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Document Version
Final published version

Publication date:
1999

Institut for Nationaløkonomi

Handelshøjskolen i København

Working paper 1-99

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January 13, 1999

Abstract

By replicating Articles 85 and 86 of the EC Treaty the Danish Competition Act (put in force January 1998) constituted a shift from the control principle to the prohibition principle. This is an important improvement from the point of view that regulatory legislation should be designed to give business economic incentives to act in a socially beneficial way, placing the burden of efficiency losses at the party who can avoid such losses at the least expected cost. The Act now correctly makes businesses *ex ante* liable, but two equally important elements of an optimally designed antitrust legislation are missing: (1) The authority of the enforcing agency to impose administrative fines of a magnitude that makes the expected cost of infringements negative; (2) An appropriate organizational structure. With these two deficiencies the practical significance of the shift of principle is likely to be insignificant.

Journal of Economic Literature Classification: K21, L4

Keywords: Competition law, antitrust economics, deterring incentives, design of enforcing agency.

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1. Introduction

The new Danish Competition Act[1], CA98 (passed in June 1997 and put into force January 1998), essentially adapts Articles 85 and 86 of the EC Treaty, prohibiting agreements in restraint of trade and abuse of a dominant position. As emphasized by the Minister of Business and Industry in his remarks accompanying the proposal, the aim was to

> to adapt the Danish Competition Act to EU competition rules while simultaneously considering the Danish industrial structure. In so doing, the best possible interaction between EU competition rules and Danish competition rules are ensured. Similarly, it ensures that the legal conditions regarding competition do not differ significantly from those that follow from the EU rules. Business conduct in the market place thus only has to adjust to one set of rules. ... The [fundamental rules] are in line with the EC Treaty and the practice of the Commission and the Court will guide their interpretation.[2]

The adaptation of the Danish Competition Act to EU competition rules constituted a long due shift from the control principle[3] to the prohibition principle. However, this important consequence was not considered an aim in itself. In fact, the committees which prepared both the previous Competition Act (CA90) and the new CA98 both concluded that the choice of principle would be of little practical significance. The reports and the discussions in Parliament are superficial on this topic. The economic rationale behind of the prohibition principle and its implications for the way in which the law should be enforced appear never to have been discussed (or apprehended, for that matter).

The harmonization of *substantive* law to the prohibition principle is an important step (even though merger control is still absent). However, as we shall

[1] See http://www.ks.dk/eng/loveng97.htm or the Supplement to Issue 5 of the *European Competition Law Review*, 1998. For an overview of the new act, see Kofmann, 'The Danish Competition Act,' *European Competition Law Review* 19(5) (1998), at 269-272.

[2] Quoted from the Danish Competition Authority *Konkurrenceloven 1998 – Den ny konkurrencelov med forarbejde*, Copenhagen, 1997, at p. 16 (authors' translation).

[3] For an overview and history of the previous legislation, see Albæk, Møllgaard and Overgaard, 'Law-Assisted Collusion? The Transparency Principle in the Danish Competition Act' *European Competition Law Review* 17(6) (1996), at 339-343; and Albæk, Møllgaard and Overgaard, 'The Danish Competition Act' in S. Martin (ed), *Competition Policies in Europe*, Elsevier, Amsterdam, 1998, at 75-104.

argue, the legal consequences of misconduct depend as much on *procedural* law. A recent survey of the impact of EU competition law on member state competition law thus concluded by posing the question 'as to whether enforcement of the laws has also been harmonized, both in terms of intensity of enforcement and in terms of common approaches to the interpretation of the laws ...' [4] We shall answer this question in the negative as far as Denmark is concerned.

2. A law-and-economics approach to competition law.

The fundamental idea of the law-and-economics approach to regulatory legislation is that firms or rather managers are 'rational' in the sense that they use all information available to them to maximize expected utility or profits. Law makers should utilize this insight to design regulations as incentive systems with a view of placing the burden of efficiency losses by the party who can avoid the loss at the least expected cost. It is of less importance whether or not the harm to society was or could be foreseen. Regulatory legislation is not (primarily) a question of *culpa* and punishment, but rather an institutional mechanism by which society may *deter* unwarranted conduct. In case of anti-trust legislation, this approach implies that firms should be given economic incentives to abstain from collusive agreements and abuse of a dominant position.[5]

An indispensable element of law-and-economics based legislation is *ex ante* liability: The 'owner' of the risk must be responsible for losses arisen *before* damages to efficiency have been observed and the case tried by the enforcing agency or court. A regulation that exempts firms from the cost of harmful behaviour up to the point of time when the harm has been demonstrated gives no incentive to consider and avoid possible harms *ex ante.*

This is the fundamental difference between anti-trust legislation based on the *prohibition principle* and legislation based on the principle of *abuse control.* Only a law based on the prohibition principle can be designed such as to deter firms from engaging in activities that are considered harmful to society.

However, the adoption of the prohibition principle cannot stand alone. It must be accompanied by an appropriately designed incentives / penalties.

In designing the incentive system, legislators run the risk of making two kinds

[4] See L. Laudati 'Impact of Community Competition Law on Member State Competition Law' in S. Martin (ed) *Competition Policies in Europe*, Elsevier, Amsterdam, at pp. 381-410.

[5] See e.g. W.M. Landes 'Optimal Sanctions for Antitrust Violations' *University of Chicago Law Review* 50 (1983), at pp. 652-678.

of errors: being too lenient (in effect, conniving at efficiency reducing actions) or being too strict (thereby discouraging efficiency improving structural adjustments and price setting). Consequently, the ideal incentive system is not just the one that minimizes the risk that firms ever infringe the rules (in the eyes of the competition authority), that is one that imposes extremely stiff penalties regardless of the nature and the severity of the infringement. Nor should it be one that, effectively, makes it free of cost for firms to engage in activities that are clearly contrary to the intent of the legislature and/or to protract a final verdict. To put it shortly, penalties should be *smallest* possible to make the *expected* gains from infringing the competition act negative.

As an example, suppose that two firms consider entering a collusive agreement, the effect of which is to raise profits by Euro 1 mn and inflict a loss on consumers and others of Euro 2 mn. In money terms the efficiency loss to society at large is Euro 2 - 1 mn = Euro 1 mn.. Suppose further, that the firms are risk-neutral, disregard non-pecuniary factors, and assume that the probability that the authorities will detect the collusion is one third. In this case the fine if detected must be at least Euro 3 mn to deter the firms from entering the agreement. I.e. the optimal fine exceeds both the gain to the colluding firms by an considerable margin and the loss to consumers and others and the efficiency loss to society at large. In fact, these losses are irrelevant in determining the optimal deterrent penalty unless, of course, detection enables the losers to claim damages.

3. An inappropriate incentive system

By and large the incentive system remained unaffected by the adaptation of Danish competition law to that of the EU and grossly inappropriate to support the self-enforcement of good market behaviour. In this respect, Denmark differs from other small countries such Sweden, Norway and Finland which also in recent years have shifted from the control principle to the prohibition principle. A recent survey[6] of member states' sanctions in cases violating national competition laws showed that while there were no statutory limits on sanctions in Denmark '[f]ines [were] rarely imposed. In 1991, a settlement was entered in which the company agreed to pay DKK 10,000 (ECU 1,333) for a refusal to supply. Fines generally would not exceed DKK 5,000 (ECU 666.3).'

[6] European Commission, *Surveys of the Member States' Powers to Investigate and Sanction Violations of National Competition Laws*, Office for Official Publications of the European Communities, Brussels, 1995.

In fact, firms still hardly have any economic incentive to abstain from infringing the prohibitions on collusions and abuse of dominant position. The cases in which infringers will get fined are likely to be rare and, if actually fined, the fines are likely to be very small compared to the expected gain from infringing the rules. The reasons are the following:

1. Infringements of the prohibitions on collusion and abuse of dominant position are considered 'criminal offences'. In case of infringement, the director of the Competition Authority must ask the public prosecutor in the district in which the firm is located to bring the case before the (ordinary) court. In general, neither the prosecutor, nor the judge will have expertise in competition law.

2. Any infringement of the prohibition on abuse of dominant position is exempt from penalty unless a firm has committed a 'similar' offence previously and by its new offence breaches a no more than five-year old order by the Competition Council to abstain from the activity in question.

3. The sizes of the fines are determined according to the ordinary principles of the penal code. That means that infringers are only subject to penalty if the infringement is wilful or is caused by gross negligence. Furthermore, it supposedly means that the level of the fine must correspond to the level of fines imposed in other crimes of similar severity. When introducing the proposal to CA98 the Minister said that fines should be raised significantly relative to what was common under the previous Competition Act, but according to his remarks, the fines should in no way reach the levels of the fines imposed by the Commission. That would be 'contrary to Danish tradition'. As mentioned, under CA90 only very few cases were brought before the court and the largest fine imposed on any firm was DKR 15.000 (app. ECU 2,000). So far, no case has been decided according to CA98. With no clear provision and with ambiguous political signals we consider it highly unlikely that we will see fines of a size that will have any significant deterrent effect.

4. Firms accused of infringing the competition law have any incentive to protract the case. Traditionally, compulsory fines (in case of unwillingness or negligence in delivering information required by the Competition Authority) are waived when, eventually, the firm comply. Appealing the decision of the Competition Council to the Appeal Tribunal is almost free of cost. In case

of appeal, the implementation of the decision of the Competition Council is most often deferred.

5. A firm that has suffered from illegal restraints on competition may bring the case before the court and claim damages. However, claims will be considered according to the ordinary rules of the civil code; there are no specific provisions in the competition act. This means that the claimant has to prove the size of the damage and, at most, can hope to get the damages covered. There has been no single case of private legal action under the previous competition act. Under the Monopoly Act (in force from 1955 to 1989) we saw only one case and that was lost by the claimant.[7] CA98 has not significantly increased the incentive to take private legal action: If a plaintiff has suffered damages of Euro 1 mn, it will have to convince a court both of the illegality of the practice and of the size of the damages. Following the Commissions decision to impose heavy fines for price fixing and bid-rigging in the *district heating pipe cartel*[8] there appears to be consensus that it is likely to be very difficult to prove the claimed damages to the satisfaction of the court.[9] In expected terms, the plaintiff might get, say, Euro 0.1 mn out of the case. Litigation costs (including resources spent at the firm) are likely to exceed the expected compensation making it unprofitable to sue. Consequently, and contrary to the US where the treble damages principle apply, private legal actions are not likely to contribute significantly to the (self)enforcement of the competition act.

[7] See Koktvedgaard, *Lærebog i Konkurrenceret* (3rd ed.), Jurist- og Økonomforbundets forlag, Copenhagen, 1997, at p. 167.

[8] European Commission's press release IP/98/917 on October 21, 1998.

[9] One of the companies in the *pipe cartel*, Løgstør, recieved a fine of ECU 8.9 mn. It has decided to appeal the size of the fine. At the same time, it has entered a settlement with 170 customers, primarily small district heating power plants. This settlement involves a compensation for high pipe prices amounting to 1.5 percent of the company's revenue from the 170 customers during the five years during which the cartel was active. (*Berlingske Tidende Erhverv*, Dec. 12, 1998, at p. 2). The compensation amounts to abt. ECU 1 mn. If the CFI reduces the fine, the compensation will be increased by another ECU $\frac{1}{2}$mn. Finally, if the five big cities agree to the settlement (which is unlikely to happen), another ECU $\frac{1}{2}$mn will be added to the compensation. In agreeing to the settlement, the small power plants have argued that they were unlikely to get higher damages out of going to court and that so doing would involve significant costs.

4. Organizational aspects of the shift to the prohibition principle

The second problem facing a successful harmonization of Danish competition policy is a problem of institutional design: How to construct an agency that best carries out what the law ordains. A fundamental constraint on this institutional design is 'that competition authorities are staffed by limited numbers of individuals working with limited information; these are real people with goals and aims of their own rather than impersonal embodiments of the public good.'[10]

This means that lawmakers in designing the institutions should keep principal-agent theories, notably the theory of regulatory capture,[11]in mind. According to these theories, interest groups try to capture the authority's decision-making. Interest groups have a variety of means of influencing public decision making including (most obviously, but also less realistically) bribes, future job possibilities (knowledge of antitrust economics or competition law is a scarce resource!), creation of personal relationships with decision makers, refraining from publicly criticizing the authority (if it behaves) or threatening to do the opposite (if it does not behave), or influencing politicians who may influence the authority.

Normally, the institution is designed as *administrative review* subjected to *judicial review*[12]. In Denmark, the design is not that simple. Danish anti-trust legislation goes back to the 30s, and has for historical reasons developed its own peculiar 'corporatist review.'

Decisions on significant, precedent-building cases are taken by the Competition Council. This is a body that now consists of eighteen members and a chairman. The chairman and eight members shall be independent of 'commercial or consumer related interests' and one of these 'shall have a special insight in governmental business activity'. Seven members are appointed on the recommendation of trade organizations, one member shall be appointed on the recommendation of consumer

[10]Kai-Uwe Kühn, Paul Seabright and Alasdair Smith 'Competition Policy Research: Where do we stand' *CEPR Occasional Paper* 8, 1992.

[11]See George Stigler 'The Economic Theory of Regulation' *Bell Journal of Economics* 2 (1971), at 3-21 and Jean-Jacques Laffont & Jean Tirole 'The Politics of Government Decision-Making: A Theory of Regulatory Capture' *Quarterly Journal of Economics* 107 (1991), 1089-1127.

[12]For a discussion of the relative merits of judicial vs. administrative review, see Anders Chr. S. Ryssdal, 'Implementation of Second Best Solutions: The Judge or the Bureaucrat? – A Lawyer's Perspective,' paper presented at the Second Oslo Competition Conference "Foundations of Competition Policy Analysis."

organizations, and two members with special insight in public business activity shall be appointed on the recommendation of the municipal organizations.' The Competition Council meets once every month to discuss the cases brought up by its secretariat. Members of the competition council are thus not working full time on competition cases but only review the secretariat's arguments and vote on the basis of those arguments.

By CA98 and contrary to general movement away from 'corporativism', the direct representation of interest groups in decision making was enlarged and 'independent expert members' reduced to a minority in the Competition Council[13]. Further to this, the Council's secretariat, the Danish Competition Authority, is an agency under the Ministry of Business and Industry and its staff may be transferred between different parts of the Ministry, *e.g.* as part of a promotion.[14] Disregarding the fact that the Council is an independent body not subjected to instruction from the Minister, it is obvious that the organizational design does not constitute an inviolable shield against influence if other parts of the Ministry, not to mention the Minister, should have a political agenda that differs from that embodied in the CA98.

The shift from the control principle to the prohibition principle has aggravated the problem of regulatory capture. The need for a large corporatist body is less than obvious. In fact, it may endanger an efficient and consequent enforcement of a, now, *potentially* effective law. In our view the organizational counterpart to the shift to the prohibition principle would have been the formation of a much smaller and more effective decision-making body of independent 'commissioners' (appointed by the King) with a strong background in law and economics backed by a similarly highly professional secretariat. The independence typically granted to central banks may serve as a model. Independence of both private interests and politicians is important.

5. Conclusion

The harmonization of the Danish competition act to the EU rules has been half-hearted and inconsequential. Despite the unfortunate failure to introduce merger control, the substantive law is now in place. The shift from the control to the

[13] In the previous act, there were 14 members of the Competition Council. The Chairman and seven of the members should be independent of commercial interests.

[14] A case in mind is the current director of the DCA who used to be a head of department in the Ministry of Business and Education.

prohibition principle is a significant improvement. However, the procedural law, i.e. the incentive system and the organization of the law enforcement, has remained by and large unaffected and highly inappropriate to support an efficient enforcement of a competition act based on the prohibition principle.

In order to become effective and to constitute a real harmonization with EU competition rules, the Danish Competition Act needs to be reformed once more. In so doing, Parliament should abolish the corporative tradition and create a council of independent 'commissioners' who should be given the authority to impose administrative fines in case of infringements. The fines must be of an order of magnitude such as to create proper incentives. The incentive principle should be explicitly stated in the law.

The judicial review of the decisions of the Council should rest with the Commercial Court (as, in fact, was suggested by the committee that prepared CA98) with the possibility of appeal to the Supreme Court.

With the enforcing agency organized as stipulated above and access to appeal directly to the court system, there appears to be no need to uphold the present administrative pseudo-judicial Competition Appeals Tribunal.

Last, but not least, Denmark needs merger control.