Ordo and European Competition Law

Flavio Felice and Massimiliano Vatiero[1]

ABSTRACT. It is commonly "assumed," even among well-informed lawyers and economists, that European competition law is an emulation of the US antitrust law because of American influence on European political and economic debates after the WWII. However, such an assumption is fundamentally wrong: the competition law in Europe is an indigenous product based primarily on ideas developed in Austria and Germany by the so-called Ordoliberal thought. Having witnessed the anticompetitive conducts of agents with economic power during the Weimar period to destroy political and social institutions, the main characteristic of the ordoliberalism is the need to protect individuals from the misuse of economic power in the market, i.e. abusive conduct of firm(s) with dominant position, beyond that from the misuse of public power. The aims of this article are to furnish a critical examination of Ordoliberal ideas of competition and anti-competitive conducts and underline the role of Ordoliberal thought on the origins and the development of the modern European competition law.

Keywords: Ordoliberalism, Freiburg School, Social Market Economy, European Competition Law, Market Power.
JEL Code: B13, B2, K21.

[1] Flavio Felice, Pontificia Università Lateranense, Rome, Italy. Massimiliano Vatiero, Università della Svizzera italiana, Lugano, Switzerland, vatierom@usi.ch. An earlier version of this paper circulated as "Concealed Ordoliberal Inheritances". This article has benefited from correspondences and conversations with David Gerber and Nicola Giocoli. Authors also want to thank anonymous referee and the editor of this review. The usual disclaimers apply.

1. The European origins of the European competition law

Europeans began to develop the idea of competition law around the end of the 18th century in Vienna, the true core of the European competition law tradition. In Vienna, a group of intellectuals – Carl Menger and Eugen Bohm-Bawerk, among others – began to explore the idea of using law to protect the process of competition (Gerber 1987, 1998, 1999). From Vienna, Austrian ideas were planted in Germany, where the first European competition law was enacted in 1923; but this law was too weak to withstand the pressures of economic lobbying and public opinion against it, and Nazism eliminated it. However, during the Nazi regime, a group of lawyers and economists called Ordoliberals continued to explore, "underground," the issue of Continental and Austrian ideas on competition law (Gerber, 1999). The Freiburg School of law and economics composed by Walter Eucken, Franz Bohm, Friedrich A. Lutz and Fritz W. Meyer and, later, Hanns Grossmann-Doerth, became the main reference for competition law.[2]

As Professor Gerber (1999:17) writes,

> The most important [misleading assumption], and perhaps the most persistent and pernicious, is [the] widely held belief that antitrust law in Europe was merely an import from [the] United States. Indeed, many scholars believe that after the Second World War Germany copied U.S. antitrust law and transmitted it to Europe.

There is, a *mistaken identity* (Gerber, 1994) between Allied decartelization laws – based on U.S. antitrust law – and the conceptual foundations of German and European competition laws, which were in large part indigenous products (Gerber 1998, 1999).

Although scholars do not wholly recognize it, Ordoliberal thought had a direct and relevant impact on EU law and, in particular, on EU competition law after the Second World War. In fact, the German Law Against Restraints of Competition (hereinafter GLARC), and in particular its draft – the so-called Josten draft, which had a deep Ordoliberal derivation (Gerber, 1998) – substantially influenced the formulation of the Treaty of Rome (Gerber, 1987). Moreover, the members of Ordoliberalism played a prominent role in the political program of the German Christian Democratic party. In particular, Ludwig Erhard – the economic minister of the Federal Republic from 1949 to 1964 and its chancellor from 1964 to 1966 – followed most Ordoliberal ideas and generated the so-called "German miracle".

[2] For a review of the main ideas of Ordoliberalism we suggest Willgerodt and Peacock (1989), Streit (1992), Rieter and Schmolz (1993), Nicholls (1994) and Gerber (1998).

In light of this, Germany – hostile territory for liberalism during the Second World War – by the advent of Ordoliberal thought had given more ground in the liberal direction after the Second World War than traditional European liberal bastions such as England (Gerber 1998). The aim of this article is to furnish a critical examination of Ordoliberal thought on the meaning of competition and anti-competitive conducts and stress the Ordoliberal influences on the actual European competition law. The sections 2 and 3 are dedicated respectively to the role of the state and the meaning of the competition in a social market economy. The section 4 focuses on the constitutionalizing of the competition law. In Section 5 we sum up our findings

2. Strong State, Free Markets

The main characteristic of Ordoliberalism is its insistence on the fact that markets can fulfil positive functions only if the state establishes a clear institutional framework within which spontaneous market processes take place. In this respect, Ordoliberalism is different from the Hayekian and Austrian School's spontaneity in determining the rules of the system.[3] For Eucken and his colleagues, history, with particular regard to the Weimar Republic, has proven that competition tends to be self-destructive because firms prefer to coagulate in joint power, form cartels or misuse economic power rather than compete. Moreover, the failure of the Weimar Republic shows that firms often achieve such a great degree of economic power that they can affect political power and restrain competition. Therefore, if the state does not take active measures to foster competition, then firms with market power will emerge; they will not only subvert the advantages offered by the market economy, but will also possibly undermine democracy itself, since strong economic power can be transformed into political power.

In particular, market participants have incentives to incrementally transform the decentralized decision making of competitive markets into increasingly centralized variants: each individual agent can improve its welfare if it is able to circumvent competitive pressures or gain protection from competition. Therefore, unlike the laissez-faire idea of the night watchman, in the Ordoliberal

[3] Thought in the first issue of "Ordo" in 1948 we find a seminal essay by Hayek – *Wahrer und Falscher Individualismus* – and it is disputed if the Hayekian position on spontaneous order meets Ordoliberalism thanks to the mediation of Röpke's theory on market conformity (Forte and Felice, 2010; Forte et al., 2012). Moreover, Hayek, Eucken and Röpke were cofounders of the Mont Pélerin Society.

paradigm, liberals must take initiative when a government's weakness or lack of judgment leads to capitulation to private business (see Röpke, quoted in Megay 1970:425).

A weak state allows the private concentration of power, which, through interest group pressure, threatens individual freedoms. Ordoliberals demand a strong and independent state, with functions strictly limited to the protection of individual freedoms, to ensure economic order and leave all forces to pure spontaneity. In order to accomplish their goals Ordoliberals called for a strong state with their slogan, as Rustow (1932, in Friedrich 1955) titled: Strong State, Free Market. That is, the rules of the free market game could be guaranteed by a strong state.

Many scholars have criticized this aspect of their program as an inevitable threat to economic freedom (Gerber 1998). It is what Giuliano Amato calls the liberal dilemma: "the risk of 'too much' public power or, contrariwise, 'too much' private power'" (Amato 1997:109). However, a strong state does not imply a strong totalitarian state, but a strong guarantor of the free play of market forces. Hence, the competition office would have to be a strong institution to wield sufficient enforcement authority and resources to operate quickly and effectively, in order to attract high-level personnel and protect them from outside political and pecuniary influences (cf Vatiero, 2009B). Ordoliberals advocated a strong state to establish a set of general rules and rejected discretionary regulations that hamper the proper working of markets.

It was especially important to them that economic policies should not interfere with the smooth function of the price system (cfr. Kerber and Hantig 1999). Ordoliberals asserted, indeed, that such a society could develop only where the market was imbedded in the constitutional framework that is necessary to protect the process of competition from distortion and to minimize governmental intervention in the economy – i.e., public officials derive their actions from an economic constitution, a sort of Kelsenian *Grund Norm*, without any discretion. Hence, rejecting Marxist central planning – and therefore implicitly the Nazi variant of central planning, corporatism and its tradition of cartels, and interventionism – Ordoliberals advocated a genuine market economy (Vanberg 1998; Kerber and Hartig 1999).

However, Ordoliberals also rejected the idea of the minimal state; in their opinion a *laissez-faire* economy would fail to ensure the proper working of markets due to an inherent tendency toward the cartelization and monopolization of markets (Eucken, 1951). As noted by Eucken (1951:83, italics added), property and freedom do not assure a competitive order:

> [t]o an increasing extent, for example, 'freedom of contract' is used to abolish competition by means of cartel agreements […] Freedom of contract is often used *to alter the form of the market* and build up concentrations of economic power. As a result, it reduces economic freedoms of consumers. Moreover, such concentration of economic power can exercise *strong lobbying and rent-seeking activities*, threatening the normal functioning of democracy and, thus, the *effective political liberties of citizens*.

Indeed, having witnessed the use of private economic power during the Weimar period to destroy political and social institutions, the Ordoliberals emphasized the need to protect individuals from the misuse of such power.

The Weimar experience led Ordoliberals to demand the reduction not only of political power, but of economic power as well. In this way, Ordoliberals expanded the lens of liberalism (Gerber 1994, 1998). It was not sufficient to protect the individual from the power of the government, because government was not the only threat to individual freedom. Powerful economic institutions (i.e., cartels) could also destroy or limit freedoms, especially economic freedom (Gerber 1998). The core of the Ordoliberal philosophy is that the legal system should prevent the creation and misuse of private economic power. When the presence of a relevant economic power is counterbalanced by a strong state in a sort of *Schumpeterian creative destruction process*, we obtain the Ordo – the economic order for Ordoliberals. They indeed realized that power could be controlled only by power, *and* in reasserting the limits of state functions over and against private interests, they were willing to entrust the government with the balance of power.

3. Competition and the abuse of dominant position

The main two theses of Ordoliberalism are: (i) only a state independent of economic lobbies can secure the freedom and rights of its citizens against abuses of market power and (ii) only a state with bounded functions can protect individuals from the arbitrary use of public power. Hence, a central tenet of Ordoliberalism is the protection of competition (see also Lutz, 1956).

For Ordoliberals, "The only way of achieving sustained economic performance and stability was through an economic order based on competition" (Gerber, 1998:241). The main pillar in the protection of competition is competition law, which defines and limits the conduct of powerful enterprises (or market-dominating firms) while it defines and limits state intervention. When

Ordoliberalism talks about competition, it means an open form of supply and demand (cf. Eucken, 1951:186f.) with actions and reactions among agents. For Ordoliberalism: "Every supplier and demander does exert some small influence. Without individuals being conscious of it, all together determine prices and therefore the whole economic process" (Eucken, 1951:270). Hence, for Ordoliberals the idea of competition is not related to price-taker agents, but involves contexts in which "the individual unit is *almost* powerless, but not completely so" (Eucken 1951:270, italics added).

Therefore, the Ordoliberal program states that where competition is weak, the state should require enterprises to conduct business *as if* they were without the power to coerce other firms in the market (see Moschel 1989). Ordoliberal Leonhard Miksch was the first to adopt the idea of as-if competition. Miksch states that any economic policy measure requires a normative reference point to uncover and restrict private market power. He individualized the prospect of a comparison between markets with and without market power. Conduct must be compared in such a way that competition is emulated where it does not work.

Eucken distinguished between capacity and handicap competition (cf. Budzinski 2007). Capacity competition serves to absolutely improve one's performance, that is, to produce the best goods and services at the lowest prices. Handicap competition aims to degrade the performance of competitors, thereby relatively improving one's own performance (but without any absolute improvement). Capacity competition is based on rival self-interested agents. Handicap competition, however, also called prevention-competition by Ordoliberals, is based on rival other-regarding agents and is directed at preventing competition from other producers, rather than improving one's own performance in the service of consumer interests (Vanberg 1998). For Eucken and his colleagues, the target of competition policy was to frustrate handicap competition and, thereby, force enterprises to concentrate on capacity competition: "This objective justifies us to speak of an economic policy as-if" (Miksch 1949; quoted in Goldschmidt and Berndt 2003:4).

This objective is included today in the European concept of the *abuse of the dominant position*. According to the European Court of Justice, abuse occurs when a dominant firm utilizes its economic power to gain a competitive advantage other than by "competition on the merits" and where this conduct has a substantial effect on the structure of competition. The Court says that, in the presence of a significant power, competition on performance can degenerate into "different

methods" with the effect of hindering maintenance of the degree of competition still existent in the market (cf. Vatiero, 2009C, 2010).

As Parcu (2006) noted originally, the definition of a dominant strategy in game theory – which implies the possibility of choosing without taking into account the other players' strategies – suggests a natural parallel with the occurrence of the firm with market power that we find in European antitrust law, that works, to "an appreciable extent independently of its competitor, its customers and ultimately of consumers." A dominant strategy represents this request, recalling the significance of the "substantial" independence of a dominant firm from the choices of other agents, as is required by Art. 106 TFEU. Handicap competition illustrates the idea that when the *dominant* firm abandons its *dominant* strategy, renouncing part of its profits, it reduces its competitors' payoffs relative to its own; this impairs capacity competition.

Take, for instance, predatory pricing practices. The firm with the dominant position continues to lower its price until it is below the average cost of its competitors, thereby losing its profit per unit sold. The rationale of this practice is not derivable from capacity competition; it is, indeed, irrational to self-determine a reduction of one's own profits. The rationale, instead, can be found in handicap competition. The aim of this practice by the dominant firm is to force their competitors out of the market and, consequently, to raise price and gain monopoly profits forever thereafter. In fact, such a practice is successful if and only if the losses of the dominant firm's competitors are greater than those of the firm with the dominant position. When this occurs, competitors may exit from the market, allowing the dominant firm to improve its market position. Then, predatory pricing becomes a convenient practice for the dominant firm, which does not want to compete by cutting prices or improving product quality, or both, in capacity competition. Therefore, the special responsibility given to the market-dominant firm in accordance with Art. 106 TFEU can be illustrated as a mode in which handicap competition is reduced because a switch from the dominant strategy of capacity competition is sanctioned.

In the GLARC there is a distinction between the "exploitation of abuse" and "impediment abuse" (Gerber 1987, 1998). Exploitative abuse regards practices concerning suppliers and buyers extracting extra profits, offering, respectively, low- and high-exchange prices. Impediment abuse, rather, concerns the practices that do exclude a competitor from competing. This distinction relies on two aspects of power (see Vatiero 2009A; and also Gerber 2004): the concept of exploitation, which describes the level of power between a powerful agent and its vertical counterparty (i.e., the

firm with market power and her supplier or client), and the concept of exclusion, which describes the level of power between a powerful agent and its horizontal competitor (i.e., a market-dominant firm and her competitor). Exploitative and exclusionary power may be (and actually they are) circularly connected. By excluding a viable competitor, the dominant firm can increase its exploitative power over clients and suppliers because their alternatives are reduced. Greater exploitative power can offer the economic resources to the market-dominant firm to increase her power of exclusion, and greater power of exclusion can offer her the economic resources to increase her power of exploitation. In this process, cause becomes effect and such an effect becomes a cause:7 the dominant firm benefits through exercising exploitative power that determines her means of increasing her exclusionary power, and vice-versa. This *path dependence* leads to a polarization of power: any power accumulation becomes the means of new accumulation. This is the Ordoliberal understanding of economic power.

Given the process of the polarization of power, for Ordoliberals who want to limit the accentuation of power, a third party must *make order*. This does not mean that the third party must play the game, but that it must design the rules of the game in such a way that the path-dependence of power is limited. In this sense, a central tenet of Ordoliberalism is that the state should form an economical order because agents cannot spontaneously coagulate into an effective countervailing power. Hence, for Ordoliberals, when individuals or groups have the power to influence the conduct of other market participants, the model does not work properly. Protecting the economic freedoms of individuals from the power of the government is not enough, because powerful economic agents could also destroy or limit such freedoms. Ordoliberalism sees this as the lesson of the Weimar period, when political and social institutions were undermined by private economic power. Therefore, in order to preserve a free market is necessary to have a strong state.

4. The *Ordnungspolitik*

Ordoliberalism saw two basic threats: state power and private economic power. Defence from the second threat extends the investigation of liberalism. The Ordoliberal solution to these two problems was to embed the market in a “constitutional” framework that would protect the process of competition from distortion by private power and minimize state intervention in the economy (Bohm, 1966).

According to Franz Bohm (quoted in Gerber 1998:246), an economic constitution is "a comprehensive decision concerning the nature and form of the process of socio-economic cooperation." As Bohm (1989:47) emphasises, it is a constitutional choice in and of itself, a choice of the *rules of the game* under which social and economic interactions would proceed. Similarly, for Walter Eucken (1951:88), "[b]y an economic constitution we mean the decision as to the general ordering of the economic life of a community." Namely, it represents a political choice about the kind of economy a community wants, in the same way that the political constitution represents basic decisions about the kind of political system a community wants; Ordoliberals called this *Ordnungspolitik*. This *untranslatable soul of liberalism* (Gerber, 1998:246) envisages markets flowing from the principles embodied in the economic constitution.

In this respect, the state does not direct the processes of the economy, but merely establishes structural conditions within which those processes might function effectively (Gerber, 1998). Such economic constitution assures the free play of the actors, limiting harmful interventionism. The aim of the state is not to regulate or to steer the market as an interventionist, but rather to shape the legal and economic frameworks from which an economic order can emerge.

Ordnungspolitik has two major consequences. First, the state must intervene when (and only if) a powerful firm misuses her power: this occurs when a firm with market dominance does not act *as if* she were powerless. The as-if standard requires that firms refrain from conduct that would be unavailable to them if they had no monopoly power (cf. Vatiero 2010). State intervention would be merely authorized to apply this standard; the law would not give the state discretionary power to intervene in the economy. This intervention is necessary because Ordoliberal path-dependences lead to the polarization of power. By this polarization, Ordoliberals state, economic power will affect political power and, consequently, will reduce competition. The second consequence of Ordnungspolitik is that the defence of competition is seen as an end, and not as a means towards a goal. In particular, following the terminology of Barry (1989), Ordoliberal economists' idea of competition is not a mere "procedural rule," but an actual "end-State." That is, the "[e]conomic system did not just 'happen'; there were 'formed' through political and legal decision-making. These fundamental choices determined nation's 'economic constitution'" (Gerber, 1998:245).

This implies that a legal setting cannot be merely *functional* for efficiency and neglect agents' preferences (in particular, those of consumers) concerning the final legal setting – namely, the

distribution of liberties, power and rights (that is, legal positions) between producer and consumer, and among consumers. Consumers' preferences must matter not only in order to determine *which* output vector should be produced, but also in order to decide *how* that output should be produced. How the output is produced involves a certain *legal setting* and consequent final legal positions to which society cannot be indifferent. This is not purely a matter of terminology. Treating part of human activity, i.e., the consumption of legal positions, only as means of or factors in production violates the basic principles of Kantian ethics: *act so as to treat man, in your own person as well as in that of anyone else, always as an end, never merely as means*. The same Kantian principle is the foundation of liberal thought.

5. Concluding remarks

It is commonly "assumed," even among well-informed lawyers and economists, that European competition law is an emulation of US antitrust law because of American *influence* on European political and economic debates after the WWII. However, such an assumption is fundamentally wrong: competition law in Europe is an indigenous product based primarily on ideas developed in Austria and Germany. In this respect, the most evident proof is the distinctive (with respect to US tradition) concept of dominant position in the EU competition law.

The truth-birthplace of the (modern) European competition law is Vienna; around the end of the eighteenth century a group of intellectuals (Carl Menger and Eugen Bohm-Bawerk, among others) began to explore the idea of using law to protect the competition. Austrian thoughts had planted in Germany, where the first European competition law was enacted in 1923 in response to the postwar inflation crisis. Nevertheless, the failure of Weimar Republic (and the rise of Nazism) determined its elimination. However during the Nazi regime a group of lawyers and economists called ordoliberals continued to develop "underground" at Freiburg University the issue of Continental and Austrian competition law. For this reason, at the end of the Second World War the first full draft of a German competition law – presented to Erhard by a committee chaired by Paul Josten (the so-called Josten draft) – was based on ordoliberal ideas. This draft influenced the actual formulation of German competition law, the articles concerning competition law in the Treaty of Rome and, by-product, the actual European competition laws.

Having witnessed the anticompetitive conducts of agents with economic power during the Weimar period to destroy political and social institutions, the main characteristic of the ordoliberal thought on competition law is the need to protect individuals from the misuse of economic power, i.e. abusive conduct of firm(s) with dominant position, beyond that from the misuse of public power. Expanding lens of liberalism, in accordance with ordoliberals, the state may create a proper legal environment for the economy and should maintain a healthy level of competition through measures that adhere to market principles (*Ordo*). In this respect, competition law is the most important means to protect a (social) market economy.

References

Amato, G. (1997). *Antitrust and the Bounds of Power*. Oxford: Hart Publishing.

Barry, N.P. (1989) Political and Economic Thought of German Neo-liberals. In A. Peacock and H. Willgerodt (eds.), *German Neo-Liberals and the Social Market Economy*. London: Macmillan, 105-24.

Bohm, F. (1966). Privatrechtgesellschaft und Marktwirtschaft. *Ordo*, 17, pp. 75-151.

Bohm, F. (1989). Rule of Law in a Market Economy. In A. Peacock and H. Willgerodt (eds.), *German Neo-Liberals and the Social Market Economy*. London: Macmillan, 46-67.

Budzinski, O. (2007). Monoculture versus Diversity in Competition Economics. *Cambridge Journal of Economics*, *32*, 295-324.

Eucken, W. (1951). *The Legal Foundations of Economics*. London: Springer-Verlag.

Forte, F. and Felice, F. (eds) (2010). *Il liberalismo delle regole. Genesi ed eredità dell'economia sociale di mercato*. Soveria Mannelli: Rubbettino.

Forte, F., Felice, F., and Forte, C. (eds) (2012). *L'economia sociale di mercato*. Soveria Mannelli: Rubbettino.

Friedrich, C.J. (1955). The Political Thought of Neo-liberalism. *American Political Science Review*, *49*, 509-25.

Lutz, F. (1956). Bemerkungen zum Monopolproblem. *Ordo*, 8, 19-43.

Gerber, D.J. (1987). Law and the Abuse of Economic Power in Europe. *Tulane Law Review*, *62*, 57-107.

Gerber, D.J. (1994). Constitutionalizing the Economy: German Neo Liberals, Competition Law and the "New" Europe. *American Journal of Comparative Law*, *42*, 25-84.

Gerber, D.J. (1998). *Law and Competition in Twentieth Century Europe. Protecting Prometheus*. Oxford: Oxford University Press.

Gerber, D.J. (1999). Europe and the Globalization of Antitrust Law. *Connecticut Journal of International Law*, *14*, 15-26.

Gerber, D.J. (2004). Fairness in Competition Law: European and US Experience. Article prepared for *Fairness and Asian Competition Laws*, 5th March 2004, Kyoto.

Goldschmidt, N. and Berndt, A. (2003). Leonhard Miksch (1901–1950). A Forgotten Member of the Freiburg School. *Discussion Paper on Constitutional Economics*, Walter Eucken Institute.

Kerber, W. and Hartig, S. (1999). The Rise and the Fall of the German Miracle. *Critical Review*, *13*, 337-58.

Megay, E.N. (1970). Anti-Pluralist Liberalism: the German Neoliberals. *Political Science Quarterly*, *85,* 425-42.

Moschel, W. (1989). Competition Policy from an Ordo Point of View. In A. Peacock and H. Willgerodt (eds.), *German Neo-Liberals and the Social Market Economy*, London: Macmillan, 146-57.

Parcu, P.L. (2006). European Dominant Position and American Monopolization: A Unifying Approach from Basic Game Theory. *Banca Nazionale del Lavoro Quarterly Review*.

Rieter, H. and Schmolz, M. (1993). The ideas of German Ordoliberalism 1938-45: Pointing the Way to a New Economic Order. *European Journal of the History of Economic Thought*, 1(1), 87-114.

Streit, M.E. (1992). Economic Order, Private Law and Public Policy: The Freiburg School of Law and Economics. *Journal of Institutional and Theoretical Economics*, *148*, 675-704.

Vanberg, V.J. (1998). Freiburg School of Law and Economics. In P. Newman (ed.), *The New Palgrave Dictionary of Economics and the Law*, *2*, London: MacMillan, 172-9.

Vatiero, M. (2009A). *Understanding Power. A 'Law and Economics' Approach*. Saarbrucken: VDM-Verlag.

Vatiero, M. (2009B). Valutazione delle Autorità di Regolazione: una Nuova Introduzione. *Economia Pubblica*, 5-6, pp. 5-16.

Vatiero, M. (2009C). An Institutionalist explanation of market dominances. *World Competition*, 32, pp. 221-226.

Vatiero, M. (2010). The Ordoliberal notion of market power: an institutionalist reassessment. *European Competition Journal*, 6, pp. 689-707.

Willgerodt, H. and Peacock, A. (1989). *German Social Market Economy: Origins and Evolution*. London: Macmillan.