ISSUEANALYSIS

THE CENTRE FOR INDEPENDENT STUDIES

The Folly of Criminalising Cartels

Jason Soon

EXECUTIVE SUMMARY No. 111 • 3 June 2009

A cartel is an agreement between competitors not to compete. The most well-known and publicised form of cartelising conduct is an agreement between competitors to fix prices. Such conduct is prohibited by Australia's *Trade Practices Act* (*TPA*) because it is seen as inherently anti-competitive. Current civil penalties mean that bodies corporate participating in a cartel can face fines of up to $10 million, 10 percent of their annual turnover, or three times the gain to the cartel (whichever is higher). However, the federal government thinks that existing civil penalties do not go far enough and proposes to introduce a jail term of a maximum of 10 years for individuals found guilty of serious cartel conduct. Its thinking, and that of other advocates of criminal provisions for cartelisation offences, appears to be motivated by three perspectives.

First, it has been argued that cartelisation is like fraud or theft and should be treated accordingly. However, this contention is inconsistent with the approach taken by the current law or with the government's proposed bill criminalising cartels, since both contain significant exceptions to the prohibition. What this suggests is that in reality the decision to punish cooperative agreements between firms is a matter of public policy—reflecting a balancing act between the promotion of competition and the facilitation of the potential benefits of cooperative agreements between firms.

Second, it has been argued that cartels are so destructive to the Australian economy that a stronger emphasis on rooting them out should be adopted. However, while it has been widely assumed that the anti-competitive effect of hidden cartels on economic welfare is significant, not many studies have successfully documented the benefits of regulatory interventions to remove cartels. Many recent post-mortem analyses of successful cartel prosecutions have failed to find that the relevant markets after such prosecution actually reaped any benefits in terms of lower prices. Furthermore, cartels by their nature tend to be unstable as they depend on the parties agreeing to price above market rates, and there will be a constant temptation on the part of these parties to undercut the agreed cartel price. This means that even without intervention, they may be unlikely to persist for long; even if they do persist, they may not be as effective as they intended to be because of the constant temptation for cartel partners to 'cheat,' which may erupt into price wars.

Third, it has been argued that civil penalties as they are implemented in practice cannot adequately deter cartels irrespective of the theoretical merits of such penalties. The strongest version of this contention relies on the claim that a credibly deterring level of civil penalty would bankrupt the individual offender and the body corporate. Therefore, it would not be possible to credibly enforce such a civil penalty because it renders the individual offender 'judgment proof.' Moreover, the courts would be reluctant to inflict collateral damage on the body corporate's other stakeholders. However, more recent research, which takes into account the impacts of relatively new initiatives such as whistleblower programs, suggests that these initiatives have significantly increased regulators' ability to detect and deter cartels.

Jason Soon is a Visiting Fellow at the Centre for Independent Studies and an economic consultant. He has previously written Issue Analysis papers for the Centre on taxi market deregulation and the unfair dismissal laws.

Introduction

A cartel is an agreement between competitors not to compete. While in practice this can take various forms, the most well-known and publicised form of cartelising conduct is an agreement between competitors to fix prices. Such agreements gained attention recently following the Visy and Amcor proceedings in which the late businessman Richard Pratt was implicated. The Federal Court found that a price fixing agreement existed between Pratt's company, Visy Industries, and competitor Amcor Ltd.

The increased public awareness of cartels because of this conviction coincided with a public campaign by the Chairman of Australia's competition regulator, the Australian Competition and Consumer Commission (ACCC), to introduce jail terms for cartel convictions.

These developments probably facilitated a more favourable legislative movement towards the introduction of jail terms for cartel convictions that was already underway. In 2003, a committee headed by Sir Daryl Dawson, which was appointed to review the competition provisions of the *Trade Practices Act* (*TPA*), also recommended jail terms for cartel participants.

In January 2008, the draft legislation to introduce criminal penalties for 'serious cartel conduct,' the *Trade Practices Amendment (Cartel Conduct and Other Measures) Bill 2008* (the bill), was released for public comment. In December 2008, an amended version of the draft legislation was introduced into Parliament. Since then, the Senate Economics Committee has conducted an inquiry into the bill. The committee's report by and large endorses the bill in its current form.

The purpose of this paper is to evaluate the case for and against the introduction of criminal penalties under this bill. It begins by comparing existing penalties against the new penalties proposed in the bill. Various arguments that have been made in support of the introduction of criminal provisions for cartelising conduct are then examined in detail. The paper finds that the arguments in support of provisions such as those presented in the bill are not as strong as they appear and that the government should reconsider the introduction of criminal penalties for cartelisation.

Main provisions of the *Trade Practices Amendment Bill 2008*

Current provisions in the *TPA* already contain significant penalties against cartelisation. In particular, under section 76(1A) of the *TPA*, bodies corporate participating in a cartel can face fines of up to $10 million, 10 percent of their annual turnover, or three times the gain to the cartel (whichever is higher), while individuals face maximum fines of up to $500,000.

The *Trade Practices Amendment Bill 2008* introduces jail terms for individuals associated with bodies corporate that are found to engage in cartelising conduct through the following steps:

- A cartel provision is defined as any 'contract, arrangement or understanding' between at least two parties that are or are likely to be in competition with each other concerning price fixing; sharing or allocating a customer base; restricting supply; or rigging a tender process.
- Corporations are defined as committing an 'indictable offence' if they make, or give effect to, an agreement that contains a cartel provision. The corporation must have known or believed that the agreement contained a cartel provision for the conduct to be indictable.
- Individuals can be liable for a contravention of this indictable offence in one of two ways—by being an accessory to the commission of an offence or by being held directly liable for the offences. On conviction, individuals face a maximum jail term of 10 years and a fine of $220,000, while corporations face as a maximum penalty the greater of $10 million, up to 10 percent of their

annual turnover, or three times the value of the benefit obtained as a result of committing the offence, whichever is greater.

The maximum jail term in the draft exposure bill released in January was five years. After consultation, the maximum jail term in the final version of the bill was increased to its present 10 years. In his Second Reading speech introducing the bill, Assistant Treasurer Chris Bowen explained that the increase was meant to better reflect the 'seriousness of the crime' and to put Australia on par with the United States in having the world's longest jail terms for such offences.[1] Another aspect of the bill that will be discussed in further detail below is the increase in investigatory powers it confers on the ACCC.

Arguments advanced for criminal treatment of cartels

A number of arguments have been advanced in recent years for extending criminal provisions to anti-cartel laws. Each of these arguments, which are not mutually exclusive, is discussed in detail below.

1) Cartelisation is like fraud or theft and should be treated accordingly

One of the most prominent claims advanced to support the criminalisation of cartel conduct draws on the community's moral outrage, which can be exploited every time a particular example of such conduct like in the Visy and Amcor case comes to light. For example, it is often asserted that cartelisation is morally equivalent to theft or fraud. The ACCC's Chairman has repeatedly compared cartelists to thieves. At a November 2007 press conference on the Visy case, he referred to cartelists as 'well dressed thieves.'[2] Two years earlier, he had stated that 'cartel behaviour is a form of theft and little different from classes of corporate crime that already attract criminal sentences.'[3] Meanwhile, the Assistant Treasurer's Second Reading speech implicitly compared cartelisation to fraud when it justified criminal provisions on the basis that other forms of corporate fraud also included such provisions.[4]

While the analogy between theft and fraud may have some emotional force, it falls short on the substantive details.

In particular, it is uncommon for criminal provisions or anti-fraud provisions to contain statutory exceptions from application of the legislation on the basis that some kinds of criminal activity or fraud promote net economic benefits. Yet such statutory exceptions are in fact taken for granted in the case of anti-cartelisation laws, which suggests that at least not all aspects of cartelisation conduct considered fraudulent or criminal are equivalent to such conduct.

Indeed, the fact that some long-term cooperative agreements between firms are not only tolerated but recognised as being of social value is evident both under current provisions in the *TPA* and in the bill itself where specific exemptions from the prohibition on cartelisation are listed. The exemptions in the bill apply to:

- **Conduct notified under the collective bargaining regime in the Act**. In other words, a specific exception is carved out for what seems like distributional onsiderations to provide relative advantages to small businesses bargaining collectively with a larger business.
- **Conduct subject to a grant of authorisation**. This refers to cases where the businesses voluntarily inform regulators that they wish to enter into agreements that may be in breach but apply to the regulator for exemption on the basis that they can demonstrate net public benefits.[5]
- **Contracts, arrangements or understandings between related bodies corporate**.
- **Joint ventures provisions contained in contracts**. Again, the main rationale is the recognition of economic benefits that may be facilitated by joint ventures.
- **Anti-overlap exceptions**.

In his Second Reading speech for the bill, Assistant Treasurer Bowen said these exceptions were introduced to recognise 'legitimate business activities that are beneficial to the economy or in the public interest.'[6]

Of these exemptions, it can be said that the exemptions for contracts between related bodies corporate and anti-overlap exceptions are not significant policy based exemptions but simply clarifications of the legislation to ensure that they do not apply to where they are not meant to anyway. However, the other exemptions listed are clearly significant. One of these exemptions—exempting conduct subject to authorisation procedures—includes by implication subjecting the conduct in question to a test of whether the economic benefits of the conduct would outweigh the costs. A second exemption—for joint venture contracts—recognises the consensus among economists that the joint venture format allows participants to a joint venture to capture significant economic benefits.[7] The exemption for collective bargaining singles out particular cooperative agreements as being of presumptive social value without any need for the parties involved to demonstrate net benefits (i.e. benefits exceeding costs) from the conduct.

The use of criminal penalties cannot be a priori, without further elucidation of the net benefits of such an approach, be justified on the basis of emotive comparisons.

What this suggests is that notwithstanding the rhetoric of the government and other advocates of jail terms for cartelists, the decision to punish cooperative agreements between firms is a matter of public policy. It reflects a balancing act between the preference for promoting atomistic price-based competition between non-cooperating firms and not smothering the potential benefits of such agreements in cases where they can facilitate efficiencies. Such a 'balancing act' has no equivalent in criminal laws.

A detailed example of the internal contradictions of laws against price fixing is discussed in Box 1.

None of this is to suggest that criminal penalties for cartelisation might not be justified on public policy grounds. The case for such treatment is discussed further below. Without further elucidation of the net benefits of such an approach, the use of criminal penalties cannot be *a priori* justified on the basis of emotive comparisons.

Another crucial respect in which the comparison between prohibitions on cartelisation and criminal laws is undermined is with respect to the certainty and predictability of cartelisation offences. While certainty and predictability are generally desirable qualities that should be associated with all laws, this consideration has tended to be even more important in the case of provisions defining criminal offences. This is understandable given that the most severe social stigma and penalties tend to be reserved for criminal offences. Such a high degree of predictability and certainty is desirable insofar as it means that the general public knows in advance what sort of conduct to avoid in order not to become subject to criminal prosecution. Thus, there are easily ascertainable elements to a criminal offence such as theft that cartelisation is commonly compared to by advocates of the criminalisation of cartel offences. For example, the Victorian *Crimes Act 1958* defines the main elements of theft as comprising dishonest appropriation of property belonging to another with the intention of permanently depriving others of it.[8] There is a mental element to the offence (the appropriation must be intentionally 'dishonest' rather than unintentional) and a conduct element of appropriation (transfer of property with such conduct being easily verifiable in all but the most exceptional cases).

While these elements are also present in the proposed cartelisation offences, their definitions are far less straightforward. For instance, a corporation commits an offence under the bill where it is found to make or give effect to 'a contract, arrangement or understanding that contains a cartel provision' and does so with the 'intention of dishonestly obtaining a benefit.' The concept of an 'understanding' in itself is a problematic one. In cartelisation cases, it can be difficult to point to a 'smoking gun' that definitively demonstrates the existence of such an understanding. Indeed, this is one of the reasons for the failed prosecution of the parties in the Geelong petrol case discussed below.

Adding to the reduced element of certainty and predictability in the proposed cartelisation offences in the bill are the significant economic issues involved in the determination of whether a particular provision is a 'cartel provision.' Two elements are employed to determine the existence of a cartel provision. First, as noted above, there is a purpose/effect element that involves ascertaining whether the provision has the purpose or effect of fixing prices; sharing or allocating a customer base; restricting supply; or rigging a tender process. Second, a 'competitive condition' has to be met as well, which is that at least two of the parties to a 'contract, arrangement or understanding' are in competition with each other, i.e. belong in the same market.

None of the above is meant to suggest that such elements can or should be dispensed with in proposing cartelisation offences. Indeed, given the potential economic benefits associated with conduct that would otherwise be caught under cartelisation offences, such multiple lines of enquiry are necessary to ensure that efficient business conduct is not discouraged. However, the presence of these elements of cartelisation and the complexity they introduce into ascertaining whether a genuine offence has been committed obviously weakens the predictability and certainty of such laws compared to the predictability and certainty of more conventionally understood criminal offences and further weakens the comparisons between cartelisation and theft

The concept of an 'understanding' in itself is a problematic one. In cartelisation cases, it can be difficult to point to a 'smoking gun' that definitively demonstrates the existence of such an understanding.

2) Cartelisation is economically destructive and must be deterred

The Second Reading speech introducing the bill emphasised that cartels do great harm to the Australian economy. It argued that 'cartel conduct harms consumers, businesses and the economy by increasing prices, reducing choice and distorting innovation processes.' The speech went on to say, 'The total annual cost of such conduct is difficult to quantify because the effects are dispersed and it is by its nature secretive, but it is likely to exceed many millions of dollars to the Australian economy each year, and many billions worldwide.'[10]

How justified are these concerns?

Clearly, not all business conduct that would be captured under anti-cartelisation provisions are economically destructive. As noted previously, this is acknowledged in the bill itself, which provides for various statutory exceptions.

However, it could be argued by the proponents of such legislation that these statutory exceptions should provide enough of a safety net for firms that were confident of demonstrating a net benefit from their cartelisation arrangement to do so and thus obtain an exemption from the law. But assuming that this safety net is sufficient, does it follow that other cartelisation agreements that do not meet these exemptions because they have an anti-competitive purpose and remain hidden would necessarily lead to large economic detriments?

The evidence on its face for this proposition appears mixed.

Studies of cartels in other countries suggest that if they can get up and running they can raise prices quite substantially for a number of years.[11] Other studies have estimated that the costs of overcharging by past cartels in Australia could be in the magnitude of billions of dollars.[12] However, such estimates tend to be based on assumptions garnered from studies of cartel overcharges in other economies. As ACCC Chairman Graeme Samuel himself notes, there is 'debate about the exact extent of price rises caused by price fixing.'[13]

It is also pertinent to consider whether the particular conditions of the Australian economy make it more vulnerable to cartels and their possible economic costs. On the one hand, it is possible that cartels could be more effectively organised in Australia than in larger markets simply because the smaller the market, the easier it is for cartel participants to police each other (they can monitor each other's pricing and 'punish' defectors from their cartels). All other things being equal, this might provide

Case Study of the Contradictions of Anti-cartel Laws

In November 2008, the federal government's FuelWatch legislation was defeated in the Senate.

And in May 2007, the Full Federal Court handed down the decision of *ACCC v Leahy Petroleum Pty Ltd* [2007] FCA 794. What could these two developments possibly have in common?

The short answer is that they illustrate some of the contradictions of anti-cartel laws.

In *ACCC v Leahy*, the Federal Court, after four years of litigation by the ACCC at great financial cost to all parties concerned, dismissed price fixing charges against a group of petrol stations in Geelong. The ACCC had alleged that these petrol stations had engaged in price fixing through telephone calls discussing the amount and timing of petrol price rises.

The court found that the oral evidence of witnesses tendered by the ACCC merely established discussions about prices between the petrol station owners. The ACCC was, however, unable to establish any commitment on the part of these owners to act in any particular way as a result of such discussions.

Indeed, the court noted other evidence that contradicted any such interpretation—for instance, sustained price rises were routinely made even when there were no phone calls; station owners even continued to make such calls **after** it was revealed that the ACCC was investigating these practices.

So, all that the ACCC had been able to establish was the exchange of pricing information between petrol station owners.

Fast forward a bit to November 2008 when the government's FuelWatch bill was defeated in the Senate. The government had been selling this bill as a win for the consumer, yet the scheme would have **required** petrol service stations to publish their prices on a government website once a day **and** keep their prices at that level for the next 24 hours.

In other words, a scheme trumpeted as a pro-consumer policy would in effect have involved not just facilitating but actually imposing the same sort of 'information exchange' (in a more effective format) that the ACCC spent four years prosecuting. In addition, it would have entailed hooking up petrol stations throughout Australia and not just Geelong **and** forcing these stations not to compete for a 24-hour period.

Thus, the draconian implications of the ACCC's pursuit stands in stark contrast to arrangements that would have been imposed on competing petrol stations had the federal government's proposed FuelWatch scheme been passed by the Senate.

Around the same time and with no apparent sense of irony, the ACCC Petrol Commissioner had expressed reservations about a commercial website called Informed Sources that was already providing a similar service on the basis that it could—wait for it—facilitate 'tacit collusion.'[9]

While it can be argued that there is a big difference between FuelWatch and the sort of information exchange between petrol station owners in *ACCC v Leahy* because consumers, not just retailers, obtain the benefit of better diffused pricing information, this is offset by a number of other considerations:

- The 24-hour pricing commitment imposed on retailers by FuelWatch would have encouraged retailers to think twice before setting a price. The pro-competitive rationale behind it was that a retailer would not want to risk being a 'price leader' in the sense of setting a price that was higher than its competitors because it would then suffer sustained damage to its business for 24 hours before it could adjust prices down.
- However, taking a more long-term view, the increased price transparency also means that over repeated interactions (i.e. retailers deciding how to set prices day by day), the ability of retailers to collude by, in effect, giving binding and verified commitments (i.e. by signalling to each other over time that they will price less aggressively through the proposed FuelWatch site) would also have been enhanced.

In other words, the stability and transparency that FuelWatch would have cultivated in the market, primarily because of the 24-hour commitment rule combined with easy access to pricing information, could equally be as conducive to collusion as the information exchange commitments alleged of the retailers in *ACCC v Leahy*, except it would have extended over a much larger market than just the Geelong area.

some support for the idea that Australia, as a relatively smaller market compared to other countries, needs to be even more vigilant about deterring cartels because the smallness of the market makes it relatively easy to set up and enforce cartels.

On the other hand, the smallness of the domestic market is not the only variable that matters. Australia's economy is extremely open to trade and investment flows. Such openness increases the effective size of the Australian market because it means that the scope for competition is not restricted to existing domestic firms. This, in turn, means that whatever advantages cartels have (if any) in organising themselves in a smaller geographical market like Australia may be superseded by the effective increase in the size of the market and the more competitive environment facilitated by Australia's openness to international competition. Since a cartel relies on its participants agreeing to maintain prices above market rates, a cartel operating in a highly open economy would be less effective if it did not incorporate international suppliers. Yet the sheer number and diversity of international suppliers in such an economy would make the successful implementation and maintenance of a cartel highly improbable.

It is pertinent in this respect to note that there is a body of research that finds openness to trade in the form of significant import competition to be an important determinant of the intensity of competition in a national economy as determined by various proxies such as the level of mark-ups in concentrated industries. For instance, various studies have found that the level of price-cost markups in highly concentrated industries was heavily dependent on similar markups set by competing imported products and that import competition had a significant effect on price-cost margins.[14] This raises the question of the extent to which competition laws are particularly important or useful in promoting competition within an economy relative to this and other institutional factors.

The few post-mortem studies of successful cartel prosecutions mysteriously find that such actions do not appear to confer any benefits to consumers.

Indeed, while there is another large body of research that has discovered correlations between the state of competition in a market and the existence of competition or antitrust laws,[15] correlation does not imply causation. One plausible interpretation of these findings is that countries that have implemented competition law tend to have a strong policy commitment to promoting competition through other means, including a general commitment to free trade policies.

At the same time, the few post-mortem studies of successful cartel prosecutions mysteriously find that such actions do not appear to confer any benefits to consumers. In some cases, consumers are actually worse off if the results are assessed in terms of pricing trends. For instance, one analysis of 25 US price fixing cases found that prices actually rose after indictments.[16] A similar exercise was recently performed for a number of Australian price fixing cases by Moran and Novak,[17] who were unable to find any improvements in pricing trends following the successful prosecution of two major price fixing cases.

Ultimately, given the fragile nature of cartels, which has been extensively documented and analysed by economists,[18] measures to introduce criminal penalties for cartelisation offences are akin to cracking open a nut with a sledgehammer. As is the case with public policy, so it is with business objectives—intentions and outcomes may differ. Cartelists may enter into an agreement with the intention of 'ripping off' a market but the outcomes of the agreement may end up radically differing from this intention for various reasons and not even from lack of trying. For instance, for a cartel to be successfully enforced, participants must themselves be able to detect 'cheats' among their membership and then punish those cheats through responses. These responses would in effect reduce the profitability of the defector (for instance, enforcing an extended period when the other cartel members are allowed to cut their prices but the defector cannot).

In other words, the means by which a cartel tries to enforce itself among its members may bring with it seeds of its own destruction.

First, if such punishments take the form of retaliations against cheats, they may end up degenerating into price wars, which then threaten the viability of the cartel itself. If the cost that a cartel pays for being long lived is that it needs to retaliate against defecting members periodically through price wars, then it becomes an open question whether the gains to consumers over the retaliatory period may significantly mitigate a large part of the losses over the periods of quiet. Ironically, a cartel is more likely to be successful in maintaining itself if it also facilitates significant efficiency gains,[19] which further reinforces the argument that the actual economic harms imposed by cartels are not as great as supposed.

Second, such punishments may itself increase the probability of detection by authorities, insofar as they lead to the defector being aggrieved and becoming a whistleblower or lead to volatile prices that attract the attention of the regulator.

These difficulties associated with maintaining a cartel agreement would need to be considered when assessing the net deterrent effects that existing provisions already impose on cartel activity, a topic that is the subject of further discussion below.

Given the fragile nature of cartels, ... measures to introduce criminal penalties for cartelisation offences are akin to cracking open a nut with a sledgehammer.

3) Existing penalties are inadequate for deterring cartels

One argument expressed in the Second Reading speech is that existing civil penalties are inadequate for deterring cartelisation because fines can be dismissed as a mere cost of doing business. By contrast, it is argued that the prospect of a jail term for committing a cartel offence sends a clear message as it has an immediate deterrent effect for business conspirators.

The Chairman of the ACCC, made similar claims in a press conference on the Visy case in 2007, saying:[20]

> [N]othing concentrates the mind of an executive contemplating creating or participating in a cartel more than the prospect of a criminal conviction and a stretch in jail. When monetary penalties and damage to reputation are the only risks, some greedy executives will run the gauntlet. But a criminal conviction coupled with jail time for executives to meditate on their actions would in my mind provide the greatest deterrent.

However, it is a trivialisation of current penalties to dismiss them as a mere cost of doing business: existing penalties encompass fines of a maximum of $10 million, up to 10 percent of a cartelist's annual turnover, or three times the gains to the cartel, whichever is higher, and were only recently increased from a mere maximum of $10 million. This is despite the fact that previous penalties awarded had not yet taken maximum advantage of the discretion available to the courts. For instance, the penalty imposed on Visy in the Visy and Amcor proceedings, even under the previous penalties provided for, was $3 million short of the maximum. The total penalties in the Visy case were the highest ever imposed to date. Even if an alleged 'deterrence gap' exists, it is not because the full extent of past financial penalties was exhausted.

It is a trivialisation of current penalties to dismiss them as a mere cost of doing business.

As a matter of economics, any existing non-monetary penalty for offences can theoretically be translated into some monetary penalty that can yield the same degree of disutility to the offender. However, it has been argued by the proponents of criminal sanctions for price fixing that the threat of being sent to jail has an especially heavy 'sting.' For instance, most offenders would be deterred by a short stint in prison, but they are unlikely to be deterred to the same extent by a large fine. But even accepting this argument, all it implies is that the kind of prison sentence needed to deter the average offender could be significantly 'lighter' in terms of jail time served than the kind of fine needed to deter the average offender in terms of the amount that would need to be levied for breach. It does not negate the theoretical possibility of 'simulating' the magnitude of deterrence that proponents of criminal sanctions wish to impose on offenders through an appropriately high fine.

Furthermore, flipping the comparison around, this argument does not consider the possible opportunity cost of using jail terms as a means of deterring conduct,

which could feasibly be deterred by levying fines. Using civil penalties allows for the possibility of recovering at least some of the costs of prosecution and having a deterring effect, whereas prison sentences have the opposite effect of consuming significant government resources.

While proponents of jail terms like to refer to the trivial sentences that can have the same effect as heavy fines, in reality, the proposed criminal sanctions have been designed to be quite high. The proposed five-year jail term in the draft legislation has already been extended to a maximum of 10 years. In addition to the costs to the government of keeping offenders in jail, we should also consider the opportunity costs to society as these offenders can have quite productive working lives out of jail. Confining them to jail may also mean that society forgoes possible increases in production and productivity that would be possible if the offenders were merely to pay a fine and re-enter the labour market.

Though the 'judgment-proof' argument for criminal penalties has not been explicitly made by the government, it is a prominent part of the general advocacy among regulators and legal academics for the use of criminal penalties to punish cartels.

Another question is how high this so-called 'optimal fine' would have to be to have the allegedly desirable properties of deterrence that proponents of criminal sanctions claim for jail terms. If there is reason to believe that the 'optimal fine' is unrealistically high so as not to even be credibly enforceable, then this may well be a reason to consider the use of criminal sanctions. There is in fact no such consensus or decisive finding among legal and economic researchers along such lines. The strongest argument that the 'optimal fine' is too high to be imposed goes under the heading of the problem of the 'judgment-proof' defendant, but this argument is far from compelling.

Under this argument, the gains from becoming part of a cartel are high and the chances of being caught may be so low that a heavy fine is needed to 'tilt the odds' enough to discourage businesspeople from 'gambling' to join a cartel. In which case, why not simply levy higher fines rather than introducing criminal provisions? According to the 'judgment proof' defendant argument, any fine heavy enough to put businesspeople off the 'gamble' of engaging in cartelisation will be higher than their capacity to pay, insofar as the body corporate or businessperson can simply declare bankruptcy. A fine that in effect cannot be collected will not carry much credibility and therefore not much of a 'sting' for deterring the indicted conduct.

A variant of this argument is that in modern corporations, which are characterised by the well-known 'separation of ownership and control,' shareholders cannot always keep tabs on their managers' excesses. In such companies, which may have revenues running into the millions, managers have even more to gain from being part of a cartel, especially if they have stock options. Therefore, for penalties to be effective they need to be targeted at the personal comfort of the managers. Again in these cases the 'judgment proof' dilemma intervenes to reduce the sting of fines on the manager because of personal bankruptcy laws.

Though the 'judgment-proof' argument for criminal penalties has not been explicitly made by the government, it is a prominent part of the general advocacy among regulators and legal academics for the use of criminal penalties to punish cartels.[21] It has also been made by one of the most vocal exponents of criminal penalties for cartels, Graeme Samuel, who has summarised the academic research on cartels as follows: [22]

> The research does support the conclusion that cartels are so profitable and difficult to detect that it may be impossible to set a pecuniary penalty at a level adequate to deter collusion without threatening the very existence of offending firms.

While the arguments relying on the 'judgment proof' dilemma may give pause for thought, they are hardly decisive.

First, the concern that the appropriate fine for deterring cartelisation is so high as not to be credible due to the option of bankruptcy as an escape hatch seems to downplay the sting of being bankrupted by being convicted of an offence, both in terms of the stigma and the significant inconvenience to the future business prospects

of the offender. Additionally, there has been no evidence to date that Australian courts have been prevented from setting higher fines out of fear of bankrupting offenders. Instead, there has even been one case where the ACCC managed to recover penalties from an insolvent company.[23]

More importantly, the concern that defendants may be 'judgment proof' does not take into account the broader experience of new regulatory strategies that have increased regulators' ability to detect cartels, which in turn suggests that the level of fines that would be needed to deter indictable cartelisation offences may be much lower than presumed and well within a firms' ability to pay.[24] This finding should come as no surprise as a matter of economics, as the deterrent effect of a law depends on both the **penalty** that would be faced by the offender if the offence were detected and successfully prosecuted, and the **probability** that the offender would be detected and successfully prosecuted. Raising the latter will allow the former to be reduced while having the same deterrent effect and vice versa.

The main innovation that increases the 'odds' of a cartel being detected are whistleblower programs such as the Immunity Policy used by the ACCC.

The main innovation that increases the 'odds' of a cartel being detected are whistleblower programs such as the Immunity Policy used by the ACCC, which grants immunity from prosecution for corporations and individuals who are the first to 'squeal' on a cartel.[25] Indeed, past assertions by the ACCC, and in particular by Graeme Samuel, on the effectiveness of the Immunity Policy seem to directly contradict Samuel's more recent statements on the ineffectiveness of the civil penalties regime. For instance, as recently as 2006, in an address to the 2nd Antitrust Spring Conference, Samuel stated (emphases added):[26]

> The Immunity Policy, released on 5 September 2005, makes it more likely that cartel participants will break ranks and report illegal conduct to the ACCC, and more likely that perpetrators will be caught and punished. **This dramatically changes the risk-weighted cost-benefit analysis massively against involvement in a cartel …**
>
> So there's a much greater chance of being exposed, and when the cartel is exposed, the new fines will mean the cost for any company will outweigh the gain.

Also specifically relevant to an assessment of the deterrent effects of civil penalties in Australia is the fact that the bill provides for increased surveillance powers for the ACCC. Specifically, the bill amends the *Telecommunications (Interception and Access) Act 1979* to enable the ACCC to seek to use intercepted material in relation to cartel investigations. Such increased surveillance powers would make it easier to detect and break up cartels and, hence, reduce the need for greater penalties to deter such offences.

Summary and conclusions

The federal government proposes to introduce a jail term of a maximum of 10 years for individuals found guilty of serious cartel conduct because it thinks that existing civil penalties against individual and corporate participants to anti-competitive cartels are insufficiently high. Its thinking and that of other advocates of criminal provisions for cartelisation offences appears to be motivated by three perspectives that are not mutually exclusive, namely:

- Cartelisation is like fraud or theft and should be treated accordingly;
- Cartelisation is an extremely economically destructive form of conduct which consequently must be strongly deterred; and
- Existing penalties are inadequate for deterring cartels.

The first contention is not consistent with the approach taken by the current law or even with the government's proposed bill criminalising cartels, since both contain exceptions to the prohibition that recognise the fact that under certain

conditions, agreements between competitors may be of public benefit. Furthermore. the cartelisation offence is not capable of the same degree of predictability and certainty of application that can be found in more conventionally understood criminal offences like theft. What this suggests is that in reality the decision to punish cooperative agreements between firms is a matter of public policy. It also reflects a balancing act between the benefits of promoting competition and not smothering the potential benefits of cooperative agreements between firms in cases where such cooperative agreements can foster various efficiencies.

Anti-cartel laws may be at best ineffective in increasing economic welfare through lower prices.

The second contention, that cartels are extremely destructive to the Australian economy, has not been based on much solid evidence. Recent post-mortems of successful cartel prosecutions have failed to find that the market after such prosecution actually reaped any benefits in terms of lower prices, so it is unclear exactly what the criteria of 'success' should be. In addition, cartels by their nature will tend to be unstable as they depend on the parties to a cartel agreeing to price above market rates, and there will be a constant temptation on the part of these parties to undercut the agreed cartel price. This means that even without intervention, they may be unlikely to persist for long. Even if they do, cartels may not be as effective as they intended to be because of the constant temptation on cartel partners to 'cheat,' which may erupt into price wars.

The third contention also appears to be based on dated arguments. The strongest version of this contention relies on the claim that a credibly deterring level of civil penalty would bankrupt the individual offender and the body corporate. Therefore, such a deterrent would not be credible because it renders the individual offender 'judgment proof,' while the court would be reluctant to inflict collateral damage on the body corporate's other stakeholders. However, the assumption that civil penalties would never be high enough to deter appears to be exactly that, an assumption, while the concern is an academic one. This is more so given that recent research that takes into account the impacts of relatively new initiatives, such whistleblower programs, suggests that these initiatives have significantly increased regulators' ability to detect cartels. This development in turn means that the level of fines that would be needed to deter indictable cartelisation offences may be much lower than originally presumed by researchers.

It should be noted that while for the sake of argument, this paper has accepted the premise that existing prohibitions against cartelisation are here to stay, it has also discussed briefly why anti-cartel laws may be at best ineffective in increasing economic welfare through lower prices. Even with this best case scenario, it is not obvious that such laws can be justified given the costs of enforcing such laws, both in terms of the administrative, judicial and regulatory resources that they consume, and the increase in risk faced by businesses legitimately trying to compete and innovate and may erroneously become the target of such provisions.

The latter may have significant flow-on effects, for instance, in distorting business conduct by 'chilling' competitive conduct or innovative cooperative agreements between firms that would otherwise capture efficiencies, especially given the increased penalties that the ACCC would be able to levy. Indeed, even the existing bill, which provides for statutory exceptions, has already been criticised for amending existing provisions in such a way as to unintentionally narrow the scope of these exceptions, thus increasing the risk of erroneous prosecution of businesses engaging in efficient and competitive conduct.[27]

Endnotes

1 Hansard, House of Representatives (3 December 2008).
2 See Visy News Conference, Opening statement by Graeme Samuel, www.accc.gov.au/content/item.phtml?itemId=802637&nodeId=6131d945203f7f1ac39efde321315e44&fn=Opening%20statement%20-%20Visy%20news%20conference.pdf.
3 See speech by Graeme Samuel at International Bar Association, International Competition Enforcement Conference, Tokyo (21 April 2005), www.accc.gov.au/content/item.phtml?itemId=680262&nodeId=b0cdbca549bc51e0a93090922b33a97a&fn=20050421%20IBA%20Tokyo.pdf.
4 Hansard, as above.
5 To grant such an exemption, the ACCC must be satisfied that the benefit of the conduct will outweigh any detriment to the public constituted by any lessening of competition that would result, or be likely to result, if the conduct occurred.
6 Hansard, as above.
7 These benefits were acknowledged in the Dawson Committee's Review. Specifically the committee noted: 'Currently, in recognition of the economic benefits of joint venture, Section 45A(2) provides an exemption for joint ventures from the per se prohibition against price fixing under section 45A of the Act.' And further: 'Joint ventures may be pro-competitive, particularly when they are employed as a means of developing new products or services or producing existing products or services more efficiently.' (Review of the Competition Provisions of the *Trade Practices Act*, January 2003). Indeed, while the committee also noted that such joint venture structures may also have costs in terms of possible detriments to competition, on balance it was convinced that the current exemptions did not go far enough and 'may not accommodate newer kinds of joint ventures that involve alliances between corporations.'
8 Section 72 of the *Crimes Act 1958*.
9 'No FuelWatch under Christmas tree,' *The Sydney Morning Herald* (3 November 2008), www.smh.com.au/news/national/no-fuelwatch-under-christmas-tree/2008/11/02/1225560645011.html.
10 Hansard, as above.
11 John Connor, 'Price-fixing overcharges: Legal and economic evidence' (2004), www.agecon.purdue.edu/staff/connor/papers/PRICE%20FIXING_OVERCHARGES_FULL_TEXT_8-20-05.pdf.
12 For instance, Graeme Samuel's speech to the Economics Society of Australia Detection of Cartels symposium on 28 September 2005 cites an estimate that an express freight cartel that operated in Australia for 20 years through the 1970s and 1980s may have cost Australian consumers around $3 billion to $4 billion based on OECD calculations included in the 2002 OECD report on the nature and effect of cartels. www.accc.gov.au/content/item.phtml?itemId=709298&nodeId=f28aff772612974642756d8c555f6ae0&fn=20050928_Economics%20Society_Cartels.pdf.
13 As above, footnote 2.
14 For instance:
    1. Alexis Jacquemin and Andre Sapir, 'Competition and imports in the European market,' CEPR Discussion Papers 474 (1990).
    2. Harry Bloch and Michael Olive, 'Cyclical and competitive influences on pricing in Australian manufacturing,' *Economic Record* 75 (1999).
    3. See also Michelle Katics and Bruce Petersen, 'The effect of rising import competition on market power: A panel data study of U.S. manufacturing,' *Journal of Industrial Economics* (1994) using data for the period 1976–86 from the US manufacturing industry.
    4. Vivek Ghosal, 'Product market competition and the industry price-cost markup fluctuations: Role of energy price and monetary changes,' *International Journal of Industrial Organization* 18:3 (2000) found that increased import competition reduced markups but only in the most concentrated industries.
    5. The above result was also found in Yvonne Prince and Roy Thurik, 'The intertemporal stability of the concentration-margins relationship in Dutch and US manufacturing,' *Review of Industrial Organisation* 9 (1994).
    6. Ian Domowitz, Robert Hubbard, and Bruce Petersen, 'Business cycles and the relationship between concentration and price-cost margins,' *Rand Journal of Economics* 17 (1986), found that import competition reduces margins most significantly in concentrated industries.

15 Hiau Looi Kee and Bernard Hoekman, 'Imports, entry, and competition law as market disciplines,' CEPR Discussion Paper No. 3777 (2003); Keith Hylton and Fei Deng, 'Antitrust around the world: An empirical analysis of the scope of competition laws and their effects' *Antitrust Law Journal*, Boston University School of Law Working Paper No. 06-47 (2007).
16 Michael Sproul, 'Antitrust and prices,' *Journal of Political Economy* 101 (August 1993), 741–54.
17 Alan Moran and Julie Novak, 'The adverse effects of government actions against cartels,' Institute of Public Affairs Occasional Paper (2009).
18 See Andrew Dick, 'Information, enforcement costs and cartel stability: An empirical investigation' (1993) cited in Alan Moran and Julie Novak, as above. A comprehensive survey of cartels by Margaret Levenstein and Valerie Suslow, 'What determines cartel success?' University of Michigan Business School Working Paper No. 02-001 (31 January 2002), http://ssrn.com/abstract=299415, found that though cheating was a common cause of cartel breakdown, far more frequent causes of breakdowns included competitive entry into the market occupied by the cartel, external shocks, and bargaining problems.
19 Andrew Dick, 'When are cartels stable contracts?' *Journal of Law and Economics* 39:1 (1996), 241–83.
20 See Visy News Conference, as above.
21 See for instance Andreas Stephan, 'The bankruptcy wildcard in cartel cases,' Centre for Competition Policy Working Paper No. 06-5 (2006), http://ssrn.com/abstract=912169.
22 Graeme Samuel's speech to the Economics Society of Australia Detection of Cartels, as above.
23 'ACCC to recover penalties from an "insolvent" company for price fixing contraventions,' ACCC Media Release (7 October 2005), www.accc.gov.au/content/index.phtml/itemId/710214/fromItemId/2332.
24 Paolo Buccirossi and Giancarlo Spagnolo, 'Optimal fines in the era of whistleblowers—Should price fixers still go to prison?' Lear Research Paper No. 05-01 (2005), http://ssrn.com/abstract=871726.
25 Wouter Wils, 'Leniency in antitrust enforcement: Theory and practice' *World Competition: Law and Economics Review* 30:1 (March 2007), http://ssrn.com/abstract=939399.
26 Graeme Samuel presentation to 2nd Antitrust Spring Conference, 'Key developments in antitrust regulation in Australia' (28 April 2006), www.accc.gov.au/content/item.phtml?itemId=733030&nodeId=9e480e84a65c748cc9543fa6210157de&fn=Key%20developments%20in%20antitrust%20regulation%20in%20Australia.pdf.
27 See for instance the submissions of the Shopping Centre Council of Australia and Brent Fisse to the Australian Senate Inquiry into the *Trade Practices Amendment (Cartel Conduct and Other Measures) Bill 2008*, www.aph.gov.au/SEnate/committee/economics_ctte/*TPA*_cartels_09/submissions/sub01.pdf and www.aph.gov.au/SEnate/committee/economics_ctte/*TPA*_cartels_09/submissions/sub05.pdf respectively.

THE CENTRE FOR INDEPENDENT STUDIES

Issue Analysis (ISSN:1440 6306) is a regular series published by The Centre for Independent Studies, evaluating public issues and government policies, and offering proposals for reform. Views expressed are those of the authors and do not necessarily reflect the views of the Centre's staff, advisors, directors, or officers. Issue Analysis papers (including back issues) can be purchased from CIS for $5.50 each (plus postage) or can be downloaded free from **www.cis.org.au**.