1983

Economic Foundations for the Competition Policy Implemented by the EEC

J. Patrick Raines
University of Richmond

Follow this and additional works at: https://scholarship.richmond.edu/robins-white-papers

Part of the Business Commons

Recommended Citation

This White Paper is brought to you for free and open access by the Robins School of Business at UR Scholarship Repository. It has been accepted for inclusion in Robins School of Business White Paper Series, 1980-2011 by an authorized administrator of UR Scholarship Repository. For more information, please contact scholarshiprepository@richmond.edu.
ECONOMIC FOUNDATIONS FOR THE COMPETITION POLICY
IMPLEMENTED BY THE EEC

by

J. Patrick Raines
University of Richmond

1983-6

Presented at the
Academy of International Business Annual Meeting
December 29, 1983
Introduction

The purpose of this study is to provide a theoretical economic framework for the analysis of the competition policy implemented by the European Economic Community (EEC). The fundamental objective is to demonstrate that the EEC's actual approach to regulating restrictive business practices can be related to a concept of competition that is relevant and adequate for the analysis and explanation of competition policy in the EEC. The thesis is that a strong theoretical relationship can be shown to exist between EEC business regulation and the conceptual parallels in the theories on competition of J.A. Schumpeter and J.M. Clark.

A United States Congressional inquiry into international antitrust legislation determined that EEC competition rules are designed to facilitate the control of abusive enterprise practices, not the proscription of restrictive business practices or concentrated market structures per se. The finding implies that statutes affecting competition policy in the European community are based upon the control of abuse of power competition principles. Competition legislation which is founded upon the control of abuse principle mandates a significantly different competition policy than laws that are based upon the prohibition principle, which is the other common basis for rules which regulate anti-competitive enterprise activities.

The properties of the prohibition principle are that certain restrictive business practices are prohibited per se, and in addition, the acquisition of dominant or monopoly power is proscribed. Countries which base their competition policy upon the prohibition of per se
principle do not usually require a case-by-case determination of whether potential social or economic benefits mitigate the economic costs of competition-distorting practices.

Richard Leftwich asserts that for countries such as the United States which employ the prohibition principle in their enforcement of antitrust legislation the model of perfect competition provides the norm for evaluating business practices. He states, "Presumably it [the theory of perfect competition] underlies the philosophy and enforcement of the Sherman Act of 1890... government regulation of public utilities and many other public policy measures."³

Since the model of perfect competition is credited with being the underlying economic justification for the prohibition principle, it is necessary to develop a theoretical economic rationale for competition policy like the EEC's, which is based upon the control of abuse principle.

The essence of the control of abuse of power competition principle is that restrictive business practices or firms with dominant market positions can be rationally overseen to achieve the most socially beneficial use of resources.⁴ Competition legislation and policy that is based upon the abuse principle allows exemptions from prohibitions on anti-competitive activities when restrictive business practices and agreements, which limit competition between firms, enhance economic efficiency or are likely to produce new or improved products. A further requirement is that the benefits which result be shared with ultimate consumers. Basically, under this type of competition policy, the criterion for determining the acceptability of anti-competitive arrangements is economic performance, and not merely the existence of
concerted practices or concentrated economic power. Authorities which carry out competition policy must therefore employ a balancing logic in order to determine if the existing or potential economic benefits to society outweigh the detrimental effects of less competition. An important factor which is included on this economic balance sheet is the possibility of long-run improvements in production efficiency that might mitigate some of the short-run imperfections of restrictive business practices.

The theories of competition of Schumpeter and Clark provide a solid foundation in economic theory for the control of abuse principle in competition legislation and policy. Further, the rules and policy implemented by the EEC are exemplary of the principle. Thus, a unique theoretical economic model can be presented for the analysis and explanation of competition policy in the European Community.

The Literature

Several studies exist that present plausible rationales for EEC competition policy. Typically they explain EEC legislation and regulatory action as a function of pragmatic socioeconomic considerations. Little, if any, effort is exerted to relate policy and practice to a theoretical economic model.

Angulo and Minshall (1964) explicate competition policy in the United States and the EEC by theorizing that the acceptability of business practices is determined by authorities on the basis of nationalistic economic and political objectives. The authors speculate that the national economic concern for geopolitical economic power and the economic needs necessitated by various stages of economic development affect the focus of a nation's competition policy.
The study's findings indicate that when the theorem is applied to the EEC, the advantages of industrial concentration respond to the EEC economic needs more suitably than unfettered competition. Angulo and Minshall conclude that as a result of the economic needs created by the desire in the EEC to improve its trade balance, the rapidly expanding economies in the Common Market at the time of the research, and the lack of inherent fear of large firms in Europe, EEC regulatory policies are favorable toward the existence of firms with significant market power.

Clock and Lee (1975) present general economic philosophies which they assert have influenced EEC business regulation. The "economic cooperation" and "economic moderation" schools of thought are set up as partial determinants of antitrust action in the EEC.

The economic philosophy of the cooperation school is that the advantages of economies of scale typically associated with industries that have small numbers of stable, protected, large firms should be encouraged. The view holds that to promote effective competition between large multinationals, a few monolithic firms are necessary in each industry. The benefits of promoting the development of large-scale industrial structures are envisioned as lower-cost corporate financing, and increased profits which should foster technological progress. Although the authors are critical of the EEC Commission and Court of Justice for utilizing the cooperation concept, they suggest the philosophy has significantly influenced EEC policy.

Clock and Lee maintain that in the early 1970s EEC policy began to change from wholesale approval of highly concentrated industry arrangements to guarded enthusiasm for additional concentration. The indication of this less-than-blanket acceptance of cooperation
agreements was the EEC Statement of May 27, 1970. The statement exempted agreements between firms with less than 5 percent of their product market from competition legislation and implied that agreements between firms with more than 5 percent would have to be notified to the EEC Commission. Thus, the authors postulate that the logic of economic moderation impacted EEC antitrust policy.

The findings of the study are that EEC authorities who deal with competition matters now attempt to achieve a balance between the benefits that scale economies offer with the anti-competitive effects created by restraints of trade. Clock and Lee conclude that a more specific set of economic criteria is necessary to measure the impact that agreements have on net market efficiency if optimal economic and social results are to be ascertained from EEC policy.

The Schumpeter-Clark Model

In this section the main currents of Schumpeter's theory of "creative destruction" and Clark's "workable competition" are isolated, shown to be remarkably similar, and integrated into a framework for the explanation of EEC competition policy. The visions of capitalist competition expressed by Schumpeter and Clark provide theoretical underpinnings for regulatory action that stresses the control of restrictive business practices. The two mainstream economists contend that effective competition can be achieved if society recognizes that: 1. static models of competition are inappropriate norms for assessing business practices; 2. long-run dynamic factors, e.g., new products or technologies, can mitigate the immediate costs of restrictive practices; and 3. competition policymakers should employ a case-by-case evaluation
of anti-competitive activities to facilitate the social and economic benefits of dynamic progressiveness.

Once the Schumpeter-Clark model is formalized, explanatory power for European Community competition policy is demonstrated.

Background of Creative Destruction and Workable Competition

Competition in the capitalist system is presented as a process of creative destruction in Schumpeter's 1942 publication *Capitalism, Socialism and Democracy.* The purpose of the treatise is to demonstrate the inevitability of the emergence of a socialist economy because of the decomposition of capitalist society. The theory of creative destruction facilitates the prediction of capitalism's demise because it is indicative of the rationalist mentality inherent in the system. Basically, capitalism develops rationality and the cost-profit calculus which propels the logic of enterprise. However, a by-product of the rationalistic attitude is a critical mindset which eventually attacks and undermines the economic system.

Schumpeter describes capitalist competition as a process of creative destruction because continuous change from within business enterprises is envisioned. Incessant revolution takes place inside firms and industries as old methods and products are supplanted by improved technologies and differentiated output. In light of the existence of creative destruction, survival in the arena of capitalist competition requires firms to perpetually strive to: 1. develop more efficient production methods; 2. improve product quality; and/or 3. create an entirely new product or service. The systematic destruction of the old and creation of the new has important implications for the regulation of enterprise activities.
The impetus for J.M. Clark's explanation of effective capitalist competition is much different than Schumpeter's. Clark is virtually indifferent to the overall question of the continued existence or disintegration of modern industrial societies. Instead his analysis is a response to the perceived intellectual shortcomings of the theories of imperfect competition.

The principles of Clark's effective competition appear in his 1940 paper entitled "Toward A Concept of Workable Competition." He states that his article:

...is an attempt to find an escape from the negative conclusions stemming from the Chamberlin-Robinson group of theories, in which it appears that all feasible forms of competition in industry and trade are defective, from the standpoint of the services competition is supposed to render.

The predominant objective of Clark's theory of workable competition is to encourage the development of realistic and desirable concepts of competition, from those that are practically possible, within the limits set by conditions that are inescapable. Further, he emphasizes that the acceptability, or workability, of an industry should be determined on the basis of careful economic analysis of the structure of the industry; the behavior of the firms which make up the industry; and industrial performance.

Views of Static Models

A fundamental principle in both the process of creative destruction and workable competition is an emphasis on the dynamic characteristics of the competition process. The capitalist economy that Schumpeter perceives is characterized by incessant change from within - destroying the old vestiges of competitive advantages and creating new ones.
Schumpeter stresses that such a process necessitates models and theories of competition which account for the impact of innovation over time. Similarly, Clark maintains that economic activity, as well as the psychology of economics, should realistically be analyzed from a dynamic perspective. Both economists assert that precisionist models, aimed at the mathematical determination of static equilibrium, create an overly mechanistic view of the economy and overlook possible social benefits made possible by changing economic conditions.

Schumpeter is not satisfied with economic theory which is directed toward the mere analysis of how capitalism administers existing structures. He defines capitalism as "a form or method of economic change" that never has been and never will be stationary. He describes capitalism as an evolutionary process, one which is characterized by incessant revolution from within.

He is critical of theorists who use fragments of this reality and attempt to generalize conclusions about the functioning of capitalism from limited observations. Once Schumpeter explains capitalism to be an ever-changing economic system, the interpretation of its institutions requires dynamic methods of analysis. To facilitate such analysis, he argues that it is pointless to evaluate capitalist performance from a static point in time. Rather, since it takes considerable time for the process to manifest its true features and effects, it is better to judge economic performance over time. He states that:

A system - any system, economic or other - that at every given point of time fully utilizes its possibilities to the best advantage may yet in the long-run be inferior to a system that does so at no point in time, because the latter's failure to do so may be a condition for the level or speed of long-run performance.
In order for society to have the opportunity to benefit from the dynamic progressiveness of capitalist competition, the performance of an enterprise must be evaluated on factors other than the price and quantity features that are focused upon in static models. In Schumpeter's view a realistic measure of competition must include contributions to new technologies, new products, and new types of industrial organization. Further, he argues that if perfect competition existed, it would not result in the most efficient use of resources. He declares that the existence of perfectly competitive firms would most likely result in wasted opportunities and resources because of their inability to judge and take advantage of new methods of production and profitable investments.

Another fallacy of the model of perfect competition according to Schumpeter is that it assumes easy entry into any industry. Yet, when new products or new methods of production are introduced, firms may not be able to readily enter the field of competition. He also recognizes that economic profits acquired through business strategy are eliminated, or competed away, according to the model of perfect competition. Any attempt to maintain surplus profits is "inimical to growth of total output." However, Schumpeter stresses the necessity of such profits in the process of capitalist evolution, and adds that "perfect competition is not only impossible but inferior, and has no title to being set up as a model of ideal efficiency."

In Clark's view, neither the model of perfect competition nor the models of imperfect competition expounded in the 1930s are appropriate guidelines for competition policy. Nevertheless, he applauds the theorists of imperfect competition for their attempt at making economic
models more relevant to modern experience. He believes their emphasis on the effects of large firm size, small numbers of producers, and differentiated products is pertinent and useful. However, he asserts that an analysis using graphical models, of which the aim and end is the mathematically precise definition of a state of stable equilibrium, leads away from increased realism. He states that "this static character, plus the requirements of mathematical precision...impose limitations on the extent to which these models can reflect the behavior of actual, dynamic economic situations and the forces that operate on them."  

Clark deals primarily with the fallacies he perceives in the models of imperfect competition developed by Chamberlin and Robinson. However, he does state that the use of the standard of perfect competition cannot "afford reliable guidance to the factors which are favorable to the closest working approximation of that ideal under actual conditions." He charges that equilibrium conditions of perfect competition eliminate progress by assumption. In his view, the model brings forth an inescapable conclusion, namely: 

...this allegedly desirable condition is something nobody really wants, including the theorists whose models impliedly set it up as a desideratum. They do not want techniques to be static or diversity of products to be wiped out, and complete homogeneity of products would threaten competition worse than differentiation does.

Clark's critique of Robinson and Chamberlin's works focuses upon the absence of dynamic considerations which Clark believes ameliorate the pessimistic predictions of imperfect competition. He points out that it is quite possible that firms with market power and a measure of control over prices can perform well enough to be considered adequate and reliable forms of actual competition.
The long-run, dynamic forces, which Clark believes mitigate the unfavorable results of higher than competitive prices and restricted output predicted by models of monopolistic competition, are the potential for both more competition and an increased number of substitute products. He notes that neither factor is individually capable of offsetting monopolistic tendencies, but he submits that, in concert, they might come close to a perfect check on such activities.

Clark's fundamental proposition is that demand and cost curves in the long-run and much more elastic than short-run curves, and considerably more elastic than the ones used in the diagrammatic expositions of theories of imperfect competition. Clark states that he expects "the apparent seriousness of Professor Chamberlin's results derives from...the exaggerated steepness of the curves he used to illustrate them." ¹⁸

The development of substitutes over time represents, in Clark's view, a dynamic factor which results in more elastic demand schedules and reduces the seriousness of imperfections that theories of monopolistic competition suggest. In a comment on the importance of innovation reminiscent of Schumpeter, Clark points out that competition between substitutes is possibly the most formidable kind of rivalry because it can threaten the existence of an entire industry. He suggests that the development of substitute goods is so pronounced and inevitable in the capitalistic economy that it should be viewed as a form of competition itself.

The awareness that potential competition can materialize prevents enterprise, in Clark's opinion, from pursuing an "unduly grasping policy in regard to price, and an unduly restrictive policy as to output." ¹⁹
Clark insists that static models portray businessmen as totally preoccupied with the short-run maximization of profits. Although he recognizes that businessmen do not possess perfect foresight, he believes that decision-makers in industry are aware that substantial short-run profits eventually attract new competitors.

The essence of Clark's position is that the emphasis of competition theories must be changed from one which views competition as a mechanism of equilibrium to one which explains competition as a dynamic process. If this position is accepted, it is possible to understand his presumption that "competitive forces persist more pervasively and effectively than existing theories typically assume." 20

The Impact of Dynamic Economic Factors

Schumpeter and Clark maintain that the development over time of new products, or commodities of better quality, or more technologically advanced methods of production should be acknowledged as compensatory effects of short-run restrictive practices. They insist that the type of competition that generates these results is the most desirable since decisive cost or quality advantages are afforded society. Furthermore, in their view, such improvements in products or production techniques strike at the foundation and very lives of firms with significant power.

The process of creative destruction, Schumpeter insists, unremittingly reduces the concentration of market power and ultimately produces price and output levels near the competitive optimum. In fact, he suggests in the long-run that behavior is very similar to the perfectly competitive pattern. 21 Several tenable arguments are presented to justify Schumpeter's position that anti-competitive arrangements have redeeming
social and economic features. In the gale of creative destruction restrictive practices acquire a new meaning. He asserts that the materialization of the threat of new products and technologies is sufficient to reduce the "long-run scope and importance of practices that aim, through restricting output, at conserving established positions and at maximizing the profits accruing from them." Also, he suggests that practices which appear in the individual case to be restrictive may do a great deal to "steady the ship" during the expansions and contractions of business cycles. In particular, some restrictive arrangements prevent resource dislocation and large numbers of business failures. He states:

We may assume that the refusal to lower prices strengthens the position of the industries which adopt that policy either by increasing their revenue or simply by avoiding chaos in their markets...it may make fortresses out of what otherwise might be centers of devastation.

In other words, firms with some degree of price control may be able to maintain total output and employment at higher levels than would be possible if complete price flexibility exist.

Also, because Schumpeter describes capitalism as a system of incessant change from within - a sort of innovative competition - he views certain protective devices and strategies as imperative for survival in the capitalist order.

The nature of the system, which constantly induces the introduction of new commodities and techniques, necessitates certain protective measures. Schumpeter considers patents, restraints on the dissemination of production technique information, and long-run contracts as essential to insure the continuation of investment under the constantly changing conditions of capitalism. He points out that, in reality, such
generally accepted practices are not different, only special cases, from the class of restrictive practices held in such contempt by theorists and politicians.

He admits that if restrictive enterprise activities are viewed statically vis-a-vis a model of perfect competition they appear to be detrimental to social utility because of higher prices or smaller quantities of output. However, Schumpeter maintains that these strategies or practices should be viewed as part of a long-run process of expansion and development of the capitalist system. He suggests that if restrictive practices are viewed from this perspective they can be judged as protecting rather than impeding economic and technical progress.

Another reason why the conclusion that firms with market power inevitably restrict output is unacceptable to Schumpeter is that such enterprises "largely create what they exploit." The argument is that it is irrational to condemn firms with the financial ability or entrepreneurial talent to create new products. These enterprises expand total output when they produce the new or improved commodity which they have developed.

The process of creative destruction also has an impact on the price strategies of firms. Since innovation is indigenous to Schumpeter's vision of capitalist competition, he avers that "price rigidity is essentially a short-run phenomenon. There are no instances of long-run rigidity of prices." He explains that the rational cost-profit calculus which drives capitalism eventually brings forth a new product or production method which reduces the market power of its competition and forces prices down. In other words, the process of
creative destruction insures that the fruits of technological innovation are passed along to consumers.

A conclusion similar to Schumpeter's regarding the acceptability of anti-competitive business practice is reached by J.M. Clark in his concept of workable competition. In his famous article Clark contends that businessmen want to avoid attracting new competitors so it is unlikely they will pursue the highly restrictive, short-run price and output strategies that static models of imperfect competition demonstrate. He further argues that the constant introduction of substitute products results in more elastic demand schedules and, consequently, price and output levels close to the ideal of perfect competition. Thus, he explains that competition is "more pervasive and ever present than commonly believed." 26

Business awareness that the probability of new competitors increases when restrictive short-run price and output strategies are pursued forces sellers to behave in a manner that is more farsighted. Clark points out that many businessmen believe it is good business to expand their output and sales volume and, thus, avoid "unduly grasping" profit-maximizing strategies.

The serious, derogatory results demonstrated by Chamberlin's model of imperfect competition are the product of the exaggerated steepness used to illustrate product demand according to Clark. He states that the abstraction of a timeless demand schedule neglects the elasticity increasing impact of potential competition and substitute goods. It is highly possible, in his view, that the effects of these factors in the long-run force the demand schedule for most products to approach infinite elasticity, and thus reduces or eliminates the difference
between price and output levels of imperfect competition and those of the perfectly competitive ideal. According to Clark, the conditions of workable competition reduce the discrepancies between long-run and short-run results so that levels closer to the "ideal" are achieved.

Although no specific standards are presented by Clark to judge the abuse of economic power, some degree of price control is considered beneficial to effective competition. The positive characteristics of price control are: 1. it allows reward for the technological progress and product development; and 2. price flexibility "affords a stimulus to demand in dull times, and the reverse in boom times."27

Innovations in technology or products improve the performance of imperfect competition, and the inherent sloped demand curve is seen as imperative to reward the risk and cost of innovation. Actually Clark alleges that the advent of innovations or improvements in quality enhances effective competition because the accompanying competitive advantages provide a stimulus for others in the industry to improve their productive efficiency or to increase the attractiveness of their product.

The ability to affect prices implied by negatively sloped demand curves also produce stabilization benefits for the economy. Clark submits that effective competition requires "an individual demand curve with sufficient slope to bring price, on the average, far enough above marginal cost so that average cost may be covered over the run of good times and bad."28 Thus, he concludes that workable competition has some positive use for the sloping individual demand curve.

In summary Clark maintains that competition between even a few sellers will in the long-run approximate the results of perfect
competition, and short-run practices result in considerably less restrictive price and output levels than theorized. Clark predicts these outcomes because he believes businessmen rationally pursue price and output strategies that try to avoid attracting rivals, and that expand their sales volume and market share - even at the expense of short-run profits. Essentially, to have a system of workable competition the effects of ever-changing long-run factors must be considered. It is these dynamic, long-run effects which mitigate the seriousness of short-run results under imperfect competition.

The Role of Competition Policy

Three parallel themes exist in Schumpeter and Clark's views of capitalist competition which require consideration in decisions that regulate business enterprises. First, innovation is stressed as the most effective kind of competition. Next, a degree of price control is advanced as necessary to stimulate and reward technological research and development. Finally, they contend over the long-run restrictive practices may afford economic stabilization benefits to society. Consequently, it is their position that the effects of these dynamic practices must be estimated when business activities are evaluated.

Schumpeter submits that the competition which counts the most is "from the new commodity, the new technology, the new source of supply, the new type of organization (the largest-scale unit of control for instance) - competition which strikes not at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives." He maintains competition policy should decide the acceptability of enterprise positions and activities on their ability to
contribute to the development of the economy over time. In his view, considerations other than static comparisons of price-quantity relationships are important. Factors such as the likelihood of increasing social welfare from new or improved products, or contributions to technical progress, or an improved source of supply are identified as worthy considerations. The implementation of policy in this manner contributes, in Schumpeter's opinion, to the organic development of the capitalist economy.

Clark, like Schumpeter, recognizes the importance of innovation. He defines it as the utilization of applied science to the competitive forces of a thoroughly dynamic economy. Clark emphasizes the import of innovation in much the same way as Schumpeter does. Clark believes that the significance of innovation is in the new forms it creates; the new kinds of things it does; the new organizational sponsorship it necessitates; and the new "enabling conditions" it creates. Furthermore, Clark asserts that when innovation facilitates the development of substitutes it may promote the most formidable kind of competition - that which can threaten the existence of an entire industry.

The possibility that cooperative agreements between firms might facilitate technological progress should also be considered in Clark's opinion. Although the agreements conceivably reduce competition between firms, Clark argues they promote the introduction of closer and more general substitutes. He recognizes that such anti-competitive arrangements have the effect of increasing the concentration of industry. However, he contends that large-scale production has the characteristics of fairly healthy and workable, imperfect competition. Clark expresses hope that in these cases government will "not assume the
burden of doing something about every departure from the model of perfect competition."

Schumpeter was avidly against antitrust ideology which emphasizes attacking the existence of significant market power (the ability to maintain a price greater than marginal cost) or restrictive business practices without considering the role such positions, practices, and strategies play in the process of economic development. He admits that there are some cases of anti-competitive business practices which may prove detrimental to long-run output. However, he contends that competition authorities should not uncritically assume that all practices, which appear anti-competitive, are injurious to long-run development. This position can be interpreted as an argument against ruling enterprise activities illegal per se. However, Schumpeter does not argue against all state regulation. For instance, he observes that it is possible for a cartel system to sabotage all progress or to accomplish the same results as perfect competition with smaller social and private costs. This possibility, he believes, shows "that there is no general case for indiscriminate trust-busting or for the prosecution of everything that qualifies as a restraint of trade."  

The type of regulatory philosophy that Schumpeter advocates for regulatory authorities to pursue is what he calls a rational instead of a vindictive competition policy. Although no explicit detail is given concerning how a rational policy can be implemented, the statement condemning indiscriminate trust-busting implies that concentrated industries and restrictive practices should be regulated to facilitate the social and economic benefits of innovation.
The most precise elaboration of the competition policy necessary to promote effective competition is made by J.M. Clark. He maintains that a case-by-case method of determining whether enterprise activities satisfactorily meet competition criteria is the appropriate approach for authorities to employ. He notes that a balanced evaluation of competition is "one in which the aspects of productive techniques, improved and differentiated products, and price all play a part." Clark's belief in the relevance of pragmatic analysis necessitates that behavior be analyzed in light of many diverse, realistic variables. When such logic is extended to the criteria for identifying effective competition he states:

...the case-by-case type of study does not mean that the concepts of general theory play no part. They are used and useful. But it does mean that no one or two such concepts can be counted on to dominate a particular situation; and that the facts of the case must be appealed to in trying to decide how important any one factor is. To put it briefly, the concepts of theory suggest some of the things a student should look for; but he also needs to be looking for other things and be prepared for the unexpected.

The approach that Clark advocates is one which determines the legality of enterprise activities on the basis of practices judged desirable and those judged harmful from a competitive standpoint. He calls the prohibitionary antitrust policy approach a negative method of implementing policy, but observes that it has some value if offenses are defined and firms are told what to do to rectify their violations. Therefore, appropriate competition policy under Clark's theory of competition would not automatically attack the acquisition or existence of substantial market power.

The theories of the two economists on effective capitalist competition provide a theoretical framework for the economic analysis of
competition policy which does not automatically condemn concentrated market structures or restrictive business practices. The principles of their concepts of acceptable competition establish a basis for competition policy which utilizes a case-by-case evaluation of enterprise practices and market positions to determine if imperfections can make positive economic or social contributions. Competition policy directed at the control of the abusive use of economic power, and not at the existence or acquisition of power, is theoretically rationalized on the basis of Schumpeter's and Clark's competition theories.

The next section indicates that EEC competition policy is representative of this type of approach.

**EEC Competition Policy: Theory and Practice**

**Introduction**

The rules and regulations which facilitate the implementation of competition policy in the European Community are presented in this section and several relevant cases are examined. The analysis of competition statutes and important precedents will indicate that EEC policy is primarily designed to control the abuse of economic power, and is consequently rationalized by the Schumpeter-Clark model of competition.

On March 25, 1957, the Benelux countries, France, Germany, and Italy, signed the Treaty of Rome and established the European Economic Community. The Treaty came into force on April 1, 1958. Since 1958, Britain, Ireland, Denmark, and Greece have joined the Community.

The EEC extended the common market principles of the European Coal and Steel Community by abolishing quotas on goods and services, by
eliminating obstacles to the free movement of people and capital, and creating institutions with supranational powers. In the area of competition rules, the ECSC set the precedent for Community competition rules (Articles 85 and 86) by establishing Articles 65 and 66 in the Paris Treaty.

The importance of effective competition is set out early in the Rome Treaty. Article 3(F) states that the Community must promote the "institution of a system ensuring that competition in the Common Market is not distorted." Articles 85 and 86 are perceived to be necessary, as both Schuman and Monnet had earlier realized, to prevent private accumulations of power from restricting competition where national trade and tariff barriers are eliminated. In other words, Articles 85 and 86 are designed to eliminate public trade barriers and abusive practices of powerful private enterprises which would otherwise prevent or distort free trade among member states.

The basic aim of the EEC is to eliminate barriers to free trade, and to form a vast single market for all goods. Thus, competition provisions are intended to promote the accomplishment of these goals and advance the "four freedoms:" freedom of movement of goods, services, persons and capital.

The Commission of the European Economic Community, after advisement from the Committee on Competition, has issued a statement of the basic objectives of EEC competition policy. They state:

The first objective is to help create and maintain a single, common market for the benefit of business and consumers: it has been felt from the outset that the market which the Treaty aims to establish would be made impossible if, while conventional trade barriers among the member states were speedily reduced, obstacles to trade resulting from private agreements and abuses of dominant position were allowed to remain.
The second objective is to prevent large companies from abusing their economic power.

The third objective is to induce firms to rationalize production and distribution and to keep up with technical and scientific developments.\(^{36}\)

The objectives specified by the Commission indicate that competition policy in the EEC is concerned with the encouragement of investment and the modernization of industry. The statement suggests that regulation of concerted practices and economic power is preferred over complete proscription of restrictive practices or the existence of a dominant position.

EEC Competition Regulations

Regulation 17 was adopted by the Council of the EEC on February 6, 1962, and came in force March 13, 1962.\(^{37}\) The Regulation was the Council's response to the mandates of Article 87 of the Rome Treaty which gave the Council three years from the time the Treaty went into effect to "adopt any appropriate regulations or directives to give effect to the principles set out in Articles 85 and 86."\(^{38}\) Prior to the adoption of Regulation 17, competition authorities in member states were responsible for the application of Articles 85 and 86.

The basic function of Regulation 17 is to provide for a "comprehensive administrative machinery for the uniform application and enforcement of a coherent competition policy."\(^{39}\) The preamble states that "some [restrictive agreements] have special features which may make them less prejudiced to the development of the common market."\(^{40}\) Thus, the Council recognized in the first regulation to implement Articles 85 and 86 that the evaluation of enterprise practices must balance economic objectives against the degree of competition.
The Regulation confers exclusive authority upon the EEC Commission to investigate complaints concerning anti-competitive activities. It also establishes procedures for firms to notify the Commission when they are contemplating entering into an agreement which may violate the Treaty. Upon notification, the Commission is capable of reviewing enterprise agreements and determining if the agreement is in fact covered by Article 85 or 86; if the agreement is a violation of the Articles; or if it can qualify for an exemption under Article 85(3). If the Commission feels there is no violation of the Treaty, than a negative clearance can be issued. If it determines that an agreement is in violation of the Treaty, but it meets the criteria of Article 85(3), an individual exemption can be granted.

When the Commission determines that an individual exemption or negative clearance is not warranted, it has the power to declare the agreement invalid. Failure to align agreements with EEC rules, or to discontinue anti-competitive practices can result in fines which may range from 1,000 to 1,000,000 European currency units, or a sum of up to ten percent of the participating firms' previous year's turnover. The Commission may also levy fines of from 50 to 1,000 European currency units on a daily basis for non-compliance.

Decisions by the Commission are subject to review by the European Court of Justice. However, the Court will hear such appeals only when it can be shown that the Commission has exercised a lack of competence, violated an essential procedural requirement, or misused its powers. Upon the review of a Commission decision, the Court of Justice has the jurisdiction to "cancel, reduce, or increase the fine or periodic penalty imposed."
In the SAFCO (72/23) and CHEVRON (75/95) cases the Commission recognized that enterprises had entered into agreements which restricted competition in the produce retailing and oil refining industries. However, based upon the facts before it at the time, the Commission found that trade between member states was not substantially restricted and issued a negative clearance, i.e., no violation of the Treaty existed.

Regulation 17 authorizes the EEC Commission as the only institution in the Common Market capable of issuing an individual exemption from the competition rules of Article 85(1). The ability to grant an individual exemption under the conditions set out in Article 85(3) is particularly indicative of the discretionary powers granted to the Commission.

Article 85 of the Rome Treaty presents the first rule that must be adhered to by firms competing in the Common Market. Paragraph (1) of the Article states that all agreements or concerted practices between enterprises which prevent, restrict, or distort competition between member states are prohibited as incompatible with the Common Market. However, paragraph (3) of the Article 85 mandates that the prohibitions declared in paragraph (1) may be inapplicable if the agreement or concerted practice "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...." 42

In order to implement Article 85 the Commission must employ a "balancing logic" to determine if restrictive practices warrant an individual exemption. The evaluation process is analogous to the "rule of reason" approach which has developed under United States antitrust law. An important difference in the Common Market is that the entire burden of proof does not rest entirely on the undertakings seeking the
exemption from competition rules. The Court of Justice decided in the Grunding-Consten (64/566) case that the Commission must use the full extent of its resources to establish if there are grounds for an individual exemption under Article 83 (3). In every case that a violation of Article 85 (1) is determined, the Commission considers whether there are sufficient grounds for issuing an individual exemption.

In effect, the approach legislated under Article 85 requires the Commission to draw up an "economic balance sheet." On one side, the actual or potential loss to society resulting from fewer producers or concerted practices must be considered. The perceived costs may be the traditional ones that market power or dominance generate, i.e., the ability to control prices to some degree and to limit the quantity of output produced. Other factors which could increase social costs are the ability of powerful firms or anti-competitive agreements to limit the entry of competitors in the future and/or to restrict technological development. Also, the Commission must determine whether anti-competitive arrangements undermine the objectives of a unified single market.

Virtually all of the possible costs from restrictive enterprise agreements must be carefully considered before an arrangement between firms can be authorized.

The realized or potential improvements for the Common Market economy must be entered on the social benefit side of the Commission's hypothetical "economic balance sheet." Obviously, agreements which reduce competition between producers but have a considerable likelihood of reducing user prices or increasing product supply are viewed as highly beneficial to the Community.
The Commission recognizes other beneficial results which might arise from collusive or restrictive enterprise activities that go beyond mere price and output considerations. A willingness has been demonstrated repeatedly by the Commission to include the multi-dimensional character of consumer welfare. This has been done by accepting anti-competitive agreements which are likely to result in the production of a new or improved product.

In its decisions the Commission has identified the potential and existing benefits for consumers created by business agreements. One way cited repeatedly, which consumers stand to benefit from enterprise agreements, is lower product prices. Agreements which limit competition between firms, but rationalize or increase the specialization of the production process are most likely to result in lower user prices. The Jaz-Peter (69/242) application, which has been exempted twice by the Commission, was considered likely to reduce clock prices because of specialization. The Henkel-Colgate (72/241) joint research and development agreement was authorized by the Commission because it believed the arrangements would lead to the production of improved detergents which would be available to users at better prices. This decision was made despite the fact that Henkel and Colgate were two of the four largest detergent manufacturers in the world.

It is important to note that the Henkel-Colgate (72/241) decision indicates that the Commission is willing to apply its balancing logic to restrictive agreements between firms with substantial market power. Henkel, of Dusseldorf, and Colgate-Palmolive, of New York, entered into an agreement to coordinate their development projects in the area of certain laundry soaps and detergents.
At the time of the agreement, the market structure in the soap and detergent industry was highly oligopolistic. In the Common Market Proctor and Gamble, Unilever, Henkel, and Colgate-Palmolive accounted for 80 percent of the total sales. Henkel and Colgate-Palmolive had approximately 37 percent of the detergent market. Despite the oligopolistic market structure, the Commission granted the agreement an exemption from prohibition on the grounds that joint research between the parties should promote technical and economic progress. The Commission reasoned that the sharing of research expenses created the expectation of "greater results."

The Commission believed consumers would receive a fair share of the advantages of the cooperation because of the likelihood of a greater supply of technically-improved products. Furthermore, the Commission explained that, in its view, competition was not jeopardized because the contracting parties did not have a dominant market position in the relevant products within the Community.

Lower product prices are one way in which the stipulation that benefits from restrictive agreements be passed to consumers can be satisfied. The Commission, however, has found that there are other results which may benefit the public interest as much as reduced prices.

The Commission exempted an exclusive license agreement in the 1978 Campari (78/253) case primarily because the "restriction helped to concentrate the licensees' sales efforts and provided a better supply to consumers." The result of the licensing agreement was to increase the quantities of Bitter Campari available to consumers through improved distributing, so that consumers benefited directly.
The benefits to consumers that the Commission recognized in its Clima-Chapee (69/241) decision were the increase in production and sale of a greater range of products, and greater product choice for consumers. The rationalization of production of air conditioning equipment intended in the specialization agreement also had the potential of lowering production costs. Conceivably, consumers then stood to benefit from lower product prices.

Agreements which have limited or restricted competition to a substantial degree in the Common Market have been authorized by the Commission when consumers were likely to receive a fair share of the benefits through the development of a new or improved product.

In a 1968 decision the Commission authorized an agreement for technical cooperation and joint research and development in an application for exemption by ACEC-Berliet (68/319). The purpose of the agreement was to design and market a new type of passenger bus with an electrical transmission system. It provided for specialization and division of labor in research as well as manufacture. The agreement contained provisions which restricted free trade between member states because it limited the number of buyers to one per EEC country. Nevertheless, the Commission granted the agreement an exemption because it fulfilled the conditions of Article 85 (3).

The agreement promoted technical and economic progress because the joint research was likely to produce a bus with simplified mechanical construction and better performance capabilities. Consumers' share of the profits (i.e., benefits to operators of motor coach lines) was judged to be the probability that a new product would become available more quickly as a result of the joint technical operation. The decision
was the Commission's first in which it decided that an evaluation of consumer benefits could be based upon the probability that beneficial effects would result.

Since the ACEC-Berliet (68/319) decision, the Commission has exempted other agreements because of the likelihood that consumers would benefit from the production of a new product. In 1977, the two leading manufacturers of switchgear apparatus in the United Kingdom received an exemption for an agreement to design, manufacture and sell a new type of circuit breaker. In Vacuum Interrupters (77/160) the Commission decided that the agreement was likely to result in a more durable and efficient circuit breaker for consumers at a more reasonable price. The Commission also noted in this decision the potential for the agreement to put the switchgear industry in the EEC in a better position to meet future competition in this product from outside the EEC.

An agreement to do joint medical research was sanctioned by the commission in its 1979 Beecham/Parke Davis (79/298) decision. Once again, the primary justification for the authorization of the anti-competitive arrangements was the probability of benefits to consumers from a new product. The joint research and development agreement was designed to create a new medicine for the long-term treatment of the impairment of blood circulation. Thus, consumers stood to gain benefits from the development of a new medicine.

It is essential that parties seeking an exemption under Article 85 (3) assure the Commission that consumers are likely to receive a fair share of the benefits resulting from the anti-competitive arrangements. It is necessary to satisfy this condition in all cases, and it may be a
sufficient justification individually for an exemption in some situations. (e.g., the Campari (78/253) decision). The Commission may impose specific requirements on the parties involved to insure that consumer benefits are manifested. Also, the fact that individual exemptions are granted for a specified period of time and are subject to review, increases the probability that enterprises will make benefits effective for consumers.

The preceding analysis of the individual exemption process under Article 85 (3) provides a fundamental link between the Schumpeter-Clark model of competition and EEC competition policy. It is highly possible that this provision, which grants exemptions from the ban on restrictive practices, is the statute most indicative of the EEC attitude towards competition.

The exemptions allowed under Article 85 (3) manifest the historical European approach to concerted practices and concentrations. No inherent fear of concerted practices or dominant positions is reflected. Rather than proscribing the existence of market structures or activities, the policy attempts in a realistic way to promote competition and ensure that consumers receive a fair share of the benefits.

The cases that were presented support this contention. The litigation is evidence that the EEC desires a system of competition which promotes modernization of the production, even if it comes from rationalization agreements which are restrictive by nature. Also, the Community's approach is to encourage the development of new or improved products or production techniques. Joint research and development, joint production, and specialization agreements are sanctioned to promote such technical and economic advances. Even a new industry
(nuclear fuel reprocessing) was created in the United Reprocessor 76/248 case, despite its monopolistic features, because it organized the industry in the most rational manner at the European level. 50

Thus, Article 85 (3) mandates a flexible, realistic approach to EEC competition policy. The Commission and Court enforce the rules in a manner which encourages the efficiency of large-scale production and the benefits stemming from modernization. The process of individual exemptions is clearly exemplary of the EEC concern for effective competition and is indicative of a rational, pragmatic competition policy. This approach is consistent with the Schumpeter-Clark model of competition.

Article 86 of the Rome Treaty is directed towards preventing the abuse of economic power by enterprises with a dominant market position. It does not proscribe the existence or acquisition of market power, but states that "any abuse by one or more undertakings of a dominant position within the Common Market or in a substantial part of it shall be prohibited as incompatible within the Common Market insofar as it may affect trade between member states." 51 The Article prohibits a non-exhaustive list of abusive practices (e.g., unfair prices, production limits, or restraints on technological development) if they are undertaken by a firm with a dominant market position and the activity affects trade between member states.

That which is not proscribed by Article 86 is as important to EEC competition as the practices that are prohibited. Article 86 does not prohibit the existence of market power in any form. Monopolies and cartels are not declared illegal by the statute. Neither does the Article prohibit the acquisition of a dominant market position, i.e.,
monopolizing. In other words, Article 86 is not designed to prohibit or limit the degree of market power in the EEC, but to control the abuse of economic power.

Enterprises which restrict competition but meet certain conditions can be granted exemptions under Article 85 (3). However, there is no exemption clause similar to 85 (3) under Article 86. To some extent these factors have made Article 86 the more flexible of the two treaty statutes. The result has been more restrained enforcement and substantive development of Article 86 as an integral rule of competition policy in EEC.

There are two main issues which must be resolved by the Commission in order to apply Article 86. One consideration is with structural competition. This issue involves the legal issue of the existence of a dominant position. The second issue involves the behavioral aspects of competition because a determination must be made of whether an abuse of power exists.

The determination of whether a firm possesses dominant market power hinges on whether the firm has a significant degree of influence in a well-defined geographic and product market. The Commission must determine that a firm holds the dominant position in a specific market before the question of abusive behavior is considered.

The determination of a dominant market power is made in the EEC by considering a firm's relative size or market share, the command it has over technological expertise, its control over raw materials and capital, and the market position of competitors. The Court of Justice decided in Continental Can (6/72) that a dominant position exists when a firm has the power to behave independently and act without considering competitors, purchasers, or suppliers.
No exact percentage of market share has been determined which automatically indicates a dominant position. For example, in United Brands (76/353) it was determined that dominance in the market for bananas existed because of the cumulative effect of advantages the firm enjoyed, even though the firm had less than 45% of the determined relevant market. However, in other significant cases decided under Article 86, nearly 80% of the relevant market share was necessary to constitute the requisite degree of control. The table below indicates those cases and the market shares that were considered dominant.

**THE CRITERION OF DOMINANT MARKET POSITION UNDER ARTICLE 86**

<table>
<thead>
<tr>
<th>Firm</th>
<th>Product</th>
<th>Market Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Re Gema (German Performers' Rights Society (71/224)</td>
<td>Supply of recording services</td>
<td>100%</td>
</tr>
<tr>
<td>Commercial Solvents (73/7)</td>
<td>aminobutanol-ethanebutol</td>
<td>100%</td>
</tr>
<tr>
<td>General Motors Continental (75/267)</td>
<td>Issuance of &quot;conformity certificates&quot;</td>
<td>100%</td>
</tr>
<tr>
<td>Continental Can (72/6)</td>
<td>Meat tins</td>
<td>70-80%</td>
</tr>
<tr>
<td>Continental Can (76/6)</td>
<td>Fish tins</td>
<td>80-90%</td>
</tr>
<tr>
<td>Continental Can (72/6)</td>
<td>Metal caps</td>
<td>50-55%</td>
</tr>
<tr>
<td>Sugar Cartel (73/40)</td>
<td>Sugar beets</td>
<td>85%</td>
</tr>
<tr>
<td>Sugar Cartel (73/111)</td>
<td>Raw sugar</td>
<td>90-95%</td>
</tr>
</tbody>
</table>

The pattern of requiring such a large percentage of market share to establish market dominance has reduced significantly the number of cases which may have infringed Article 86. The approach taken by the Commission and Court to establishing dominance adds credibility to the
belief that the EEC's main concern is for effective competition, not market structures.

The Court of Justice established the importance of an accurate assessment of the relevant product market in Continental Can (72/6). The Commission determined that the American firm possessed a dominant position in the German national market for light metal containers and certain metal tops, and that its purchase of 80 percent of a Dutch enterprise was a violation of Article 86 because it virtually eliminated competition in a substantial part of the Common Market. The Commission considered the relevant product market to be the German market for metal containers, and thus only directly competing metal containers were included in the analysis.

The appeal to the Court of Justice resulted in an annulment of the Commission's decision. The Court felt that the Commission did not "sufficiently explain the fact and appraisals on the [the decision] was based." In particular, the Commission failed to make clear why the markets for meat and fish tins, and metal tops should be treated separately and independent of the general market for light containers. Thus, although the market shares were 75, 85, and 55 percent, respectively, the Court believed the Commission should have considered existing or potential competition from substitute materials such as plastic and glass.

By virtue of the Court's decision in the Continental Can case, a full market power analysis is required to establish market dominance. Products which are more than to a limited extent interchangeable must be included within the same market. The selection of the appropriate product and geographic market is a key in determining whether a dominant position exists.
The result of the Court's decision in the Continental Can (72/6) case is that the determination of the relevant product market under Article 86 must include actual and potential competition. An implication of the Court's action for competitive policy is that the inclusion of potential competition in the relevant product market analysis substantially broadens the competitive product area and reduces the probability of a firm being in a dominant market position. Thus, the application of Article 86 is more difficult for the Commission, because it must be able to prove that an enterprise can operate totally independent of suppliers, consumers, as well as existing and future competitors.

As stated, there are behavioral elements which must be determined in order to apply Article 86. In other words, once dominance in a relevant market has been established the Commission must decide whether an exploitation of that power has occurred. It should again be noted that existence of dominance is not an infringement of Article 86. Market power is merely the first criterion necessary to establish if an abuse of power has taken place. It is this abusive behavior which is considered contrary to Article 86.

Of course many types of behavior may ultimately violate the intentions of the competition rules. To date, however, the abuses prohibited have fallen into the following categories:

1. the imposition of unfair terms and conditions upon members of an association in charge of the exploitation of music performing rights (Re Gema 71/229);
2. a merger which has as its effect to substantially lessen competition (Continental Can 72/6);
3. a refusal to supply goods to a customer (Commercial Solvents 73/7);
4. the charging of excessive prices (General Motors 75/26);
5. discriminatory pricing (United Brands 76/26);
6. the imposition of exclusive purchase obligations (Hoffman-La Roche 76/85);
7. a discriminatory reduction in supplies to certain customers (European Sugar Cartel 73/50).

The varied nature of the abusive behavior proscribed in the cases heretofore suggests the capability of a flexible approach in applying Article 86. The definition of what constitutes an abuse has essentially been determined on a case by case basis. Such an open-ended approach to abuse may serve the needs of the Community well. The result of this approach is that "one is left with the conclusion that abuses occur where the Commission finds them to exist. This [can be] a deterrent to firms with market power in their relations with suppliers, purchasers, and competitors."^55

In summary, the Community has the ability to prevent or eliminate the abuses of dominant market power under Article 86. However, the Community preference for regulating restrictive practices, rather than prohibiting dominant market structures, is evidenced in the enforcement of Article 86 and indicative of the control of abuse of power competition principle.

Summary and Implications for Future Policy

An examination of the competition policy implemented in the EEC indicates that the Community attempts through its policy to achieve
supranational economic objectives, and control the abusive use of economic power. The balancing logic that authorities employ requires that potential social and economic benefits (e.g., new products, improved production techniques, and more efficient forms of industrial organization) be measured in relation to the costs of anti-competitive activities. It was resolved in this study that the basic standard by which imperfectly competitive practices are judged is economic performance; a criterion which primarily emphasizes contributions to efficiency enhancement and technological progress. In other words, community competition authorities attempt to balance the tradeoff between static efficiency and the benefits of dynamic progressiveness.

This study concludes that EEC competition policy is a pragmatic policy designed to foster innovational competition and provide benefits to the Common Market from a dynamic economic system. Furthermore, the research indicates that the Schumpeter-Clark model of competition provides a logical theoretical framework for the analysis and explanation of the policy.

Future Policy Implications

The conclusions of this study have realistic implications for future EEC policy decisions, and for other research directions.

Presently, the EEC is investigating the practices of two U.S. firms; IBM and Reynolds Tobacco Co. IBM has been accused by its European competitors of abusing its dominant market position. The Reynolds investigation is concerned with the impact on EEC tobacco markets of the U.S. firm's purchase of 22 percent in Rothmans International of London.
European manufacturers of computer equipment contend that IBM's refusal to disclose technical details of interface components precludes them from developing and selling memory devices that are plug-compatible with IBM computers. IBM has countered by arguing that if their lead time is reduced, the company's incentive to be innovative will be diminished. Assuming the political ramifications of the firms being American are minimal, the interpretation of competition precedents and the proposed economic principles of policy presented in this study can be useful for predicting an outcome. Assuredly, the Commission's decision in the IBM case will hinge upon the firm's promotion of technological progress and the benefits that EEC consumers receive from the advances.

In the Reynolds-Rothmans' agreement, the Commission is interested in the possible creation of a dominant market position, and the potential for the abuse of the accompanying economic power. The findings of this research are that the control of concentrations falls within the ambit of Article 86, and that the priority of effective competition has precluded its application to the existence of economic power. The most notable precedent in this area is the Court of Justice's decision in the Continental Can Case (6/72). The Court ruled that the Commission must make a thorough evaluation of all the relevant facts, including substitute goods and potential competition.

It is hoped that this study of competition legislation and policy by the EEC, and the model presented as its theoretical foundation will prove useful for the explanation and prediction of the future direction of EEC competition policy.
Notes


10. Ibid., p. 141.

11. Schumpeter, Capitalism, Socialism and Democracy, p. 82.

12. Ibid., p. 68.

13. Ibid., p. 105.


17. Ibid., p. 245.


21. Ibid., p. 49.
23. Ibid., p. 88.
25. Ibid., p. 93.
28. Ibid.
29. Schumpeter, *Capitalism, Socialism and Democracy*, p. 84.
34. Ibid., p. 50.
40. Ibid., Article 1, ¶ 2411.
41. Ibid., Article 17, ¶ 2561.


