

# ECONOMICS OF EXEMPTIONS FROM COMPETITION LAW

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*Exemptions and exceptions under the Competition laws are commonly granted under various jurisdictions. The author examines the economic rationale behind the granting of these exemptions especially focusing on the practices prevalent in USA, Canada, European Union, UK, Australia, New Zealand and Japan. Identifying various similarities the world over, the author segregates the generally exempted economic activities into four categories and reasons as to why a given activity is exempted. In the end, the article deals with exemptions in the Indian context and in the light of international experience, recommends the incorporation of basic economic principles in the exemption policy of India.*

I. INTRODUCTION.....	63
II. USA .....	64
III. CANADA .....	65
IV. EUROPEAN UNION .....	65
V. UNITED KINGDOM .....	66
VI. AUSTRALIA.....	67
VII. NEW ZEALAND.....	68
VIII. JAPAN .....	68
IX. THE ECONOMIC RATIONALE FOR EXEMPTIONS .....	68
A. EXEMPTIONS AIMED AT BALANCING UNEQUAL BARGAINING POWER....	69
B. EXEMPTIONS AIMED AT ADDRESSING INFORMATION, TRANSACTION COSTS AND “COLLECTIVE ACTION” PROBLEMS.....	70
C. BOARD INDEPENDENCE .....	71
D. SPECIAL SECTOR AND INTEREST GROUP DEMANDS.....	72
CONCLUSIONS AND RECOMMENDATIONS .....	72
THE INDIAN CONTEXT .....	73

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## **I. INTRODUCTION**

Recently, after the Competition Commission of India [Hereinafter “CCI”] raised concerns over the telecom ministry’s plans to allow Mergers and Acquisitions [Hereinafter “M&As”] if the combined market share of merged mobile phone companies was up to 35% but less than 60%, the Department of Telecom has reportedly approached the Union Cabinet seeking exemption under the purview of the Competition Act 2002.

Similarly, in the backdrop of the Ministry of Railways seeking a similar exemption in December 2011, the Railway Board in an ongoing inquiry before CCI ,challenged its jurisdiction on the grounds, *inter alia*, that Railways is not an “enterprise” as it performs “sovereign” function at par with those related to currency, defence ,atomic energy and space, already exempted under the said Act. On rejection of its challenge by CCI, the Railway Board filed a writ petition before the Delhi High Court but the High Court dismissed the same holding that “Railways” is indeed an enterprise covered under the Act.

Earlier, the Standing Parliamentary Committee on Finance in December, 2011 recommended a proposal, initiated by the RBI, in the Banking Laws Amendment Bill, 2011 to keep the bank mergers outside the purview of the Competition Act, which is pending a decision. Further, there are already rumours of the Shipping and Aviation sectors waiting in the wings to chorus for a similar exemption.

Though media reports do not give details of such proposals yet, with the draft *National Competition Policy* making a passing reference to such “deviations”, it is just appropriate to examine whether such demands are merited from international experience. At the outset, one may ask whether India, after having adopted a modern competition law, in sync with the developed economies such as the European Union and the United States of America [Hereinafter, “USA”], is going to let state monopolies continue forever (as in the case of Railways) or avoid antitrust scrutiny based on well tested economic principles by the competition regulator and instead continue regulation of even competition related issues by sector regulators, as before (as in case of Banking, Telecom or shipping sectors). What is then the economics of granting exemptions under competition laws in the world over?

A brief research into this subject by the author, including a review of different competition laws, suggests that granting exemptions is not uncommon and, depending upon the level of maturity in the economy, a wide range of exemptions

and exceptions have been granted by various jurisdictions. However, there are no *en bloc* exemptions of the whole sectors of economy from antitrust scrutiny but specific economic activities, within some sectors are exempted. For instance, the commercial exploitation of Intellectual Property Rights, say, patent-licenses for mass productions in pharmaceutical sector are exempted in most of the jurisdictions, including India, but this does not mean that the whole pharmaceutical sector (which has a history of cartelization) be exempted. The most common sectors where types of economic activities are exempted are labour, agriculture and transportation. There are also exclusions from competition law in sectors such as financial services, energy, telecommunications (including postal services) and media/publishing.

The author has relied heavily on a Paper published by United Nations Conference on Trade and Development on this subject,<sup>1</sup> which, *inter alia*, suggests that there are more similarities than differences in the general approach to exemptions. While some economies such as the European Union describe the general conditions for granting exemptions, others tend to be more specific by listing particular sectors or activities, such as in Canada and the United States. These are discussed with country specific details as under.

## II. USA

In USA there are extensive sets of exemptions. While the Sherman Act (1890), the Clayton Act (1914) and other legislations do not list them, specific areas for the exemptions have been defined by court and congressional actions. These areas cover agriculture, defence mobilization, energy, export trade associations, government enterprises, insurance, labour, learned professions, marine insurance, newspaper joint operations, resale price maintenance, small business concerns, sports, state actions, and transportation by air, ocean and surface. In addition, various measures, regulations and laws permit the formation of trade associations, exchange of statistics, development of product standards and cooperation in Research & Development (the latter under the National Research Cooperative Act, 1984). Exemptions are also provided for selected aspects of intellectual property rights dealing with products covered by patents, copyrights and trademarks. However, these exemptions appear unique to USA for reasons which may not be necessary to go into for the present article.

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1 R. Shyam Khemani, Application of Competition Law: Exemptions and Exceptions, UNCTAD/DITC/CLP/Misc. 2.5 (LECG, Europe), 2002.

## *Economics of Exemptions from Competition Law*

*Horizontal M&As* - In addition, USA's enforcement policies allow for a "defence" (exceptions) to be made for horizontal M&As, which while resulting in substantial lessening of competition, have significant efficiency gains that cannot be realized otherwise through less anticompetitive means such as a joint venture. Consumer welfare or surplus standard is used in USA to judge whether such M&A transactions should be permitted. The enforcement policy of USA, as well as several court cases in this regard, has interpreted this exception very strictly. Generally speaking, the merger cannot result in lower output and the efficiency gains must not only be credible but also of such a magnitude that prices are not likely to increase. Moreover, the efficiency gains must be passed on to the consumer in the form of lower prices and/or improved quality and choices.

### **III. CANADA**

In Canada, limited exemptions are provided for professional sports, financial institutions' activities, and products covered by intellectual property laws (patents, copyrights and trademarks). However, these exemptions cannot be used to violate specific provisions of the Competition Act. For example, financial institutions cannot get together and set the deposit/loan interest rates and other service charges to customers (except for transactions outside Canada); professional sports organizations cannot impose unreasonable terms and conditions or limit the opportunities of individual players, but can form leagues and enter into franchise agreements that may be necessary in order to maintain a reasonable balance among teams, and participate in international agreements for that purpose. In a similar vein, the statutory monopoly position granted to products under the patent law may be withdrawn or amended if a firm engages in illegal business practices.

### **IV. EUROPEAN UNION**

The European Union under Article 81(3) of the Treaty of Rome<sup>2</sup> can grant exemptions from certain agreements and practices if they have significant countervailing benefits, either on their individual merit or through the application of a "*block exemption*". A block exemption relates to certain categories of agreements and to agreements in specified sectors. Only the European Commission can issue exemptions, which must be notified for clearance (except in the case of those matters covered by block exemptions). If an agreement or practice is not notified and authorized, it is subject to investigation and prosecution under the competition provisions of the Treaty.

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2 Art. 81(3), Treaty of Rome, 1957.

*Block exemptions-* The European Commission has issued a series of block exemptions for certain types of business practices and economic sectors in order to reduce the number of notifications, and the regulatory burden imposed on both the Commission staff and business firms. The block exemptions that have been granted cover exclusive distribution and purchasing arrangements, Research & Development cooperatives, patent and know-how licensing, and specialization agreements.

In each of the exempt areas, clauses are listed that define what may be legally incorporated or prohibited in the agreements. For example, a joint venture agreement between firms may contain a “non-competition clause” if it is “indispensable” to the success of the venture; otherwise it may be viewed as collusion to limit competition. Similarly, a block exemption may permit territorial restrictions of sales by firms for a period of time but not allow any other restrictions of competition.

In addition, the Commission has issued a number of exemptions covering transportation (road, inland waterways, air and marine), insurance, and agricultural sectors, and also computer reservation systems and motor vehicle distribution and licensing. Export cartels are also exempted in so far as they do not restrict exports and/or competition in the common market.

In contrast to the Canadian and United States approach where exemptions are based either on specific laws and legal provisions and/or on court rulings, the European Commission’s approach to granting exemptions is through administrative actions. The exemptions can be time-bound and can be reviewed and amended by the Commission itself. Interestingly, unlike in United States, the European Union does not have provisions for granting exceptions to M&As that may result in dominance on the grounds of economic efficiencies.

## V. UNITED KINGDOM

The United Kingdom’s new Competition Act (1998) has provisions for granting exemptions on a similar basis as contained in Article 85(3) of the Treaty of Rome.<sup>3</sup> The Director General of Fair Trading may also impose conditions on a parallel exemption or vary or cancel the parallel exemptions that may be granted by the European Commission. The exemptions are time-limited, and can have an effect earlier than the date on which they are granted. The provisions of the Competition Act apply to public bodies or undertakings in so far as they engage in commercial economic activities. Enterprises or sectors covered by specific legislation may not

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3 Art. 85 (3), Treaty of Rome, 1957.

### *Economics of Exemptions from Competition Law*

be subject to the provisions of the Competition Act if certain activities are explicitly permitted which may tend to restrict competition.

However, the Director General may make representations or call for the review and amendment of such laws in the interest of promoting competition. In this connection, it is noteworthy that even though recently privatized and deregulated economic activities such as the provision of water, power and telecommunications services are subject to oversight by different regulatory bodies, the provisions of the Competition Act still apply. The United Kingdom's Competition Act continues to exempt certain medicaments and books from the Resale Price Maintenance [Hereinafter, "RPM"] provisions. The law does not contain an exception for mergers on efficiency grounds. However, the Minister of Trade and Industry may override the decision of the competition authority if the M&A transaction is deemed to be in the public interest.

European Union member countries such as Belgium, Italy, Norway, Spain and others also have time-bound exemptions which are granted if, for example, they improve supply conditions in the market which lead to substantial benefits to consumers, improved quality of products, technical and technological progress and international competitiveness. The exemptions must be proved to be strictly necessary and not eliminate competition in a substantial part of the market.

## **VI. AUSTRALIA**

Australia's competition legislation i.e. the Trade Practices Act (1974) provides the Australian Competition and Consumer Council [Hereinafter, "ACCC"] with extensive powers for maintaining and promoting competition. Aside from the exemptions granted in areas similar to those in many other countries, such as international liner cargo shipping and collective bargaining agreements, the ACCC has extensive oversight responsibilities for competition matters in the provision of telecommunication and other infrastructure services, which, as noted above, do not always fall under competition laws of other jurisdictions.

Recently, the application of the Trade Practices Act was extended to cover certain operations of the government's postal services monopoly, which was previously exempted. The Act is otherwise generally binding on Crown (government) agents.

## VII. NEW ZEALAND

New Zealand's Commerce Act (1986) also exempts agreements relating to international shipping, wages and working conditions, joint purchasing and promotion, intellectual property rights, product standards, export cartels and the like. As in the case of Australia, the law applies to Crown (government) enterprises. Provisions also exist for authorization of such specific exemptions as may be deemed necessary.

In addition, the New Zealand law allows an exception to be made for M&As that may result in substantial lessening of competition but result in net benefits to the public. Net benefits have been interpreted to cover economic efficiencies and not social benefits.

## VIII. JAPAN

Japan's Antimonopoly Act (2009) applies to all industries. However, it has exemptions covering natural monopolies/infrastructure industries relating to "*railways, electricity, gas or any other business constituting a monopoly by the inherent nature of the said business*",<sup>4</sup> and intellectual property rights and cooperatives for agricultural and consumer products that are governed by other laws or regulations. In addition, there are provisions for exempting cartels for exports, depressed industries, and small and medium-sized enterprises. Japan also exempts some pharmaceutical and cosmetic items from the prohibition of the RPM provisions. The exemptions require notification and authorization by Japan's Fair Trade Commission [Hereinafter, "JFTC"] or the relevant authorities established under other laws. The cartels currently exempted from the Antimonopoly Act are being reviewed by the relevant ministries and agencies from the stand-point of abolishing them in principle, under Japan's regulatory reform programme. With respect to M&A transactions, Japan's competition law policy does not contain an efficiency exception. However, efficiency arguments are administratively taken into consideration in the determination of substantial lessening of competition and other horizontal agreements.

## IX. THE ECONOMIC RATIONALE FOR EXEMPTIONS

The brief overview of the competition legislation of various countries as mentioned above suggests that there are more similarities than differences in the general approach to exemptions.

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4 Art. 21, Antimonopolies Act, 2009.

While some economies such as the European Union describe the general conditions for granting exemptions, others tend to be more specific by listing particular sectors or activities, such as in Canada and USA. Nonetheless, the economic activities that are generally granted or eligible for exemptions can be said to fall into at least four categories:

- A. Exemptions aimed at balancing unequal bargaining power;
- B. Exemptions aimed at addressing information, transaction costs and “collective action” problems;
- C. Exemptions that reduce risk and uncertainty;
- D. Special sector and interest group demands.

**A. Exemptions aimed at balancing unequal bargaining power**

*Collective Bargaining*- Several jurisdictions exempt workers’ collective bargaining activities to form unions or group together to negotiate wages and other employment conditions. Such an exemption is aimed at counterbalancing the superior economic power and bargaining position which most firms/employers have vis-à-vis individual workers, and preventing exploitation of labour.

*Agriculture, dairy, fishing and forestry*- Exemptions for these sectors have been generally introduced in various countries in order to help ensure that farmers, fishermen and forestry workers receive “fair” and “stable” prices for their products and labour. The seasonal nature of their activities, the cycles in production and harvesting, and the social objectives of ensuring viable farming, fishing and forestry communities are also among the reasons for the exemptions.

In addition, with the advent of large processing firms in these sectors, the relative weak bargaining position of individuals engaged in these activities could be exploited. The formation and exemption of cooperatives and marketing boards were seen as possible corrective measures. The cooperatives can enable their members to bargain more effectively for higher prices for their products, and cooperate in such areas as processing, transportation, storage, standards and marketing to exploit available synergies and efficiencies not likely to be attained on an individual basis. However, individual cooperatives should still be regarded as businesses and subject to competition law provisions if they conspire with other cooperatives and non-members to restrain trade and/or monopolize the market. In

recent years, questions have arisen regarding the economic efficiency and pricing of agricultural and dairy products' marketing boards and cooperatives.

*Small and medium-sized firms and purchasing or buying groups-* The increased concentration in several types of industries has given rise to firms' "monopsony" market power. This can be countered by permitting the formation of purchasing or buying groups, which generally consist of small and medium-sized firms. Under such arrangements, the members can have countervailing bargaining power and obtain lower prices. Through the consolidation of purchasing decisions, transaction costs of doing business as well as potential economies of scale and scope in purchasing by the buying firms, and in production by the seller, can be exploited. For these reasons, purchasing or buying groups do not contravene competition law provisions unless they are used as a vehicle to engage in collusion and other anticompetitive business practices in downstream markets.

#### **B. Exemptions aimed at addressing information, transaction costs and "collective action" problems**

*Collection and exchange of statistics and credit information, and development and adoption of standards-* Information is an important factor in facilitating efficient trade and exchange, and so is the development, adoption and marketing of products of given standards of size, quality and other such attributes. Without information, there may be higher costs of doing business, mistakes and unnecessary risk and uncertainty. The lack of standardization can adversely affect interchangeability in the use of products, economies of scale and scope, and expanding market demand. There are few if any incentives for individual firms to engage in such activities, which serve the common good, because of high individual costs and "free-rider" problems. Exempting trade associations and firms engaged in collecting and disseminating relevant information, and promoting standards, with the proviso that this will not result in the violation of the other provisions of competition law, can thus serve to enhance economic efficiency and consumer welfare.

*Intellectual property rights-* The exemption accorded to intellectual property rights is one of the more complex areas of competition law and policy. Protecting and conferring statutory monopoly rights in respect of patented, trademark and copyright products is aimed at creating incentives not only for inventive activity but also for the early disclosure of inventions, and the diffusion of new ideas, products and production methods. Through such incentives, technological change and progress can be fostered and result in dynamic economic efficiencies.

## *Economics of Exemptions from Competition Law*

However, a careful balance has to be struck. Since exemptions in this area grant statutory monopoly rights to firms in respect of the IPR protected product(s) and exclude coverage of such matters as the prices that can be charged, the licensing of the product, geographical markets, and exclusive dealing, the firms can potentially abuse their dominant market position. To prevent such possibilities, many jurisdictions have published guidelines and legal provisions that delineate permissible and prohibited practices in exercise of intellectual property rights under the competition law.

*Learned Professions-* Exemptions for various professional occupations such as lawyers, physicians and accountants are granted on the grounds of ensuring qualified and ethical services. However, experience demonstrates that professional bodies frequently limit competition by erecting barriers to entry; for example, they set preferential standards and qualifications, prevent even informational advertising and fix fees. Given that most professional services are non-tradable and, in the case of medical services, entail non-discretionary expenditures, the consumer welfare consequences can be quite significant. Except for ensuring minimal qualifications and standards of services, blanket exemptions for professional bodies are not justifiable on economic grounds.

### **C. Board Independence**

*Insurance, investment brokerage and banking services-* The exemptions granted for underwriting insurance and securities and other selected activities of financial institutions such as consortium lending, are granted so as to reduce risk and uncertainty. However, these exemptions do not extend to pricing of insurance or security brokerage services, or to setting of interest rates and service charges by banks. Although in many jurisdictions financial institutions are completely exempted from the purview of competition legislation on the grounds of “systemic stability or the “specialized nature of the industry” there are no sound economic reasons for doing so. Given the central role played by financial intermediation, savings and investment in the economic development process, it is important to ensure a competitive financial services industry.

*R&D cooperatives-* R&D activity can be highly uncertain and risky, and require large investments over extended periods of time. Moreover, such activity, essential for technological progress and economic development, may not take place if firms fear that antitrust actions may arise against cooperative R&D joint ventures. Exemptions for R&D activities are therefore, generally speaking, justifiable. Cooperation and competition between firms are not necessarily in

conflict with each other. In industries such as pharmaceuticals and electronics, firms cooperate in R&D but compete vigorously against each other in the pricing and sale of their respective products. In most instances, the exemptions are time limited and necessary only as long as the cooperative or joint venture activity is envisaged. As in other situations, the exemptions can be withdrawn and member firms prosecuted if the R&D cooperative has served the purpose of engaging in illegal activities in violation of the competition laws.

#### **D. Special sector and interest group demands.**

In a number of jurisdictions, exemptions are granted for “special” sectors such as energy, liner shipping, air, trucking, professional sports, small business and government enterprises. In most of these cases there are no credible economic bases for exempting these sectors or types of economic activities from competitive pressures. This view also holds for many “natural monopolies”, which while being regulated by separate bodies are insulated from the application of competition law principles. Developments in technology, organizational methods and applied economics suggest that alternative pro-competition approaches to these sectors are feasible.

For example, privatization, deregulation, structural changes and the introduction of competition in several countries in the airline, power and telecommunication sectors have increased productivity, lowered prices and improved services. Arguments advanced for exemptions by specific industry groups (as against generic types of business arrangements) should almost always be treated with suspicion.

## **CONCLUSIONS AND RECOMMENDATIONS**

This overview of exemptions granted to specific types of economic activities and sectors under the competition laws of various countries suggests that there are more similarities than differences between jurisdictions. In almost all of the economies reviewed, the competition laws apply to both public and private sector enterprises, and exempt areas that are covered by other government legislation and regulations. In many instances, exemptions can be authorized on a time-limited basis and/or can be amended or removed if they result in violations of the substantive provisions of competition law. However, there are some notable differences as well. In some of the more established competition law regimes, especially USA, there is a patchwork of exemptions that have evolved through court proceedings and legislative actions responding to special interest groups. In many cases, there is a recognized need to re-evaluate these exemptions.

### *Economics of Exemptions from Competition Law*

Exemptions from the application of competition laws may be justified on various grounds as discussed above. However, as Governments need to respond to such needs, it may be useful to adopt certain basic procedures and principles in the granting of exemptions. In this regard, it will be prudent to quote suggestions from the UNCTAD Paper, as under:

- (i) Exemptions should be granted on a limited-time basis with a “sunset” clause and provisions for periodic review.
- (ii) The review of exemptions should include analysis of their impact on economic efficiency and consumer welfare, and in a cost-benefit framework identify the “winners” and “losers,” and whether indeed there are overriding benefits that serve the consumer or broader economic interests.
- (iii) The exemptions should be granted after public hearings with the participation of the interested and affected parties.
- (iv) The exemptions should be as minimally restrictive of competition as possible.
- (v) Exemptions should be generic in nature, relating to types of economic activities or arrangements, and be less industry or sector-specific.

## **THE INDIAN CONTEXT**

Thus, enough guidance is available on the economics for grant of exemptions. Interestingly, under the Competition Act, the grounds on which the Central Government is empowered to exempt any enterprise or any class of enterprise (read sector) under section 54 of the Act are, besides the ground of performing “sovereign” functions of the State (as was claimed by the Railways), the security interest of the State or public interest or to honor any international treaty or agreement, which may not be entirely justified on the economic principles enunciated in the International best practices, discussed above. Of course, the exemptions to IPRs and export cartels under section 3(5) and 3(6) of the Act, respectively, are based on sound economic rationale.

However, as Government needs to respond to such demands, more often than not, on political rather than economic considerations, it may be useful to adopt certain basic principles in the granting of exemptions, such as exemptions should be granted on a limited-time basis with a mandatory “sunset” clause and provisions for periodic review based on analysis of their impact on economic efficiency and consumer welfare and that exemptions should be generic in nature,

relating to types of economic activities or arrangements, and be less industry- or sector-specific.

Luckily, the draft National Competition Policy has recognized some of these economic principles and has devoted Para 5.2 for “Deviations from Principles of Competition Policy” which at least in principle accepts the “time limits” for such exemptions and the need for having a “sunset” clause in such exemptions. The relevant extracts are quoted below:

Deviations from Principles of Competition Policy-

- 5.2 Any deviation from the principles of competition should be only to meet desirable social or other national objective, which should be clearly spelt out. The deviations should adhere to the following rules:
- i. the desirable objective be well defined,
  - ii. should be decided in a transparent and rule bound manner,
  - iii. should be non-discriminatory between public and private enterprises,
  - iv. the mode, manner and extent of deviation should have the least anticompetitive effect.
- 5.3 There should be accountability in the process so that deviations are not made without adhering to the accepted competition principles. As a general rule, any deviation should be an exception with pre-determined tenure. There should be an in built sun-set clause to limit its continuation until it is found necessary.

It is hoped that the Central and State Governments will consider the above basic economic principles and heed to the lessons drawn from international experience described very briefly in this article. In particular, it is hoped that the governments will pay heed, at least, to the requirement of setting time limits for such exemptions and the need for having a mandatory “sunset” clause on such exemptions, as mentioned in the National Competition Policy. Otherwise, given the political compulsions of coalition governments in India, grant of such blanket exemptions to whole sectors of our economy will open a Pandora’s box for similar demands from other sectors, which will not only cripple the competitiveness in those sectors, but also render the modern competition law toothless and redundant in India, which in the long run will seriously affect our rate of growth and our dreams of having a free market economy based on competition principles, to be able to compete with our peers.