COOPERATION AND TRUST IN INTER-FIRM RELATIONS: BEYOND COMPETITION POLICY?

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Simon Deakin
ESRC Centre for Business Research
Department of Applied Economics
University of Cambridge
Sidgwick Avenue
Cambridge CB3 9DE

Phone: 01223 335242
Fax: 01223 335768
Email: sfd20@econ.cam.ac.uk

Tom Goodwin
Warwick Manufacturing Group
International Manufacturing Centre
University of Warwick
Coventry
CV4 7AL

Phone: 01203 522962
Fax: 01203 524307
Email: tom.goodwin@warwick.ac.uk

Alan Hughes
ESRC Centre for Business Research
Department of Applied Economics
University of Cambridge
Sidgwick Avenue
Cambridge CB3 9De

Phone: 01223 335248
Fax: 01223 335768
Email: ah13@econ.cam.ac.uk

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Abstract

This paper considers the implications for competition law and policy of evidence that cooperation between firms is an important element in productive innovation and competitive success. The treatment of vertical inter-firm relations in US, British and European Community competition law is analysed. Notwithstanding growing flexibility in the treatment of vertical contracts, competition authorities continue to treat arms-length relations between firms as a first-best option. We argue that without abandoning the necessary mechanisms for dealing with abuse of economic power where its existence is clearly shown, competition policy should more clearly recognise that cooperation between firms is an important mechanism by which both static efficiency and dynamic efficiency may be enhanced.

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Introduction

Competition law is an important source of regulation of inter-firm relations of both a vertical and horizontal kind. This paper considers the implications for competition policy of a growing body of evidence to the effect that cooperation between firms is a necessary feature of productive innovation and competitive success. The focus is on vertical relationships, that is to say, linkages between firms at different points in the supply chain. These include relations between suppliers of component parts and manufacturers and assemblers of final products, on the one hand, and relations between producers and the distributors and retailers of their products, on the other. We also consider the role of horizontal links between competitor firms in the context of the activities of trade associations and the setting of industry-wide standards.

The paper begins by outlining three models of competition policy. The US model, dating from the first antitrust legislation of the 1890s, is largely hostile to formal arrangements between competitor firms and also proscribes certain forms of vertical restraints between firms in the supply chain, such as agreements for resale price maintenance. Under the influence of the Chicago school, economic analysis has come to play a more prominent role in the judicial construction of the legislation and this has prompted a more tolerant attitude towards vertical restraints, notwithstanding a slight re-tightening of controls in recent years. UK law, while containing some elements of an effects-based analysis, still relies excessively heavily on a form-based approach dating from the 1950s and 1960s which is not consistently capable of distinguishing between different contractual arrangements in terms of their welfare effects. EC competition law, by contrast, was established with the paramount goal of internal market integration, with a more marginal role, in comparison with the US, for the aim of enhancing economic efficiency. It also differs from the US approach in relying more heavily on administrative techniques, in particular those of the block exemptions issued by the Commission, to distinguish between the positive and negative economic effects of restraints.
In all three systems, a sharp distinction is drawn between dealings within the firm, which are not subject to competition law controls, and dealings between firms, which are. There is a danger, as a result, that cooperative links *between* firms, which in economic theory are sometimes characterised as ‘neither market nor hierarchy’, are not adequately dealt with. In particular, the efficiency-enhancing properties of long-term and trust based cooperative relations may not be captured using more traditional modes of analysis (Deakin and Wilkinson, 1996).

In many respects, competition policy is now sufficiently flexible to ensure that efficiency-enhancing arrangements are not too easily struck down. At the same time an important counterfactual role still exists for the notion that the first best position is that competitors should be kept at arms length from each other, and this is often coupled with a suspicion that vertical restraints are simply a front for cartelisation or for monopoly power. Our view is that without abandoning the necessary mechanisms for dealing with abuse of economic power where its existence is clearly shown, competition policy should more clearly recognise that cooperation between firms is an important mechanism by which both static and dynamic efficiency is enhanced. Furthermore a range of instruments beyond competition policy also needs to be considered as means of promoting efficiency based on cooperation: these include the legal and/or administrative implementation of production and process standards; support for self-regulating associations of firms; and the targeted use of public procurement.

**Competition Policy: Three Approaches to Organisational ‘Hybrids’**

The category of vertical restraints is a broad one and ranges from agreements over price fixing (minimum and maximum resale price maintenance) to ‘non-price restraints’ involving controls of various kinds, such as agreements for exclusive distribution and exclusive purchasing, territorial restrictions, and ‘tie-ins’ which require the retailer to buy additional products or services from the manufacturer. Certain common ‘hybrid’ arrangements, such as franchising contracts and patent licensing agreements, frequently contain one or more restrictions of this kind. Such relationships pose difficult issues for competition policy since they can contain both efficiency-enhancing
and efficiency-reducing characteristics. In general, an agreement which appears to depart from the competitive counterfactual paradigm of atomistic competition may be an attempt on the part of the organisations concerned to increase efficiency by overcoming market failures of various kinds. Alternatively, a similar agreement could be an attempt to extract rent from agents further down the chain or from consumers, and could be sub-optimal from the point of view of general welfare even if it is privately efficient. These economic arguments, which have increasingly come to dominate legal analysis of vertical restraints in the United States and to a lesser extent in Europe, have however started to do so only comparatively recently.

Antitrust and economics: The United States

The first attempt by a modern legislature to control inter-firm dealings and dominant economic behaviour was the US antitrust legislation of the 1890s, which has since been extended through various amendments and additions. The origins of US antitrust reflect a number of political pressures for the control of large corporations, and for much of the history of this legislation the link with economic efficiency was, at best, a tenuous one (see Hovenkamp, 1993). The Chicago school of law and economics, beginning in the 1950s with the work of Director and Bork, was the first to insist that antitrust interventions could not be supported unless they were shown to be justified on economic efficiency grounds. According to Chicago there was in fact little by way of coherent economic thinking behind the development of legal practice in this field in the US. In particular, Bork (1954; 1993) attacked the treatment of vertical price restraints, which the courts had come to regard as *per se* illegal. Resale price maintenance had been declared illegal under section 1 of the Sherman Act, which invalidates ‘every contract... in restraint of trade or commerce among the several States, or with foreign nations’, in one of the early, formative antitrust cases, *Dr. Miles Medical Co. v. John D. Park & Sons Ltd.* (1911),¹ largely on the grounds that it amounted to an unjustified interference in the property rights of the buyer of goods (here, the retailer) to resell them on its own terms. The Supreme Court also appears to have regarded resale price maintenance as a device for cartellising either or both of the upstream (manufacturing) or downstream (retailing) markets (Hovenkamp, 1993: 217), but this reasoning was not spelled out.² After hinting in *White Motor Co. v. US* (1963)³ that non-price restraints, such as territorial ties,
might be subject to the *rule of reason*, which would enable the courts to balance pro- and anti-competitive effects of a particular restraint, the Court then reaffirmed the rule of *per se* illegality in non-price restraints in *Schwinn* (1967), on grounds which again elevated formal analysis of property rights above considerations of economic welfare: non-price restraints were to be conclusively illegal where the manufacturer parted with property rights in the goods, but could be justified under the rule of reason where the distributor or retailer merely acted as a conduit through which goods passed from the manufacturer to the final consumer.

The essence of the Chicago school’s argument against these rulings was that it could not be in the interests of any single manufacturing firm to raise prices if this led to a decrease in demand for its products and hence in its output; it was more likely that the restraint was imposed for reasons of efficiency (see Bork, 1954; 1993: 291). In particular, it was argued that vertical restraints could enhance consumer welfare by encouraging retailers to invest in advertising and marketing for the product. The imposition of territorial restrictions and minimum resale prices could be seen as designed to eliminate free riding by certain retailers on the promotional efforts of others (Telser, 1960, 1990). A vertical restraint was thought unlikely to be a cover for a manufacturer or retailer cartel, either of which could easily be identified in its own right and dealt with accordingly (Bork, 1993: 292-294). These arguments were largely accepted by the Supreme Court in its ruling in *Sylvania* (1977), which upheld a franchise contract containing a ‘location clause’ restricting the franchisee to operating in a defined geographic area. The Court placed particular stress on the role of intra-brand restrictions in promoting inter-brand competition. *Sylvania* formally overruled *Schwinn* and instituted a rule of reason test for non-price restraints. In *Monsanto* (1984) the Court was invited by the Department of Justice in its submission to abolish the distinction between price and non-price restraints completely, but the Court declined. As a result, *Dr. Miles* still stands, but its scope has been narrowed down. Between 1985 and 1993 only one prosecution was brought by the Department of Justice against vertical price fixing (Gellhorn and Kovacic, 1994: 299).

The main feature of the ‘rule of reason’ in the US system is the broad discretion which it gives to the courts to decide on which factors should
determine the legality of particular arrangements. The need for a broad judicial discretion is said to stem from the broad terms in which section 1 of the Sherman Act (see above) is phrased. In the leading case of *Chicago Board of Trade* the Supreme Court held that the rule of reason test seeks to establish

whether the restraint imposed is such as merely regulates and thereby perhaps promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the Court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect; and its effect, actual or probable.⁹

Under *Sylvania*, non-price restraints have been judged against factors such as the degree of market power of the manufacturer, as measured by its share of the relevant market; the duration of restraints; and the extent to which entry to the market in question is costly or artificially impeded. These factors operate as general standards providing guidance to the courts, rather than as ‘bright-line rules’ around which the parties to contracts can more confidently plan their own arrangements (Areeda, 1992). Given the encouragement to speculative litigation which is provided by the ‘no win, no fee’ system for calculating lawyers’ fees and by the ‘treble damages’ rule, which grants successful private plaintiffs supra-compensatory damages in antitrust suits (see Baumol and Ordover, 1992: 86-88; Bork, 1993: 439), the open-endedness of the rule of reason is a major potential source of uncertainty and extra cost in the system in a whole. To some extent, however, this danger has been mitigated by the supervisory role played by the two federal agencies with responsibilities for antitrust, the Federal Trade Commission and the Department of Justice. The Department of Justice periodically publishes Guidelines which represent its policy with regard to antitrust enforcement. In certain contexts, such as patent licensing, the Department has adopted ‘safety zone’ criteria which are meant to provide firms with a reliable indicator of the boundaries of lawful activity (see Gutterman, 1997). However, although the Department’s Guidelines on given subjects are meant to distill the latest case-law and they can also be seen as providing a good indication of what steps the public authorities are likely to take by way of prosecutions, they do not bind the courts and they do not prevent private litigation.
During the 1980s, widespread acceptance of the Chicago view was reflected in the *Vertical Restraints Guidelines*, issued by the Department of Justice in 1985. The 1985 Guidelines expressed the view that 'vertical restraints that only affect intrabrand competition generally represent little anti-competitive threat and involve some form of economic integration between different levels of production or distribution that tends to create efficiencies'. However the guidelines were never fully accepted by the courts, and they were rescinded by the Department in August 1993 amid criticism that they had unduly elevated theory at the expense of factual analysis. Since then there have been signs that the tide of antitrust law has started to flow strongly in the opposite direction. The Chairman of the Federal Trade Commission has commented that 'we have restored much of the antitrust agenda that was abandoned during the period 1980 through 1988', and during the first half of 1996 the Department of Justice initiated a number of actions against manufacturers allegedly involved in resale price maintenance, exclusive dealing and the imposition of liquidated damages clauses aimed at raising entry barriers (Comanor and Rey, 1996: 11-14).

This shift in attitudes reflects not just the changing political make-up of the federal administration, but also a wider reassessment of the economic arguments underlying the liberalising approach of courts and the agencies alike in the 1980s. In particular, the benign effects attributed to vertical restraints by the Chicago school have been called into question by the use of game-theoretical analysis and principal-agent theory. These approaches make systematic use of asymmetric information and attempt to incorporate a dynamic element into the analysis by modelling agents' decision-making over time. Firms are assumed to behave strategically, in particular by taking into account the behaviour of their rivals in previous rounds of bargaining when determining their next contractual moves. One insight derived from this body of work is that apparently optimal contracts which are designed to align incentives between upstream and downstream firms may have the effect of foreclosing a particular market to new entry. For example, restrictive terms in exclusive dealing contracts, such as liquidated damage clauses which penalise retailers who deal with other producers, can be seen as deterring entry by third parties, which in effect have to pay an 'entry fee' in order to buy out the retailers from their existing
obligations (Aghion and Bolton, 1987; Brodley and Ma, 1992). Asymmetries of information and switching costs are seen as enabling producers to extract rent from retailers through arrangements such as tie-ins (Salop, 1993). An argument to this effect influenced the Supreme Court majority in the Kodak case in 1992, which ruled that complaints of illegal tying should proceed to a jury trial (Kodak had sought summary judgment in its favour). Kodak was accused of illegally tying the sale of replacement parts to the purchase of its photocopying equipment. Kodak argued that the ties were justified as a form of quality control, but the Court rejected this argument for lack of evidence. Kodak further argued that if it was charging excessive prices, it would lose out to competitors offering equipment with a lower lifecycle cost. However, the court held that this was potentially unlikely given the difficulty for purchasers of obtaining the information necessary to make an informed choice and the ‘switching costs’ involved in moving to new suppliers.

According to Bork (1993: 438), the majority approach in Kodak can be applied to all antitrust questions and it is capable of driving rational economic analysis from the law. It is always possible to posit ‘market imperfections’ that may result in markets working contrary to the predictions of economics. Those ‘imperfections’ are typically, as they were in Kodak, both ingenious and imaginary. The result of reintroducing them into the law is lengthy trials on baseless claims and with unpredictable outcomes.

In practice, the extent of any ‘retreat from Chicago’ may well be limited by the difficulty of drawing clear policy conclusions from game-theoretical analyses. The high level of abstraction involved in most modelling of the kind associated with ‘new industrial organisation’ theory is widely seen as making it difficult for the courts to assess and apply this body of work (Shapiro, 1989; Fisher, 1989; Schmalensee, 1990: 140-141; Kleverick, 1993; Gellhorn and Kovacic, 1994: 89-90). At the same time, other developments in economic theory are pulling in the direction of continued liberalisation, although not necessarily for the same reasons as those initially put forward by the Chicago school. Transaction-cost considerations have been deployed by Williamson (1975, 1987, 1996), Joskow (1991) and others to argue for the
efficiency-enhancing qualities of ‘hybrid’ forms. From this point of view, the mixture of controls over the retailer’s freedom to price and market the products, on the one hand, and guarantees of protection from intra-brand competition, on the other, offer a means of promoting information flows, encouraging innovation and protecting joint investments in know-how and other relation-specific assets. Another influential body of work is provided by ‘contestability’ theory (Baumol, Panzer and Willig, 1988). This attacks the apparent antitrust ‘ideal’ of a perfectly competitive, atomistic market structure, by arguing that what matters for a given industry is the level of entry and exit costs and not the degree of concentration. A market is ‘contestable’ where entry and exit costs are close to zero; here, even a firm with a preponderant market share is still subject to the threat of competition from new entrants. Contestability theory therefore implies a greater focus on entry conditions rather than on market share as a test of legality.

The upshot of these developments seems likely to be a renewed emphasis on the rule of reason test, with increasingly sophisticated economic arguments being deployed both for and against restraints of particular kinds. Summing up the literature, Comanor and Rey (1996) suggest that while vertical restraints can be means of facilitating collusion and cartelisation, they can promote both intra-brand competition, by aligning incentives in such a way as to minimise externalities, and inter-brand competition, most notably by increasing returns to investments in know-how and raising profits in such a way as to encourage entry by both new producers and new retailers. However, these positive effects depend on market structure, in the sense that ‘if market structure ensures a vigorous competition among rival vertical structures, vertical restraints are unlikely to harm economic efficiency or affect competition’ (1996: 3). Courts and officials should accordingly look to such factors as the intensity of competition and the likely demand from consumers for promotional and marketing services for particular products. At any rate, there should be no general presumption of per se legality or illegality, nor should it be assumed that different types of restraint should necessarily be treated in the same way, contrary to the Chicago view that price and non-price restraints are generally substitutable. This view, whatever its intrinsic merits, would seem to place particularly heavy demands on the courts in the context of a system, such as the American one, which favours enforcement through private litigation.
Form-based approaches: The UK

Whereas US antitrust has extensively incorporated certain developments in economic theory, competition policy in the UK has avoided becoming a dedicated follower of economic fashion, and has instead been guided by broadly defined conceptions of the public interest (Goodwin, 1996). UK law operates, in effect, a form based approach towards restrictive trade practices, where some kinds of contract are specifically exempted and many potentially anti-competitive practices may not be caught at all. This has allowed competition policy to proceed without specific guidance as to which forms of vertical agreement are acceptable, although from time to time informal guidelines have sought to clarify practice.15 There is very little scope for private litigation, with the principal remedies being concentrated in the hands of administrative agencies and the President of the Board of Trade. There are two separate legislative arrangements within UK competition law regarding vertical contracts. Firstly, all firms must have regard to restrictive practices legislation, in particular the Restrictive Trade Practices Act 1976 and the Resale Prices Act 1976. Secondly, those firms with market power must have regard to monopoly legislation, in particular the Fair Trading Act 1973 and the Competition Act 1980.

The need for competition legislation in the UK was identified in the White Paper on Employment Policy of 1944.16 This concluded that the common law doctrine of restraint of trade had proved ineffective in controlling inter-firm collusion, and that the monopolisation of much of British industry as part of the war effort could only be countered by statutory intervention. This led to the 1948 Monopoly and Restrictive Practices (Inquiry and Control) Act. However, the purpose of the legislation was not to promote competition, but rather to ensure that dominant firms were efficiently organised and run. In this context, vertical contracts could only be considered in so far as they were deemed to be an impediment to efficiency or the operation of employment, regional or technology policies, and hence contrary to the ‘public interest.’ The Board of Trade had the power to refer a monopoly or restrictive practice to the Monopolies and Restrictive Practices Commission only if the firm or ‘complex monopoly’ in question controlled more than one third of specified goods (services were only included later). In determining whether a particular practice operated
against the public interest, the Commission was empowered to take into account 'all matters which appear in the particular circumstances to be relevant'. A non-exhaustive list of such factors included production and distribution efficiency, efficient industrial organisation and freedom of entry, employment and regional policy considerations, and the need for technological innovation; the need to promote or protect competition was not an explicit consideration. In effect, then, the system of control contained no presumption that monopolies were against the 'public interest' as broadly defined. No practices were identified as being undesirable ex ante; each case was to be determined on its merits. Nor was there a presumption that a practice identified by the Monopolies and Restrictive Practices Commission as against the public interest would be remedied by the Secretary of State (now the President of the Board of Trade), although there was a power to do so. These features of the statutory framework for dealing with monopolies remain largely intact.

The investigation of monopolies continued to be governed by the 1948 Act until replaced in 1973 by the Fair Trading Act which established the Office of Fair Trading ('OFT'). Section 2 requires the Director General ('DGFT') to keep commercial activities in the UK under review in order to detect 'monopoly situations' and anti-competitive practices. Where a monopoly appears to the DGFT to exist, the DGFT can refer it to the Monopolies and Mergers Commission (MMC) for investigation. The Act retains the feature that there is no presumption that a monopoly should always be referred, or that any particular monopoly practices are against the public interest. It remains for the MMC to determine the range and nature of the effects it can consider in determining the impact of a monopoly upon the public interest, although it must take into account: the "desirability" of effective competition; promoting consumers', purshasers' and other users' interests with regard to price quality and variety; promoting via competition cost reduction, new techniques, products and entry; a balanced distribution of industry and employment; and competition abroad, among UK suppliers. As we have noted, the legislation prior to 1973 made no reference to competition being desirable per se. In addition, the 1973 Act brought services within the scope of restrictive practices legislation, and reduced the monopoly market-share threshold from 33% to 25%. The Competition Act of 1980 gave the OFT powers to undertake investigations into 'anti-competitive' practices (defined as
courses of conduct by a firm which have or are likely to have the effect of restricting distorting or preventing competition in the production, acquisition or supply of goods), involving neither registrable inter firm agreements nor dominant statutory monopoly positions. Whilst there is no requirement of dominance in a particular market, the OFT asserts that there is, in practice, a relationship between anti-competitive practices and market power. The OFT frequently makes ‘preliminary investigations’ which can lead to it referring a matter to the MMC for further scrutiny; alternatively, the DGFT can accept undertakings from the investigated party.

The restrictive practices part of UK competition law developed out of the Restrictive Trade Practices Act 1956, which took restrictive practices outside the scope of the 1948 Act and subjected them to a more critical system of judicial examination. This Act transferred the principal responsibility for considering restrictive practices to the newly created Restrictive Practices Court (RPC). No criminal offences were created, only a civil remedy exercisable by the Crown. The principal reform involved compulsory registration for a wide range of restrictive practices, with registration to be followed by judicial investigation by the RPC. The Act established a presumption that a registrable agreement was contrary to the public interest unless the parties could convince the RPC that the agreement fell within one of seven categories for exemption (the ‘gateways’). In addition, the parties had to meet the general criterion that the restriction was not unreasonable having regard to the balance between the gateways and the detriment to persons who were not party to the agreement (the ‘tailpiece’). Following the 1956 Act and its subsequent consolidation in the Restrictive Trade Practices Act of 1976 the following broad categories of agreement between two or more parties are statutorily subject to registration on a register maintained by the Director General of Fair Trading (DGFT):

(i) agreements where one or more parties in business in the UK (when acquiring as well as supplying) accept limitations on their freedom of action concerning prices (including prices to be recommended), conditions of sales, customers, quantities or descriptions, and processes of manufacture;
(ii) agreements providing for the furnishing of information about prices or terms and conditions of supply except to ‘specified authorities’ (such as government departments).

It is important to note that registrability depends on the form of restriction contained in an agreement and not on whether the effect of the agreement is anti-competitive.

Each restrictive agreement is subject to judicial examination in the Restrictive Practices Court unless under section 21(2) of the Act the DGFT represents to the Secretary of State that its effect on competition is insignificant and the Secretary of State gives a direction to the DGFT relieving him of his duty to refer the agreement to the Court. It does, however, remain on the public register.

A review of restrictive trade practices policy in the UK (Liesner Committee, 1979) concluded that the legislation was too inflexible and argued that it was possible that desirable agreements which had significant or insignificant competitive effects might be deterred by it. It was also argued that it failed to deal with significant anti-competitive behaviour which did not take the form of a registrable agreement, especially single-firm practices by concerns not falling within the statutory criteria necessary to permit investigation under monopoly legislation. This latter argument produced a recommendation for specific legislation to deal with such anti-competitive practices. This was subsequently embodied in the Competition Act 1980. The review also suggested inter alia:

(i) a two part registration procedure giving the DGFT greater discretion not to proceed in insignificant cases;

(ii) power to be given to the DGFT to approve cases without taking them to the Court for adjudication;

(iii) exemption from the legislation for trade association - recommended codes of practice which were sponsored by the OFT;
(iv) amendments to the act to permit trade-associated recommendations to be individually treated as separate agreements (so as to avoid referring a whole agreement instead to the offending part).

None of these recommendations was embodied in the 1980 Competition Act legislation and reform of the RTP legislation has yet to proceed.

The emphasis on technical form therefore remains, although the RPC has been virtually inactive since its decision in the collective reciprocal exclusive dealing ABTA case in 1985.19 Even during its most active years, from 1957 to 1968, the Court was largely involved with horizontal agreements, although some vertical contracts were also caught by the legislation.

Resale price maintenance has been all but outlawed in a series of steps which began in the 1950s with a series of reports of the Monopolies Commission, most of which concluded that collective enforcement of resale price maintenance was against the public interest. Collective enforcement was then formally prohibited by the RTPA 1956, and individual enforcement was severely restricted by the Resale Prices Act 1964 (now largely consolidated in the Resale Prices Act 1976). An exemption from prohibition can only be obtained from the RPC, and the Court has allowed just two exemptions, relating to books and to pharmaceuticals, of which only the latter remains relevant following the demise of the Net Book Agreement in 1995. The Net Book Agreement was an agreement between publishers to require retailers to resell books at a minimum, ‘net’ price set by the publishers. It was first considered by the Court in 1962 under the RTPA 1956, when it upheld the view of the Publishers’ Association that the consequences of the removal of the main restrictions would include fewer and less well-equipped stockholding bookshops, more expensive books, and fewer books being published.20 In 1968 the Agreement was granted exemption under the Resale Prices Act. In 1989 the DGFT undertook an investigation but decided not to refer the Agreement back to the Court; however, when expected government legislation on the subject failed to emerge, in 1994 the DGFT announced his intention to apply to the Court to have its earlier judgments reversed. Shortly afterwards the Agreement collapsed under the pressure of a series of defections. In March 1997 the RPC
formally ruled that the restrictions contained in the Agreement were contrary to the public interest.

The near-complete prohibition of resale price maintenance may be contrasted with the leniency with which most non-price restraints are treated. The restrictive practices legislation only covers vertical agreements in which both sides accept restraints. In addition, bilateral exclusive dealing contracts are specifically exempted. Various other exemptions have the effect of ruling out consideration of most territorial ties and certain kinds of exclusive purchasing and distribution agreements (Goodwin, 1996). Under the monopoly legislation, larger firms may be caught, and where vertical restraints have been considered they have often ended up being either prohibited or strictly controlled. However, economic welfare has been less of a guiding light than generalised statements of the ‘public interest’. It is largely in this vein that the MMC has considered selective distribution,\textsuperscript{21} patent licensing\textsuperscript{22} and tie-ins.\textsuperscript{23} The most detailed analysis has been in the context of exclusive purchasing arrangements in petrol and beer. Even here the focus has tended to be on market structure and industry practices, with the parties invited to offer a defence of those practices.

The supply of petrol has been the subject of three reports.\textsuperscript{24} In 1965 the Monopolies Commission looked at ‘solus agreements’, the long-term exclusive purchasing agreements between the petrol companies and retailers, and concluded that the element of exclusivity improved quality of service and did not restrict the motorist’s choice of petrol. However, there were doubts concerning the length of the contracts and about the number of outlets owned by the petrol companies and leased out to retailers. The petrol companies gave undertakings not to increase the number of retail sites which they owned beyond 15% of the market. However, in 1968 these undertakings were allowed to lapse in order to enable the petrol companies to increase UK refinery capacity. By 1977, outlets owned by the petrol companies had increased to over 50% of the market, but the MMC was able to report two years later that the existing arrangements were not contrary to the public interest, largely because of changes in the structure of the industry which had seen a growth in the numbers of independent outlets with significant negotiating strength, such as supermarket outlets. In 1990 a further reference was made. The MMC
recommended a five year limit on solus ties but again concluded that the level of wholesaler ownership (now 53% of the market) did not operate against the public interest.

In the case of beer, the 1969 and 1989 Reports of the MMC\textsuperscript{25} were much more interventionist. In 1969 the Commission found that the long-term supply arrangements and legal difficulties associated with establishing new outlets constituted significant barriers to entry and to the adoption of more efficient distribution procedures, but that the existing system should not be broken up because this would lead to a loss of management skills and would disrupt the property market. In 1989, however, the Commission reiterated that ‘competition is structured by producers rather than being driven by consumers’;\textsuperscript{26} and recommended, among other things, a ceiling on the number of on-licensed premises which a brewer could own and a requirement for the provision of ‘guest beers’ in order to widen choice. In the event the Secretary of State only implemented a part of these recommendations. The impact of the resulting Beer Orders is still working through the market; however, in 1993 a Report of the House of Commons Agriculture Committee\textsuperscript{27} concluded that regional concentration of licenses had increased as a result of the compulsory sell-offs; increased consumer choice through the provision of guest beers had been offset by the closure of some rural outlets; and that while wholesale prices had declined, retail prices had gone up by 13% after inflation. The cost of implementing the changes had been £500 million.

**Competition and market integration: the EC**

The position of vertical contracts under EC law has been overshadowed by the constitutional commitment of the EC Treaty\textsuperscript{28} to the integration of the common market. The Commission and the Court have taken the view that vertical agreements can have the effect of dividing up the common market and hence should remain under review by competition law. This policy has been pursued to the extent of marginalising arguments based more generally on economic welfare, giving rise to suggestions that undue costs have been imposed on European businesses both by the prohibition of certain efficiency-enhancing agreements and by the expense involved in clarifying the law (Korah, 1986).
Article 3(f) of the Treaty of Rome stated that one of the activities of the Community in achieving its fundamental tasks would be ‘the institution of a system ensuring that competition in the common market is not distorted’. The rules governing how this activity was to be conducted were set out in Articles 85 and 86 of the Treaty. Article 85 prohibits as incompatible with the common market all agreements between undertakings which ‘may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition’. Particular prohibitions are concerned with agreements to fix prices; limit or control production or markets; share markets or sources of supply; discriminate in the terms of trade offered to parties ‘thereby placing them at a competitive disadvantage’; and make the conclusion of contracts subject to ‘supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.’ Vertical contracts have mostly been considered under Article 85, although they may be considered under Article 86 if they constitute an abuse of a dominant position, or under the Merger Regulation 4064/89 if they constitute a merger or concentrative joint venture.

Agreements prohibited under Article 85(1) are automatically rendered void by Article 85(2). However, Article 85(1) may be disapplied on the grounds that the agreement ‘contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and does not ‘impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives’ or ‘afford... the possibility of eliminating competition in respect of a substantial part of the products in question.’ Unlike in US antitrust law then, vertical restraints can be exempted administratively from the general prohibition if they are deemed essential for the achievement of significant benefits. This exemption may take place administratively, through the European Commission. The principal responsibility for enforcing competition policy lies with the Commission, which under Regulation 17/62 has powers to investigate and exempt agreements and to levy fines. Articles 85 and 86 are directly effective in national law and may, depending under certain circumstances give rise to litigation in national courts, but the role of private litigation is, as yet, very limited.
Arrangements may be exempted individually by the Commission on request, or they may be exempted if they fall within the provisions of a ‘group’ or ‘block exemption’. Block exemptions set out in detail, for different kinds of agreement, the types of clauses which are deemed to be acceptable and those which are not. Block exemptions are drawn up when the Commission has gained significant experience in dealing with a particular kind of agreement, and are meant to follow previous practice as well as the case-law of the Court interpreting the Treaty. In the light of these factors, the Commission sets out those clauses which generally do not significantly distort competition in a ‘white list’, and those which do in a ‘black list’. Firms which are wholly within a block exemption are, in effect, automatically exempt from the general prohibition. It is theoretically possible for the European Court to strike down a block exemption, like any other regulation, on the grounds of its incompatibility with the Treaty (in particular, in this context, with Article 85 or Article 86). In practice, such a course of action is much less likely than a ruling of a US federal court which departs from the Guidelines issued by the Department of Justice. It is also possible for the Court to overturn an individual exemption. In the context of vertical contracts, however, it is the Commission which has given a broad interpretation to Article 85 and the Court which has on occasion ruled that the Commission has acted too widely in prohibiting certain transactions.\(^{32}\) The Commission has the power, under the various block exemptions, to lift the exemption from certain individual agreements.\(^ {33}\)

Within this framework, vertical contracts have been the subject of distinct treatment. Economic arguments in favour of restraints have not gone unheeded, but they have consistently run up against the prohibition on measures which might have the effect of partitioning markets on national lines. In *Consten and Grundig*, the ruling which first established that vertical agreements could fall under Article 85, the Court rejected arguments that the pro-competitive effects of an agreement should take it outside the scope of the Article. *Consten and Grundig* concerned an exclusive distribution agreement, under which Grundig granted Consten exclusive rights to market certain Grundig products in France, and to take legal action against any other distributor selling those products in France. The Court concluded that

since the agreement thus aims at insulating the French market for Grundig products and maintaining artificially, for products of a
very well known brand, separate national markets within the Community, is is therefore such as to distort competition in the Common Market... no further consideration, whether of economic data... or of the correction of the criteria upon which the Commission relied in its comparison of the situations of the French and German markets... can in any way lead to a different solution under Article 85(1).\(^{34}\)

Shortly after, in 1967, the Commission produced its first block exemption on distribution agreements. There are now several block exemptions covering vertical restraints: these include regulations on exclusive distribution (1983/83), exclusive purchasing (1984/83), technology licensing (240/96, replacing regulation 2349/84) and franchising agreements (4087/88). In addition, certain types of contract, such as car distribution agreements, are the subject of individual regulations (123/85). Only resale price maintenance, of the principal types of vertical restraint, is completely prohibited.

The language used in the block exemptions often represents an uneasy compromise between recognition of the economic benefits which flow from vertical restraints, and the goal of prohibiting limits on trade flows between states. For example, the exclusive distribution block exemption notes the following virtues of exclusive distribution agreements:

exclusive distribution agreements facilitate the promotion of sales of a product and lead to intensive marketing and to continuity of supplies while at the same time rationalising distribution; they stimulate competition between the products of different manufacturers; the appointment of an exclusive distributor who will take over sales promotion, customer services and carrying of stocks is often the most effective way, and sometimes the only way, for the manufacturer to enter a market and compete with other manufacturers already present.\(^{35}\)

On the other hand, the following disbenefits are noted:

consumers will be assured of a fair share of the benefits resulting from exclusive distribution only if parallel imports remain possible; goods which the user can obtain only from the exclusive
distributor should therefore be excluded from the exemption; [if] competition at the distribution stage is ensured by the possibility of parallel imports, the exclusive distribution agreements covered by this Regulation will not normally afford any possibility of eliminating competition in respect of a substantial part of the products in question.\textsuperscript{36}

This tension is reflected in the structure of the block exemptions and in particular in the distinction which some of them draw between ‘active’ competition by the downstream firm with its upstream supplier, which on the whole may be legitimately controlled, and ‘passive’ competition in the sense of responding to unsolicited requests for sales from third parties, which may not be controlled to the same extent (Goodwin, 1996).

The Court has held that certain features of vertical contracts may fall outside Article 85(1) altogether, but it seems that these do not form the basis for a US-style rule of reason which would be administered by the courts (Whish and Sufrin, 1987; Whish, 1993: 209; although cf. Korah, 1986). In \textit{Remia}\textsuperscript{37} restrictive covenants imposed on the owner of a business were held to fall outside Article 85(1) where were they deemed necessary for the effective transfer of ownership. In \textit{Pronuptia}\textsuperscript{38} clauses protecting the intellectual property and common identity of the franchisor fell outside Article 85(1). These cases can be understood as similar to restraints which fall under the US doctrine of ancillarity, that is, restraints which are ancillary to the main purpose of an otherwise lawful agreement and which are commercially necessary for the carrying out of that agreement. A more difficult category consists of cases where protection is deemed to be objectively necessary in order for the contract to be made at all. In the leading patent-licensing case of \textit{Nungesser},\textsuperscript{39} the Court held that an ‘open’ exclusive license could fall outside Article 85 if the technology was new and if, without protection from competition from the licensor and other licensees, the licensee would not have risked making the investments in question.\textsuperscript{40} If this principle exhibits logic similar to the rule of reason, it is nevertheless confined to a relatively narrow set of cases. If the rule of reason were not confined in this way, the system of block exemptions might not be viewed as the source of salvation to quite the same extent as at present.
The adoption of the Treaty of European Union made a number of changes which could affect the treatment of vertical restraints and of inter-firm relations more generally. Article 3(g) of the EC Treaty, replacing the old Article 3(f), now speaks of the activities of the Community as including ‘a system ensuring that competition in the community is not distorted.’ Formerly, the emphasis was on ‘the institution’ of such a system. The change may imply a recognition that as the process of integration is completed, less concern need be expressed about the partitioning of markets, although how this may be reflected in competition policy is not yet clear. More radically, Article 3(l) now refers to the goal of ‘the strengthening of competitiveness of Community industry’, and under Article 130 a number of conditions ‘necessary for the competitiveness of the Community’s industry’ are laid out, including ‘an environment favourable to cooperation between undertakings’. This opens up the possibility of a competition policy openly re-orientated towards the broad goal of competitiveness. To see what this might look like, however, we must first examine whether the concept of ‘competitiveness’ can be operationalised sufficiently for it to bear the weight which such a change of direction would imply, and how cooperation may be related to it. In doing so we present a range of arguments for maintaining a sufficiently flexible effects-based approach to vertical restrictions to permit efficiency improving co-operative and collaborative activities.

Cooperation, Innovation and Competitiveness

Defining competitiveness

Much of the debate regarding ‘competitiveness’ has been vague about the precise meaning of this term. One common element in the various definitions, however, is that competitiveness means survival or success in the process of competitive rivalry. This implies a dynamic or inter-temporal perspective stressing competition as a process, and the role of innovation in production and supply chains, which may be contrasted with static models of allocative and productive efficiency in which firms seek profit maximisation via price competition and cost minimisation with known technologies (Schumpeter, 1942: 84; Hughes 1978, 1989; Baumol and Ordover, 1992; Deakin and Wilkinson, 1996; Cosh and Hughes, 1996).
At the level of the firm a number of definitions of competitiveness have been offered. All share the idea that a competitive firm is one which has the ability and potential to produce competitive products and gain market share at the expense of rivals. The UK Department of Trade and Industry White Paper on Competitiveness of 1984 proposes that:

for a firm, competitiveness is the ability to produce the right goods and services of the right quality, at the right price, at the right time. It means meeting customers’ needs more efficiently and more effectively than other firms (DTI, 1984: 9).

Another typical example is that of the European Management Forum which defines competitiveness as ‘the immediate and future ability of, and opportunities for, entrepreneurs to design, produce and market goods worldwide whose price and non-price qualities form a more attractive package than those of foreign and domestic competitors’ (EMF, 1984).

Definitions of competitiveness at the level of the state (or in our context of EU, UK, or US industry as a whole) tend to focus on the trade balance or world market share, a state becoming more competitive if its trade balance is improving or its share of the world market is increasing. For example, the 1984 White Paper, citing the OECD, suggests that the competitiveness of a state is:

the degree to which it can, under free and fair market conditions, produce goods and services which meet the test of international markets, while simultaneously maintaining and expanding the real incomes of its people over the long term.

Alternatively, Scott and Lodge (1985) suggest that ‘national competitiveness refers to a country’s ability to create, produce, distribute and/or service products in international trade while earning rising returns on its resources’. Increasing import penetration is therefore seen as measure of poor competitiveness (European Commission, 1994: 72). While increasing import penetration may be due to a number of factors, for example overvaluation of domestic currency, a linkage between the competitiveness of firms, industries and the state is nonetheless asserted.
There is however some debate as to whether it is meaningful to talk about competitiveness at the level of the state, and whether the term means anything more than productivity. Thus Krugman argues that as an empirical matter it is simply not the case that ‘the world’s leading nations are to any important degree in economic competition with each other, or that any of their major economic problems can be attributed to failures to compete on world markets’ (1994:30). In his view ‘competitiveness is a meaningless word when applied to national economies’ (1994:44). Countries, he argues, unlike firms, do not have well defined bottom lines and the trade balance in particular is a misleading bottom line for a state given the implications of surpluses or deficits on capital account. Combining the trade balance with another factor such as sustained growth in living standards has more bite but Krugman argues that in practice declining exchange rates can balance the books without a significant impact on living standards. In a closed economy growth in the long run depends as a matter of logic on productivity growth, and in his view it does so in actual open economies as a matter of empirical fact. Thus he argues that international trade competition has not impeded long run growth in living standards, and that international rivalry is not a zero-sum game. On the contrary, rising productivity abroad is beneficial in that it raises incomes and the demand for goods abroad, and cheapens imports. Low domestic productivity growth leads to a low growth of domestic living standards, but it is largely irrelevant whether that growth is higher or lower than that abroad.

This argument of course ignores lost output from restraining the growth of demand and employment to maintain the trade position, because it is implicitly or explicitly argued that ultimately everything adjusts through the price mechanism. Moreover, it is assumed that there is no structural impediment to adjustment. There is an implicit reliance on comparative advantage theory and on the assumption that there is always some tradeable good or service, which may be sold at some exchange rate which will pay for whatever imports are demanded given domestic levels and patterns of expenditure. This is demonstrably not so for some economies over reasonable policy horizons (see Cosh, Hughes and Rowthorn 1994).

Nevertheless, the central point remains that slow growth in living standards in the long run reflects low domestic productivity growth;
relabelling productivity as ‘competitiveness’ adds very little to the analysis. This view is shared by the leading analyst of competitive advantage: ‘[t]he only meaningful concept of competitiveness at the national level is national productivity’ (Porter, 1990: 6).

What has to be understood, then, are the determinants of productivity and the rate of productivity growth, and we may suggest that this is best explored not at the level of the economy as a whole but at the level of specific industries or industry segments: ‘[i]t is the outcome of the thousands of struggles for competitive advantage against foreign rivals in particular segments and industries in which products and processes are created and improved, that underpins the process of upgrading national productivity’ (Porter, 1990: 9).

Competition policy is then best seen as one of the factors which can enhance or detract from the process of upgrading the productivity or competitiveness of industries in a nation state (Areeda, 1992). The adoption of the language of competitiveness by the EC leads us to the question of precisely how competition policy can effectively regulate the interplay between cooperation and arms length rivalry in these struggles so that the process of upgrading national productivity is enhanced.

Innovation, product diversity and cooperation

A central issue for competition policy and for related areas of state action in the regulation of vertical arrangements is the degree of encouragement which it is appropriate to give to cooperative activity between firms. Such cooperative activity is an important factor in the creation of what may be termed ‘social capital’, the extent to which businesses build up relationships and institutional forms which speed up information flows, disseminate best practice, both horizontally, and vertically through supply chain connections, and generally encourage the development and exchange of ideas. There is, of course, evidence to suggest that competitive rivalry is conducive to innovative and productive activity by firms (Porter, 1990). There is equally persuasive evidence, however, that the embedding of such rivalry in productive systems with strong intermediate organisations such as trade associations and supplier organisations, and strong networks and clusters of personal and corporate interactions is also conducive to
competitive advantage (Porter, 1990, in particular chapter 4; Sako, 1992; Putnam 1993; Aston and Williams, 1996; Deakin and Wilkinson, 1996). In the context of the present discussion of competition policy we will focus on inter-firm cooperation, although this is not meant to imply that cooperation in labour-management relations is not equally important within the productive process. We discuss by way of illustration a number of ways in which vertical co-operative relations can enhance productive performance.

Product variety and just in time production

For a very straightforward product, there may be many variants which can be produced according to buyer specification. For more complicated products the number of variants quickly becomes very large indeed. Whilst some variants are more popular than others, firms which attempt to improve competitiveness by offering product diversity need to able to produce small numbers of any given variant. This gives rise to a number of problems. Firstly, production must be flexible so that one production line can produce the number of variants required. This can be addressed over time by appropriate investment in capital equipment and training, ensuring that all economies of scope are exploited.

The second problem is that there is a tension between the need to keep stocks of parts and finished goods as low as possible, and the need to minimise delivery times. Stock and work in progress represent valuable working capital which must be financed, but customers want immediate delivery, particularly if the product is an input to another production process. This problem is to a certain extent faced by all firms but is particularly acute for firms which produce a large number of product variants. For a standardised product the firm can estimate demand and set a production target to match. The rate of production can be adjusted if the estimate is incorrect or needs to be revised. If the level of demand is stable then the rate of production can exactly match it, each unit being sold as it completes the production process. However, with a large number of product variants the estimate for any given variant becomes increasingly imprecise. Furthermore, the costs of having partially completed units, ready to be finished to any particular specification, also becomes greater the larger the number of variants. Thus as the number of variants grows, the product becomes
increasingly competitive in that it is more likely to be ‘the right product’. However, it becomes progressively harder for manufacturers to have partially completed products to be finished to order, hence lead times grow, and it becomes increasingly difficult to deliver ‘at the right time’.

The response to this problem, developed by Toyota in Japan for the car industry where the number of product variants reaches over 100,000 (Asanuma, 1994), has been just in time production. This system is not appropriate for all firms or products, but it has proved itself extremely successful in improving competitiveness in circumstances described above by limiting stock levels and reducing lead times. These methods, however, require a long-term relationship between manufacturers and suppliers which is far from the type of atomistic relations generally assumed in much of economic and legal theory concerning competition. These theories presume that parties have freedom to conclude any bargain they wish, agree that bargain at an identifiable instant in time, and that exchange then takes place on the basis of that agreement. Just in time relationships, although perhaps atypical in some respects, are an instructive example of the sense in which productive success can depend on the capacity of the parties to develop a trading relationship which develops over time.

Co-operation and innovation

Innovation is not typically a linear progression, starting in research and leading to development, design, manufacture, marketing, retail and after-sales service with information flow between the stages one-way towards the market. This vision is not appropriate for evolutionary changes or perhaps for the application of existing ideas in new ways. For these, a simultaneous model better captures the information flows (Jorde and Teece, 1992). While information does flow towards the consumer, information also flows back from the consumer, preferences being fed back up the production chain; information exchange between firms at different points in the supply chain is also an essential part of the process. Aside from establishing formal cooperative joint ventures, informal feedback between stages of the vertical production chain aids the successful commercial exploitation of new ideas.
The more cooperative the links between stages in the chain, the more responsive the productive system to consumer tastes:

R&D personnel must be closely connected to the manufacturing and marketing personnel and to external sources of supply of new technologies and complementary technologies so that supplier, manufacturer, and customer reactions can be fed back into the design process rapidly. In this way new technology, whether internal or external, becomes embedded into designs that meet customer needs quickly and efficiently (Jorde and Teece, 1992: 49).

There is increasing evidence that various forms of cooperation are a significant factor in enhancing the productive performance of both large and small firms. Thus recent work for the UK suggests that amongst small and medium sized firms (SMEs) the propensity to innovate is positively related to involvement in collaborative and partnership arrangements with other firms, and with higher educational establishments. Cooperation aimed at expanding their range of expertise and products, and gaining access to overseas markets ranked highest amongst the reasons given for collaborating SMEs with as many as 44% of the surveyed firms reporting vertical collaborative links with suppliers and customers, and around a third being involved in collaborative R&D (Kitson and Wilkinson, 1996).

While innovation is a key aspect of competitiveness for firms, incentives to innovate are well known to be impaired. The prospect of competitors free-riding on technological investment provides the rationale for intellectual property law (Gutterman, 1997). However, the possibility of substantial rent dissipation remains and may lead to suboptimal incentives to innovate (Levin, 1987). Jorde and Teece (1992) argue that cooperation can improve these incentives. First, they note that the exploitation of innovations requires complementary assets, such as complementary technologies, manufacturing, marketing, distribution, sales and service. Some of the assets, often in the form of know-how or tacit knowledge, will be specific to the innovation, and it is these that competitors will find hard to copy. Thus incentives to innovate depend on the extent to which firms can exclude competitors not only from intellectual property, but also from the complementary assets involved in production. If firms have exclusive or principal use
of the manufacturing, distribution, or after-sales service processes then this will buttress their intellectual property rights. In this way, elements of exclusivity of the kind associated with vertical restraints may enhance dynamic efficiency.

Standards, trust, and competitive intensity

A growing number of studies stress the role of collective institutions and standards in supporting cooperative activity at the inter-firm level, including innovation; these include industry-level trade associations, standard-setting bodies such as the British Standards Institutions and the Deutsche Institut für Normung, and the legal system (Swan, Temple and Shurmer, 1995; Lane and Bachmann, 1996, 1997; Hawkins, Mansell and Skea, 1996; Lane, 1997; Deakin, Lane and Wilkinson, 1997). Standards perform a number of important functions of market regulation, including the dissemination of technical information and information concerning best practice in such a way as to overcome market failures concerning quality (Swan et al., 1995) and the building of product reputation through the control of externalities which might arise from risks to consumers, employees and the environment (Lane, 1997). Trade associations play an important role in formulating commonly agreed standards at industry level, and the norms they establish can feed into the processes which operate at the level of national standard-setting bodies and of the legal systems of nation states and of inter-state bodies such as the EC. At the same time, the effectiveness of trade associations and of standard-setting bodies differs considerably between countries (Deakin, Lane and Wilkinson, 1997). One aspect of this is the attitude of the state, and in particular of competition law, to collective action by firms.

For most of its history, US antitrust has, as we have seen, been hostile to horizontal linkages between firms, and in particular to associational links between competitors in the same industry. Open-price associations - associations of firms whose aims included standard-setting, exchange of information about prices and costs and, in some cases, resale price fixing - received some support from the courts and the Federal Trade Commission in the immediate post-war years; however, they were weakened by the courts’ insistence that these activities amounted to illegitimate attempts to restrict competition and raise prices (Berk, 1995). Statutory support was then provided to
industry associations under the National Industrial Recovery Act 1934, which was part of the New Deal legislation, but this was later repealed. On the whole, the courts have tended to regard associational activities as *per se* violations of section 1 of the Sherman Act (see Bork, 1993: 338-344); as a result, it has not been possible, in most cases, to put arguments in favour of their efficiency-enhancing effects. As Bork (1993: 341) has commented, the courts’ position in these decisions amounted to ‘objecting to superiority gained through economic cooperation’.

In the UK, the first targets of competition law following the 1944 White Paper were the trade associations. Trade associations were involved in nine out of the first ten Monopolies Commission reports. The Commission tended to see trade associations as mechanisms for facilitating horizontal and vertical anti-competitive agreements primarily regarding price and certain other matters. The Commission’s recommendations, while having the primary effect of ending particular restrictive practices, had the secondary effect of reducing the effectiveness of many of the associations in those industries. Arguments for the pro-efficiency properties of collective action were put, but in this context at least were consistently rejected (Goodwin, 1996). The general prohibition of collective resale price maintenance in the RTPA 1956 confirmed this pattern. The weakening and, in some cases, complete disappearance of trade associations following the outlawing of resale price maintenance illustrates the weakness of the majority of the British trade associations and the relatively narrow range of functions which they performed, in particular by comparison to their German counterparts. At the time competition policy began to bite, many of the British associations had few functions other than price fixing (see Mercer, 1995: 28-34). Many of those that survived and extended their activities to standard setting and product promotion only did so with the support of the then nationalised industries, and have been substantially weakened through the withdrawal of this form of support following privatisation (Lane and Bachmann, 1995; on the position of trade associations under Articles 85 and 86 of the EC Treaty, see Watson and Williams, 1988).

Joint ventures are another form of horizontal cooperation which have come under the spotlight of competition policy, although recently there have been signs of attempts to distinguish more precisely between
predatory and efficiency-enhancing agreements. In Sealy\textsuperscript{41} the US Supreme Court struck down an agreement between manufacturers to share a trademark and engage in joint marketing and advertising on the basis of agreements to fix prices and divide up territories for sales, while in Topco\textsuperscript{42} it invalidated exclusive territorial agreements made by an association of supermarket firms engaged in joint purchasing. However, following the broad acceptance of the Chicago analysis in the Sylvania case in relation to vertical contracts, the per se rule has come under attack in the context of horizontal agreements too.\textsuperscript{43} The Antitrust Enforcement Guidelines for International Operations issued by the Department of Justice in 1991 attempted to draw a distinction between ‘naked restraints’ which are ‘not plausibly related to some form of economic integration... of the parties’ operations that may generate procompetitive efficiencies’, and other horizontal agreements, with the latter subjected to a rule of reason test based around the existence of market power. A further important development was the passage of the federal National Cooperative Research Act 1984. This applies a rule of reason test to joint research and development agreements between firms for the marketing of intellectual property, and provides for a registration system under which registered firms are protected against the normal liability for treble damages and the winning side’s legal costs. However, the Act was limited, in that it

unwisely precludes joint manufacturing and production of innovative products and processes, which are often necessary to provide the cooperating ventures with significant feedback information to aid in further innovation and product development, and to make the joint venture profitable. Unfortunately, the NCRA seems to have adopted - at least implicitly - a ‘serial’ view of the innovation process. (Jorde and Teece, 1992: 57).

In response to this kind of criticism, the US Congress enacted the National Cooperative Research and Production Act in 1993. This extended protection to cover joint product development and production, product testing, the joint collection, exchange and analysis of research or production information, and the setting up of joint production facilities.

The EC block exemption dealing with research and development agreements (Regulation 418/85) excludes from the scope of Article 85(1) agreements for joint research and development, a category which
includes agreements for the exploitation of the results of research and agreements for the joint development of products and processes. The protection is thereby extended to the manufacturing phase. The protection does not apply in a case where the parties are competing manufacturers with a joint share of 20% of the relevant market.

These provisions illustrate the degree to which competition law has come to reflect differing models of the competitive order. On the one hand, scope has been created for cooperative agreements aimed at enhancing product quality and innovation, under the scrutiny of the competition authorities. These arrangements can be seen as providing the necessary stability within which inter-organisational trust can develop. Cooperation of the kind required to foster competitiveness in the sense described above involves more than just repeat trading, but requires firms to engage in a number of non-market exchanges within the framework of a specialised governance structure. Both the contract itself and the wider institutional framework are required to support cooperative behaviour designed to maximise the parties’ joint gains from trade by restraining opportunism (in the sense of short-term self-interest). But at the same time, these exemptions do little to alter the broad orientation of systems of competition law which continue to privilege models of industry structure based on atomistic competition. The continuing assumption is many areas is that commercial transactions should occur at ‘arms length’ in the form of spot trades, and that longer term relationships should take the form, at best, of repeat purchases.

As we have already indicated, Porter (1990), while stressing the importance of dynamic efficiency and inter-firm cooperation within the process of innovation, also identifies the ‘competitive intensity’ of an industry or country as an essential ingredient of competitive advantage. This theme was taken up in the McKinsey Reports to the European Commission of 1992 and 1993, and has formed the basis for arguments put by the European employers’ association UNICE in favour of greater deregulation as part of the internal market programme:

one of the strongest drivers of innovation and improvements in operating efficiency across the economy is the level of competitive intensity. Fierce competition between companies is the major spur through which management takes the key decisions on the development of new products, the entry into new
markets, and the productive use of resources. If competitive intensity is diluted then companies lack the incentive to take difficult and risky decisions (UNICE, 1995: 14).

According to this point of view, there is ‘a compelling case for governments to encourage inter-firm rivalry’ (UNICE, 1995: 15). If this means the promotion of inter-firm competition for its own sake, it has the potential to undermine arrangements, both public and private, which sustain ‘social capital’ and cooperative forms of behaviour conducive to productivity growth through risk sharing and information pooling between firms. It is particularly important, from this point of view, to preserve a space for regulatory standards and for associational action by firms, and not to allow or encourage them to be undermined by intensive competition. Whatever its stimulating effect on incumbents might be, entry in the form of ‘intense competition’, in the sense of competition based on the evasion of collective standards, will often be sub-optimal, in the sense of giving rise to market failures which inhibit innovation and risk-taking. This is not to say that arrangements which regulate competition should completely escape the scrutiny of competition authorities; but, at the very least they should not be subjected to per se illegality. On the contrary they should, wherever possible, be protected by clear guidelines of the kind provided by the antitrust ‘safety zones’ in the US or by the EC’s technique of block exemptions.

Conclusion

Competition law needs to be more sensitive to the possibility that apparently ‘collusive’ arrangements promote trust of the kind needed to enhance dynamic efficiency. But the question must be whether this is enough. We would suggest that competition policy, broadly conceived, can also play a more active role in promoting cooperation and hence competitiveness. Regulation of procurement processes, which is now a major area of law at domestic and EU level, should be orientated more clearly towards the achievement of quality goals, and not simply focused on promoting competition through market entry and the periodic renewal of contracts. More generally, the role of trade associations deserves to be reconsidered. Far from seeking to undermine these expressions of collective voice, the state should accept the legitimacy of such organisations and, while being alert to anti-
competitive practices, be prepared to grant its support to their activities in promoting trade and development.

If competition law is to play its proper role careful consideration must be given not just to the efficiency properties of ‘hybrid’ forms, but to the different institutional modes of economic governance which support them. The policy issues involved cannot be resolved into a straightforward conflict between regulation and deregulation. It may be instructive, here as elsewhere, for policy-makers to reflect on Coase’s comment (1988: 9), that ‘for anything approaching perfect competition to exist, an intricate system of rules and regulations would normally be needed’.
Notes

1. 220 US 373.

2. Subsequently, a number of states passed ‘fair trade statutes’ permitting resale price maintenance under limited circumstances, and Congress then granted exemption at federal level from the Sherman Act for agreements which followed the terms of these state laws. However, the state laws were an unsatisfactory form of protection since they varied considerably in scope (Bork, 1993: 281), and the federal exemptions contained in the Miller-Tydings Act and the McGuire Act were repealed by Congress in the 1970s.


7. Maximum resale price maintenance is also per se illegal (Albrecht v. Herald Co., 390 US 145 (1968)), although a private plaintiff will not receive substantial damages unless it can show that it was injured by ‘predatorily low’ prices: Atlantic Richfield Co. v. USA Petroleum Co., 495 US 328 (1990).

8. One way round Dr. Miles has been for producers to arrange distribution through agents, retaining title in the goods until they are sold on to a third party: US v. General Electric Co., 272 US 476 (1926); see Gellhorn and Kovacic, 1994: 304-307. Alternatively, manufacturers can announce a list of resale prices and lawfully refuse to deal with those distributors who subsequently fail to observe the list: Monsanto v. Spray-Rite Service Corp., 465 US 752 (1984).
9. *Chicago Board of Trade v. US*, 246 US 231, 238 (1918). Another principle on which the courts rely is the ‘ancillarity doctrine’ which is borrowed from the common law of restraint of trade, whereby a restraint can be upheld on the grounds that it is ‘merely ancillary to the main purpose of a lawful contract, and necessary to protect the covenantee in the enjoyment of the lawful fruits of the contract, or to protect him from the unjust use of those fruits by the other party’. *US v. Addystone Pipe & Steel Co.*, 85 Fed. 271 (6th. Cir. 1898), Taft J.


11. Speech by Assistant Attorney General Bingaman before the Antitrust Section of the American Bar Association, 10 August 1993.


13. On the background to these developments in the economic theory of contract, see Deakin and Michie, 1997.


15. See, for example, the Annual Report of the Director General of Fair Trading 1980 on agreements involving standard terms and conditions and codes of practice (DGFT: 1980).


17. MRP(IC)A 1948, s. 14.

18. FTA 1983, ss. 6-11.


23. Ibid.


27. HC (1992-93) 402.


29. This was later amended by the Treaty of European Union, and is now Art. 3(g) which refers to a ‘system ensuring that competition in the internal market is not distorted’.

30. EC Treaty, Art. 85(1).


35. Regulation 1983/83, recital (6).

36. Ibid., recitals (11) and (12).


40. The Court also considered a number of other factors, one of which involved examining the consequences of restricting intrabrand competition in the light of its effects on inter-brand competition.


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