Optimal Enforcement and Decision Structures for Competition Policy: Some Economic Considerations

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Preliminary – Comments Welcome

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1. *Introduction*

Competition Authorities (CAs) at both national and cross-national (i.e. EU) level have recently adopted significant reforms in enforcement and decision procedures. One such reform, in particular, is that many competition authorities are willing to use economics-based methodologies in the implementation of competition policy drawing on developments in Industrial Organisation theory over the last 30 years. This has led to the adoption of an *effects-based* rather than a *Per Se* approach to deciding cases[3]. It has also resulted in the appointment of eminent academic economists to top positions in some competition authorities.

There have been many other reforms in enforcement and decision structures in competition policy. In Europe, the Commission's Regulation 1/2003 and the 139/2004 Regulation on the Control of Concentrations have been landmark reforms[4] amounting to the most far-reaching restructuring of the EU Competition Policy procedures in more than forty years. Since 2004 the Commission and many national competition authorities have undertaken a series of further important changes in their decision structure by introducing in the system review panels, the chief economists departments, a hearing officer etc. All these reforms have been the subject of heated debate in recent years[5].

Now, while in the past economists have focused on analysing the potential anti-competitive outcomes of various business conducts, as they have become more involved in the implementation and enforcement of Competition Policy they have recently turned their

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[3] See for example the recent decision on *Microsoft* (2004) and the US Supreme Court decision in *Leegin vs PSKS*. See also the recent (December 2008) Guidance paper issued by the Commission on implementing Competition Policy in the area abusive practices by dominant firms (art. 82 EC).
[4] For a recent economic analysis of the effectiveness of the 1/2003 reforms see Will *et.al* (2008).
[5] See for example the collection of articles in "The Reform of EC Competition Law", edited by I. Kokkoris and I Lianos, Kluwer Publishers, 2008.

attention to considering the optimal design of Competition Authority decision and enforcement practices and of other enforcement procedures (e.g. considering the role of Courts).

2. *Choosing between alternative decision procedures in enforcing competition policy: some results from economic analysis*

Thus Katsoulacos and Ulph (2008a) – hereafter K&U (2008a) - develop a *very general* welfare-based framework for determining the conditions under which, for *any* type of potentially anti-competitive business practice, an *effects-based* approach is superior to a *Per Se*[6] legal standard. While this issue has been widely discussed by both lawyers and economists, until recently the discussion has remained rather informal and has focused solely on the impact of different legal standards on the decisions made by the competition authority on the cases coming before it. The new results that emerge from the framework proposed by K&U (2008a) are:

- There is an exact condition under which decision cost errors are lower under *an effects-based procedure* than under *Per Se*. This involves a comparison of the *quality of the model/analysis* available to the CA in undertaking an *effects-based* investigation with the *strength of presumption of legality/illegality*. The *quality of the model/analysis* depends on the propensity to make Type I and Type II errors (resp. false convictions and false acquittals). The *strength of the presumption of legality/illegality* depends on the frequency with which actions are anti-competitive, the degree of harm they cause if they are and the degree of benefit they create if they are pro-competitive[7].
- However decision errors affect only the welfare consequences of the CA's procedures on the cases that come to its attention. But CA's procedures could also affect firms who do not come to its attention, for example by influencing the decision of a firm to engage in potentially anti-competitive actions. These

[6] A *Per Se* legal standard allows or disallows an entire class of actions without trying to identify more carefully sub-classes of actions that might generally be harmful or generally benign. A *discriminating* legal standard or effects-based approach requires the CA to establish explicit criteria for deeming some actions to be harmful and others benign and to then investigate each case to see which of these criteria it meets. An extreme form of the *effects-based* approach is what in US is termed *Rule – of – Reason* under which competition authorities have the discretion to apply economic methodologies on a case-by-case basis.

[7] Previous literature had identified all these factors as being relevant, but had not shown exactly how they should be combined to give an exact test.

indirect/behavioural/deterrence effects could potentially have much more significant welfare effects than the *direct/decision* effects. So the second important result of K&U (2008a) comes from incorporating indirect effects of different decision procedures adopted by a CA on the behaviour of firms deciding whether or not to take a business action. This enables them to undertake a full welfare analysis of the overall effects of adopting different legal standards and show that even if *effects-based* procedures improve on decision errors they could lower welfare relative to *Per Se*. They also identify the full welfare consequences of making improvements to the underlying model/analysis used by the CA under an *effects-based* procedure.

- In analysing these indirect effects of the choice of legal standard on the decision by firms as to whether or not to take an action, K&U (2008a) also demonstrate that it is important to take account of certain other *procedural features of a CA's operations* – the coverage rate (i.e. the fraction of all actions that is investigated by the CA), delays in decision-making, and the penalty regime. They show how these procedural factors enter explicitly into the welfare comparison of different legal standards[8].

The importance of deterrence effects is shown in Katsoulacos (2008) who applies the above framework to the analysis of legal standards for refusals to license intellectual property rights and to the recent decision by the European Commission and the Court of First Instance in the *Microsoft* (2007) case. It is shown that if a *Per Se Legality* standard is not used to handle such refusals then the "exceptional circumstances test" would be the most appropriate test *because* of its superior indirect / deterrence effects.

K&U (2008a) assume that firms know whether their action is harmful or benign for consumer welfare and the CA's model for assessing their action/conduct, and so can infer the likelihood that their actions will be disallowed. This implies that there will be differential deterrence of firms whose actions are harmful from those whose actions are benign. In K&U (2008b) it is assumed instead that firms can only deduce the average likelihood of having their actions disallowed. In this case improving the accuracy of the decision rules may not always be a good thing if it leads to a greater deterrence by firms whose actions are on average beneficial. A similar result is obtained by Immordino and Polo (2008) who focus on

[8] These factors had been ignored in the existing literature on legal standards.

the special case of innovative activities where firms have to undertake an investment in order to innovate.

In a related paper confined to mergers, Sorgard (2008) determines the optimal number of merger cases to investigate taking account of both the quality of the analysis used by the authority and recognising the indirect effects on behaviour. In another paper by Will & Schmidtchen (2008) that also focuses on a specific type of action – non-hard-core-cartel agreements – the welfare effects of the recent Council Regulation EC 1/2003 are examined which significantly changed the way in which such agreements would be treated. They show that such a "relaxation" of notification requirements may not produce adverse indirect effects.

3. *Alternative decision procedures and Legal Uncertainty*

One of the most important issues in comparisons of *effects-based* (or discriminating) and *Per Se* decision rules concerns the implications of the former for Legal Uncertainty. Under *Per Se* rules firms' perception as to whether any given conduct is allowed or disallowed is certain[9]. Under discriminating rules this is no longer the case. The latter give rise to Legal Uncertainty in two senses. First, even assuming that firms know whether their conduct is harmful or benign and the model/analysis that the CA will employ to assess their conduct, because of the inherent inability to avoid decision errors firms will no longer be able to say with certainty whether their conduct will be allowed or disallowed. Type I decision errors imply that some benign conduct will be disallowed. Type II decision errors imply that some harmful conduct will be allowed. Second, when CAs adopt extreme forms of discriminating procedures associated with the discretionary application of different models on a case-by-case basis (*Rule-of-Reason*), then it is likely that firms will not be able to infer exactly how the CA will assess their conduct – in this case firms can only deduce the average likelihood of having their actions disallowed. The welfare cost of legal uncertainty that can be produced by an effects-based approach in this second sense, can be measured by the difference in welfare when: a) firms are deterred "correctly"; i.e. through correctly anticipating how the authority will assess their own conduct (as is the case under *Per Se* or under less extreme forms of an *effects-based* procedure), and b) when firms are deterred on

[9] Of course, if the conduct is presumptively (or prima facie) illegal, firms face *procedural uncertainty* about whether or not their conduct will be investigated.

the basis of their knowledge about what, on average, the authority has done in the past when investigating similar practices (because the firms cannot correctly anticipate exactly how their conduct will be assessed by the CA).[10] We refer to the first case as "marginal" and to the second case as "average" deterrence.[11]

Under average deterrence the fraction of firms deterred will be the same, irrespective of the type of their conduct (harmful or benign). A firm whose conduct is benign will perceive that its conduct will be disallowed with higher probability than with marginal deterrence. A firm whose conduct is harmful will perceive that its conduct will be disallowed with lower probability than with marginal deterrence. As a result, welfare under average deterrence will be lower than welfare under marginal deterrence.

4. *Choosing between alternative enforcement structures: The Role and Impact of Judicial Reviews*

Ahlborn Evans and Padilla (2008) explore the issue of whether enforcement procedures should involve some kind of appeals or referral process. They focus on the impact of such a process on the cost of decision errors and argue that an appeals process will reduce these costs. However their argument is rather informal and also they ignore the impact of an appeals process on deterrence effects – in which case it will be important to recognise the possibility that an appeals process will also involve more delay.

K&U's (2008c) "Optimal Enforcement and Decisional Structures for Competition Policy", examines the implications of different enforcement structures for the costs of decision errors **and** for welfare. Concerning the role of judicial appeals and referral procedures, the following results are obtained. Appeals procedures:

(i) Do not affect the decision errors of *Per Se* legal standards, while they

(ii) Affect the decision errors made by *effects-based procedures* and in particular they:

  (a) Increase the costs of Type II errors (false acquittals) whilst they

  (b) Reduce the costs of Type I errors (false convictions)

[10] Vickers (2007) also distinguishes between "discretionary decision making" by a CA "based on whatever is thought to be desirable in economic terms case by case" and the effects-based approach proposed recently in EU. The latter need not necessarily produce legal uncertainty in the second sense above, as when the CA uses clearly specified models and criteria that allow firms to anticipate correctly how their conduct will be assessed—in the sense of correctly anticipating when the conduct will be allowed or disallowed depending on whether it is harmful or benign.

[11] *See* Katsoulacos and Ulph (2008a, b and 2009); also G. IMMORDINO AND M. POLO, JUDICIAL ERRORS AND INNOVATIVE ACTIVITY, mimeo (2008).

(iii) Will affect decision errors in a way that depends crucially on whether the conducts or actions investigated are *presumptively legal* (on average or *prima facie* benign to welfare) or *presumptively illegal* (on average or *prima facie* harmful to welfare). The stronger the presumption of legality the *more* likely that decision errors will be reduced for a presumptively legal practice. The stronger the presumption of illegality the *less* likely that decision errors will be reduced for a presumptively illegal practice. It is more likely that decision errors are reduced for presumptively legal than for presumptively illegal actions.

(iv) Through their indirect / deterrence effects they will tend to improve welfare for presumptively legal actions and will tend to worsen welfare for presumptively illegal actions.

(v) Are more likely to improve overall *welfare*[12] when actions are presumptively legal than when they are presumptively illegal. Indeed because of their beneficial deterrence effects they may improve welfare even when they increase decision errors for presumptively legal actions.

5. *Choosing between alternative enforcement structures: The Role and Impact of Internal Error-Correction Mechanisms*

K&U (2008c) also examine the implications of internal error-correction mechanisms such as those introduced by the Commission since 2004. An important issue here is whether, in the presence of such procedures, it is then best to take final decisions in the Competition Authority unanimously or through a majority rule. Such mechanisms:

(i) Produce exactly the same decision errors as a judicial review system if internal review panels allow the same number of reviews as there are potential judicial reviews (usually two) ***and*** decisions in the authority are reached unanimously.

(ii) If decisions in the authority are not reached unanimously but rather a majority rule is used the internal review panels will produce more Type I errors and fewer Type II

[12] Overall welfare refers to welfare when account is taken of both costs of decision errors and of indirect / deterrence effects.

errors relative to unanimity and hence, given (i), relative to an equal number of judicial reviews.

(iii) Under unanimity, in contrast to judicial reviews, internal reviews unambiguously reduce deterrence effects and thus tend to improve welfare for a presumptively legal practice and tend to worsen welfare for a presumptively illegal practice. However, if decisions in the authority are reached using a majority rule then internal review panels may well increase deterrence effects. This suggests the interesting result that, *ceteris paribus, final decisions in the CA with internal review panels should be taken unanimously when the action investigated is presumptively legal and through a majority rule when the action investigated is presumptively illegal.*

Corollaries:

A somewhat loose but still quite accurate interpretation of what the results outlined in the last two subsections imply is the following:

- "Heavier" procedures (judicial appeals, internal reviews, chief economists, unanimity rules) are more likely to be used with benefit for *prima facie* good than for *prima facie* bad conduct.

- When the presumption of illegality is very strong (cartels would be a good example), so *Per Se Illegality* seems the right legal standard to use, one should not rely on "heavy" procedures. However, when behavior is presumptively illegal but the presumption is not very strong (RPM may be such an example, for which many would like to adopt an *effects-based procedure*) adopting an intermediate degree of "heaviness" might be most appropriate (e.g. internal reviews and unanimity may not be called for but one should allow for judicial reviews).

Intuitively: if the conduct is *prima facie* good, let's put as many obstacles as possible in the way of the authority; if it is *prima facie* bad, the conclusion is the reverse.

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