

The case of romanian cigarette market essay



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CHAPTER VIII. STUDY-CASES 1. THE CASE OF ROMANIAN CIGARETTE MARKET

1. Introduction Among the obligations assumed by Romania by (1) the EU Adhesion Treaty (2) there is the fact that, until 2010, the minimum tax level for cigarettes must be aligned with the minimum tax level of the member states - 57% of the most popular cigarettes' (MPPC) price, but not less than 64 Euros for 1000 cigarettes. Through the modifications made to the Fiscal Code in April 2006 by the OU 33/2006 the government approved the tax level, which will increase gradually until it reaches the required level. In 2006, this happened two times, at an approximately two month's interval). According to the decision, the tax of the cigarettes will be calculated by means of a fixed quota and another quota computed from a percentage of the cigarettes' value. The first increase stipulated that the tobacco tax should be of 9. 10 Euros for 1000 pieces plus 30% of the maximum price of retail selling (a medium tax of 32. 13 Euros for 1000 cigarettes), which produced an increase of approx. 0. 8 RON in the price of a cigarette package. Starting with the 1st of July, the tobacco tax jumped to 16. 8 Euros/1000 pieces plus 29%. The 177 article of the Fiscal Code was as well modified: for cigarettes the taxes due to equal the sum of the specific and ad valorem taxes, but not less than 19. 92 Euros/1000 cigarettes. When this sum is less than the minimum taxes, they are paid. The tobacco industry companies solicited a five year transition (however obtaining only three), in order for the tax level to reach 64 Euros in 2012. They claim that this period is necessary because the medium income in Romania is half the one of the other candidate states, and consumers can't afford the increase in price.

This statement is justified, even if it's about tobacco, which is harmful for health. The Romanian tobacco market amounts almost 1 billion Euros, with a total volume of 35 billion cigarettes, and is dominated by three large international producers, Philip Morris, British American Tobacco, and Japan Tobacco International, who dominate almost 90% of the market share. The remaining 10% is controlled by other producers or importers (a competitive cluster, because these firms have low market shares), making the market look like an asymmetrical oligopoly. 4 The paper analyses from the point of legislative and economic perspective the impact of the measures taken by the Romanian government in order to comply with EU requirement and their impact on the Romanian competition market. 2. Case analysis from the perspective of the Competition Law The tax increase has a significant impact on the entire industry, but the ones who are most affected are the poor quality cigarettes, the best sold brands, whose prices will get closer to the ones of the superior quality cigarettes.

As a consequence of the actions of the central administration, the premises for an unfair competition are shaped by favourizing certain producers (discrimination). Under these circumstances, the minimum taxes computed for 1000 low cost cigarettes amount to approx. 17 Euros. The producer won't pay only this amount, since there are also obliged to pay the minimum value of 19. 92 Euros established by the government. As a result of setting a minimum tax level and a process of taxation, the taxes applied to filter cigarettes are approx. 65% of their price, while the ones applied to cigarettes without filter are 90-95% of their price.

This measure negatively influences in particular the activity of the firms with low prices (most of which are, ironically, Romanian!), indirectly pursuing their elimination from the market. This way, discriminatory conditions are created for economic agents operating in this market. The prices of all cigarettes will increase, but the increase won't be proportional with the price, because the prices will increase more in the inferior segments than in the superior ones. The direct effect to this which will occur is that a market compression. The premium segment will take some of the share of the popular, sub-medium and medium cigarettes.

This means the elimination of the sub-medium and medium cigarettes producers and the consolidation of the position of premium and prestige cigarettes producers. They will share the remaining market shares, favouring the creation of a symmetrical oligopoly. The computations demonstrate that the main producers on the market will remain BAT and PM, who's portfolio mainly consists premium cigarettes and which will distribute the remaining 10% between themselves after the elimination of the small ones, as well as the 10% lost by their main competitor, JTI. Thus, the ompetition on the market will be significantly diminished through the eradication of the very condition of a competitive market - the existence of a sufficiently large enough number of producers so that the price is a result of the balance between offer and demand, as article 4 from the Competition Law stipulates.

95 By imposing the minimum tax, the base and value cigarettes producers will be forced to choose between two alternatives equally disadvantageous to them: either they sell at a lower price, and they lose, or they sell at the minimum price of 2. 6 RON, and their sales go down.

Due to this, their autonomy is affected, and also the freedom of trade (art. 9). The consumer has a limited possibility to choose and is forced to accept a higher price for a base or value product, which affects his/her welfare. The welfare of the end user is assured by the quantitative, qualitative and diversified existence of the goods on the market, depending on their utility, as perceived by the consumer. This way, the diversification in types of a homogenous good (the cigarette) is eliminated, and thus the possibility for the consumer to maximize his/her options is abolished.

3. Case study analysis in terms of economic effects

1. The contestability degree of the market and the importance of entrance barriers

A market which firms may enter or exit without incurring unredeemable costs of entrance is named a perfectly contestable market. A market may be perfectly contestable, even if the firm has to pay some entrance costs, as long as they may be redeemed during the firm's life. Because all markets necessitate at least some unredeemable entrance costs, their contestability should be accurately understood. It is generally considered that if the unredeemable entrance costs are lower, the market is contestable.

Unredeemable entrance costs form an entrance barrier and the higher they are, the higher are the profits of the firms already on the market. This doesn't even necessarily involve the appearance of new entrants. Generally, where the occurrence of contestable markets is possible, they act as a force which diminishes the profits of the existing oligopolists. Even if the entrance is not manifested, the easiness with which it could be executed can hinder the existing oligopolists to claim prices which may lead to the maximization of their reunited prices.

The majority of the economists consider that, although contestable markets are a refined extension of the competitive markets theory, there are at least some entry barriers in almost all real markets, which are very strong in some markets. Practically, contestability is something which must be measured, not just estimated. The higher the entrance costs, the less contestable is the market, and the higher are the profits the existing firms can earn without inducing the appearance of new entrants. 96

Scale and scope economies Big firms with large number of sales have a competitive advantage as compared with firms having low amounts of sales, once there is an important potential for economies that are based on the extensive division of labour. Scale economies emerge from the capacity to execute a firm's activities differently and more efficiently, thus obtaining increased amounts of products, as well as from the capacity of covering the costs of intangibles (like those for advertising and R&D) by distributing them to a larger number of products to be sold.

Scale economies may derive from the growth of efficiency in the effective execution of an activity on a larger scale, as well as from a slower increase in overhead or infrastructure expenses needed for financing a growing business. Scale economies should be clearly distinguished from the utilization of capacity. The increase of the degree of utilizing the capacity distributes fixed costs of production means and personnel to a larger production volume, while scale economies imply the fact that an activity which is performed at an integrated capacity is more efficient on a large scale.

The confusion between the degree of capacity utilization and scale economies may drive a firm to the false conclusion that, once the maximum degree of existing capacity utilization is reached, its costs will continue to go down if it extends its capacity. Big firms benefiting from scale economies may produce differentiated products which generate a different type of advantages, namely the range or scope economies. The development of a new product is costly and sometimes that product may be replaced by a superior version of it, in a few years.

These costs of product development should be covered from its sales. The higher the firm's sales, the lower the cost which has to be covered from the selling price of each unity. Where the size of the company confers an advantage of cost because of the existence of either scale or scope economies, there is practically no room except for a few firms, although the market as such is large enough. This size-based cost advantage will compel the industry to turn into an oligopoly, except in the case when the governmental regulations impede the firms' development to their efficient size.

In terms of the tobacco industry in Romania, the diversification of existing brands within the portfolio of big firms (PM, BAT, TI) represents an entrance barrier in the market for new firms, as well as the development of new products (high quality) by firms which produce cheap cigarettes, to exit the market. The idea of penetrating on new market segments with new products by small firms cannot be a solution, at least on the short run. In our case, since the most important three firms on the market each own an average of 7 brads, we can assume 97 hat there is an average of 21 brands on the <https://assignbuster.com/the-case-of-romanian-cigarette-market-essay/>

market. Thus, the market share a new brand could own would be below 1.5% (at most) in the first year, with the risk of losing it in the next years.

Installation costs- the advertisement The existing big firms can create entrance barriers by imposing some significant high fixed costs to new firms that enter the market (or a market segment), especially if the respective industry has relatively low natural barriers. The advertisement is one of those means through which the existent firms can impose high installation costs to new comers.

The advertisement itself has other purposes than those of creating entrance barriers. Among others, it fulfills the useful job of informing buyers about different existing products, facilitating in this way a better functioning of markets. Indeed, a new firm could consider that advertising is essential even when the other existing firms do not use it, simply for the fact that it attracts attention to its entrance on a market where it is still unknown. Advertising can operate as a possible entrance barrier, implicitly engaging an increase of entrance costs for new comers where intense advertising has facilitated the consolidation of a strong brand image for existing product. A new firm will have to spend more on advertising for the configuration of its own brand image in the mind of the consumer. If the firm's sales are low, advertising cost per sold unit will be high and its price will have to be high as well in order to cover those costs. A new entrant which has low sales, but which has high installation costs, will be in a substantial cost disadvantage compared to its rivals, who are already established on the market.

The tobacco industry is an example in which the combined use of the brand notoriety and the advertising acts like a market entrance barrier. In this

case, a firm sells most of the time multiple brands of the same product which are not only in competition with one another but also with the products of other firms. The tobacco industry is a classic example of such a behavior. Due to the fact that the economy of scale can be done in the case of cigarettes with small installation costs, they have few natural entrance barriers.

Usually, on the market there are a few big firms in which each produce a wide range of products who are intensely promoted. The high number of existing products makes it difficult, most of the time, to obtain a new market niche by a new entrant. Intense advertising, despite the fact that it targets already existing products, creates an entrance barrier by increasing the installation costs of new products who seek to capture and to win the consumers' attention through establishing their own brand image.

In addition, the reorientation of some producers towards other market segments (from base to value for example) becomes a very important barrier on the market if reorientation costs are high. This is due to the fact that the products that should be selling in the disadvantage of those offered by a supplier already set on the market should indeed have a special advantage for covering the reoriented costs generated by the entrance to the new market segment.

The governmental intervention This measure taken by the authorities can constitute a barrier for the entrance as long as they try to regulate the respective market by adopting a severe regime of granting licenses by granting exclusive franchises, setting rules or asking for great financial

efforts from companies or have as an effect discriminatory contributions between companies situated on the same market or simply by the taxation method. There are several types of taxes: progressive taxation (progressive tax) represents a higher proportion from the revenues of a person when the revenue increases.

In other words, the average taxation rate increases. regressive taxation represents a lower proportion from the revenue when the revenue increases. The average taxation rate decreases. proportional taxation (linear) means the percentage from the revenue paid as a tax is fixed (does not depend on the revenue). Thus the average taxation rate is constant. In the western countries it is considered that the fair and even fiscal system must have as a foundation 2 basic principles: the evenness principle and the advantage principle.

According to the first principle each person should pay a differentiated tax according to his or her revenues and payment capacity. The higher the revenue the higher the tax. The second refers to the fact that each person should pay the taxes according to the proportion in which he or she benefits from the taxed good or the utility received through that good. Even one of "Taxation rules" developed by Adam Smith says that the higher the taxed revenue of a person the higher the taxation rate.

Applying the taxation system on the cigarettes market contravenes the basic principle of evenness and of differentiation according to the payment capacity: the ones with low revenues and the reduced payment capacity have a higher taxation rate (90%) and those with higher revenues and a

higher payment capacity a lower taxation rate is applied (65%), instead of having it the other way around. The equilibrium of these taxes can have a significant effect on the distribution of revenues in an economy.

If a government wants to modify the structure of the taxes from progressive taxation to regressive taxation then the companies with low market share and reduced profits in a society will be 99 more affected by taxation. The government, through the taxation system, can favor certain types of behavior and can penalize others. The overall impact of a taxation system on the groups with high, medium and low revenues is best observed by evaluating the progressivism or regressivism of the entire set of taxes as a whole.

The current excising system on the tobacco market consists of applying a specific excise which, in its essence, is a regressive tax to which an ad-valorem tax is added, which is a linear (proportional) tax. The specific excise is a hidden tax by nature, because it is part of the products' price but obviously is not a tax on sales. On the whole, the excising system is a regressive one since the weight of the excises in the total selling price represents 84% for the cheapest cigarettes and reaches 54% of the price of the most expensive cigarettes.

In other words, the cheaper the brand the higher the incidence of excises, or the more one earns the smaller the proportion of the tax from the revenue, which is nothing else but the basic principle of the regressive taxation. 3. 2.

The effects on consumers and producers The effects of a tax must be analyzed taking into account the following aspects: those to whom these

taxes are imposed are not always the ones who actually pay them; moreover, the demand and offer elasticity for the product in question influences the effects of applying the tax.

When taxes are increasing and the demand decreases the most affected are the small firms (with small market shares, smaller profits and which produce goods with low prices). Let's take a hypothetical example where the equilibrium price and the equilibrium quantity on a market, before applying taxes, are 8 euros and 15 million pieces. Let's assume that the government applies an excise of 2 euros per piece. Who will pay this tax in the end? Due to the fact that the government imposes this tax to producers it can be interpreted as a surplus to the marginal cost of the good.

In this way, the producer must charge 2 euros/piece more in order to get the equivalent profit per piece it would have otherwise obtained in the absence of the application of the tax. The price after taxation is 9 euros per piece, whereas before it was 8 euros per piece. So in this case, the consumers will pay half of the tax of 2 euros because of the fact that they will pay a higher price for the good, while the producers will bare the other half by obtaining lower revenue.

Thus, both consumers and producers bare and share equally the tax.

Consequently, the equilibrium quantity sold from the good in question would decrease as an effect of increasing the price from 15 million pieces to 12.5 million pieces. If consumers bare the whole tax it would mean a higher selling price of the good (10 euros), which would generate the decrease of market sales to an equilibrium quantity of 10 million pieces. If the 100 inal

price determined by applying the specific excise raises the price in a discriminatory manner (meaning more for a cheap product and less for an expensive product), the effects will consist of a higher decrease in the quantity sold by cheap cigarettes producers (who will be obliged to increase the price per piece with the tax size if they want to maintain the same profit) compared to that sold by the producers of expensive cigarettes.

If the producers will wholly support the incidence of the application of the excise tax, due to the fact that the specific part of the excise on cigarettes is actually a tax per unit, the company pays it for each produced unit. This is therefore a fixed cost. So, the tax can be considered as if the costs associated to the production of each unit would increase. Hence, if the producer wants to maintain the price of 8 euro per piece for the sales volume not to decrease, he will have to deduct these 2 euros from his profit.

If the profit from the price was of 2 euro before taxation, the profit obtained by the company after taxation will be zero, even if the sales volume will remain the same. Given these conditions, the company will not be able to stay on the market for a long time. The Government's intervention on any industry with free market entry and exit can influence the size of the industry, the total sales volume, and the price at which its goods are sold, but the intervention cannot influence the long run profitability of the companies remaining on the market.

The method of sharing the fiscal tax between the producer and the consumer, or the incidence of the tax, depends on the elasticity of demand and supply. Generally, the tobacco market is considered an inelastic one.

However, even if the elasticity is less than one, it does not equal to zero. The sensitivity of smokers to the modification of the cigarettes' price has been studied for decades, through several researches, in different countries, in various periods of time. The vast majority of research studies have shown an inverse relationship between the price modification and consumption.

The price elasticity of demand is the proportion with which the demand for a certain product modifies with respect to a 1% increase of its price. When the price will increase, a quantitative decrease of the demand will be recorded. When the price will decrease, we will have a quantitative increase of the demand. By using quarterly data about tobacco products consumption in France, between 1976 and 1995, Anguis and Devaux (1997) estimated a price elasticity of -0.3 over a period of 9 years.

For the rich countries, several studies estimated a decrease in demand of approximately 4% accredited to a 10% increase of cigarette price that corresponds to an elasticity of -0.4. In countries with low and medium incomes, the price elasticity of demand is estimated to be greater than in the rich 101 countries, varying between -0.6 and -1.0. For these countries, a reasonable value for the average elasticity would be -0.8, according to research studies done by the World Bank in Bulgaria.

In terms of demand, the more inelastic it is for a product, the greater is the portion of tax which the consumers have to carry. In order to show this graphically we can use the extreme cases in which the demand is perfectly elastic, and perfect inelastic, respectively. In the first case, the negative effects of the tax are wholly carried by the producers; in the second case, by

the consumers. 3. 3. The contortion of the allocation of resources on the market The prices on a competitive market are the result of an equilibrium position on the market, which is considered optimal.

The optimum is defined in Pareto's sense, which means that no change from this equilibrium position can improve the wealth of some people without reducing the wealth of others. The imposing of a specific excise is an intercession of this kind, because it changes the relative price rates and therefore leads to a resource allocation which is not optimal. Pareto's optimum is more a necessary condition rather than a sufficient one. It doesn't take into account a model of distribution of the existing income, nor forecasts an unique optimal point.

However, a contortion of the relative prices determined by the application of taxes contradicts the necessary condition which assumes that a tax on the general income, or a tax on the total sales, leaves the relative prices unchanged and doesn't contort the optimal allocation of resources. Of course there is strong criticism attracted by the theory of the optimal allocation of resources. The first limit of this theory is that it cannot be applied unless the situation before the application of the tax is of competitive equilibrium.

Since this is not the case, it cannot be said for sure whether the excise will worsen the allocation of resources. It could be difficult to appreciate whether the specific excise will push the system farther or closer to the Pareto's optimum. On the other hand, if the position before tax is not of competitive equilibrium, it could be stated that in terms of economic wealth a tax on

income (output) or on factors of production (input) cannot improve the allocation of resources.

This tax will maintain an existing situation status quo that is less than optimal. Another limit could be determined by the fact that the optimal resource allocation can only take place if we assume that there are no external economies in the system. On top of that, a social decision, such as a fiscal measure, could not be conceived in the absence of external economies. Still, one could argue that there are some excises which can ameliorate resource allocations on the market, even when external economies are not present. 102

A principle established by Ramsey in 1929 shows that, if we assume that the demand and supply functions for a product's market and the production factors' function are linear, the smallest distortion in the optimal resource allocation would be determined by those excises whose rates vary indirectly proportional with the elasticity of demand. Due to this theory, and the corresponding argumentations, we can conclude that in order not to distort the current situation on the tobacco market, the specific excise should be higher where the elasticity of demand is lower (i. . on the prestige segment) and to decrease to its lowest rate for the base segment (where the elasticity of demand is highest), rather than opposite to the situation generated by the way excises are actually applied. According to Article 176 from the Fiscal Code, the excise for one thousand cigarettes is determined by the specific component, in the amount of 16. 28 € (increased from 15. 53 €), and the ad-valorem component of 29% (reduced from 30%), without making any distinction between different quality segments.

Article 177 adds the fact that, for cigarettes, the excise equals the sum between the specific component and the ad-valorem component, but for 1,000 cigarettes it equals no less than 30.83 € - the amount representing the minimum excise. When the sum between the specific component and the ad-valorem component is less than the minimum excise, the minimum excise must be paid, situation which increases the difference between the excise rate for the base segment and the one for the prestige segment (the rate is inversely proportional to the price and directly proportional to the elasticity, respectively, a situation which is opposite to Ramsey's principle on the optimal resource allocation). Any tax (which modifies relative prices) determines distortions and inefficiency, because of the different ways in which producers and consumers perceive the price of the same product on the market.

The consumers adjust their marginal substitution rates to prices which include taxes, whereas the producers adjust their marginal costs and, therefore, also the marginal rates of transformation, to prices which do not comprise taxes. Thus, the distortions occur since taxes determine consumers to perceive different relative prices than those perceived by the producers. Such a situation takes place when a product is taxed and another one is not, or when the effects of taxation have different influences on the price.

In our case, the excise represents between 65% and 95% of the product's price, situation which changes relative prices from the buyers' and the sellers' points of view (the seller perceives a rather small price, lowered by the excise, whereas the buyer of the same product perceives a higher price, which includes the excise). Hence, the difference between the relative prices

as perceived 103 from the two points of view rises once the cigarette brand stands closer to the base segment, meaning that the greatest distortions occur between the consumers earning low incomes and the producers of cheaper cigarettes. . 4. Effects upon the State The economic theory underlines the fact that an increase of taxation rates above a certain level would rather decrease than increase revenues from taxation. This affirmation is based on the fact that when obligations exceed the limits of equitable requirements, both companies and individuals lose interest to pay up debts, as they compare expenses and taxes to their revenues and notice the low profits they obtain. Laffer, a famous economist, demonstrated with the help of a curve that bears his name, that very high compulsory taxation rates destroy the base.

In this way, the phenomena of resistance and the reduction of the productive effort are provoked (the disintegration of work, savings and investments), which reach a level that determines the decrease of their total amount. It becomes obvious that an erroneous choice of the taxation method reduces the optimal level of intervention and turns gains into losses. Hence the introduction of a minimum level for excise and of a method of taxation which stronger influences the increase of prices on the segment, targeting low income consumers, has nothing but negative effects.

The consumers (especially those who earn low incomes and who, according to various studies and analyses, are proved to smoke more) will have to switch to, and focus on, cheaper products, which can only be found on the black markets. Under these circumstances, the degree of tax evasion is expected to increase and revenues from excises to the state budget to

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decrease. Large scale smuggling, which involves the illegal transportation, distribution and sale of huge amounts of tobacco products and the avoidance of taxes in general, represents the highest proportion of illegal commerce.

This form of commerce may be responsible for as much as 80% of the total national consumption. In Norway, for instance, the undeclared consumption of tobacco products represented almost 25% of the total consumption within this category for the period of 1997-2000. Another example is that of Great Britain, where taxes have risen 5% above the inflation rate between 1998 and 1999, but revenues to the state budget have decreased as a result of a continuous increase in smuggling.

Until 1999, uncollected revenues due to tobacco smuggle have therefore been estimated to as much as 25% of total collected revenues from tobacco excises. In March 2000, the government has launched a strategy of handling the problem related to smuggling, allocating ? 209 million for a period of three 104 years. In 2000, the taxes applied to tobacco increased 5% more than the inflation rate, whereas during 2001 and 2002 they were kept at the same level.

Excises for cigarettes cause the increase of the inflation rate, as prices increase without contributing to the improvement of the product. The increase of excises should not be greater than or equal to the inflation rate in order not to affect the categories of consumers who have low income, as a result of the inflationary trend determined by the increase of prices. Thus, the fiscal policy has major negative consequences on the disinflation process

in a country like Romania, where cigarette excises have increased twice in two months time.

In the daily consumption basket considered by the National Institute of Statistics, cigarettes have a share of 4%. In this way, further increases in the excise for this category of products might seriously reflect upon the level of increase of price consumption. 4. Conclusions The case presented supports the fact that the Romanian market experiences a period of accelerated fiscal transition and dynamics, and cannot, under any circumstances, be considered a functional market.

The laws of market economy state that, in the end, it is the consumer who decides which producer is to stay on the market and which one has to exit, and not the state, voluntarily or involuntarily, through different sorts of measures it takes. With the end of the transitional period towards the goal recommended by the European Union and assumed by Romania, the market will stabilize due to the ceasing of the accelerated fiscal dynamics encountered at present.

This might represent the moment when the exit of producers from the market will only be a consequence of the customers' preferences. The public authorities should do their best in order to make sure that customers' decisions are made under the circumstances of the highest possible freedom of choice, meaning that the range of quality, price and producer segments should be as wide as possible. If those conditions would be met, nobody could argue that we deal with unfair competition. Studies show that there is no European model regarding the structuring of excises.

The harmonization at European level is very limited and has just recently started. The only common element is the measure stipulating that taxes must represent at least 70% of the retail price of the best sold category of cigarettes - 57% corresponding to the excises and 13% to the VAT. There are countries in which the specific component dominates the structure of the overall excise, as well as countries in which the ad-valorem component is more significant. When the public authorities probably decided to structure excises, they considered not only the amount of associated revenues to the state budget, but also the actual situations of each market, taking into account the presence of such factors as: the standard of living of the population, the structure of competition on that particular market, and the presence of local players. However, one can notice that there is some consistency with respect to the situation of EU member countries. Hence, in the less economically developed Mediterranean countries (Spain, Portugal and Greece) the ad-valorem component is more significant, whereas in the more economically developed Nordic countries, the specific component is more important.

As a consequence, a direct correlation can be made between the standard of living in a country and the preference of its government for the ad-valorem excises, which generate a wider range of prices for all population segments and mostly for those earning low incomes. On the other hand, it can also be concluded that the southern countries, which have a tradition in the production of tobacco and in its consumption (and present a relatively high number of local independent tobacco producers), have preserved this state of fact through maintaining a higher ad-valorem component.

Moreover, on the markets of the more economically developed countries where the low quality segment is much less important, the application of excise policies did not have significantly distorted effects. In the case of East European countries, a difference must be made concerning the process of privatization of the local tobacco producers. Once these have been acquired by the greater and more powerful transnational companies in the tobacco industry, the local brands have implicitly become part of diversified portfolios which also include luxury brands.

Should this be the case, the structuring of the excise becomes rather irrelevant from the point of view of the competition. The problem of structuring excises and its potential anticompetitive effects is more difficult to handle in the countries where the local tobacco producers have remained independent, in which they offer a portfolio of products which have not significantly changed, and are still focused on cheap and low-quality brands. This is mostly the case in Romania, but Bulgaria also deals with a similar situation.

Beyond the complexity of the effects it entails, this case remains an illustration of the low enforcement level of competition law in Romania, the non-implication of the Competition Council in a situation that infringe the competition law having a negative impact on the Romanian business environment as a whole. Thus, we may conclude: (1) the Romanian business environment still represents an unstable environment, in which the most powerful players set the rules; 106 2) the influence of politics in adjusting market mechanisms is still significant; (3) the correct and transparent application of the law is not entirely ensured, remaining a desiderate; (4) the <https://assignbuster.com/the-case-of-romanian-cigarette-market-essay/>

Council of Competition, even though it made sustained efforts regarding its transparency and credibility, remains an institution subordinated to political interests, lacking the force and necessary instruments needed to create the competitive climate specific to market economies. 2.

THE VOLKSWAGEN CASE When the firms agree to cooperate by restricting the production and increasing the prices, their behavior is called explicit or tacit complicity. The complicity behavior can occur with or without a settled agreement of being accomplices. Where an explicit agreement occurs, the economists say it is open or covered complicity, depending on the agreement which can be open or secret. Where an explicit agreement does not occur, it is defined as tacit complicity.

This type of complicity behavior existed between the Volkswagen AG car manufacturing company and its dealers from Germany during 1996-1999, being sanctioned by the Commission in 2001 with a fine amounting to EUR 30.96 million¹². The reference case is still in view, because of the implications in the competition field, but also because of the interdependence, most of the time an unfortunate one, between a rigorous marketing policy and the anti-competition practices forbidden by the competition law.

Although, initially, there was no written agreement, due to the letters and circular letters repeatedly sent by the manufacturing company to the dealers from Germany, through which they were advised to observe the price recommended with regard to the selling of the new model of VW Passat, due to the minutes of the meetings between the leadership of VW and the

leadership of the dealers association, but also due to the letters through which some of the dealers were disclosing the practicing of some prices under the level established by other dealers, we can qualify this behavior as one of explicit cooperation.

But which is the argument of accepting this type of behavior by the distributing companies? The explicit or tacit cooperation, by correlating the production or the price, allows the firms participating in the cartel to achieve results equivalent to a monopoly on that market. In case of oligopoly (107 dealers' market from Germany), where the number of firms is small, in order for each of them to take into consideration the way in which other firms will react to its private actions, the behavior models are numerous. The behavior of the oligopoly is generally a strategic behavior, which means that the firms are explicitly taking into account the impact of their decisions on other firms on the market and the decisions they expect from them.

If the firms cooperate, whether open or tacitly, in order to share the production or territory (in this case, a distribution network), it can lead to the maximization of their reunite profits (this was the objective of VW manufacturing company). If they do this, they will reach what it is called the cooperation solution, meaning that position on the market, which a single firm (monopoly) can occupy if it would hold all the distribution firms on the market.

The exclusive distribution agreements (whereby the German dealers were accepting the conditions imposed by the manufacturing company to trade the products only in a certain area and for a fixed price) had the significance

of a carteltype agreement for the pricing on the market (at an imposed retail price, without having the possibility to grant price reductions, only exceptionally and only small reductions) and of a market division (they were forced and agreed to sell in a pre-established area).

The accepting of this type of cooperating behavior from the dealers from Germany can be more simply explained with the help of games theory (namely, "prisoner's dilemma"). Briefly, the explanation resides in the fact that, in case of oligopoly, as it is currently the case, the results obtained by each firm depend not only on their decision but also on the decision of the competitors. ¹³ Let's suppose that two companies, A and B, form a local duopoly within the distribution sectors for motor-vehicles.

In December, both firms use to make great investments in advertisement, so great that they are losing the entire benefit. This year, they have decided and agreed not to advertise, in order for them to be able to obtain benefits amounting to EUR 50 million, if each of them fulfills the agreement. Still, one of them can prepare its advertising campaign in secret, launching it in the last moment, so as to attract all consumers.

In this case, its benefits would be in amount of EUR 75 million, while the other company would lose EUR 25 million. ¹⁰⁸

	Company A Cooperates	Company A Cheats
Company B Cooperates	50, 50 (2, 2)	75, 0 (1, 4)
Company B Cheats	0, 75 (4, 1)	-25, -25 (3, 3)

If both companies get involved in a price war, making each time greater reductions, both would suffer important losses, amounting to EUR 25 million each. If they agree not to make reductions, each of them would win EUR 50 million, and generally, they will have a maximum profit.

The fact that the maximum amount which can be obtained is of EUR 75 million or 85 million does not influence too much the adopted decisions, the only thing that truly interests is the way in which the results are arranged. If we substitute the concrete value of the benefits depending on the order occupied among the preferences of the players, we will obtain a new matrix. This type of situations is very frequent in the real life and it is called “Prisoner’s dilemma” (to cooperate or not cooperate).

Starting from this reasoning and from the applications of the games theory in economy, the final objective of VW company can be deducted: maximization of the profits cumulated from the sale of the new model of Passat (which could not be obtained if the dealers would have been allowed to break the agreement and to grant price reductions) and the consolidation of its position on the market.

The games’ theory and the prisoner’s dilemma also explain the motivation for which some of the German dealers have broken the exclusive distribution agreement, by trying to sell the car at a smaller price than the one recommended (by applying reductions of 7% up to 12% of the recommended price) because the cooperation behavior always provides the individual companies with stimulants for cheating, by increasing the sold quantity and obtaining increased profits. The larger the number of companies is, the greater the temptation to cheat, for any of them.

In the previously presented example, if one of the companies does not observe the agreement by making a small reduction, it will be able to sell more and obtain a benefit of EUR 75 million, while the other one will lose

many clients, remaining without benefits and registering 109 financial losses. In practice, when one of the companies cheats, also the other has the motivation to cheat. Company A will count as following: " If B does not advertise, it suits us best to break the agreement, but if they are the first who cheat we will also be suited to do it.

Irrespective of the strategy adopted by our competitors, what suits us best is to cheat them. " Company B will make a similar analogy. As a consequence of this fact, they will both cheat on each other and they will get worse results than they would have gotten if the agreement was maintained. 15 The behavior of the company which betrays the agreement will determine a decrease of prices on the respective market and it will impede the two companies to reach the sales which maximize their profits in general, which in this case will be more decreased.

When each of them is guided by the same selfish strategy, they reach a non-cooperative equilibrium point, in which the total production is greater than the one produced by a monopolist. Each of them has at that point less profit than in case of a cooperative solution. This fact could not be avoided in the case of the agreement between VW and its dealers; some of them could not resist the temptation to offer price reductions in order to sell a greater quantity and to finally obtain a more increased individual profit.

Still, the constraints imposed by the Volkswagen AG manufacturing company (the threats of terminating the agreement or bringing into court) were meant to impede the generalization of this type of behavior and to encourage its denunciation by other dealers (which would have suffered great losses, if

they had observed the agreement and not cheat, according to the above mentioned reasoning), because, in case of a non-cooperative behavior, the company which cheats obtains great profits, only if the others cooperate.

Anyway, in spite of the efforts of the car manufacturing company to impose the dealers a certain behavior (which has maintained for three years, between 1997 and 1999), the Commission has decided that the respective agreement is a serious infringement of art. 81(1) and sanctioned the anti-corruption practice with a fine amounting to EUR 30. 9 million. Its quantum was established based on the analysis of the main aspects connected to the infringement of the legislation in the competition field, namely: the nature of the agreement and its seriousness, the duration of the practice and its effects on the trade within the community. 10 By its nature, the agreement between VW and the dealers is a vertical-type agreement based on an exclusive distribution contract, whereby the manufacturing company requires the distributors to sell within a delimited area, not to supply to other distributors and not to distribute competitive products of other manufacturers. Also, the manufacturer sets the price and forces the distributor to sell the products at this price, any reduction resulting in the cessation of the supply by the manufacturer because it brings prejudice to the product and mark image, being contrary to the interests of VW.

In other words, it is about imposing a selling price, which in order to elude the legal regulations, is under the aegis of the recommended price. But a recommended price has a strictly guiding character and, if the distributor fails to observe that price, it can not be sanctioned by supplier (through the

circular letters sent, the company VW threatened to take actions in case of this type of behavior is carried on).

The consequences of this type of vertical agreement on the competition depend on the (current or potential 16) negative effects on the intra 17 and inter branch trade (demonstrated through the evolution of the imports and exports in and from Germany for the new Passat model, which have decreased during the reference period 18). The recommended price reductions (together with the service and other related services) are the main advantage put at the disposal of a car dealer in order to handle the intra and inter brand competition with national and foreign dealers.

This only contributes to the establishment and consolidation of an area with an artificially increased price for a certain model, this aspect being incompatible with the objectives of the sole internal market. Due to the fact that Germany is by excellence one of the most expensive countries from EU as concerns the acquisition of new cars, we could think that, in their search for a better price, the German consumers could have migrated to the country which was able to offer the best price.

Still, in this case, the agreement has prejudiced the consumer's welfare as this reasoning is not widely applicable. Thus, a multitude of other obstacles come in the way of parallel trade and the acquisition of a new car by a consumer from another state of the European Union proves to be difficult, especially where the local dealers serve a certain territory (as in this case, and possible advantages were only offered to the ones from the respective territory: down payment, post-sales services, warranties, etc.).

The principles of the fair competition suggest the contrary: the consumer should have the last word in selecting a product, and the price represents an important factor in justifying his choice. 111

3. THE CASE OF GERMAN BANKS AND THE EURO CURRENCY

Euro - a feared competitor The European Council from Madrid 19 has settled, in December 1995, the schedule for the transition to the sole currency and a common framework for the development of this process, but many details related to the technical preparation remained unsolved.

Thus, starting with January 1st, 1999, for a three years period, Euro has existed only as virtual currency in the states from the economic and monetary union. 20 The national banknotes of the participant states have continued to circulate and to be part of a transaction through the currency exchange services, at a currency rate irrevocably established between them and Euro from January 1st, 1999, the units of the national currencies becoming subunits of Euro currency.

Starting with February 1st, 2002, the national banknotes and coins have actually circulated in parallel with Euro for a six months period, being gradually withdrawn from circulation during this period. Before January 1st, 1999, the earnings of the banks for the currency exchange transactions were exclusively represented by the difference between the selling rate and the buying rate of different currencies (spread).

After this date, the fixed and irrevocable conversion rate between the currencies of the 12 states and Euro currency had as effect the disappearance of the double and automatically rate of the earning cashed by

the banks as a result of these operations. Even if this fact had to lead to the decrease with 20% of the costs determined by the elimination of the currency exchange risk (by eliminating the fluctuations of the exchange rate), still the banks have considered that the currency transactions have to be taxed as a commission.

The commission was going to cover the storage, transfer, provision and processing costs connected with the sole currency, but also the inventory and risk coverage costs for the risk of receiving fake banknotes. The recommendation of the Commission from April 23rd, 1998, regarding the banking commissions levied for the conversion to Euro currency, stipulated only one good practice standard. Thus, the communitarian authority has not expressly requested that the currency exchange, between the currencies of Euro area, be made without levy a commission 112 (excepting the amounts transferred from Euro in the national currency and vice versa, within the transition period) nor has it imposed restrictions to the freedom of the banks in applying this commission according to the individually established policy. The only mandatory stipulation for the banks was referring to the fact that the application means for this type of commission have to be based on transparency and informing of the consumers in due time.

Tricky commission The developed banks, whose currency exchange operations were significantly contributing to the total profits, were the most affected by the consequences of adopting the common currency. The loss of some additional incomes in a technologically readapting period was felt in a more profound way by the great institutions, with a developed infrastructure, whose exchange offices, with an activity exclusively based on currency

operations, could not be supported during the transition period, although their activity continued in the same manner, even more sustained.

For example, Deutsche Reisenbank 21 had in 1997 approximately 60 exchange offices and 300 associates and 80% of the obtained profits were coming from the exchange operations, which were going to decrease with 40% after the introduction of Euro currency. Furthermore, Bundesbank 22 was bound, according to art. 52 of the SEBC 23 statute, to buy the currencies of the states from Euro area, from the banks or the public, free of any commission, during the transition period. In this way, the other banks from the system would have been forced to apply a similar treatment, to perform exchange operations free of commission or with low commission.

The effects would have been felt by the Dutch banks, forced to review their earning margin, or to face the risk of movement, with regard to the currency market, from Holland towards Germany, where the costs of the transactions would have been more attractive. 24 Thus, the relevant market of the product in this case is formed of the Euro subunits exchange service, in which at least a part of the transaction contains banknotes and coins of the 12 states that are members of Euro area, this service being mainly offered by the banks and exchange offices.

The German system is dominated by the universal banks, which at the end of 1998 did not exceeded 3400, having more than 45 000 subsidiaries. 25 Confronting with an inevitable fact, which was going to decrease their profits, Commerzbank AG, Dresdner Bank AG, Bayerische Hypo- und Vereinsbank AG, 113 Deutsche VerkehrsBank AG, Vereins- und Westbank AG

appreciated, as a result of some successive meetings and discussions in 1997, that they can not handle the costs determined by the sole currency only if they continue the application of 3% banking commission during the transition period.

This fact has helped them to recover 90% of the losses they would have unconditionally suffered between January 1st and July 1st 2002. If the application of a commission, even if it is only of 3%, was in full accordance with the recommendations of the Commissions, without existing an express interdiction, taking into consideration that this decision has been fully considered an infringement of art. 81, which regulates the agreements between firms. It is not accidentally that the five banks, which infringed the provisions of art. 1, form the group of the commercial banks (Kreditbanken – a distinct category among the universal banks) also known as „ the big four”, and their share on the retail currency market represents an average between 70% and 80%. Although the Commission did not make this distinction in the analysis of the case, they can be seen on the sub-market delimited by the segment of commercial banks as an oligopoly, which is automatically subjected to the trend of coordinating the behaviour in order to preserve the profits and consolidate a position on the respective market.

It would not have been that simple, and the stake not so important for the 594 savings offices or 2 256 cooperative banks present on the banking market from Germany, whose influence, determined by a reduced market share, would have been an insignificant one. It is not surprising the fact that Deutsche mark held at that point in time the supremacy between the most

requested exchange currencies, both for buying and selling on the Union territory.

Thus, of the total volume of the selling transactions with the national currencies of the states from Euro area of approximately EUR 17 billion in 1998, 35% were represented by the sales performed with Deutsche marks. At the same time, the German currency held more than 50% of the total volume of buying transactions, evaluated at EUR 24. 7 billion. Decision without comments On December 11th 2001, the European Commission decided to apply to the five banks, who have agreed on the application of the commission, fines between EUR 2. million and EUR 114 28 million, depending on their importance on the relevant market, based on the income obtained within the previous financial exercise. In order to obtain a greater discouraging effect for this type of practices, for some of the banks participating in the agreement 26 , the value of the fine was doubled, taking into account their size and the available resources. To the initial amount, reflecting the seriousness of the understanding, an increase of 40% was added, representing the duration of the infringement.

Although the understanding had as object the application of the commission between January 1st, 1999 and December 31st 2001, the Commission applied the fine, taking into consideration the time of decision-making, namely October 15th 1997. Having as object the way of taxing the transactions with currencies under the form of a commission, but also of the level of this taxation of approximately 3%, in order to recover some future losses, the understanding of the German banks have been considered a

serious infringement of art. 81 (direct pricing) forbidden per se, without existing the need to demonstrate an effect.

The understanding did not have as result the application of a 3% fixed commission by all the banks which have not participated in the understanding, but the causing or non-causing of the effects on the market is not relevant in the assessment of this type of understandings, especially if the object is the price. 27 Anyway, the common discussions took into considerations a margin of the commission between 2 and 4%, but finally, none of the banks practiced a commission under 3%. The legislation in the competition field forbids the coordinated behaviour of the participants or nly their intention to align the price (in our case, the price for the currency exchange service) to the prejudice of the consumer, without being important if the effects were concretely caused, are about to be caused or are just probable. The understanding had an explicit character, existing concrete evidence of the agreement (multiple meetings ascertaining documents, facsimiles and invitations), whose object or effect was the diminution of the competition, being capable to affect the commerce between the member states.

In spite of the fact that the respective understanding was referring to the banking market from Germany and cross-border regions from Holland, the European courts think that any diminution of the competition, which regards the territory of a member state, by its nature it has the effect of enforcing the division of the market at national level, which contradicts the principles of the sole market. Still, in this case, the exchange services with the currencies of the 12 member states imply multiple operations of selling and

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buying banknotes in the international markets by the banks, as result of the foreign currency demand, which is encountered in each state. The currency exchange is guided towards consumers in general and especially the tourists (both from and out of the Community), who wish to make payments within Euro area. In other words, it means a cross-border service, with effects on the intercommunitarian commerce. Implications for Romania According to the officially expressed intentions of adopting the European sole currency, Romania will adopt Euro between 2012-2014, after it will have accessed the European exchange rates mechanism (ERM II) between 2010-2012.

Among other measures, this fact also means the maintenance of the exchange rate between Euro and the Romanian currency within the limits -2.25% , $+2.25\%$. Among the states from the Central and Eastern Europe, which acceded to UE in 2004, Estonia, Lithuania, Slovenia, Cyprus, Latvia and Malta are already in the preliminary stage of adopting Euro (ERM II), most probably following that in 2008 to be members with full rights of the Euro area.

For Slovakia, Czech Republic and Poland 2009-2010 perspective is the most realist one, while the bets for Hungary (with a record in budgetary deficit over the last year) rather indicate the year 2014. It should be specified, before introducing Euro, the banks do not have an explicit commission for the currency transactions. The consumers pay for any currency exchange a fee hidden in the difference between the sale rate and the buying rate of the respective currency (and in Romania it is erroneously perceived as 0%).

In Germany, before introducing Euro, this fee was varying from 1.5% to 7%, depending on the type of currency. Together with the disappearing of the double rate, through the existence of the fixed and irrevocable convertibility between the other currencies and Euro (an inevitable fact before adopting Euro), the existence of the commission will be directly perceived by the consumer through a percentage applied to the value of the transactions.

Sometimes, this acknowledgement has dramatic effects on the banking sector, as it has happened in Germany, where more than 700 complaints submitted by the consumers have apprise the Commission with regard to the commissions practiced on the currency exchange, and implicitly, lead to the investigation and application of a fine amounting to EUR 100. million given to the bank. 116 Romania may adopt Euro currency before Hungary or not, but the German experience is relevant for Romania due to at least two viewpoints. First, an important step, such as the introduction of Euro has to be prepared and assessed in order not to surprise the actors on the banking market, or the authorities and consumers.

Each of them has to know in due time which are the available instruments, when and how they need to access them in order not to break the competition rules: The authorities have to issue in due time clear norms and regulations together with an adequate interpretation and communication to the financialbanking environment, which should provide it with a facile and less expensive conversion towards Euro, banking institutions should correctly and transparently apply these norms, and the consumer should know which is his/her role in the implementation of the competition legislation.

Secondly, the application of an individual banking policy under any form, even with the risk of bearing some costs on short term is preferred instead of a common agreement against the consumer, likely to be sanctioned by the competition law. 117