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Price-Fixing: Hefty Penalties on Big-Biz Cartels Will Provide Level Playing Field to Small Businesses

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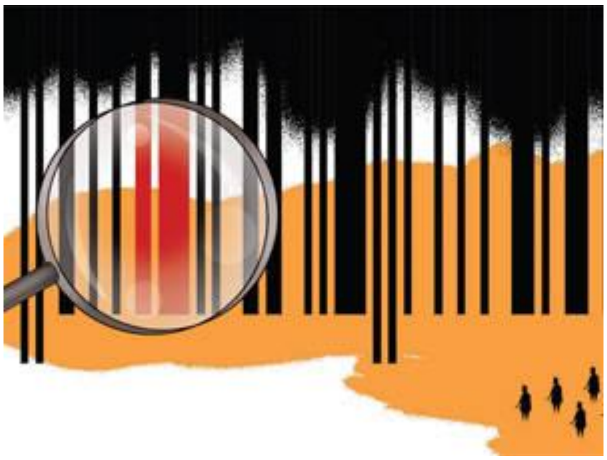
- 

(Cartels usually raise prices…)

By: John M Connor & Robert H Lande

Businesses form price-fixing cartels because market conditions allow the cartel to be profitable and because they judge the chances of paying large fines to be low. Cartels usually raise prices by over 20% on average, although of course the exact amount varies greatly from one product to another. This increases the profits that the colluding firms make, often dramatically.

Typically, the members of a cartel control a large share of their industry, so they don't have to worry very much about firms who aren't in the cartel or outsiders undercutting their price increases. Cartels are illegal in India, as is true in nearly every nation in the world. For example, the Competition Commission of India (CCI) recently imposed a collective fine of more than Rs 60 billion ($1.1 billion; £675 million) on firms that fixed the prices of cement, which raised the costs of building homes, offices and factories. The firms deny that they violated the law and said they will appeal the fine. In light of the possibility of such large fines, why do firms fix prices?

Quite simply, the rewards from fixing prices usually are very large relative to the penalties that are imposed if they are caught and convicted. Because cartels operate in secret, most are not caught and convicted of violating the law. To illustrate, suppose a group of firms decides to fix prices, and expects to increase their profits by Rs 1 billion. In order for a fine to discourage them from fixing prices, it would have to exceed Rs 1 billion. Suppose that if the firms do get caught, the fine would be Rs 2 billion.

However, nowhere in the world is there a 100% chance that the local competition authorities will catch and convict this group. Many experts believe that there is only a 20% chance that the businesses will be caught and convicted. Under these circumstances, the firms would be rational to engage in a simple cost/benefit analysis. First, they start with their expected Rs 1 billion in profit. Second, with a 20% chance of getting caught and convicted, the riskadjusted chance of paying a Rs 2-billion fine drops to only Rs 400 million (Rs 2 billion x 0.2 = Rs 400 million).

Because the 'benefits' of Rs 1 billion are greater than the anticipated 'costs' of Rs 400 million, the firms involved quickly would conclude that it would be rational for them to fix prices and take a chance that they will get caught. For India, what are the actual odds of getting caught and convicted, relative to the expected rewards and probable fines that would be imposed? Unfortunately, India's competition law is too recent for experts to gather the necessary facts. We have, however, performed this calculation for the US, a country that made price fixing strictly illegal 122 years ago. The data we assembled and analysed for the US shows that price fixing is, on average, a rational strategy for US firms to engage in.

This is true even though the US antitrust authorities impose a large number of sanctions on firms caught fixing prices, rigging bids or engaging in similar behaviour. We studied a sample of 75 recent cartels that operated in the US and internationally. We found that their median overcharge was about 19% of their sale volumes. We also found that they were sanctioned almost the exact same amount: a median sanction of about 17% of their sales.

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Note that if they were certain of being caught, forming most cartels would be a close call, because the benefits (19%) are only slightly larger than the costs (17%). What makes it so tempting to fix prices in the US is that there is much less than 100% chance of being caught and convicted. Indeed, we found that, historically, cartels in the US faced only a 20-24% chance of being discovered and convicted.

Thus, the 'costs' of being punished are reduced to an expected 4%, not 17%. Indeed, US sanctions imposed on cartels would have had to be at least three times higher to truly discourage most firms from colluding. Sadly, we found that 73 of the 75 cartels we studied were sanctioned much less than the optimal amount. Only two of the cartels actually were sanctioned enough to deprive them of their illegal profits and also to send a proper signal not to do it again. For the other 73 firms, however, the small sanctions that were imposed on them in effect told them that they should attempt to fix prices again.

We cannot, of course, be certain that these results would apply to India as well. We urge analysts in India to attempt to acquire the necessary data for a large number of cartels — including information on the profitability of Indian cartels and the sizes of the sanctions that were imposed on these cartels — and to undertake an analysis similar to the one that we performed for the US.

We strongly suspect that the results would be the same. We believe that it is as rational for businesses in India to fix prices as it is for firms in the US to do this. Imposing large fines on proven pricefixers is unpopular with some business groups. We applaud what the CCI is doing, because it will benefit not only India's consumers but will also level the playing field for thousands of small and mediumsize businesses. And because many cartels operate across national boundaries, international cooperation in suppressing cartel behaviour will benefit consumers and small businesses everywhere.

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