

Legal Standards and the Role of Economics in Competition Law Enforcement

(Or, Has the “More Economic” Approach been a Success or Failure?)

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Objective of presentation

- Shed light on the following question: **what determines the extent of economic analysis and evidence in Competition Law enforcement?**
- Split this question into two:
 - What **should** determine extent of economic analysis if this was decided purely on the basis of social welfare maximization?
 - What determines the extent of economic analysis **in enforcement in practice**?

Rephrasing the basic question

- Extent of economic analysis relied up by CAs and Courts in assessing whether specific conduct violates CL depends crucially on the *legal standard* adopted – the *decision rule* that provides the guide for how assessment should be undertaken and a decision reached.
- Therefore, a more or less equivalent question is: **what determines the legal standards applied in Competition Law enforcement?**

The twin role of economic analysis

- Worth stressing that economic analysis has a **twin role** in enforcing Competition Law:
 1. It **provides the analytical tools and models** for understanding potentially illegal conduct and assessing its welfare implications.
 2. It has an (increasingly) important **role in the evaluation and choice of legal standards** (as well as the shaping of other enforcement tools such as sanctioning, leniency programs etc) – evaluation that can lead to object-(rather than, effects-) based rules been proposed!

The *Continuum*

- Usually we distinguish between two broad types of legal standards: **effects-based and object-based** (or, to use US terminology **rule-of-reason and Per Se**).
- But: it is very important to remember that there are **variations in these rules**.
- Indeed, it is best to think of legal standards as forming a ***continuum*** at the opposite extremes of which are the Per Se and “full” rule-of-reason standards.
- This idea has a long history: Italianer (2013) refers to Justice Stevens as the first to point out that one should think of legal standards as forming a *continuum with Per Se and r-o-r at the opposite extremes*.

The *Continuum* (cont.)

- The US Supreme Court has explicitly recognized that “the categories of analysis cannot be pigeonholed into terms like “Per Se” or “r-o-r”. No categorical line can be drawn between them. Instead, what is required is a *situational analysis* moving along – what the Court referred to as – a *sliding scale*”. Also, Gavil (2008).
- The main **difference between the two categories of legal standards** is that in many cases, with effects-based, the CA can satisfy a higher **standard of proof** (its **threshold for discharging its burden of proof** and establishing its ultimate contention) than can be satisfied with Per Se.
- We implicitly assume that the “ultimate contention” regards a reduction in welfare - come back to this later.

Implications

- One of the main implications of thinking of legal standards as forming a *continuum* is that this makes clear that, while the **extent and sophistication of economic analysis** used under effects-based is greater, how much greater depends again on the exact variant of the object-based or effects-based rule used.
- This in turn has the important implication that **the object-based approach might not require much less in economic analysis and evidence than witnessed in cases determined via an effects-based approach!**

Variants and an example

- The main variants:
 - Strict Per Se: “form” of conduct all important
 - Rebuttable object-based
 - Modified Per Se or object-based: contextual analysis of market and firm characteristics important.
 - Structured rule-of-reason
 - “Quick look”
 - Full (unstructured) or “open-ended” rule-of-reason
- An example: information exchange.

How should we choose legal standards?

- Main factors to take into account:
 - Decision errors
 - Deterrence (or indirect, or incentive) effects
 - Effects on predictability / legal certainty
 - Administrative costs of enforcement.
- Discussion relies on series of papers by Katsoulacos and Ulph:
 - “Optimal Legal Standards for Competition Policy: a General Welfare-Based Analysis”, the *Journal Of Industrial Economics*, Sept. 2009.
 - “Optimal Enforcement Structures for Competition Policy: Implications of Judicial Reviews and of Internal Error Correction Mechanisms”, *European Competition Journal*, 2011, 7(1).
 - “Legal Uncertainty, Competition Law Enforcement Procedures and Optimal Penalties”, *European J. of Law and Economics*, June 2015.
 - “Regulatory Decision Errors, Legal Uncertainty and Welfare: a General Treatment”, *International Journal of Industrial Organization*, 2016.

Decision errors

- According to the **Decision Theoretic Approach** the legal standard should *minimize the cost of decision errors* – false convictions (Type I) and false acquittals (Type II).
- K&U (2009) derive an **explicit test** for deciding if a higher legal standard will reduce decision errors: as expected, **the discriminatory quality of the rule's analysis must exceed the strength of the presumption of illegality (or legality).**

Decision Errors (cont.)

- Most economists would argue that advances in theoretical, empirical and experimental economics over the last 25 years point quite strongly towards considering as *less* presumptively illegal, many forms of conduct that in the past were considered as strongly presumptively illegal.
- Also, these advances have allowed us to discriminate more accurately between harmful and benign conduct.
- These developments suggest that **a move towards higher standards is justified.**

Deterrence effects

- Deterrence (or incentives) effects – on the behavior of firms when deciding whether or not to adopt particular conduct - have been recognized for a long time as probably as the most important factor in legal rulemaking (P Joskow, 2002; K-U Kuhn, 2011).
- K&U (2009) show that effects-based rules generate relative to Per Se Rules:
 - **Absolute deterrence effects** that are too weak (too strong) when the action is presumptively illegal (legal) – thus *lowering* welfare.
 - **Differential deterrence effects** whereby harmful actions are more heavily deterred than benign actions – thus *increasing* welfare.

Deterrence effects (cont.)

- When conduct is not very strongly presumptively illegal (or legal), this is sufficient for the differential deterrence effects to dominate, implying that then, **in terms of deterrence effects, higher legal are superior.**
- This reinforces the argument for using such rules for lowering costs of decision errors.
- **Procedural effects** (coverage rate, delays in reaching decision, level and structure of penalties) also influence these outcomes.

Legal Uncertainty

Another important factor that should affect the choice of legal standards is legal uncertainty:

-**Legal Uncertainty (LU)**: inability of an agent to assess with certainty whether or not an action that it wishes to pursue is legal (and so would be permitted if detected and investigated by an Authority or court) or it is illegal (and so it would be disallowed).

Legal Uncertainty (cont.)

- Argument: effects-based rules induce Legal Uncertainty and thus should be less attractive than Per Se Rules.
- However it has been shown that [according to (K&U, 2015, 2016)] **there is no monotonic link between LU and welfare.**
- Effects-based procedures generate **variability of treatment but not necessarily uncertainty of treatment.** In this case, provided effects-based reduces costs of decision errors, welfare is higher than under Per Se.
- When effects-based generate legal uncertainty they may still be superior to Per Se because of the **superior deterrence effects** that the uncertainty generates.
- Indeed under some circumstances **having some degree of legal uncertainty (partial legal uncertainty) may be welfare superior** to having no legal uncertainty.

Where does this leave us?

- Moving towards more effects-based rules is going to **involve higher administrative costs** (though it should be recognized that the increase need not be substantial).
- Thus **adopting higher standards *needs to be justified by quite strong potential benefits.***
- As noted above it is likely that for a range of conducts, *now understood* not to be strongly presumptively illegal (or legal), moving to higher standards will improve welfare.
- Further, we showed that the (potentially negative) implications for legal certainty may have been exaggerated.
- But, the standards adopted and the extent of economic analysis applied by many CAs remains very low.

Where does this leave us? (cont.)

- This implies that the arguments concerning decision errors, deterrence effects and legal uncertainty / administrative costs, may NOT be the only, or even the most important, influences on choosing which decision rules to adopt.
- **In practice other factors can be very important.**
 - One is the **substantive standard** of the Authority or Court.
 - The second is that the CA may, besides taking into account the welfare impact of its rules, be influenced by **other considerations**, as a utility-maximising organisation.

The importance of the substantive standard

- Throughout the discussion above we have been implicitly assuming that **the CA criterion in assessing conduct** - the **substantive standard** - is that of welfare maximisation.
- Irrespective of whether **Consumer Surplus or Total Welfare** is the criterion adopted, more or less everything mentioned above is unaffected.
- But the substantive standard may not be that of Consumer or Total Welfare.
- CAs and Courts may adopt other substantive standards and this of course influences their choice of the decision rule that should be used.

The importance of the substantive standard (cont.)

- This is illustrated clearly by the exchange between Wils (2014) and Rey & Venit (2015) concerning the low standard adopted by the Court in the, by now, famous *Intel* decision.
- The first commends this Decision while the latter criticize it. But first commends decision for *focusing on the effect of the conduct on “the preservation of undistorted competition”*.
- The meaning of “preserving undistorted competition” was actually made clear by the General Court which, upholding in its entirety the Commission’s Decision, argued that making it more difficult for a rival to compete “in itself suffices for a finding of infringement”.

Utility maximizing authorities

- Competition Authorities are government or independent organisations and as such they typically have a certain degree of freedom to choose among different possible courses of action.
- Thus, while they may be concerned with the benefits that their activities bring to society, they will also be concerned with how their activities impact on their public image and reputation.

Utility maximizing authorities (cont.)

- Recent work, by Katsoulacos (2016) and by Katsoulacos, Avdasheva and Golovanova (2016), influenced by the work of Harrington (2011) and Schinkel et.al. (2014), assumes that **CAs maximise a utility function** that depends on a composite indicator of **Enforcement Success**.
- This in turn depends positively both on the welfare impact of decisions on any given conduct-type but, also, *on the difference between decisions reached and decisions expected to be annuled by Courts of Appeal.*

Utility maximizing authorities (cont.)

- Here the CA will *not* have an incentive to adopt higher standards, that utilise more economic analysis and evidence, if this can lead to an increase in the probability that appealed infringement decisions are annulled by Courts of Appeal.
- The issue of how economic analysis and evidence influences the probability that appealed infringement decisions are annulled by Courts of Appeal is both a theoretical but also, and primarily, an empirical question.

Utility maximizing authorities (cont.)

- Katsoulacos, Avdasheva and Golovaneva (2016) provide a preliminary empirical exploration using a very large dataset of infringement decisions made between 2008 – 2012 by the Russian Federal Antitrust Authority (FAS).
- They consider a number of alternative indicators that measure “economic analysis and evidence” and show that, however measured, *an increase in the value of these indicators, has a statistically significant and strong impact on the probability of annulment by Courts of Appeal.*

Utility maximizing authorities (cont.)

- While these findings are preliminary and need to be corroborated by more extensive testing, both with the Russian dataset and in other countries, they point to an important alternative explanation for the lack of (sufficient) progress in moving, when this seems welfare improving, towards legal standards with enhanced application of economics.

Thank you!!

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