

Cartels and Antitrust

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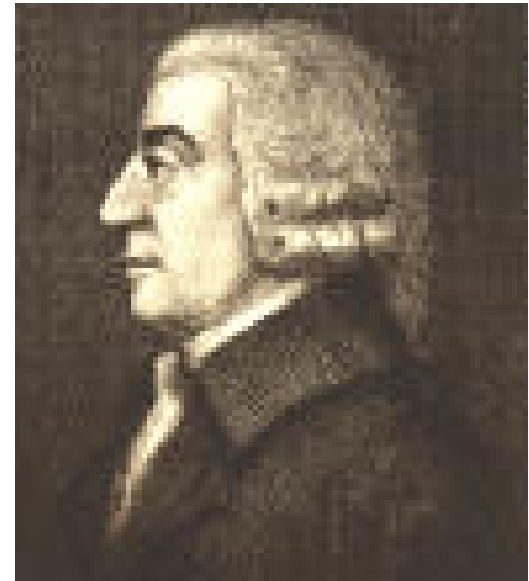
Outline

- Cartels are bad and common
- Why do cartels form?
- Firms cheat on cartels
- Conditions for successful cartels
- Cartels over time
- Antitrust laws
- Lysine cartel movie

Cartels: bad and ubiquitous

"People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or some contrivance to raise prices."

— Adam Smith



Why do cartels form?

- Firms form a cartel so that they can raise profits
- They earn greater profit by coordinating their activities rather than acting independently

Why can cartels raise profits?

- If a firm is maximizing its profit, why should joining a cartel increase its profit?
 - A firm is already choosing output (or price) to maximize its profit
 - However, it ignores effect that changing its output level has on other firms' profits
- Cartel takes into account how changes in one firm's output affect cartel profits

Firms "cheat"

- Luckily for consumers, cartels often fail because each firm in a cartel has an incentive to cheat on the cartel agreement
- Cheating firm
 - Produces extra output or lowers its price
 - Ignores the negative effect of its extra output on other firms' profits

Conditions for cartel success

- The cartel can significantly raise price
- Cartel controls market
- Low organizational costs
 - Few firms (or a few large ones)
 - Industry association
- Many small buyers: no monopsony power
- Cartel can be maintained
 - Cheating can be detected and prevented
 - Low expectation of severe government punishment

Cartel can greatly raise price

- Only incur cost of organizing a cartel and enduring risk of prosecution if cartel can raise price substantial
- Demand facing cartel cannot be very elastic, which is more likely if the cartel controls the market

Cartel controls market

- If the cartel does not have a large share of the market, it cannot raise price much
- To control the market
 - Few noncartel firms
 - No recycling
 - Limited entry

Entry and cartel success

- Barriers to entry limit competition
- Cartels with large number of firms rare (except professional associations)

Evidence

- Dept. of Justice price-fixing cases 1963-1972
 - 48% involved 6 or fewer firms
 - average number of firms: 7.25
 - only 6.5% involved 50 or more conspirators
- Global cartels from 1990 to 2003
 - 77% involved 6 or fewer firms
 - median number of corporations was 5
 - only 13% had 10 or more participants
- Cartels often fall apart after entry (mercury)

Organizational costs are low

- There are few firms in the industry
- A few firms make most of the sales
- Output is homogeneous
- There is an industry organization
 - To give pretext for meetings
 - To detect cheating

Detecting cheating

- Few firms in cartel
- Homogeneous good
- Large infrequent purchases
- Divide market
 - By customers (vitamins)
 - By region (mercury cartel, 1928-1972, allocated U.S. to Spain and Europe to Italy)
- Adjust if a firm over produces

Monitoring techniques

- Check each other's costs
 - Inspect each other's books
 - Most-favored nation clauses
- Governments report bids on government contracts
- Offer "low price" guarantees

Avoiding legal problems

- Illegal cartel avoids detection or government punishments are small
- Tacit collusion (possibly not illegal)
- Sophisticated communication
- International cartels (OPEC) and cartels within certain countries operate legally

Cartels over time

- According to game theory collusion is difficult in a single period game
- Easier in a multi-period game

Reason for U.S. antitrust laws

In late nineteenth century, cartels (trusts) were legal and common in the United States

- Oil
- Railroads
- Sugar
- Tobacco
- Steel



J.D. Rockefeller

U.S. laws against cartels

- In response to trusts' high prices, Congress passed
 - Sherman Antitrust Act in 1890
 - Federal Trade Commission Act of 1914
- These laws prohibit firms from explicitly agreeing to take actions that reduce competition, such as jointly setting price
- These anti-cartel laws are called
 - *Antitrust* laws in U.S.
 - *Competition policies* in most other countries

Effectiveness of Antitrust Laws

- At first U.S. laws had no bite because the language was vague and full of loopholes
- Mocked as "the Swiss Cheese Act"

Supreme Court

- In 1902, Teddy Roosevelt had DOJ sue Northern Securities Company (railroad — part of J.P. Morgan empire) under the Sherman Act
- 1906 sued to dissolve Rockefeller's Standard Oil
- 1911: Supreme Court breaks up oil trust — Sherman Act gains teeth

Antitrust laws require agreement

- 1981-82, American Airlines (AA) and Braniff Airlines (BA) have fare war
- Feb 21, 1982: Robert Crandall (RC), president and CEO of AA calls Howard Putnam (HP), president and chief executive of BA
- HP taped the call (RC didn't know)

Phone call

- **RC:** I think it's dumb as hell for Christ's sake, all right, to sit here and pound the @#%#@!\$ out of each other and neither one of us making a #@\$\$#!@ dime.
- **HP:** Well...
- **RC:** I mean, you know, @\$#@, what the hell is the point of it?
- **HP:** But if you're going to overlay every route of American's on top of every route that Braniff has—I just can't sit here and allow you to bury us without giving our best effort.

- **RC:** Oh sure, but Eastern and Delta do the same thing in Atlanta and have for years.
- **HP:** Do you have a suggestion for me?
- **RC:** Yes, I have a suggestion for you. Raise your @\$@~!\$ fares 20 percent. I'll raise mine the next morning.
- **HP:** Robert, we...
- **RC:** You'll make more money and I will too.
- **HP:** We can't talk about pricing!
- **RC:** Oh !#!@*!, Howard. We can talk about any @#!\$! thing we want to talk about.

Aftermath

- HP rejects RC's proposal
- After learning about the call, DOJ files suit accusing Crandall of violating antitrust laws by proposing to fix prices
- But, *proposing* to fix prices doesn't violate Section 1 of the Sherman Act—*proposing and agreeing* does
- Because HP rejected RC's proposal, couldn't nail RC for price fixing
- Court later ruled: proposing to fix price could be an attempt to monopolize part of the airline industry and, if so may violate Section 2 of the Sherman act
- AA promised never to be bad again

Europe vs. the U.S.

- Until recently Europe had weaker competition laws than the U.S.
- Over the last dozen years, the European Commission has been pursuing competition cases under laws that are similar to U.S. antitrust laws
- Recently EC, DOJ, and FTC have become increasingly aggressive, prosecuting many more cases
- Following U.S., which uses both civil and criminal penalties, British government introduced legislation in 2002 to criminalize certain cartel-related conduct
- EU uses only civil penalties, but its fines have increased dramatically, as have U.S. fines

Corporate Leniency Program

- In 1993, DOJ introduced new Corporate Leniency Program: participant in a cartels that blows the whistle receives immunity from federal prosecution
- Consequently, DOJ has caught, prosecuted, and fined several gigantic cartels (e.g. vitamins)
- On Valentine's Day, 2002, EC adopted a similar policy

Lysine cartel

- 1996: Archer Daniels Midland (ADM) pleaded guilty to price fixing
- ADM admitted to price fixing in lysine (used in livestock feed) and citric acid (used in soft drinks and detergents)

Lysine market

- Perfectly homogeneous product
- Share of global production of 4 largest manufacturers of lysine in early 1990s
 - > 97% in U.S.
 - > 95% world
- Purchases of four largest buyers < 30%
- Large infrequent purchases
- Cost of a new plant \$150+ million (over 3 years to build)

Lysine agreement

- Felt they needed everyone's agreement
- Allocated sales quotas across firms
- Used industry organization to meet and Collect data
- Shared cost data
- Had a punishment scheme in place

Lysine fines

- 5 corporate fines
 - U.S. corporate fines: \$92.5 million
 - EU: \$97.9 million
 - Canada: \$11.5 million
- Lysine cartel U.S. fine was 7x previous highest fine
- 7 personal fines
- In 1999, 3 people got prison sentences of 99 months total (individual max of 36 months)

Individual fines

Michael D. Andreas (U.S.), Vice Chairman, ADM, \$350,000 fine,
36 months of jail

Terrance Wilson (U.S.), Pres., Corn Products Div., ADM,
\$350,000, 33 months

Mark Whitacre (U.S.), Pres., Bioproducts Div., ADM, \$350,000,
30 months

Kanji Mimoto (J), Div. Mgr., Ajinomoto, \$75,000

Hirozaku Ikeda (J), Div. Mgr., Ajinomoto \$0

Kaztoshi Yamada (J), Mng. Dir., Ajinomoto, Fugitive

Masaru Yamamoto (J), Div. Mgr., Kyowa, \$50,000

Jhom Su Kim (SK), Pres., Sewon America, \$75,000

Lysine buyers

- Individual U.S. buyers received compensation \approx their losses — that is, they did not get treble damages
- Total U.S. corporate settlements: about \$85 million

Lysine Movie

- Unusual evidence: One of the leading participants of the cartel helped the FBI tape the colluders "secret" meetigns...

Lysine cartel: sources

- DOJ movie:
 - Free VHS tape and transcript from
United States Department of Justice, Antitrust Division
Freedom of Information Act Unit
325 Seventh Street, NW, Suite 200
Washington D.C., 20530, USA
- Eichenwald (2001): *The Informant*, Broadway Books.
- Connor (2003): *Private International Cartels, Effectiveness, Welfare, and Anticartel Enforcement*. Purdue University working paper.