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CARTELS: A GOOD OR A BAD STRATEGY?

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ABSTRACT

Any organization should seek the efficiency maximization, namely the achievement of an effect/effort ratio as high as possible. In order to apply this economic ground rule, some companies use strategies based on gaining a competitive advantage over competitors. In contrast, other companies choose lighter options to increase profitability. They apply strategies focused on agreements with competitors that aim to maintain prices at a certain level regardless of economic factors governing the market mechanism.

The purpose of this paper is to highlight the positive and negative effects of cartels as a management strategy. In this regard, the first part of the article summarizes the most important theories about cartels and their characteristics, while the second part presents some European and Romanian cartels, based on data provided by the European Commission and the Competition Council. The final part presents the most important findings and conclusions but also some recommendations for future research.

KEYWORDS: *cartels, competition, strategies, development, price*

JEL CLASSIFICATION: *F63, D40, M10, M21*

1. Introduction

Throughout the years many business entities have resorted to various strategies, including illegal strategies, in order to create for themselves a favourable situation in the market. For some entities the free price fixing based on supply and demand in a competitive market economy is more difficult to accept than the market share negotiations with their competitors and the taking over in turns of contracts allocated as a result of bid rigging (Smith, 1961).

Despite the sanctions imposed by the law, there are many companies which continued to practise such cartel-like deals in order to maximize their profits (Hahn et al., 2013). Moreover, some large corporations' unwritten rules promise bonuses and stimuli for their employees who get involved in the cartel creation and management (Connor & Lande, 2012). Therefore, the natural question arises whether the creation of cartels is a viable business strategy despite the legal sanctions both against the firms and the involved employees.

To check the assumption based on which cartelisation is a profitable management strategy, as the first step of our research we analysed the pros and cons of this type of deal between competitor firms by reviewing the literature on this topic. The second part of the article presents a series of case studies from the US, Europe and Romania so as to demonstrate the extent to which this strategy is used worldwide.

2. Cartels and their characteristics

The hard core cartels are defined as “*agreements or concerted practices between two or more legally independent companies operating in the same market on the fixing of prices (consumer overcharging or reductions in prices for suppliers), the restriction of output or sales quotas, and the allocation of markets in order to generate higher profits, restrict competition and autonomy of decision making*” (Bruneckienė et al., 2015a, pp. 217-218). Bid rigging and import restriction are also actions typical of cartels.

The theoretical and empirical studies have proved that cartels are most commonly seen in the oligopolistic markets (Bruneckienė et al., 2015b, p. 49), namely on the markets with few competitors. Also, collusion appears most likely in markets with moderate growth, and less likely in either rapidly declining or rapidly growing markets (Levenstein & Suslow, 2006). In order to be able to raise price substantially, the demand for the cartels’ products has to be sufficiently inelastic. Among the other factors facilitating the creation and operation of cartels are the excess in production capacity and the lack of or small number of short term substitutes (Levenstein & Suslow, 2006).

Since they affect the market mechanism through which the prices are fixed based on the supply and demand ratio, cartels are perceived as a negative strategy applied by companies in order to maximize their profit (Hahn et al., 2013). According to the Competition Council, the main negative effects of cartelisation are the following: (1) the artificial limitation of competition; (2) an increase in prices; (3) the avoidance of innovation generating constraints (e.g., the development of a certain product or the introduction of new, more efficient production methods); and (4) a restriction in employment opportunities (Matache, 2011).

Given its negative effects, the creation of cartels is considered an illegal activity which is punished by the law through various sanctions such as (Connor & Lande, 2012): (1) criminal fines for the firms involved; (2) prison, house arrest and fines for the corporate officials involved. Some research has shown that the effects of these sanctions on fighting against the creation of cartels are small. It is generally found that the legislative methods adopted with a view to the elimination of cartels fail to reach this goal everywhere worldwide (Stellios & Hancock, 2014). For instance, Connor and Lande, (2012) showed that in the U.S. the sanctions against cartels are only about 9% to 21% of what they should so as to be able to protect the consumers and discourage the application by firms of this strategy. The reasons for which the sanctions imposed by the law are inefficient to prevent cartelization are (Connor & Lande, 2012):

- a) the expected costs divided by the probability the illegal activity will be detected and sanctioned (20% to 24%) are less than the expected rewards;
- b) Some of the corporations involved forgive or even reward their price-fixing employees—directly or indirectly, legally or not—after they "take a bullet for the team" by going to prison;
- c) For the firms involved in a cartel, the fines are almost like parking tickets (too small).
- d) The number of years of imprisonment is small and generally the people who are sentenced are not the top, but the middle managers.

The low effect of the legislative sanctions on the annihilation of cartels is also emphasized in Levenstein & Suslow's paper (2006), according to whom "antitrust indictment are one of the most insignificant causes of cartel breakdown, after (1) cheating and disagreement over market shares, (2) external shock, (3) entry and substitution, and (4) technological change."

Thus, it can be noted that the firms involved in a cartel must face a large number of threats besides the legal ones. As a result, the average lifespan of a cartel is approximately 5 years (Levenstein & Suslow, 2006). The most important challenges for cartels are (Levenstein & Suslow, 2006): (1) selecting and coordinating the behavior of all cartel participants on mutually consistent, collusive strategies; (2) monitoring the behavior of cartel participants to detect and deter defections from these collusive strategies; and (3) preventing entry (or expansion) by noncartel firms. The periods of economic recession are another major threat in the operation of a cartel since the demand and the prices decrease, which makes the involved firms more prone to cheating in order to maintain their incomes at the same level (Levenstein & Suslow, 2006). This is probably the main reason for which the Swedish-Finnish timber export cartel functioned best in the period of demand growth, but disappeared when the 1921 economic recession struck (Kuorelahti, 2015).

As for the threat from the new competitors in the market, Ciprian Scurt, competition inspector, explains that „*any new entrant in the market is either forced to join the cartel or bankrupted as the cartel members decrease the prices intentionally for a while*” (Scărișoreanu, 2009). Also, any attempt by a member to leave or to cheat on the cartel is punished as the cartel starts a price war (Connor & Lande, 2012).

3. Advantages of cartels

After a long period of time when only the negative effects generated by cartels in the economy were analyzed, in the last years the researchers have focused on discussing the benefits resulting from the application of this strategy. Thus, harmful though a cartel is for both companies and economies, in certain specific conditions its global effect can turn positive. (Bruneckienė et al., 2015, pp. 217). For example, following an analysis carried out in the South Korean auto industry, Parc Jimmyn (2014) showed that the effect of the operation of a cartel in this sector led to a better efficiency and competitiveness, which helped South Korea become “*one of the top five automobile-producing countries in the*

world”. The advantages generated by the operation of cartels both for the companies involved and for the economy and society are presented in Table no. 1 below.

Table no. 1

Advantages of cartel creation

<i>For the companies involved</i>	<i>For the economy and society</i>
<ul style="list-style-type: none"> • Improved competitiveness: “agreements between competitors may improve the ability of those competitors to compete against larger players” (Stellios & Hancock, 2014). • Increased efficiency and profitability (Stellios & Hancock, 2014). • It is an early stage in the process of strategic alliance formation (Parc, 2014). In turn, strategic alliances may help to reduce the risks of doing business (Rădulescu et al., 2015). 	<p>Following an economic downturn, cartels can generate a series of positive effects, such as (Parc, 2014):</p> <ul style="list-style-type: none"> • Avoidance of an overproduction crisis through limitation of offer; • Avoidance or limitation of the number of bankruptcies of companies by fixing a price above the breakeven point (whereas the supply and demand ratio would determine prices below the production costs); • Maintaining the current jobs; <p>Also, “by stabilizing prices at levels that cover average total costs, cartels encourage investment and productivity growth. Thus, in the long run they can have positive efficiency effects, as increased productivity growth allows for lower prices and increased output” (Levenstein & Suslow).</p>

Taking into account these advantages, we can conclude that in certain environmental conditions, cartelization may be a viable business strategy. Also, if we consider the income collected from the fines deriving from sanctioning the cartels, the state as a corporation has no interest in the disappearance of this form of co-operation between competitor companies. Therefore, setting the sanctions so that the companies would still find cartelization profitable generates income for the state as well as for the cartel members. The only ones who are prejudiced directly are the consumers.

4. The operation of some cartels in the electrical equipment industry

For a cartel to function over a reasonable period of time, a number of conditions must be met, such as (Stellios & Hancock, 2014):

- the achievement between the colluding parties of a common policy,
- the development of some mechanisms through which the actions of the firms involved can be monitored;
- the development “of an effective and credible retaliation or punishment mechanism;”
- “the structure of the market must be such that the responses of consumers or potential entrants to the collusive strategy do not undermine the strategy, either through resistance by a powerful consumer or new entry by potential competitors.”

The category of business entities which have created cartels in order to avoid competitor confrontations includes among others a series of American companies such as General Electric (GE), Lapp Insulator Co., Westinghouse, Allis-Chalmers, Federal Pacific and I-T-E, whose competitor deals were revealed in the period 1959-1961. Following the research conducted by American prosecutors, it was discovered that for over a decade a lot of experts from as many as 29 companies (among which the ones mentioned above) would meet secretly under aliases in order to fix prices, rig bids and allocate market shares among them, despite the fact that such actions were illegal and broke the principles of the free market economy. It is worth mentioning that General Electric alone was involved in a total of 19 cartels, among which power transformer cartel, the electrical insulator cartel, the turbine generator cartel, the commutator cartel, the circuit-breaker cartel, steam condenser cartel, industrial adjustments, the industrial control installation cartel and the cartel of equipment for electrical installations (Smith, 1961).

Within these cartels there were two „departments” – one dealing with rigging the bids in the public sector and the other whose aim was to maintain the reference prices and the market shares in the private sector. For example, within the commutator cartel, the closed envelope system was used for the public bids. The cartel would attribute contracts in turns to the 4 American companies which manufactured electrical comutators: GE 45% of the orders, Westinghouse 35%, Allis-Chalmers 10% and Federal Pacific 10%. Two or three times a month meetings were held during which the following „winner” was decided by consulting the „book” (a table with permanently updated information about the firms which had obtained the contracts and the values of these contracts). Subsequently the lowest price offer which would be presented by the „winning” company was set. A similar method was applied when it came to maintaining the market shares in the private sector. These aspects were discussed at the cartel’s monthly meetings (Smith, 1961).

In the period 1953-1954 GE left the commutator cartel. This led to an intensified competition. As a result, in the period 1954-1955 equipment prices decreased by 40-45% as compared to the reference prices (thus a price war was triggered). For this reason, in 1956 the cartel was recreated, but it disbanded again in 1957 after Westinghouse tried to strike a secret deal with Florida Power & Light. This led to a new intensification of the competition and to prices that fell by 60% below the reference prices until 1958 when the cartels were recreated.

This conspiracy in the electrical equipment industry ended in 1961, when a Philadelphia federal court sentenced 7 managers to prison and ordered fines of almost 2 million dollars against 29 corporations. However, as asserted by Connor and Lande (2012), the sanctions applied to the cartels are most of the times lower than the benefits which can be obtained through the application of such strategies.

5. The situation of European and Romanian cartels

In order to facilitate the exposure of the cartel-like practices both in Europe and in Romania a cartel leniency policy is applied. Through this policy the members of cartels

which decide to stop such illegal practices and offer essential evidence on these can get immunity or fine reduction in case a sanction is applied (Matache, 2005). The exposure of cartels was more successful after the introduction of the law under which if a company informed the European Commission about cartel deals and such deals proved to be true, the respective firm would be exempt from fine, even if it was the biggest beneficiary (Pescaru, 2012). While this policy has had significant effects in the rest of Europe, in Romania we cannot see the same.

5.1. Cartels in the European Union

Year after year European authorities investigate hundreds of companies which break the competition laws and resort to cartel-like deals. In 2005 the Dutch competition authority recorded 470 complaints in one semester alone (Matache, 2005). After the beginning of the economic recession this „industry” took off for real and included a large range of products, from coffee to detergents or television sets. In the period 2010 – 2012 the European Commission solved 15 important cases and applied fines of 4 billion euro to the 112 investigated companies, an amount which is three times bigger than that of all the contraventions ordered in the '90s (Pescaru, 2012). Below are presented a number of cases of breach of the competition law which were revealed.

In 2010 ArcelorMittal, the biggest steel manufacturer in the world had to pay a fine of 315 million euro for the role its companies had played in creating the largest and most long-lasting cartel in Europe which included 17 manufacturers. The EU officials accused the steel manufacturers that between 1984 and 2002 they had held 550 meetings during which they fixed the prices for the European market and allocated customers for the steel products necessary for constructions. The existence of this cartel and the discussions between its members were revealed by a German company, DWK/Saarstahl, which in 2002 quit the cartel and informed the authorities (Toreanik, 2010).

In 2011 the European Commission fined the companies Procter & Gamble and Unilever with 315.2 million euro because they had created, in eight EU countries, a cartel in the detergent market, together with Henkel which received immunity because it had exposed the existence of this cartel. The cartel operated for three years; its purpose was to try to set its members' positions in the market and the selling prices in the Belgian, French, German, Greek, Italian, Portuguese, Spanish and Dutch markets. The fine given to Procter & Gamble amounted to 211.2 million euro, whereas Unilever had to pay 104 million euro (Business24.ro, 2011).

Also, the European Commission (EC) fined nine companies, members of the „paraffin cartel“, with 676 million euro, in 2011. This cartel was created by companies from the United States, France, Hungary, Italy, Spain and Germany. The members of the cartel met regularly to set the price of paraffin and exchange commercial information. Shell, which was a member of the cartel, applied for leniency and was exempt from fine because it had denounced all these irregularities, thus assisting the launching of the investigation (Pescaru, 2012).

Therefore it can be noted that, despite their negative economic effects, cartels also represent an important source of income for the public sector.

5.2. The situation of cartels in Romania

As for the situation of cartels in Romania, no company appealed, in the period 2004-2009, for the clemency instrument offered by the Competition Council (CC), with the help of which companies can receive immunity or reduction of fine if they provide information that can lead to the exposure of cartels (Business24.ro, 2011). In Romania the Competition Council receives very few complaints regarding breaches of the competition law. The main reason for this is the „law of silence” that operates among business entities. However, the Competition Council has exposed a number of cartels.

The biggest fine ordered against a cartel in Romania was of 205 million euro, in January 2012, representing 3% of the turnover of several oil companies which had made a deal aiming at eliminating the Eco Premium petrol from the market because it was blocking their logistic chains and it required special storing tanks. These companies were: Petrom – which was the initiator of the cartel, OMV Petrom Marketing, Rompetrol Downstream, Lukoil România, MOL România Petroleum Products and ENI Romania.

In 2008 a group of four companies in the insulin market (Eli Lilly Export S.A., A&A Medical SRL, Mediplus Exim SRL, Relad Pharma SRL) were fined with 83.7 million lei for a deal they made for sharing the market. In 2006 Societatea Națională de Transport Marfă CFR Marfă (the CFR Marfa National Railway Goods Transport) was fined with 27 million lei for abusing its dominant position, while other companies, UPC, RCS&RDS, Astral Telecom and Cablevision of Romania, which are active in the service market of cable retransmission of TV programmes, were fined with 26 million lei for dealing and abuse (Scărișoreanu, 2009).

In 2005 the biggest companies in the cement industry – Holcim, Lafarge and Carpatcement – received a record fine of almost 30 million euro for striking deals in connection with their selling prices. In the same year, as a result of a deal regarding their tariffs, the Association of Harbour and River Operators in Romania, three harbour administrations (Galați, Constanța and Giurgiu) and the Administration of Navigable Canals from Constanța were fined a total of 110,300 lei. In the real estate field seven branches of the National Union of Real Estate Agencies were fined with 75,500 lei for trying to impose a minimum commission of 2% for the firms which offered real estate services at certified professional standards (Matache, 2005). Also in 2005 a fine of 20 million lei was imposed against Wrigley Romania - Produse Zaharoase and its distributors for fixing selling prices and agreeing on sharing their distribution markets (Scărișoreanu, 2009).

The first company in Romania which retorted to the clemency policy and was granted immunity by the Competition Council was Compania Radio Taxi from Timișoara, which in 2011 was exempt from paying a fine after it had denounced the existence of a cartel whose member it had been. As a result of the investigation, it was found that 11 dispatching companies and exclusive taxi operators in Timișoara had raised the prices for

their taxi transport services since December 2007. The total amount of these fines amounted to 350,000 de lei (Matache, 2011).

Baia Mare is no exception from the functioning of a market that relies more on cartels than competition. According to the Resolution of the Competition Council no. 59/18.11.2011 five companies active in the market of taxi transport services in the municipality of Baia Mare (SC Usi SRL, SC Taxi Galant SRL, SC Stotax SRL, SC Olar Rotax SRL and SC Straja Trans SRL) were fined with a total of 21,525 lei because they had created a cartel by coordinating their competitor behaviour and making a deal for fixing and increasing their taxi tariffs at the same time and to the same level (the Competition Council, 2011). An even more serious problem is the fact that these companies have not changed their attitude or behaviour after they were fined and continue to impose minimum tariffs in the market.

6. Conclusions

Despite the authorities' efforts to eliminate them, cartels have existed for tens of years and will continue to exist as long as the contraventions applied for breaking the competition principles are lower than the benefits deriving from the deals between competitors. Based on the case studies presented above, we can assert that the formation of cartels is a strategy applied frequently by the economic entities. Even if the agreements between competitors regarding the prices and their market shares are in the blacklist of competition strategies through which an organization's prosperity can be raised, this is still a strategy that is used maybe even to a larger extent than the differentiation strategy based on prices.

Besides their wish to maximize their profits, firms also apply this strategy for the simple reason that they are trying to survive in environments where high offers can sometimes determine selling prices below the minimum price which would cover the production costs.

From the case studies analysed we could notice that in the absence of cartels the market mechanism generates a significant cut in the product prices which reflects implicitly in the companies' profitability. Without the application of this strategy, the dramatic price fall spell bankruptcy for the small firms in a certain industry. Subsequently, by reducing the offer due to the fact that the number of competitors decreases, prices will rise again. Thus the consumers will be obliged to pay the same price as if in the respective industry a cartel had operated. The difference is that due to bankruptcy, the number of economic entities and implicitly the number of jobs is smaller (during certain periods of time). Of course, when prices go up again, other new companies will wish to enter in the market, which will make the cycle '*high offer* → *low price* → *bankruptcy* → *low offer* → *low price*' resume. Therefore, cartelization is a strategy which, besides helping maintain a firm's profitability, also contributes to the stability of the economic environment. Thus this strategy generates income for both the involved economic entities and the state (due to the application of fines

and the preservation of jobs). Therefore, cartelization can be considered “a rational business strategy” (Connor & Lande, 2012).

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