

Remedies and Remedy Policy: An Economic Framework

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Background on remedies

- Increasing use of remedies for resolving infringements on competition, especially in the case of mergers
 - Some remedies are becoming ever more creative in their design, in an effort to address a wider range of competitive concerns
- The appeal of remedies is that they offer a “third way” between outright rejection and unqualified approval of a merger or some practice
 - This can be an important tool for enforcing competition policy
- But remedies are an actual tool only insofar as they are effective
 - Several studies, as well as anecdotal evidence, raise questions about effectiveness
 - Concern has led to increased attention to the economics that underlies remedies

Two perspectives on remedies

- To the competition agency, a remedy is a device to preserve or restore market competition that is threatened by some action by a firm
 - This could be a merger or some practice by a dominant firm that constitutes an infringement on competition
- But to the firm, the same remedy is a mechanism that prevents it from taking a profitable or otherwise advantageous action
 - This underscores the fundamental divergence of parties' perspectives
 - This affects all aspects of the design and enforcement of a remedy
- This difference in perspective serves as starting point for an economic framework for remedies
 - The key is to examine the behavior of the firm subject to an (unwanted) remedy

Analyzing remedies in economics

- Framework for understanding the effect of a remedy is the economic theory of the firm
 - Firm in economics is an entity whose incentive is to maximize profit, but subject to various constraints
 - Constraints include demand conditions, input costs, and other possible factors that affect its opportunities to gain profit
- This model has great predictive power for how a firm will behave when demand, cost or other conditions change
- Model can be used to analyze and predict how a constraint in the form of a remedy would change the firm's behavior
 - Would—could--the remedy in fact alter the firm's behavior and prevent the anticompetitive behavior?
 - Can the remedy withstand the firm's strong incentive to maximize profit by a determined effort to engage in the offending conduct anyway?
 - Is it possible to alter the firm's incentives to align them with the intended behavior?
 - Can any simple administrative rule in actual successfully constrain the firm?

Incentives vs. constraints in remedy policy

- Key considerations are the firm's *incentives* and *constraints*
 - Illustrate this by comparing two polar opposite types of remedies
- Begin with the classic case of a merger of two multiproduct firms
 - Suppose they overlap in just one product
 - Divestiture of one of the overlapping products is the standard preferred remedy
 - Generally viewed as successful since it results in the same number of separate products as prior to merger
- Correct as far as it goes but the economic model emphasizes more fundamental reasons
 - Divested product or asset has no continuing relationship to either parent or to the merged firm. Divestiture establishes clear boundaries between firms
 - Decision-making over the overlapping asset is taken away from the merging firm and put in the hands of a fully independent agent
 - It preserves and ensures that each entity—the merging firms and the buyer of the divested asset-- has its own unaltered profit-making incentives
- The economic model predicts that with the same number of firms, undistorted incentives, and clear boundaries between firms, the same overall market equilibrium as existed before will result from divestiture

The firm and conduct remedies

- Same model gives insight into the alternative of a conduct (“behavioral”) remedy
 - Conduct remedy allows the full merger to proceed
 - Identifies specific anticompetitive actions, such as the exchange of certain information, or retaliation
 - Prohibits the merged firm from those specific actions
 - In some cases, it might impose affirmative obligation, such as continuing “must-supply” agreements
- Crucially, does not alter the merged firm’s incentives to engage in the anticompetitive action
 - Those incentives are inherent in the merged structure, and remain just as strong
 - Economic model predicts that the profit-maximizing firm will seek ways to evade or minimize the limitation
- This makes clear why conduct remedies are fundamentally different from divestitures
 - Divestitures harness the firm’s inherent profit-maximizing incentives
 - Predictably yield the competitive outcome
 - Conduct remedies work only insofar as they succeed in preventing the firm from acting on its incentives
 - Predictably result in firm seeking to evade and avoid

The agency and conduct remedies

- Key question: Can the agency write and enforce such a prohibition?
- Note there are several different types of conduct remedies, each with own difficulties in devising an effective constraint on the offending conduct
 - Firewalls seek to prevent exchange of information between divisions, but much information exchange is normal and difficult to monitor and prevent
 - Must-supply agreements require continued provision of crucial input to an independent rival on appropriate terms, but the actual conditions are difficult to observe and evaluate
 - Anti-retaliation provisions prohibit the merged firm from punitive responses against rivals, although the on-going multi-dimensional nature of engagement creates opportunities for strategic behavior
- Further difficulties arise because conduct remedies are not “self-enforcing”
 - Rather, they create need for oversight and supervision by the competition agency

Conduct remedies and regulation

- These problems of devising and enforcing conduct remedies are analogous to traditional regulation
 - Problems are inherent in the firm's fundamental incentives to maximize profit
 - Here, those same incentives are for firm to evade and avoid the remedy
 - Firm is either prohibited from certain profit-maximizing behavior, or required to assist its rivals against own interests (blurring lines between firms)
- Misaligned incentives and the difficulty of preventing evasion illustrated by well-known economics article by Averch and Johnson entitled "Behavior of the firm under regulatory constraint"
- Demonstrated that a profit-maximizing firm subject to a regulatory constraint will predictably engage in adaptive behavior that allows it
 - Nominally to satisfy the constraint, but
 - To partially evade its most adverse effects, which in turn
 - Often results in some unintended and undesirable distortions

Research and remedy policy

- Large amount of economic research on weaknesses and distortions of traditional regulation in achieving its objectives
- My statistical research has cast doubt on the effectiveness of remedies and remedy policy in the US (Kwoka, ALJ, 2016)
 - Examined product price changes from mergers that were resolved through remedies
 - On average they resulted in price increases, increases no less than mergers that were cleared without remedies
 - Conduct remedies considerably worse than structural divestitures
- Other studies are also finding weaknesses of remedy policy
 - EU study has reported prices increases after remedies, although of smaller size
 - FTC Remedies studies of 1999, 2015 both found substantial percentages of failures
- Most agencies express strong preference for structural remedies wherever possible, though there is considerable use of conduct remedies as well
 - Some recent conduct remedies have failed, raising the question of whether they are being used when divestiture or even merger prohibition is necessary

Why conduct remedies at all?

- In some cases, conduct remedy may seem better suited than divestiture
 - Conduct remedy may be the only feasible approach where merger efficiencies are deeply integrated into the merged firm, such as with network industries, or vertical mergers
 - May seem more appropriate where the issue is not related to a specific structural feature but rather is simply the conduct itself, e.g., certain practices by a dominant firm
- In other cases, it may be possible to identify conditions under which conduct remedies are more likely to be effective
 - More likely effective when offending conduct is not central to business plan of the firm
 - When it is central, the firm will work aggressively to minimize its constraining effect
 - More likely effective when the offending conduct can be specified with precision ex ante, and not easily altered by firm ex post
 - More likely effective when violation results in effects are more readily observable
- Key caveat is always that enforcement requires agency to act as monitor and regulator
 - Enforcing conduct remedies encounters problems of asymmetries of information, uncertainty about future, opportunities for strategic behavior that can defeat the agency's purposes

Incentives and structural remedies

- Divestitures may raise some incentive problems as well
 - Merging firms have incentives to divest a weak product or asset, or may degrade it before divesting
 - Merging firms may promote less capable buyers for divested asset
 - These issues require careful agency scrutiny, but largely ex ante
- Further question about logical limits of structural remedies
 - When do structural remedies shift paradigms from separating out an overlapping product to rearranging industry assets more broadly?
 - Is this within the competence of a competition agency?
- Further compelling argument for structural approach is enforcement
 - Structural remedy avoids entangling agency in on-going role as de facto regulator
 - Economic model implies that structural remedy can be self-enforcing, allowing the agency to withdraw from the industry once the remedy is in place and standard incentives lead firm to behave in a manner consistent with market equilibrium

Final thoughts and questions

- Remedies can be very potent and important policy tool, but as they are increasingly used, questions arise
 - Are they over-used, substituting for a stronger policy response?
 - Or can they be better designed and applied?
 - If so, what changes in policy and practice should be implemented?
- A further set of questions concerns where there more to be learned from past experiences with remedies
 - Should the agencies have a on-going program for ex post review to facilitate continual improvement, as is done in a few countries?
- This incentives/constraints framework would seem useful in addressing these and other issues in developing and assessing remedies

Sources

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