



BASIC PRINCIPLES OF ECONOMICS FOR COMPETITION LAW

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Economic principles....1

Competition as a desirable condition

- ▶ In mainstream Microeconomics, competition is considered as a desirable state of affairs.
- ▶ The model of perfect competition is based on the assumptions that:
 1. There are many small firms competing in the market
 2. All firms produce products which are perfect substitutes
 3. There are no barriers to entry and exit from the market

Economic principles....1

Competition as a desirable condition

- ▶ The perfect competition model is associated with maximum consumer welfare.
- ▶ Although such a market structure cannot exist in the real world, it is argued that the more a real-world market approaches perfect competition, that is:
 1. the harder it is for firms to fix prices,
 2. the easier it is for consumers find substitute goods, and
 3. the easier it is for firms enter the market the better it is for the consumer.

Economic principles....1

Monopoly as an undesirable condition

- ▶ Conversely, in mainstream Microeconomics, monopoly is considered undesirable.
- ▶ In the case of monopoly, theory refers to deadweight loss, where the consumer suffers on two counts, namely (1) loss of efficiency leading to high production costs and (2) monopoly pricing (called super-normal profits). These arise mostly from limited substitution possibilities for the consumer and barriers to entry for new firms.

Economic principles....1

Imperfect competition

- ▶ In-between these two models of market structure, mainstream microeconomics presents imperfect competition. In this case, competition exists, but it is hampered either by barriers to entry (oligopoly) or by product differentiation (monopolistic competition). In both cases the firm is likely to charge super-normal profits and will not be motivated to produce at the lowest cost possible.
- ▶ These arguments lead to the conclusion that (a) a high degree of substitution possibilities and (b) a high degree of freedom of entry into the market are desirable conditions for consumer welfare.

The Role of Economics....1

Divergent economic views:

- ▶ The role of economics in competition law is to a large degree related to the interpretation of the extent to which in the real world, the market is competitive.
- ▶ Given the complexities of the real world, a certain degree of subjectivity exists with regard to such the extent to which the government should intervene in the market.
- ▶ For example the so-called Chicago School holds that certain actions often considered as anti-competitive, such as vertical restraints, could actually promote competition. This school tends to favour a “hands-off” government policy.
- ▶ Other economists believe that government “regulation” in ensuring fair competition is warranted.

The Role of Economists....2

The role of economists is set to grow:

- ▶ The role of economists is set to grow in cases involving competition law. There seems to be a movement away from *per se* argumentation (where an action is considered unlawful before assessing its effects) towards *effects-based* argumentation.
- ▶ For this reason, interpretations given by economists are becoming increasingly important.

Defining a Relevant Market ...1

The importance of defining a relevant market

- ▶ An important role played by economists relates to the definition of the relevant market.
- ▶ Such a definition is often needed in cases relating to:
 1. **article 102** dealing with abuse of dominant positions, where the focus of attention is on past practices. In this case a relatively large share of the market (for example 40%) is required for an abuse to be investigated.
 2. **mergers** where the focus on attention is on the future. In the case of mergers, the objective is to assess whether competition will be substantially reduced in the future as a result of firms having a larger share of the market.

Defining a Relevant Market ...2

What constitutes dominance

- ▶ In the EU, a market share in excess of 40% is associated with a dominant position.
- ▶ It is therefore important to define the relevant market in order to determine whether a firm has such a dominant position.
- ▶ In many cases relating to abuse of dominant positions, several cases required that the court defines what the relevant market.

Defining a Relevant Market ...3

Cases involving definition of dominance in Malta:

- ▶ One case involved a major supplier of soft drinks in Malta, who, in order to establish that the firm did not enjoy a dominant position, attempted to include all soft drinks, water, and even teas and coffees in the relevant market.
- ▶ Another case involved a bookshop on the runway side of the airport, where the relevant market was considered to be that area, given that a passenger's choice of outlets is limited to that area for certain products.

Defining a Relevant Market ...4

Abusers prefer a wide definition of the market:

- ▶ In general the narrower the definition of a market the easier it is to establish that a firm or group of firms have market power. As a result, firms accused of abusing the consumer tend to prefer to define the market in which they operate as widely as possible, so as to show that their share is relatively small.
- ▶ It is not infrequent that firms accused of market abuse contest the opinion of the competition authority regarding the size of their relevant market.

Tests relating to market definition...1

Tests relating to a relevant market

What criteria can be used to define a relevant market?

In basic economics, a market for a product is one where:

- (a) The product itself is bought and sold
- (a) Other products, that are considered to be good substitutes, are bought and sold

Tests relating to market definition...2

Tests relating to a relevant market

- ▶ The concept of the cross elasticity of demand has used to assess the extent to which goods are good substitutes.
- ▶ Broadly defined, this measures the relative change in demand for product A as a result in the price of product B, and the magnitude of the elasticity will signify the extent of substitution between the two products.
- ▶ When the two goods are independent, and therefore belong to separate markets, the cross elasticity demand will be zero.

Tests relating to market definition...3

Misuse of elasticity estimates

- ▶ However, this indicator can be misused as was the case referred to as the cellophane trap. The flaw is that a profit-maximising monopolist will generally continue to raise price to the point where other products become close substitutes. (United States v. E.I. du Pont de Nemours & Co., 353 US 586 - 1957).
- ▶ The real test relates to the power to raise price and cross-elasticity at a point in time gives information after the prices have been raised.

Tests relating to market definition...4

Other methods of assessing relevant markets

Other methods that may be used in assessing the relevant Markets. These include:

- ▶ price correlations
- ▶ the SSNIP test (Small but Significant and Non-transitory Increase in Price).

Tests relating to market definition...5

Price correlations:

- ▶ This exercise is based on the traditional economic view that markets identical products will be priced equally or almost equally in similar markets, subject to some allowance for transport costs.
- ▶ The assumption here is that there will be market power in a given area, if prices in that market are considerably higher when compared to those prevailing in another similar market.

Tests relating to market definition...6

The SSNIP test

- ▶ A commonly cited, but difficult to use, test is the so-called SSNIP test, which is an acronym for “Small but Significant and Non-transitory Increase in Price”
- ▶ This test is intended to identify the smallest market within which a hypothetical monopolist or cartel could impose an increase in price. The approach is based on whether or not such a monopolist could sustain a price increase of 5 per cent for at least 12 months. If such a price increase is not profitable, because there are sufficiently close substitutes, or because consumers will switch to products produced by other firms, then the monopolist does not have sufficient market power to raise prices.

Tests relating to market definition...6

Weakness of the SSIP Test

- ▶ It has been argued that the SSNIP test makes the same mistake as the US Supreme Court made in the Cellophane case and fails to recognise that a firm may already have market power, when substitutes are available.
- ▶ However, such considerations are not relevant for defining a market when analysing the competitive impact of a merger. This is because, in this case the crucial issue is not whether one of the merging parties already enjoys a degree of market power, but whether, as a result of the merger, the degree of market power would increase.

Tests relating to market definition...7

Predatory pricing

- ▶ Mainstream economic theory predicts that it is irrational for a firm to remain in production if it does not cover variable costs (or avoidable costs, defined as the opposite of sunk costs). This theory is referred to as the “shut down point”
- ▶ A firm enjoying a dominant market position may be considered as engaging in predatory pricing if it does not cover such costs and continues to operate. Predatory pricing is generally defined as sales below variable (or avoidable) costs by a dominant firm over a long enough period of time for the purpose of driving a competitor out of the market; the predator firm then raises prices to recoup its losses.

Tests relating to market definition...8

Predatory pricing

- ▶ Predatory pricing is a subject of intense debate. Low prices are often associated as pro-competitive, but they can be also considered as an abuse of dominance.
- ▶ This is another case where a deep analysis should accompany prima facie evidence so as to assess where a pricing strategy of a firm is pro- or anti-competitive.

Tests relating to market definition...9

Predatory pricing

- ▶ There is therefore a tendency for courts not to rely exclusively on to adopt a per se rule, and consider other factors such as intent and market conditions.
- ▶ In this case the intent to defeat a competitor so as to increase the share of the market may not be unlawful, but an intent to eliminate competitors so as to raise prices after the competitor is defeated is unlawful.

Limits of Economics in Competition Law

Competition Economics and Competition Law

- ▶ There is a lively debate as to whether per se rules should be given more importance than the rule of reason (effects based) in court decisions.
- ▶ Lawyers like to work with stable and predictable rules. It is argued that court decisions should be sufficiently transparent, uniform and predictable, so that one can anticipate what actions are lawful or otherwise. For this reason, according to this argument, per se rules should be preferred to “effects-based” rules.
- ▶ The science of economics does not always lead to consistent conclusions, and what appears to be anti-competitive in some contexts may be considered as pro-competitive in others.

Limits of Economics in Competition Law

Economic evidence is important

- ▶ Courts in most countries of the world have utilised economic and econometric evidence in competition cases, and “effects-based” decisions are becoming more common.
- ▶ Sometimes, complex theories and computational approaches are used. These are costly in terms of effort and time.
- ▶ On the other hand, simple approaches are more affordable, but these may not be based on sufficient economic rigour.

Need for Judges to be well-versed in Economics

- ▶ In many countries, competition cases are considered by judges who are not specialists in the subject.
- ▶ When dealing with competition cases, it is important that judges understand economic principles, given the orientation towards “effect-based” decision making.



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