



## Efficient cartels

### Oxymoron or economic insight?

The concept of a “good” or “efficient” cartel is regarded by competition authorities as an oxymoron. A cartel is seen as the worst type of antitrust violation which warrants zero tolerance. Agreements between competitors to raise prices and share the market unambiguously reduce economic welfare. Even if these agreements are ineffective, the law should come down hard on attempts to rig prices. This Casenote argues that this view goes too far – even cartels which lower output and increase prices can be efficient, and pro-competitive.

#### Resuscitating the Efficient Cartel

Basic economic theory tells us that coordination can be efficient in many instances, and this is accepted in law, e.g. joint ventures and agreements on industry standards. But where competitors agree on prices and sales – so called “hard core” cartels – there is intolerance. Nonetheless many jurisdictions exempt export cartels, sports leagues, “crisis” cartels although under increasingly limiting circumstances, labour unions and trade and professional associations.

Even Richard Posner (*Antitrust*, 2001, pp. 29-32), a vigorous advocate of extending antitrust to outlaw all forms of coordinated behaviour, concedes that: “the possibility cannot be excluded *a priori* that a loose-knit arrangement among competing firms may sometimes create net social benefits by restricting competition among the firms”. He gives the example of the otherwise excessive advertising of homogenous products which if restrained could lower costs without reducing output; and collection societies which reduce collection costs with blanket licensing ameliorating the prospect of output reductions and monopoly pricing. Posner’s examples are confined to non-output reducing coordination which lower marginal costs. But cartels which do not have these features may also be efficient.

#### Destructive competition & the empty core

The claim that cartels have beneficial effects precedes US antitrust law. Trusts were justified as necessary to prevent ‘ruinous’ or ‘destructive’ competition in industries with high fixed costs subject to frequent ‘price wars’. This was the unsuccessful defence in the *Trans-Missouri* (1897) where 18 US railroad companies formed a trust to set their rates, arguing that absent their agreement there would be ruinous

competition, eventual monopoly and even higher prices. Since then industries such as steel, cement, paper, railways, shipping and airlines have at various times claimed that competition was unsustainable and wasteful.

The idea that some industries are unstable and without a competitive equilibrium has long been appreciated by economists. Jacob Viner (1931) noted that if all firms have identical U-shaped cost curves there will only be an equilibrium if all producers can supply where marginal costs equal average costs. A more contemporary strand of economic theory suggests that these industries may have an “empty core”. Lester Telser (1978, 1994, 1996) refreshed the idea that cooperative arrangements among firms in some industries were not attempts to impose monopoly prices but a response to their inherent structural inefficiency. While based on hideously dense mathematical game theory, the idea is simple to state. A market is said to have a “core” if there is a set of transactions between buyers and sellers such that there are no other transactions which could make some of the buyers or sellers better off. Such a “core” will survive in a competitive market if all firms can make zero economic profits. In a market where the core is empty, no coalition of firms will be able to earn zero profit; some firms will be able to earn a surplus and thereby attract entry, but because the core is empty the new entry will inflict losses on all firms. When firms exit due to their losses, the remaining firms again earn economic profits. There are no competitive long-run stable equilibria for these industries. The literature suggests that an industry is likely to have an empty core the more: (1) fixed the firms’ production capacities; (2) where firm capacities are large relative to demand; (3) there are scale economies in production; (4) incremental costs are low, (5) demand is uncertain and fluctuates markedly; and (6) the industry’s output cannot be stored cheaply.

In the 1980s several academic studies applied empty core theory to antitrust. Brittlngmayer (1982) claimed that the US iron pipe industry had an empty core, and that the famous *Addyston Pipe* case was wrongly decided, and responsible for mergers in the industry. Sjostrom (1989) and Pirrong (1992) studies concluded that conference lines were not attempts to overcharge

shippers but to counteract an empty core that led to volatile market shares and freight rates due to excess capacity and fixed schedules. A similar analysis underpinned the exemption given to conference lines. This has now fallen out of fashion, and since October 2008 conference lines are not able to fix rates or capacity under EU law.

### Export Cartels

More controversial are the exemptions given to export cartels. Levenstein and Suslow (2004) found that 51 (or about half) of the countries with antitrust regimes exempted export cartels including the USA, Australia, Canada, and New Zealand. Again there is a theory to support these exemptions: “Where the cartel is comprised of small to medium-sized businesses and its aim is to increase the value of exports by reducing costs, sharing risks and improving products, the cartel is likely to be welfare-enhancing.” (Sweeney, 2007). Dick (1992) found that of the 16 US commodity export cartels he studied, five were efficiency-enhancing, three monopoly-promoting, one with mixed effects, and seven relatively useless.

### Cartels where there are environmental problems

Cartels in industries with significant environmental problems – where there are economic “bads” rather than goods – can have beneficial effects. Restricting the output of an economic bad is good. Take an extreme example. When most people hear the word cartel they think of a Colombian drugs cartel. No one has yet suggested that antitrust should be used to bust these cartels because they restrict output and charge higher prices. And there is a good reason. A drugs cartel reduces drug trafficking to keep its profits high. For the very reason a cartel is attacked in the legitimate economy it generates a superior outcome – output reduction i.e. less drugs trafficking. Competition in the supply of a ‘bad’ is inefficient and hence high prices and lower output is good. The idea applies also to industries in which bads are a “by-product” of otherwise legitimate and productive activities.

This example has direct relevance to antitrust especially to industries where there are significant environmental problems or concerns. An industry which generates pollution does not take the full costs

of its activities into account, and hence output is over-expanded and price too low. Economic efficiency requires a reduction in the harmful activities and the associated output. It also requires the product’s price to increase to incorporate the higher pollution-inclusive costs. A cartel by raising prices can move such an industry’s output and harm closer to the efficient level, although this would not be in response to higher pollution-inclusive costs – which makes this a second-best solution.

Recently the European Commission adopted such a cartel-like solution when it permitted a restrictive agreement among producers and importers of washing machines covering 95% of European sales to discontinue production and imports of the least energy efficient washing machines representing 10-11% of current EC sales. The agreement would adversely affect competition and increase prices since the most polluting machines are also the least expensive ones.

### Common Property Industries

A more clear-cut case of an efficient cartel is where firms compete over a common property resource where property rights are ill-defined or absent such as fisheries. In these industries competition leads to excessive entry, over-exploitation, and the dissipation of the economic returns (rents). A cartel would be unambiguously efficient even though it increased prices, reduced production and foreclosed entry. The benefits of such cartels have however not been recognised by competition authorities. The Dutch competition authority’s (Case No. 2269/330) and the European Commission’s (Press Release, 27 November 2013) North Sea Shrimp decisions imposed heavy fines on Dutch shrimp fleet and wholesalers’ organisations for agreeing fishing quotas and prices. One study showed that the agreement reduced the fishing catch by at least 12%-16% during the cartel period and increased wholesale prices, implying a loss of consumers’ welfare. However, this output reduction and increased prices was not necessarily consumer welfare-reducing in the medium to long run if it is accepted that a competitive outcome (the counterfactual) would have led to over-fishing.

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