase or selling prices or any other trading conditions;
(b) limit or control production, markets, technical development, or investment;
(c) share markets or sources of supply;

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(d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
(e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts”.

The term “cartel” is however used exclusively for horizontal (as opposed to vertical) agreements, referring to agreements between producers which are qualified as being in a competitive position towards each other. In other words, they sell the same product. It should also be noted that, historically, the term was used for a formal written agreement – for example, a contract (the origin of the term comes from the Italian “carta”). It was a commercial practice that, for a period, was even enforceable like any other contract in some legal systems. But for the majority of time, a cartel has remained nothing but an informal agreement between businessmen whose observance was guaranteed by nothing but the promise of the other party.

A core difference between the types of agreements that are qualified as cartels lies in the difference between such practices on the free market as opposed to a hampered market. In the first instance, cartels have proved to be a short-lived practice that may attempt to solve some immediate dilemma for producers but cannot solve their strategic position. They are, in consequence, notoriously unstable and prone to cheating. In the second instance, due to the difference in the legal environment, cartels may be more successful due to state-erected barriers. They may be even means for reaching objectives of public policy. They are more efficient on long term in reaching their objectives.

Why cartels are anti-competitive: the common wisdom

Cartels are qualified as the most harmful anti-competitive business practice by the quasi-totality of competition law in countries where it has been adopted. They were called the “leading bête noire of monopoly policy” (Baumol, 1992, p. 129). The Organization for Economic Cooperation and Development, which plays a leading role in promoting competition policy around the world, argued that “hard core cartels are the most egregious violations of competition law” (OECD, 1998). In consequence, a great understatement would be that “the rule against price fixing is the least controversial prohibition in competition law” (Kaplow, 2011, p. 343).

The impact of cartels on economic efficiency and consumer welfare seems to be also one of self-supporting statements in economics and public policy. The common argument is that “a successful cartel raises price above the competitive level and reduces output ... a cartel shelters its members from full exposure to market forces, reducing pressures on them to control costs and to innovate. All of these effects harm efficiency in a market economy” (OECD, 2003, p. 8).

But such an absolute wisdom may default on several plans. First of all, it is not so “value free” as it pretends to be. It implicitly assumes an equilibrium approach to economic analysis, where, among other things, competitive prices and output can be ex ante identified with certainty. It adopts a narrow perspective on competition by eliminating stealth competition, that is, the potential for outside producers to enter an industry as soon as profitability has significantly increased. Last but not least, it ignores the powerful instrument that consumers have at their disposal, which is boycott. But even accepting a perspective based on common wisdom – both from a theoretical and legal dimension – the toughness of public policy towards cartels is not so unquestionable.
The formal approach versus the “rule of reason” in cartel prohibition

The prohibition of cartels in competition law is near absolute. Like other forms of business conduct which are qualified as extremely sensitive from a competitive point of view, the simple involvement in such a practice leads to the enforcement of the rule. This is called the per se approach or the formal approach to the enforcement of competition law.

Obviously, the substance of the enterprise of law in general is centered on the formal approach in the sense that individual members of a society have to know ex ante, at any moment, what is legal and what is illegal. Formalism is a way of eliminating the legal uncertainty related to the ex post interpretation of the social conduct. Individuals will adjust their behavior in consequence of such formal rules. But, on the other hand, it makes a lot of difference whether the rules are good (and legitimate, based on a correct theory of justice) or bad (or illegitimate, based on a wrong theory of justice). Besides formalism, there is always a necessity of realism in law enforcement in general. There are instances when the individual conduct seems to be breaking the formal rules but however it remains a natural and well-intentioned, non-invasive, behavior. In competition law, such realism has taken the name of the “rule of reason”.

The wisdom of the enforcement of a “rule of reason” in competition law comes from the philosophy that competition law is economics-oriented. And obviously, utilitarian considerations come into play. In other words, formal rules could be waived in case the economic impact becomes positive, when the gains outweigh the costs. Competition authorities have to balance the positive and the negative impact of a business practice that qualifies prima facie as anti-competitive. The rule of reason becomes even more important when it deals with bad rules as compared with the situation when it deals with good rules.

While the per se rules are ex ante known by market participants, the economic approach to competition policy – because it attempts to take into consideration “effects” – cannot be but an ex post intervention. In the words of a European consultant whose position is endorsed by the European Commission, “an effects-based analysis takes fully into consideration the fact that many business practices may have different effects in different circumstances: distorting competition in some cases and promoting efficiencies and innovation in others. This implies that competition authorities will need to identify a competitive harm, and assess the extent to which such a negative effect on consumers is potentially outweighed by efficiency gains” (EAGCP, 2005, p. 2-3).

As several observers noted, the debate of the economic approach versus the formal approach is only a temporary one as there is an objective impossibility of comparing ex ante rules with ex post decisions. So the economic approach has to be embodied, at some point, in the formal rules: “From this law and economics perspective, competition policy should consist mainly of (more or less differentiated) rules and should only rarely rely on case-by-case analysis. Therefore the main task of a “more economic approach” is to use economics for the formulation of appropriate competition rules” (Christiansen and Weber, 2006, p. 215).

Towards an economic approach in competition policy

The transition from a rules-based competition policy towards an effects-based competition policy has been a gradual process that occurred first in the United States of America. It culminated with the modification of the 1968 Merger Guidelines (which abandoned the traditional, static,
market structure approach) and with the rejection, in 2007, of the century’s long prohibition against the Resale Price Maintenance (which promoted intra-brand competition and prevented the control by the producer of the final prices listed by its independent distributors). The same process was also initiated, arguably at a slower pace, in the European Union. As some commentators argued, “economics is on the ascendancy in European competition policy. In the past two decades economics has featured increasingly in policy discourse and in the official documents, notices and guidelines of both European Union institutions and Member States” (Decker, 2009, p. XXI). In the same vein, “in recent decades, courts and commentators have increasingly embraced the view that competition law should be grounded in economic substance rather than formalistic distinctions” (Kaplow, 2011, p. 6).

But this significant process of transition in competition policy, which occurred in many areas of its operation, seems not to have touched the policy towards cartels. In fact, more resources and energy are allocated by competition authorities all over the world towards identifying and combating these agreements. The stance of competition authorities is uncompromising. Some officials estimated that any industrial sector experience cartel operation and, despite the apparently high number of cartels „discovered” in the last two decades, only 10% of cartels are brought to surface. In other words, suspicions that the entire fabric of the present day market economies are in fact controlled by cartels surface. Whether this is a sign of ethical failure from part of the vast majority of businessmen who engage in such practices or a sign that the policy is deeply flawed is a discussion itself.

**The special case of cartels**

This account suggests that cartels are of special interest for competition law enforcement. To be sure, cartels remain the only business practice forbidden by competition law for which courts have awarded jail terms, at least in U.S.A. Moreover, the fines received by cartel members are among the highest received by firms for anti-competitive conduct. So we witness maybe the most uncompromising policy towards a business practice which resembles few „economic crimes”.

Economics could be an explanation for such an attitude. But a strong factor in the harsh treatment of cartels could also consist in the practical easiness to prosecute a cartel as opposed to other business practices such as a merger or a single conduct. In order to identify a cartel, prosecutors use investigative techniques they can easily import from other criminal areas such as organized crime. The material proofs of a cartel are easy to amass, from documents (like flight tickets, hotel vouchers, personal notebooks) to audio and video recordings, including electronic communication. This is not the case of an abuse of a dominant position or a merger occurring on an oligopolistic market where proofs are not „hard evidence”. So, in a certain sense, the special place of cartels can be the result of an institutional bias and of the practical easiness of enforcement. Lawyers and law enforcers are more confident when dealing with material evidence than with competing theories of monopolization.

What seems to be even more paradoxical with regards the current perspective on cartels and the potential for a more economic approach is that the legal provisions are already included, at least in the European Union, in the basic legislation. For the moment, it is only a narrow path followed by competition authorities for allowing some types of state-enforced cartels (like, for example, shipping cartels or the so-called “crisis” cartels). Article 101 of the TEU states also that
the law should not pursue an agreement (and it does not exclude a horizontal one): "which contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not:

(a) impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives;
(b) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question".

A proper interpretation of such a provision, coupled with an attempt to hold a more coherent view across different policy areas of the competition policy, could lead to a more reasonable approach to cartels. The difference in enforcement between cartels and other business practices qualified as illegal under competition law raises a problem of consistency and coherence of the competition policy.

**The fundamental approach: the good rules of cartel regulation**

The fundamental critique of the cartel policy comes from a property rights perspective. According to the traditional perspective on the definition of property rights, a cartel cannot constitute an aggression against the property rights of third parties. The common decision of two independent producers to limit their output or increase their listed price in coordination does not invade the property of their potential consumers. The latter will buy only if their personal welfare is increased, from an ex ante perspective. In other words, if consumers really perceive that they are "abused" by producers, they can exit the business relationships and boycott the would-be offenders.

The idea that the price which is willingly paid by the consumer – which remains finally a market price – is somehow the manifestation of an abuse of market power got through coordination by the members of the cartel makes very similar appeals to the idea of trade as an objective exchange of equal values. The critique of such a perspective has a long and respectable tradition in economics.

Moreover, the alleged special position of cartels among the business practices is just a wrong perspective on business conduct and entrepreneurship in general. Several economists argued, for example, that "an industry-wide merger is, in effect, a permanent cartel, a permanent combination and fusion ... in many cases, a cartel can be considered as simply a tentative step in the direction of permanent merger. And a merger and the original formation of a corporation do not, as we have seen, essentially differ. The former is an adaptation of the size and number of firms in an industry to new conditions or is the correction of a previous error in forecasting. The latter is a de novo attempt to adapt to present and future market conditions" (Rothbard, 1962, p. 644). Such an opinion would suggest that making a difference between a cartel and a merger is a basic error. It is a result of arbitrarily differentiation that comes primarily from a legal perspective and has nothing to do with the economic substance of the phenomenon.

Benjamin Tucker, a XIX century commentator, argued further "that the right to cooperate is as unquestionable as the right to compete; that the right to compete involves the right to refrain from competition; that co-operation is often a method of competition, and that competition is always, in the larger view, a method of co-operation" (Tucker, 1899).
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Such position attacks the fundamental base of the contemporary cartel policy. We argue that, in addition, competition policy as embodied in the legislation and in the enforcement is incoherent in its attitude towards cartels. Even if its philosophy ignores the property rights approach, the need for a more coherent approach is obvious.

Are today’s per se rules ignorant of economics?

According to the property rights perspective, cartels should not be outlawed. The present-day illegal character of these agreements is obviously the embodiment of an economic perspective which argues that a transfer of welfare between parties to an exchange – even if done under a free mutual agreement – constitutes an act of abuse. So, in a certain sense, what are today considered to be formal rules are in fact by themselves the embodiment of an economic approach to such agreements – that is, an approach diametrically opposed to the traditional legal one. The choice between a per se approach and an economic one is, in fact, a choice between bad rules and an efficient approach. The difference consists not in nature but in the degree of reasonableness.

It is very significant to point that the original Sherman Act adopted in 1890 in the United States of America did not explicitly spell the terms “cartel” or “horizontal agreement”: “Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal”. The most relevant anti-competitive business practice for American authorities was, at that time, the trust. It also remained for the first decades of the operation of competition law the core challenge for competition authorities. Cartels become, in fact, an important issue in competition policy only after World War II and especially after the emergence of the European Economic Community. In fact, for significant periods of time in the interwar period, cartels were initiated and enforced by public authorities themselves.

What is challenging for the present-day policy towards cartels in all developed countries is that, even if we adopt the core philosophy of competition law and we let aside the property rights approach, the strict focus on the formal rules is untenable. Especially today, when competition policy is gradually adopting an economic approach towards anti-competitive practices, the tough stance on cartels should be changed.

Cartels that create consumer welfare

The economic approach to competition policy leads to a policy that fundamentally adopts an ex post stance on welfare analysis. Its opposition to per se rules is exactly an opposition to an ex ante approach that does not discriminate between different welfare effects of the same business practice. The big challenge, from such a perspective, is whether there may be cartels that increase consumer welfare. In such cases, the stance of competition policy towards cartels is in manifest opposition to its stance towards other competition areas such as vertical agreements, merger control and so on.

At least three types of cartels that do not generate a loss in consumer welfare can be thought of:

a. the cartels that commit an entrepreneurial error;

b. the irrelevant cartels;

c. the cartels with at least a cheater.
In the first case, the members of a cartel remain subject to the dynamics of the outside market (and especially consumers). They cannot eliminate risk from their decision and their price fixing or production limiting has to be confronted by the rest of market participants. Even if cartels decide to increase prices (it is commonly agreed that the increase in price due to cartel activity lies somewhere between 10 and 15%), demand may experience a stronger than expected showing in a particular case. In consequence, the competitive price could, in fact, have increased more than 15%. This means that even a cartel “succeeds” in increasing the price of its output with 15%, the price targeted by cartel members may remain under the competitive price. In this case, the common entrepreneurial judgment of the cartel members may be proved, ex post, wrong. In fact, no analysis occasioned by cartel decisions seems to seriously take into consideration the possibility of a competitive increase in competitive price that could be parallel to the cartel’s price.

In the second case, the irrelevant cartels are those agreements in which cartel members adhere to a particular scheme but nobody implements it. In other words, the participants to a cartel meeting may just look for a market research as regards the prices of their competitors. The formal decision to cooperate is not enough for a group of producers to successfully operate a cartel. In fact, in the vast majority of cases prosecuted by competition authorities, this is exactly the most frequent defense. While easy to adopt, it cannot be ex ante ruled out. Or, from a formal perspective, the proof of the success of the cartel is not needed, today, for a successful decision (from the perspective of public authorities).

The third case may deal with a potential cartel which experience cheaters. It is the case when a cartel agreement may be used by a cartel member as a dissimulation of his intention to dramatically compete the other members. While the cartel agreement may involve a significant increase in price, that particular producer may choose to offer discounts and rebates that decrease his price below the listed price by other members and also under the competitive level. In fact, any industry that experiences significant changes in market shares may also experience a cheater who undermines the cartel in order to gain market share. Moreover, an outside producer that succeeds in keeping its pre-cartel price and gaining market share may in fact generate a welfare transfer to consumers, according even to mainstream analysis.

The adoption of a dynamic perspective in the evaluation of the anti-competitive or pro-competitive business practices may raise even more challenges to the contemporary indiscriminate attitude towards cartels. A cartel may:

- emerge after a price war, when market prices fell under the competitive prices;
- be followed by a price war.

Such a perspective means that competition authorities have to analyze not only the period when the cartel succeeds to operate but also the period preceding it (or succeeding it). In other words, the period selected for a welfare analysis can make a difference between loss and increase in consumer welfare. The cartel prices from a certain period may be preceded in another period by under-competitive prices.

**Is price transparency anticompitive?**

The definition of a cartel in contemporary public policy has expanded not only to formal agreements that are implemented by producers that take part to such an agreement, but also to the simple exchange of information regarding the future endeavor on the market. In other
words, if, at an industry forum, some participants talk about their intention to keep their prices stable for the next half a year is undoubtedly a proof of the existence of a cartel for competition law enforcers. Paradoxically, a core characteristic of the perfect competition – that is, price transparency – is not highly regarded by competition authorities. According to their view, such statements are an open invitation to at least collusion and they may constitute evidence of a market failure.

But blackboard economics argues exactly the opposite. Price transparency and awareness of the relative prices in an industry is a core characteristic of equilibrium. In consequence, the fight against such price transparency among competitors is, in fact, a fight against, paradoxically, perfect competition. It means that competition authorities could in some instances fight for a competitive market failure instead of an oligopolistic market success. For example, when producers ignore each other planned production and prices they may confront each other with excess production and a dramatic and unsustainable change in market structure. The lack of such information transfer may promote an inefficient allocation of resources in the industry.

**Rate of return and competition**

Such an economic analysis of the impact of a cartel on consumer welfare must be also paired with another approach, largely ignored till now in competitive analysis. According to the logic of an economic approach to competition policy, anti-competitive conduct must be materialized somehow in gains by producers who are ready to engage in it. In other words, anti-competitive practices must, in the end, have an impact of the bottom line of the undertakings engaging in it.

It is almost against logic to argue that a monopolist abuse his market power in the condition that such a monopolist is less profitable than the average producer in the economy. Welfare analysis argues that, in the end, the rate of return should be equal among the different sectors of an economy so, *per a contrario*, anti-competitive practices should lead to a higher than normal rate of return. In fact, the concentration of competitive analysis on the dynamics of sales and market shares ignores the more important aspect of profitability. Very challenging also, a cartel that succeeds in fixing price and limiting production but assuring a "normal" rate of return for its members is nothing but a proof that such a cartel has discovered the equilibrium price and output volume. It is a poor logic to argue that a business practice is exploiting consumers as long as the overall profitability of the producer(s) is the same as in the rest of the industry.

**Record fines, total ignorance of an economic approach: the car glass cartel**

The fact that European Commission ignores the economic approach is found in each decision regarding cartels. This is also the case with the most notorious example (given the value of the fine which reached 1.4 billion Euros) in the history of European cartels. The car glass cartel started – according to European Commission – in 1998 and ended in 2003. It was formed by the Company of Saint-Gobain, Pilkington, AGC and Soliver, the biggest car glass suppliers in Europe. The European authority was informed of the existence of this cartel by a German lawyer, the assignee of a client who remained anonymous during the entire inquiry.

On the car glass market, auto manufacturers periodically organize auctions where every glass supplier can participate. In its inquiry (which included interviews with the companies
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officials), the European Commission discovered that the cartel forced car manufacturers to accept prices which were secretly set before the auction, and concluded that, in this way, final consumers of cars suffered a loss in welfare. At the core of the decision to prosecute the cartel stays the results obtained from the inquiry which reveal that there were certain bilateral and trilateral meetings between the companies having as purpose “in particular the evaluation and monitoring of market shares, the allocation of car glass supplies to car manufacturers, the exchange of price information as well as other commercially sensitive information and the coordination of their respective pricing and supply strategies” [European Commission Decision, 2008, page 26]. There is some evidence which EC can present for showing that car glass suppliers were setting the winner of the auction before its official date, by taking into consideration the comparative advantages in and between them. These actions constitute an infringement on article 101 and article 53 of the European Economic Area (EEA).

In the summary of the infringement, EC notes that “The addresses of this Decision participated in a single and continuous infringement of Article 81 of the Treaty and of Article 53 of the Agreement on European Economic Area. The infringement consisted in concerted allocation of contracts concerning the supply of car glass pieces and/or car sets for all major car manufacturers in the EEA through coordination of pricing policies and supply strategies aimed at maintaining the overall stability of the parties’ position on the market concerned” (EC Decision, 2008).

As regards the nature of the infringement, EC states that this is to be found in the express provisions of article 81 and article 53 of EEA: “An agreement can be said to exist when the parties adhere to a common plan which limits or is likely to limit their individual commercial conduct by determining the lines of their mutual action or abstention from action in the market. It does not have to be made in writing; no formalities are necessary, and no contractual sanctions or enforcement measures are required. The fact of agreement may be express or implicit in the behavior of the parties. Furthermore it is not necessary, in order for there to be an infringement of Article 81 of the Treaty Article 53 (1) of the EEA Agreement for the participants to have agreed in advance upon a comprehensive common plan”.

The concept of agreement in Article 81 (1) of the Treaty and Article 53 (1) of the EEA Agreement would apply to the inchoate understandings and partial and conditional agreements in the bargaining process which lead up to the definitive agreement. (EC Decision, 2008, pp.128): “The facts […] demonstrate that the arrangements of the undertakings Saint-Gobain, Pilkington, AGC and Soliver constitute agreements and/or concerted practices under Article 81 of the Treaty”. (EC Decision, 2008, p. 131)

A very large part of the Decision issued by the European Commission in 2008 is concerned with the specific details of the private discussions between the parties involved in cartel like the locations of meeting and also their frequency and content, but it is hard to find any proof of the cartel effects on the final consumers of cars and on car manufacturers. This proves that in the case of car glass cartel, the Commission had no intention to apply an economic analysis on cartels, although the report of EAGCP was issued and published in 2005.

Another striking example of how European Commission stuck to the per se rules is to be found when it replies to the objections issued by the parties involved in the cartel. Thus, in response to Saint-Gobain and Pilkington who argued that Commission did not succeed to prove the existence and implementation of a coherent cartel plan, and that price coordination and allocation of contracts at auctions are not sufficient per se for the cartel to exist, EC explained
that: "... it is sufficient for the undertakings to have expressed their joint intention to behave on a certain way on the market" (EC Decision, 2008, p. 45) and also that the "the Commission repeats its argument that an expression of joint intention suffices and that implementation is not required for an arrangement to be unlawful in its nature". (EC Decision, 2008, p. 83)

Conclusions

European Union as well as the quasi-totality of jurisdictions that enforce competition law is gradually transiting towards a so-called economic approach to the analysis of anti-competitive business practices. Several arguments can be recalled in this direction, from the statements of public statements of officials to the Court Decisions as well as increased resources and institutional changes in the structure of the enforcement agencies. This material has argued that such a transition won’t be fully coherent till the attitude of competition policy towards cartels won’t be also adjusted. Cartel analysis has to use more economic tools and it should not concentrate only on revealing the formal agreement of participants. Cartels should not be criminalized as they are, from an economic perspective, nothing more than partial mergers among participants. Paradoxically, cartels can increase consumer welfare as any other competitive or cooperative business practice on an unhampered market.
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