

When Can We Expect a Corporate Leniency Program to Result in Fewer Cartels?

Joseph E. Harrington, Jr. *University of Pennsylvania*

Myong-Hun Chang *Cleveland State University*

Abstract

Leniency programs have become widespread and are generally quite active as reflected in the number of applications. What is not well understood is how they affect the number of cartels. This paper develops and explores a theoretical framework to help understand when leniency programs are likely to be effective in reducing the presence of cartels. Plausible conditions are derived whereby a leniency program can result in more cartels. On a more positive note, we identify situations and policies that a competition authority can pursue that will make it more likely that a leniency program will have the intended effect of reducing the number of cartels.

1. Introduction

The Corporate Leniency Program of the US Department of Justice's Antitrust Division gives a member of a cartel the opportunity to avoid government penalties if it is the first to report the cartel and fully cooperate. Since its revision in 1993, the program has been flush with applications. Deputy Assistant Attorney General Scott Hammond noted in 2005 that "the revised Corporate Leniency Program has resulted in a surge in amnesty applications. Under the new policy, the appli-

For their valuable comments on a previous version of this paper, we thank an anonymous referee, Louis Kaplow, Kai-Uwe Kühn, Yossi Spiegel, and Juuso Välimäki; participants of the 15th Wissenschaftszentrum Berlin Conference on Markets and Politics, the second conference of the Research Network on Innovation and Competition Policy, the 2009 Helsinki Center of Economic Research Conference on Cartels and Collusion, the Third Workshop on Industrial Organization (Zapallar, Chile), the Third Annual Searle Research Symposium on Antitrust Economics and Competition Policy (Northwestern University); and seminar participants at George Washington University, Lafayette College, the University of Texas at Dallas, the University of North Carolina at Chapel Hill, the Kellogg School of Management at Northwestern University, Pompeu Fabra University, the Center for Monetary and Financial Studies, Heinrich Heine University of Düsseldorf, VU University Amsterdam, the Tinbergen Institute, and Harvard Law School. Harrington gratefully acknowledges the financial support of the National Science Foundation (grants SES-0516943 and SES-1148129) and Santander through a Chair of Excellence. He also expresses his gratitude to the faculty of the Department of Economics of the University of Carlos III of Madrid for providing a most collegial and stimulating environment.

[*Journal of Law and Economics*, vol. 58 (May 2015)]

© 2015 by The University of Chicago. All rights reserved. 0022-2186/2015/5802-0014\$10.00

cation rate has jumped to roughly two per month” (Hammond 2005, p. 10). Furthermore, he commented, “The extraordinary success of the Division’s leniency program has generated widespread interest around the world” (Hammond 2005, p. 10). That is indeed the case, as the steady flow of leniency applications in the United States led the European Commission (EC) to institute its own leniency program in 1996, and a decade later 24 of 27 EU members had one. Globally, leniency programs are now present in more than 50 countries and jurisdictions.¹

In many of these countries, leniency programs have similarly been active and viewed as successful. In South Africa, which put in place its program in 2004, applications were flowing in at a rate of about three per month by 2009–10, which even exceeded that in the United States. A week prior to Spain’s institution of its leniency program in June 2008, cartelists were literally lining up outside the doors of the National Competition Commission’s offices in order to be the first from their cartel to apply for leniency. In Germany, the cartel office noted, “The first version of the Leniency Programme was already a success. This can be seen by the number of leniency applications filed: Between 2000 and 2005 a total of 122 leniency applications were filed” (Bundeskartellamt 2010, p. 19).

It is clear that many leniency programs have sparked numerous applications. It is also clear that one can identify specific cases for which a leniency program was responsible for the discovery of the cartel and was instrumental in its successful prosecution. What is far less clear, however, is whether leniency programs have been successful in the sense that these economies are populated by fewer cartels. Ultimately, success is to be measured by a small number of cartels, not a large number of leniency applications.

In light of the widespread adoption and usage of leniency programs, there is a vast and growing body of scholarly work intended to examine the effect of these programs (see Spagnolo [2008] for a review of some of the early work). Starting with the pioneering paper Motta and Polo (2003), theoretical analyses include Ellis and Wilson (2001), Spagnolo (2005), Motchenkova (2004), Aubert, Rey, and Kovacic (2006), Chen and Harrington (2007), Harrington (2008), Harrington and Chang (2009), Houba, Motchenkova, and Wen (2009), Silbye (2010), Choi and Gerlach (2012), Lefouili and Roux (2012), Sauvagnat (2013), Bos and Wandschneider (2013), Chen and Rey (2013), Gärtner (2014), Marshall, Marx, and Mezzetti (2013), Blatter, Emons, and Sticher (2014), and Marx and Mezzetti (2014). The general conclusion of this body of work is that leniency programs make collusion more difficult.

A common feature to all of these models is the assumption that the introduction of a leniency program does not impact enforcement through nonleniency means. Nonleniency enforcement is modeled as the probability that a cartel is discovered, prosecuted, and convicted in the absence of a member having entered the leniency program. As a cartel member will apply for leniency only if it believes that doing so is better than running the risk of being caught and convicted,

¹ For a list of countries with leniency programs, see Borrell, Jiménez, and García (2014), who also estimate how leniency programs have changed the perceptions of managers.

nonleniency enforcement is integral to inducing firms to apply for leniency. If this probability is low, then few cartel members will use the leniency program, while if the probability is high, then cartel members will race to apply for leniency. The impact of a leniency program is then intrinsically tied to the level of nonleniency enforcement.

Next note that it is natural to expect that the introduction of a leniency program will affect the level of nonleniency enforcement. A leniency program may cause the scarce resources and attention of a competition authority (CA) to shift from nonleniency cases to leniency cases. However, this does not necessarily imply that nonleniency enforcement is weaker. If a leniency program is successful in resulting in fewer cartels, there will be fewer nonleniency cartel cases, and in that event the authority may still have ample resources to effectively prosecute them. Furthermore, a CA can adjust its enforcement policy in response to what is occurring with leniency applications. Thus, while we expect nonleniency enforcement to change when a leniency program is put in place, it is not clear whether it will be weakened or strengthened.

The objective of the current paper is to develop and explore a theoretical framework to understand when leniency programs are likely to be effective in reducing the presence of cartels. Its primary innovation is in providing a more comprehensive assessment of how a leniency program affects the activity and efficacy of a CA by taking account of its impact on the entire portfolio of cases, those generated through leniency applications and through more traditional methods. Our model is the first to examine the effect of a leniency program while endogenizing nonleniency enforcement.

Contrary to existing results in the literature and the general impression of practitioners, we find that a leniency program can result in more cartels, and this can occur at the same time that a leniency program is generating many applications. On a more positive note, we also identify situations and policies that a CA can pursue that will make it more likely that a leniency program will have the intended effect of reducing the number of cartels.

Before we move on, it is useful to note that, in addition to a burgeoning theoretical literature on leniency programs, there is a growing body of experimental work. Research here includes Apestegui, Dufwenberg, and Selten (2007), Hinlopen and Soetevent (2008), Hamaguchi, Kawagoe, and Shibata (2009), Dijkstra, Haan, and Schoonbeek (2011), and Bigoni et al. (2012). These experimental studies generally find that a leniency program reduces cartel formation, although some studies also find that prices are higher, conditional on a cartel forming, when there is a leniency program. Finally, there is an increasing number of empirical studies that measure the impact of leniency programs but are decidedly mixed and tentative in their findings. Miller (2009) examines the impact of the leniency program in the United States; Choi (2011) and Koh and Jeong (2014) consider the program in Korea; Stephan (2008), Brenner (2009), Klein (2010), and Zhou (2011) investigate the impact of the EC's leniency program; and Dong, Massa, and Žaldokas (2014) engage in a cross-country analysis.

In Section 2, the model is presented. In Section 3, the conditions determining the equilibrium cartel rate are derived. The impact of a leniency program on the cartel rate when nonleniency enforcement is fixed is examined in Section 4. While those results are of intrinsic interest as a benchmark, they are primarily an intermediate step toward endogenizing nonleniency enforcement. Section 5 delivers the main contribution of the paper, which is a characterization of how a leniency program impacts the cartel rate when nonleniency enforcement is allowed to adjust to a CA experiencing a flow of leniency applications. Section 6 concludes. Proofs are in the online appendix.

2. Model

The modeling strategy is to construct a birth-and-death process for cartels in order to generate an average cartel rate for a population of industries and then to assess how the introduction of a leniency program influences that cartel rate. We build on the birth-and-death process developed in Harrington and Chang (2009) by introducing a leniency program, endogenizing the intensity of nonleniency enforcement, and allowing a CA to decide on its caseload. In this manner, the full effect of a leniency program can be assessed.²

2.1. Industry Environment

Firm behavior is modeled using a modification of a prisoners' dilemma formulation. Firms simultaneously decide whether to collude (set a high price) or compete (set a low price). Prior to making that choice, firms observe a stochastic realization of the market's profitability that is summarized by the variable π (see Rotemberg and Saloner [1986] for the same informational setting). If all firms choose collude, then each firm earns π , while if all choose compete, then each earns $\alpha\pi$, where $\alpha \in [0, 1]$; $1 - \alpha$ then measures the competitiveness of the non-collusive environment. The term π has a continuously differentiable cumulative distribution function $H: [\underline{\pi}, \bar{\pi}] \rightarrow [0, 1]$, where $0 < \underline{\pi} < \bar{\pi}$. The associated density function is $h(\cdot)$, and $\mu \equiv \int \pi h(\pi) d\pi$ is its finite mean. If all other firms choose collude, the profit a firm earns by deviating—choosing compete—is $\eta\pi$, where $\eta > 1$. This information is summarized in Table 1.

Note that the Bertrand price game is represented by $(\alpha, \eta) = (0, n)$, where n is the number of firms. The Cournot quantity game with linear demand and cost functions in which firms collude at the joint profit maximum is represented by $(\alpha, \eta) = [4n/(n + 1)^2, (n + 1)^2/4n]$.³

²While a leniency program is briefly considered in Harrington and Chang (2009), that model assumes—like the remainder of the literature—that nonleniency enforcement is fixed. As we hope this paper will convince the reader, it is a technically and economically substantive extension of the Harrington-Chang model to endogenize nonleniency enforcement.

³We have specified a firm's profit only when all firms choose compete, when all firms choose collude, and when it chooses compete and all other firms choose collude. We must also assume that compete strictly dominates collude for the staged game. It is unnecessary to provide any further specification.

Table 1
Firm Behavior and Market Profitability

Own Action	All Other Firms'	
	Actions	Own Profit
Collude	Collude	π
Compete	Collude	$\eta\pi$
Compete	Compete	$\alpha\pi$

Firms interact in an infinite-horizon setting, where $\delta \in (0, 1)$ is the common discount factor. It is not a repeated game because, as explained later, each industry is in one of two states: cartel or noncartel. If firms are a cartel, then they have the opportunity to collude, but they do so if and only if it is incentive compatible. To be more specific, if firms are cartelized, then they simultaneously choose between collude and compete and, at the same time, whether to apply to the corporate leniency program. (Details on the description of the leniency program are provided later.) If it is incentive compatible for all firms to choose collude, then each earns π . If instead a firm prefers compete when all other firms choose collude, then collusion is not incentive compatible (that is, it is not part of the subgame perfect equilibrium for the infinite-horizon game), and each firm earns $\alpha\pi$. In that case, collusion is not achieved. If firms are not a cartel, then each firm earns $\alpha\pi$ as, according to equilibrium, they all choose compete.

At the end of the period, there is the random event whereby the CA may pursue an investigation; this can occur only if, in the current period, the cartel was either active or shut down and no firm applied for leniency. Let $\sigma \in [0, 1]$ denote the probability that firms are discovered, prosecuted, and convicted (below, we endogenize σ although, from the perspective of an individual industry, it is exogenous). In that event, each firm incurs a penalty of F .

It is desirable to allow F to depend on the extent of collusion. Given that there is only one level of collusion in the model, the extent of collusion necessarily refers to the number of periods that firms have colluded. A proper accounting of that effect would require that each cartel have a state variable equal to the length of time for which it has been active; such an extension would seriously complicate the analysis. As a simplifying approximation, it is instead assumed that the penalty is proportional to the average increase in profit from being cartelized (rather than the realized increase in profit). If Y denotes the expected per-period profit from being in the cartel state, then $F = \gamma(Y - \alpha\mu)$, where $\gamma > 0$ and $\alpha\mu$ is average noncollusive profit. This specification avoids the need for state variables but still allows the penalty to be sensitive to the (average) extent of collusion.⁴ As the CA will not be presumed to manipulate F , one can suppose that penalties are already set at their maximum level.

In addition to being discovered by the CA, a cartel can be uncovered because one of its members comes forth under the corporate leniency program. Suppose a

⁴A more standard assumption in the literature is to assume that F is fixed, which is certainly simpler but less realistic than our specification. All of our qualitative results hold when F is fixed.

cartel is in place. If a single firm applies for leniency, then all firms are convicted for sure, and the firm that applied receives a penalty of θF , where $\theta \in [0, 1)$, while the other cartel members each pay F . If all firms simultaneously apply for leniency, then each firm pays a penalty of ωF , where $\omega \in (\theta, 1)$. For example, if only one firm can receive leniency and each firm has an equal probability of being first in the door, then $\omega = (n - 1 + \theta)/n$ when there are n cartel members. It is sufficient for the ensuing analysis that we specify the leniency program when either one firm applies or all firms apply. In addition, leniency is not awarded to firms that apply after another firm has done so.

From the perspective of a firm, competition policy is summarized by the four-tuple $(\sigma, \gamma, \theta, \omega)$, which are, respectively, the probability of paying penalties through nonleniency enforcement, the penalty multiple, the leniency parameter when only one firm applies (where $1 - \theta$ is the proportion of fines waived), and the leniency parameter when all firms apply (where $1 - \omega$ is the proportion of fines waived).

Next let us describe how an industry's cartel status evolves. Suppose that it enters the period cartelized. The industry will exit the period still being a cartel if (1) all firms chose collude (which requires that collusion be incentive compatible), (2) no firm applied for leniency, and (3) the CA did not discover and convict the firms of collusion. Otherwise, the cartel collapses, and firms revert to the no-cartel state. If instead the industry entered the period in the no-cartel state, then firms cartelize with probability $\kappa \in (0, 1)$. For that cartel to still be around at the end of the period, conditions 1–3 must be satisfied. Note that whenever a cartel is shut down—whether because of collapsing internally, applying to the leniency program, or having been successfully prosecuted—the industry may recartelize in the future. It has an opportunity to do so with probability κ in each period that it is not currently colluding. The timing of events is summarized in Figure 1.

In modeling a population of industries, it is compelling to allow industries to vary in terms of cartel stability. For this purpose, industries are assumed to differ in the parameter η . If one takes this assumption literally, it can be motivated by heterogeneity in the elasticity of firm demand or the number of firms (as with the Bertrand price game). Our intent is not to be literal but rather to think of this as a parsimonious way in which to encompass industry heterogeneity. Let the cumulative distribution function on industry types be represented by the continuously differentiable strictly increasing function $G: [\underline{\eta}, \bar{\eta}] \rightarrow [0, 1]$, where $1 < \underline{\eta} < \bar{\eta}$. The associated density function is $g(\cdot)$. The appeal of η is that it is a parameter that influences the frequency of collusion but does not directly affect the value of the firm's profit stream since, in equilibrium, firms do not cheat; this property simplifies the analysis.

2.2. Enforcement Technology

Nonleniency enforcement refers to σ , which is the probability that a cartel pays penalties without one of its members having entered the leniency program. The

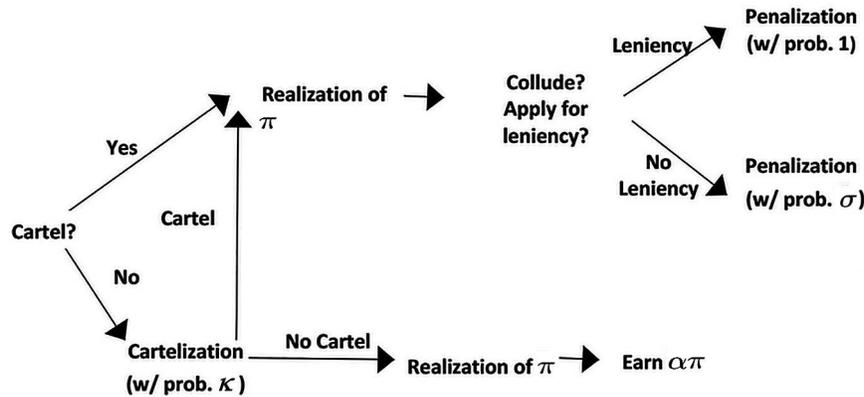


Figure 1. Timing of cartel status

term σ is the compound probability that a cartel is discovered by the CA, the CA decides to investigate a discovered cartel, and the CA is successful in its investigation, in which case penalties are levied. The probability of discovery $q \in (0, 1)$ is presumed to be exogenous and to come from customers, uninvolved employees, the accidental discovery of evidence through a proposed merger, and so forth. Of those reported cases, the CA controls the fraction to investigate, which is denoted $r \in (0, 1)$.⁵ Finally, of those cases discovered and prosecuted, the CA is successful in a fraction $s \in [0, 1]$ of them, and, as described next, s is determined by the CA's caseload.

The model is stacked in favor of a leniency program, as it is assumed that leniency cases are won for sure, while a nonleniency case is won with probability s . What is important is that the likelihood of a conviction in a leniency case exceeds that in a nonleniency case, which is compelling given that the former has a cartel member acting as a witness. In prosecuting nonleniency cases, the CA is faced with a resource constraint: the larger its caseload, the fewer resources applied to each case and the lower the probability of winning any individual case. It is assumed that $s = p(\lambda L + R)$, where L is the mass of leniency cases and R is the mass of nonleniency cases handled by the CA (and $R = q \times r \times C$, where C is the mass of cartels). It is assumed that $\lambda \in (0, 1]$ because leniency cases may take up fewer resources than those cases lacking an informant. We refer to $L + R$ as the number of cases and $\lambda L + R$ as the caseload. Furthermore, $p: [0, 1] \rightarrow [0, 1]$ is a continuous decreasing function, so a bigger caseload means a lower probability of winning a nonleniency case. In sum, the probability that a cartel pays penalties is $\sigma = q \times r \times s = q \times r \times p(\lambda L + R)$.

Key to the analysis is that the CA implicitly faces a resource constraint. While,

⁵ There is no loss of generality in assuming that $r > 0$ because if $r = 0$, then there is effectively no enforcement given that there are no nonleniency cases and, in addition, that firms will not apply for leniency as there is no prospect of being convicted.

in practice, a CA can move around resources to handle additional cartel activity by, for example, shifting lawyers and economists from merger cases to cartel cases, there is a rising opportunity cost in doing so, and that ought to imply that resources per cartel case will decline with the number of cartel cases. Of course, CA officials can lobby their superiors for a bigger budget, but, at least in the United States, the reality is that the CA's budget does not scale up with its caseload. To the contrary, the case activity of the Antitrust Division of the US Department of Justice is countercyclical (Ghosal and Gallo 2001), but its budget is procyclical, for it is increasing in gross domestic product (Kwoka 1999).

The final element of the enforcement technology to discuss is the determination of how many cases the CA pursues. If the CA maximizes welfare (which, in this model, means minimizing the cartel rate) and can freely choose how many leniency and nonleniency cases to pursue, then a leniency program cannot raise the cartel rate because the CA has the option of replicating its policy in the absence of a leniency program. However, our objective is not to examine such an idealized setting but rather to determine whether a leniency program can raise the cartel rate, assuming a plausible description of CA practices, and, if a leniency program can raise the cartel rate, to identify implementable policies that would make it more likely that a leniency program lowers the cartel rate.

With that perspective, the CA is assumed to accept all leniency applications and thereby prosecute all leniency cases. In the context of our model, this assumption is consistent with practice. According to the head of the cartels directorate unit of the EC, "As a matter of practice we pursue virtually all cases where we think we can make the case. (I'm tempted to say 'pursue all cases' but a good lawyer rarely talks in absolutes.)"⁶ Given that leniency cases are won for sure, the CA then prosecutes all leniency cases in our model. A second motivation for this assumption is that it is likely to be an implication of a plausible specification of CA preferences. However a CA is rewarded, those rewards are presumably based on observable measures of performance such as the number of cases won, the percentage of cases won, and the amount of fines collected.⁷ As leniency cases are sure to add to a CA's performance by delivering more convictions and contributing to a high prosecutorial success rate, it is reasonable to suppose that the CA pursues all (winnable) leniency cases. While we believe that it is reasonable to assume that the CA pursues all leniency cases, our results are robust as long as enough leniency cases are pursued, which is shown at the end of Section 5.

The more problematic decision for the CA is how many nonleniency cases to prosecute given that they are more difficult to win. Rather than take a position on the CA's preferences (which we leave to future research), we derive results for all

⁶ Email from Kevin Coates, head of the cartels directorate unit of the European Commission, to Joseph Harrington, July 29, 2014.

⁷ Consistent with a focus on observable performance measures, Assistant Attorney General Thomas Barnett of the Antitrust Division of the US Department of Justice stated in his opening remarks during congressional testimony (September 25, 2007) that "[t]he Division set a record for the most total jail time imposed (almost 30,000 jail days) [and] obtained the second highest amount of fines in the Division's history (over \$630 million)" (US House 2007).

values of r . For example, we derive sufficient conditions for a leniency program to raise the cartel rate regardless of the fraction of nonleniency cases that a CA pursues. Thus, the results do not depend on the CA's preferences and apply whether the CA chooses its nonleniency caseload to maximize the number of convictions, minimize the cartel rate, or achieve some other objective.⁸

3. Equilibrium Conditions

In this section, we describe the conditions determining the equilibrium frequency with which industries are cartelized. Given that there are several steps in the construction of equilibrium conditions, it may prove beneficial to the reader to provide an overview.

Step 1. Taking as given σ (the per-period probability that a cartel pays penalties through nonleniency enforcement), we first solve for equilibrium collusive behavior for a type- η industry and the maximum value for π whereby collusion is incentive compatible, denoted $\phi^*(\sigma, \eta)$.

Step 2. With the conditions for internal collapse—which occurs when $\pi > \phi^*(\sigma, \eta)$ —and the likelihood of nonleniency enforcement σ , along with the probability of cartel formation κ , we construct a Markov process on cartel birth and death from which we solve the stationary distribution of industries in terms of their cartel status for each industry type η . By aggregating over all industry types, we derive the equilibrium cartel rate $C(\sigma)$, given σ .

Step 3. The next step is to solve for the equilibrium value of σ , denoted σ^* . The probability that the CA's investigation is successful, $p(\lambda L + R)$, depends on the mass of leniency cases L and the mass of nonleniency cases R . Both L and R depend on σ as they depend on the cartel rate $C(\sigma)$; σ^* is then a fixed point: $\sigma^* = qrp(\lambda L(\sigma^*) + R(\sigma^*))$.

In other words, σ —the probability that firms are caught, prosecuted, and convicted—determines the cartel rate $C(\sigma)$, the cartel rate determines the caseload $\lambda L(\sigma) + R(\sigma)$, and the caseload determines the probability that the CA is able to get a conviction on a case and thus σ . Given σ^* , the equilibrium cartel rate is $C(\sigma^*)$.

By way of comparison, the model in Harrington and Chang (2009) involves the two nested fixed-point problems in steps 1 and 2 when σ is fixed. The current model embeds that problem in a third fixed-point problem in order to endogenize σ (step 3). We believe that this extension is both technically and economically substantive in that it introduces fundamentally new forces relevant to assessing the effect of an antitrust policy.

⁸In discussing the behavior of the competition authority (CA), it is worth noting that Motta and Polo (2003) assume that enforcement expenditure is set optimally when modeling a trade-off between monitoring and prosecution. They endow a CA with a fixed amount of resources that can be allocated between finding suspected episodes of collusion and prosecuting the cases that are found or, in the language of our model, between raising q and lowering s (assuming $r = 1$). However, their model is very different from ours—for example, they do not consider a population of industries and do not solve for the steady-state frequency of cartels—and it does not address the questions we are raising here.

3.1. Cartel Formation and Collusive Value

A collusive strategy for a type- η industry entails colluding when π is sufficiently low and not colluding otherwise. The logic is as in Rotemberg and Saloner (1986). When π is high, the incentive to deviate is strong because a firm increases current profit by $(\eta - 1)\pi$. At the same time, the future payoff is independent of the current realization of π , given that π is independently and identically distributed. Since the payoff to cheating is increasing in π while the future payoff is independent of π , the incentive compatibility of collusion is more problematic when π is higher.

Suppose that firms are able to collude for at least some realizations of π , and let W^o and Y^o denote the payoff when the industry is not cartelized and is cartelized, respectively. If not cartelized then, with probability κ , firms have an opportunity to cartelize with resulting payoff Y^o . With probability $1 - \kappa$, firms do not have such an opportunity and continue to compete. In that case, each firm earns current expected profit $\alpha\mu$ and future value W^o . Thus, the payoff when not colluding is defined recursively by

$$W^o = (1 - \kappa)(\alpha\mu + \delta W^o) + \kappa Y^o. \quad (1)$$

As it is easier to work with rescaled payoffs, define

$$W \equiv (1 - \delta)W^o \quad \text{and} \quad Y \equiv (1 - \delta)Y^o.$$

Multiplying both sides of equation (1) by $1 - \delta$ and rearranging yields

$$W = \frac{(1 - \kappa)(1 - \delta)\alpha\mu + \kappa Y}{1 - \delta(1 - \kappa)}.$$

Also note that the incremental value to being in the cartelized state is

$$Y - W = Y - \left[\frac{(1 - \kappa)(1 - \delta)\alpha\mu + \kappa Y}{1 - \delta(1 - \kappa)} \right] = \frac{(1 - \kappa)(1 - \delta)(Y - \alpha\mu)}{1 - \delta(1 - \kappa)}. \quad (2)$$

Suppose that firms are cartelized and π is realized. When a firm decides whether to collude or cheat, it decides at the same time whether to apply for leniency. If it decides to collude, it is clearly not optimal to apply for leniency since the cartel is going to be shut down by the authorities, and so the firm ought to maximize current profit by cheating. The more relevant issue is whether it should apply for leniency if it decides to cheat. The incentive-compatibility constraint (ICC) is

$$\begin{aligned} (1 - \delta)\pi + \delta[(1 - \sigma)Y + \sigma W] - (1 - \delta)\sigma\gamma(Y - \alpha\mu) \\ \geq (1 - \delta)\eta\pi + \delta W - (1 - \delta)\min\{\sigma, \theta\}\gamma(Y - \alpha\mu). \end{aligned} \quad (3)$$

Examining the left-hand side of the expression, we see that if the firm colludes, then it earns current profit π (given that all other firms are colluding). With probability $1 - \sigma$, the cartel is not shut down by the CA, and, given that the industry is in the cartel state, the future payoff is Y . With probability σ , the cartel is caught

and convicted by the CA—which means a one-time penalty of $\gamma(Y - \sigma\mu)$ —and since the industry is no longer cartelized, the future payoff is W . Turning to the right-hand side of the expression, we see that the current profit from cheating is $\eta\pi$. Since this defection causes the cartel to collapse, the future payoff is W . There is still a chance of being caught and convicted, and a deviating firm will apply for leniency if and only if the penalty from doing so is less than the expected penalty from not doing so (and recall that the other firms are colluding and thus do not apply for leniency), that is, when $\theta\gamma(Y - \alpha\mu) < \sigma\gamma(Y - \alpha\mu)$ or $\theta < \sigma$. Given optimal use of the leniency program, the deviating firm's expected penalty is then $\min\{\sigma, \theta\}\gamma(Y - \alpha\mu)$. Rearranging expression (3) and using equation (2), we can present the ICC as

$$\pi \leq \frac{\delta(1 - \sigma)(1 - \kappa)(Y - \alpha\mu) - [1 - \delta(1 - \kappa)][\sigma - \min\{\sigma, \theta\}]\gamma(Y - \alpha\mu)}{(\eta - 1)[1 - \delta(1 - \kappa)]} \quad (4)$$

$$\equiv \phi(Y, \sigma, \eta).$$

Collusion is incentive compatible if and only if the current market condition is sufficiently low.⁹

In deriving an expression for the value to colluding, we need to discuss usage of the leniency program in equilibrium. Firms do not use it when market conditions result in the cartel being stable but may use it when the cartel collapses. As the continuation payoff is W regardless of whether leniency is used, a firm applies for leniency if and only if it reduces the expected penalty. First note that an equilibrium either has no firms applying for leniency or all firms doing so because if at least one firm applies, then another firm can lower its expected penalty by also doing so. This has the implication that it is always an equilibrium for all firms to apply for leniency. Furthermore, it is the unique equilibrium when $\theta < \sigma$. To

⁹As specified in the incentive-compatibility constraint in expression (3), the penalty is slightly different from that in Harrington and Chang (2009). In terms of rescaled payoffs, Harrington and Chang (2009) assumes that the penalty is $\gamma(Y - \alpha\mu)$, while here it is $(1 - \delta)\gamma(Y - \alpha\mu)$. This means that Harrington and Chang (2009) assumes that a conviction results in an infinite stream of single-period penalties of $\gamma(Y - \alpha\mu)$ that have a present value of $\gamma[(Y - \alpha\mu)/(1 - \delta)]$, while the current paper assumes a one-time penalty of $(1 - \delta)\gamma(Y - \alpha\mu)$, which has a present value of $\gamma(Y - \alpha\mu)$. We now believe that the latter specification is more sound. For the specification in Harrington and Chang (2009), every time a cartel is convicted, it has to pay a penalty of $\gamma(Y - \alpha\mu)$ ad infinitum. Thus, if it has been convicted k times in the past, then it is paying $k\gamma(Y - \alpha\mu)$ in each period while earning an average collusive profit of μ in each period. As $k \rightarrow \infty$, the penalty is unbounded, while the payoff from collusion is not. It can be shown that the penalty specification in Harrington and Chang (2009) implies that $\lim_{\epsilon \rightarrow 1} Y = \alpha\mu$, so the penalty wipes out all gains from colluding. These properties do not seem desirable, and we believe that it is better to assume that the penalty is a one-time payment $\gamma(Y - \alpha\mu)$ rather than an infinite stream of $\gamma(Y - \alpha\mu)$. It is important to note that this change in specification does not affect the conclusions in Harrington and Chang (2009) because of the parameter γ . Starting with the original specification $\gamma(Y - \alpha\mu)$ and defining $\tilde{\gamma} \equiv \gamma/(1 - \delta)$, we see that the analysis in Harrington and Chang (2009) is equivalent to when the penalty is $(1 - \delta)\tilde{\gamma}(Y - \alpha\mu)$. This transformation works as long as δ is fixed. As the main results in Harrington and Chang (2009) do not involve performing comparative statics with respect to δ or letting $\delta \rightarrow 1$, its conclusions remain intact.

see why, suppose that all firms were not to apply for leniency. A firm would then lower its penalty from σF to θF by applying. When instead $\sigma \leq \theta$, there is also an equilibrium in which no firm applies for leniency, as to do so would increase the expected penalty from σF to θF . Using the selection criterion of Pareto dominance, we assume that, on internal collapse of the cartel, no firms apply when $\sigma \leq \theta$ and all firms apply when $\theta < \sigma$.

The expected payoff to being cartelized, $\psi(Y, \sigma, \eta)$, is then recursively defined by

$$\psi(Y, \sigma, \eta) = \begin{cases} \int_{\underline{\pi}}^{\phi(Y, \sigma, \mu)} \{(1 - \delta)\pi + \delta[(1 - \sigma)Y + \sigma W] - (1 - \delta)\sigma\gamma(Y - \alpha\mu)\}h(\pi)d\pi \\ + \int_{\phi(Y, \sigma, \mu)}^{\bar{\pi}} [(1 - \delta)\alpha\pi + \delta W - (1 - \delta)\sigma\gamma(Y - \alpha\mu)]h(\pi)d\pi & \text{if } \sigma \leq \theta; \\ \int_{\underline{\pi}}^{\phi(Y, \sigma, \mu)} \{(1 - \delta)\pi + \delta[(1 - \sigma)Y + \sigma W] - (1 - \delta)\sigma\gamma(Y - \alpha\mu)\}h(\pi)d\pi \\ + \int_{\phi(Y, \sigma, \mu)}^{\bar{\pi}} [(1 - \delta)\alpha\pi + \delta W - (1 - \delta)\omega\gamma(Y - \alpha\mu)]h(\pi)d\pi & \text{if } \theta < \sigma. \end{cases}$$

To understand this expression, first consider when $\sigma \leq \theta$, in which case leniency is not used. If $\pi \in [\underline{\pi}, \phi(Y, \sigma, \eta)]$, then collusion is incentive compatible; each firm earns current profit of π , incurs an expected penalty of $\sigma\gamma(Y - \alpha\mu)$, and has an expected future payoff of $(1 - \sigma)Y + \sigma W$. If instead $\pi \in (\phi(Y, \sigma, \eta), \bar{\pi}]$, then collusion is not incentive compatible, so each firm earns current profit of $\alpha\pi$, incurs an expected penalty of $\sigma\gamma(Y - \alpha\mu)$, and has an expected future payoff of W . The expression when $\theta < \sigma$ differs only when collusion breaks down, in which case all firms apply for leniency and the expected penalty is $\omega\gamma(Y - \alpha\mu)$.

A fixed point to ψ is an equilibrium value for Y . That is, given an anticipated future collusive value Y , the resulting equilibrium behavior—represented by $\phi(Y, \sigma, \eta)$ —results in firms colluding for market states such that the value to being in a cartel is Y . We then want to solve $Y^* = \psi(Y^*, \sigma, \eta)$. As an initial step to exploring the set of fixed points, first note that $\psi(\alpha\mu, \sigma, \eta) = \alpha\mu$. Hence, one fixed point to ψ is the degenerate solution without collusion. If there is a fixed point with collusion—that is, $Y > \alpha\mu$ —then we select the one with the highest value.

Given $Y^*(\sigma, \eta)$, define

$$\phi^*(\sigma, \eta) \equiv \max\left\{\min\left\{\phi\left(Y^*(\sigma, \eta), \sigma, \eta\right), \bar{\pi}\right\}, \underline{\pi}\right\} \tag{5}$$

as the maximum profit realization such that a type- η cartel is stable. It is a measure of cartel stability since the cartel is stable if and only if $\pi \leq \phi^*(\sigma, \eta)$ and thus internally collapses with probability $1 - H(\phi^*(\sigma, \eta))$. Note that if $\phi^*(\sigma, \eta) = \bar{\pi}$, then the cartel is stable for all market conditions (so it never internally collapses), and if $\phi^*(\sigma, \eta) = \underline{\pi}$, then the cartel is unstable for all market conditions (so firms never collude).

3.2. Stationary Distribution of Cartels

Given $\phi^*(\sigma, \eta)$, the stochastic process by which cartels are born and die (either through internal collapse or being shut down by the CA) is characterized in this section. The random events driving this process are the opportunity to cartelize, market conditions, and conviction by the CA. We initially characterize the stationary distribution for type- η industries. The stationary distribution for the entire population of industries is then derived by integrating the type-specific distributions over all types.

Consider an arbitrary type- η industry. If it is not cartelized at the end of the preceding period, then, by the analysis in Section 3.1, it will be cartelized at the end of the current period with probability $\kappa(1 - \sigma)H(\phi^*(\sigma, \eta))$. With probability κ it has the opportunity to cartelize, with probability $H(\phi^*(\sigma, \eta))$ the realization of π is such that collusion is incentive compatible, and with probability $1 - \sigma$ it is not caught and convicted by the CA. If instead the industry was cartelized at the end of the previous period, it will still be cartelized at the end of this period with probability $(1 - \sigma)H(\phi^*(\sigma, \eta))$.

Let $\text{NC}(\sigma, \eta)$ denote the proportion of type- η industries that are not cartelized. The stationary rate of noncartels is defined by

$$\begin{aligned} \text{NC}(\sigma, \eta) = & \text{NC}(\sigma, \eta) \{ (1 - \kappa) + \kappa[1 - H(\phi^*)] + \kappa\sigma H(\phi^*) \} \\ & + [1 - \text{NC}(\sigma, \eta)] \{ [1 - H(\phi^*)] + \sigma H(\phi^*) \}. \end{aligned} \quad (6)$$

Examining the right-hand side of equation (6), we see that a fraction $\text{NC}(\sigma, \eta)$ of type- η industries were not cartelized in the previous period. Of those industries, a fraction $1 - \kappa$ will not have the opportunity to cartelize in the current period. A fraction $\kappa[1 - H(\phi^*)]$ will have the opportunity but, because of a high realization of π , will find it is not incentive compatible to collude, while a fraction $\kappa\sigma H(\phi^*)$ will cartelize and collude but then will be discovered by the CA. Of the industries that were colluding in the previous period, which have mass $1 - \text{NC}(\sigma, \eta)$, a fraction $1 - H(\phi^*)$ will collapse for internal reasons, and a fraction $\sigma H(\phi^*)$ will instead be shut down by the authorities.

Solving equation (6) for $\text{NC}(\sigma, \eta)$ we obtain

$$\text{NC}(\sigma, \eta) = \frac{1 - (1 - \sigma)H(\phi^*(\sigma, \eta))}{1 - (1 - \kappa)(1 - \sigma)H(\phi^*(\sigma, \eta))}. \quad (7)$$

For the stationary distribution, the fraction of cartels among type- η industries is then

$$C(\sigma, \eta) \equiv 1 - \text{NC}(\sigma, \eta) = \frac{\kappa(1 - \sigma)H(\phi^*(\sigma, \eta))}{1 - (1 - \kappa)(1 - \sigma)H(\phi^*(\sigma, \eta))}. \quad (8)$$

Finally, the derivation of the entire population of industries is performed by inte-

grating the type- η distribution over $\eta \in [\underline{\eta}, \bar{\eta}]$. The mass of cartelized industries, which we refer to as the cartel rate $C(\sigma)$, is then defined by

$$C(\sigma) \equiv \int_{\underline{\eta}}^{\bar{\eta}} C(\sigma, \eta) g(\eta) d\eta = \int_{\underline{\eta}}^{\bar{\eta}} \left\{ \frac{\kappa(1-\sigma)H(\phi^*(\sigma, \eta))}{1 - (1-\kappa)(1-\sigma)H(\phi^*(\sigma, \eta))} \right\} g(\eta) d\eta. \quad (9)$$

3.3. Equilibrium Nonleniency Enforcement

Recall that $\sigma = qrs$, where q is the probability of a cartel being discovered, r is the probability that the CA investigates a reported case, and s is the probability of it succeeding with the investigation. We now want to derive the equilibrium value of s , where $s = p(\lambda L + R)$, L is the mass of leniency cases, and R is the mass of nonleniency cases handled by the CA. As both L and R depend on the cartel rate C and the cartel rate depends on s (through σ), this is a fixed-point problem. We need to find a value for s , call it s' , such that, given $\sigma = qrs'$, the induced cartel rate $C(qrs')$ is such that it generates L and R so that $p(\lambda L + R) = s'$.

With our expression for the cartel rate, we can provide expressions for L and R . The mass of cartel cases generated by the leniency program is

$$L = \begin{cases} 0 & \text{if } \sigma \leq \theta; \\ \int_{\underline{\eta}}^{\bar{\eta}} \{1 - H(\phi^*(\sigma, \eta))\} C(\sigma, \eta) g(\eta) d\eta & \text{if } \theta < \sigma. \end{cases} \quad (10)$$

In equation (10), note that an industry does not apply for leniency when it is still effectively colluding. When collusion stops, leniency is used when the only equilibrium is that all firms apply for leniency, which is the case when $\theta < \sigma$. Thus, when $\theta < \sigma$, L equals the mass of cartels that collapse because of a high realization of π . That it is the dying cartels that apply for leniency is consistent with the EC experience.^{10,11}

The mass of cartel cases generated without use of the leniency program is

$$R(\sigma) = qr[C(\sigma) - L(\sigma)] = \begin{cases} qrC(\sigma) & \text{if } \sigma \leq \theta; \\ qr \int_{\underline{\eta}}^{\bar{\eta}} H(\phi^*(\sigma, \eta)) C(\sigma, \eta) g(\eta) d\eta & \text{if } \theta < \sigma. \end{cases} \quad (11)$$

¹⁰ European Commission (EC) official Olivier Guersent expressed a concern that leniency applications were coming from dying cartels at the 11th Annual EU Competition Law and Policy Workshop: Enforcement of Prohibition of Cartels in Florence, Italy, in June 2006. Jun Zhou, postdoctoral research fellow in the Department of Economics at the University of Bonn, conveyed in a conversation with the authors that only 13 of 110 EC cases with a leniency awardee (over 1996–2012) involved applications before the death of the cartel.

¹¹ That either all firms or no firms apply for leniency is a property of not only our analysis but all previous analyses on leniency programs with the exception of Harrington (2012, 2013) and Marx and Mezzetti (2014).

If the leniency program is never used (which is when $\sigma \leq \theta$), then the mass of cases being handled by the CA is $qrC(\sigma)$. If instead $\theta < \sigma$, so dying cartels use the leniency program, then the cartels left to be caught are those that have not collapsed in the current period, which are $\int_{\underline{\eta}}^{\bar{\eta}} H(\phi^*(\sigma, \eta))C(\sigma, \eta)g(\eta)d\eta$.

The equilibrium probability of a CA successfully getting a cartel to pay penalties (without use of the leniency program) is the solution to the following fixed-point problem:

$$\sigma = \Psi(\sigma) \equiv \begin{cases} qrp(qrC(\sigma)) & \text{if } \sigma \leq \theta; \\ qrp \left(\lambda \int_{\underline{\eta}}^{\bar{\eta}} \{1 - H(\phi^*(\sigma, \eta))\} C(\sigma, \eta) g(\eta) d\eta \right. \\ \left. + qr \int_{\underline{\eta}}^{\bar{\eta}} H(\phi^*(\sigma, \eta)) C(\sigma, \eta) g(\eta) d\eta \right) & \text{if } \theta < \sigma; \end{cases} \quad (12)$$

where we substitute for L using equation (10) and R using equation (11).¹² If there are multiple solutions to equation (12), then it is assumed the maximal one is selected.¹³

4. Impact of a Leniency Program When Nonleniency Enforcement Is Exogenous

In this section we derive results under the standard assumption in the literature that nonleniency enforcement is fixed. These results are a necessary intermediate step toward deriving our main results for when nonleniency enforcement is endogenized, but they also serve as a benchmark for highlighting how an evaluation of a leniency program significantly changes when a more comprehensive analysis is performed.

To begin, consider the cartel rate function $C(\sigma)$, that is, the cartel rate that results for a given level of nonleniency enforcement σ . Theorem 1 is a restatement of a result in Harrington and Chang (2009) and shows that when firms assign a higher probability to the CA discovering, prosecuting, and convicting cartels, then a smaller fraction of industries is cartelized. This result is derived for when the penalty multiple γ is not too high, and in the ensuing analysis it is assumed (without being stated) that γ is such that theorem 1 applies.^{14,15}

¹²Note that the fixed point can be defined in terms of either σ or s given that $\sigma = qrs$ and, at this stage of the analysis, that q and r are parameters.

¹³We conjecture that results hold with some other selections, such as the minimal fixed point to Y . What is necessary is that a shift up (down) in Ψ increases (decreases) σ^* .

¹⁴It is also the case that γ must not be too high if there is to be some collusion in equilibrium. However, we have not ruled out the possibility that γ could be low enough for $C(\sigma) > 0$ but is not low enough for $C'(\sigma) < 0$ (that is, theorem 1 applies), although we have no reason to think that to be true.

¹⁵The analogous result in Harrington and Chang (2009) assumes that σ is sufficiently small, which we do not want to do here because σ will later be endogenized. Instead, results are derived for when

Theorem 1. There exists $\hat{\gamma} > 0$ such that if $\gamma \in [0, \hat{\gamma})$, then $C(\sigma)$ is non-increasing in σ , and if $C(\sigma) > 0$, then $C(\sigma)$ is decreasing in σ .

Next let us consider how a leniency program affects the cartel rate function, that is, whether a leniency program results in a higher or lower cartel rate for a given value of σ . For this purpose, $C_\theta(\sigma)$ denotes the cartel rate function when there is a leniency program with parameter θ .¹⁶ Similarly, $C_{NL}(\sigma)$ denotes the cartel rate function when there is no leniency program.

Theorem 2 shows that a leniency program does not raise the cartel rate function, and it reduces the cartel rate function if, in the absence of a leniency program, there is a positive measure of industries that cannot fully collude and a positive measure that can collude (assumption 1).¹⁷ In sum, for a given level of nonleniency enforcement, a leniency program results in fewer cartels.

Assumption 1. There is a positive measure of values for η such that $\phi_{NL}^*(\sigma, \eta) < \bar{\pi}$ and a positive measure of values for η such that $\sigma_{NL}^*(\sigma, \eta) > \underline{\pi}$.

Theorem 2. If $\sigma \in (\theta, \omega)$, then $C_{NL}(\sigma) \geq C_\theta(\sigma)$, and if assumption 1 holds, then $C_{NL}(\sigma) > C_\theta(\sigma)$.

Prior to explaining why theorem 2 is true, let us interpret and motivate the restriction $\sigma \in (\theta, \omega)$. If $\sigma > \theta$, then a firm that contemplates deviating from a cartel would apply for leniency because doing so reduces the expected penalty from $\sigma\gamma(Y - \alpha\mu)$ to $\theta\gamma(Y - \alpha\mu)$. Furthermore, $\sigma > \theta$ has the implication that, in response to the internal collapse of a cartel, all firms apply for leniency because it is the unique equilibrium play.¹⁸ In that situation, if $\sigma < \omega$, then a firm's expected penalty rises with a leniency program from $\sigma\gamma(Y - \alpha\mu)$ to $\omega\gamma(Y - \alpha\mu)$. Thus, if $\sigma \in (\theta, \omega)$, then a firm will use the leniency program when it deviates or when the cartel collapses, and in the latter situation expected penalties are higher than when there is no leniency program. If instead $\sigma < \theta$, then firms would never apply for leniency, in which case a leniency program is ineffectual. If $\sigma > \omega$, then, on collapse of the cartel, firms would use leniency but, relative to the absence of a leniency program, expected penalties are lower. In that situation, it is not difficult to derive conditions such that a leniency program raises the cartel rate. Thus, $\sigma \in (\theta, \omega)$ is the relevant domain for our analysis in that a leniency program is active and is properly designed so that it raises expected penalties. Given that

the penalty multiple γ is sufficiently small. This involves a straightforward modification of the proof in Harrington and Chang (2009) and is available on request.

¹⁶ Recall that a firm pays a fraction θ of the standard penalty when it receives leniency and pays, in expectation, a fraction ω when all firms apply for leniency. To reduce notational clutter, we suppress ω .

¹⁷ Assumption 1 ensures that the cartel rate is positive but not maximal and rules out extreme cases in which a leniency program does not lower the cartel rate because the cartel rate is either 0 without a leniency program or the environment is so conducive to collusion that the cartel rate is maximal with or without a leniency program.

¹⁸ If all other firms were expected not to apply, then a firm's penalty from applying is $\theta\gamma(Y - \alpha\mu)$ and from not applying is $\sigma\gamma(Y - \alpha\mu)$. If $\sigma > \theta$, then a firm prefers to apply, in which case all firms not applying is not an equilibrium. Given that it is optimal to apply when one or more other firms apply, equilibrium play must then involve all firms applying when $\sigma > \theta$.

σ will be endogenized, this leaves open the question of whether its equilibrium value lies in (θ, ω) . Note that $\sigma (> 0)$ is sure to exceed θ when $\theta = 0$ (so there is full leniency), and that case is the focus of Section 5. If all firms applying for leniency gives each an equal chance of receiving it, then $\omega = (n - 1 + \theta)/n \geq (n - 1)/n \geq \frac{1}{2}$. Thus, if $q < \frac{1}{2}$, then $\omega \geq \frac{1}{2} > \sigma (= qrs)$. Hence, if $\theta = 0$ and $q < \frac{1}{2}$, then $\sigma \in (\theta, \omega)$.¹⁹

Turning to the interpretation of theorem 2, we see that a leniency program reduces the frequency of cartels when nonleniency enforcement is fixed. Let us summarize the forces that are the basis for that result (also see these forces in Motta and Polo [2003], Spagnolo [2005], and Harrington [2008]). A leniency program increases the payoff to cheating because now a firm can reduce its penalty by simultaneously applying for leniency. This shrinks the set of market conditions for which collusion is stable and thereby reduces expected cartel duration and the value to colluding. A leniency program also reduces the value to colluding because, on collapse, firms race for leniency, and that results in higher expected penalties. Because of the lower value to colluding, either a cartel no longer forms or it has shorter duration, and this translates into a lower aggregate cartel rate.

5. Impact of a Leniency Program When Nonleniency Enforcement Is Endogenous

We now provide a comprehensive assessment of how a corporate leniency program influences the cartel rate. We address the following questions: Given the effect of a leniency program on a CA's prosecutions of both leniency and nonleniency cases, can a leniency program raise the cartel rate? If it can, under what circumstances can we be assured that a leniency program is lowering the cartel rate?

Our analysis focuses on when the leniency program provides full leniency to the first firm to come forward ($\theta = 0$). This is a natural case to consider because almost all leniency programs waive all government penalties to the first firm to come forward prior to the start of an investigation.²⁰ We also focus on this case for technical reasons related to the existence of equilibrium.

To economize on notation and make it easier for the reader to follow the analysis, $C_{NL}(\sigma)$ and $C_L(\sigma)$ are, respectively, the cartel rate functions without leniency and with (full) leniency. The associated equilibrium values for nonleni-

¹⁹ Let us also note that $\sigma \in (\theta, \omega)$ is required only for some results and only because it is a sufficient condition for the cartel rate function to be higher without a leniency program: $C_{NL}(\sigma) > C_\theta(\sigma)$; see theorem 2. When $\sigma \in (\theta, \omega)$ is needed, that condition is stated as part of the theorem. Of particular note, it is not required for theorem 4, which provides sufficient conditions for a leniency program to raise the cartel rate.

²⁰ In the United States, a firm that receives amnesty is still liable for single customer damages, so leniency is not full. Most other jurisdictions do not have customer damages, in which case government fines encompass the entirety of penalties, and, therefore, leniency is approximately full.

ency enforcement are σ_{NL}^* and σ_L^* , in which case the equilibrium cartel rates are $C_{NL}(\sigma_{NL}^*)$ and $C_L(\sigma_L^*)$.

With this notation, we can summarize the task before us. Theorem 2 shows that a leniency program lowers the cartel rate given a value for σ : $C_L(\sigma) < C_{NL}(\sigma)$. Whether a leniency program raises or lowers the cartel rate then comes down to its impact on nonleniency enforcement. If a leniency program strengthens nonleniency enforcement— $\sigma_L^* > \sigma_{NL}^*$ —then clearly a leniency program lowers the cartel rate because, by theorem 1, cartel rate functions are decreasing: $C_L(\sigma_L^*) < C_{NL}(\sigma_{NL}^*)$. If instead a leniency program weakens nonleniency enforcement— $\sigma_L^* < \sigma_{NL}^*$ —then the ultimate impact on the cartel rate depends on the extent to which a leniency program reduces nonleniency enforcement.

In Section 5.1, we show that an equilibrium cartel rate exists for when there is no leniency program or a full leniency program. In Section 5.2, we show that a leniency program can raise the cartel rate. In Section 5.3, we derive conditions for a leniency program to lower the cartel rate. While the analysis largely focuses on how a leniency program affects the frequency of cartels, Section 5.4 shows the differential impact of a leniency program across industries; a leniency program can make collusion more difficult in some industries but less difficult in other industries.

5.1. Existence of an Equilibrium Cartel Rate

The equilibrium level of nonleniency enforcement σ^* is a fixed point to Ψ , which is defined in equation (12). If firms believe that the per-period probability of paying penalties (through nonleniency enforcement) is σ^* , then the induced cartel birth and death rates generate a caseload for the CA whereby the equilibrium probability is indeed σ^* .

Theorem 3. For $\theta \in \{0, 1\}$, there exists $\hat{\gamma} > 0$ such that if $\gamma \in [0, \hat{\gamma}]$, then σ^* exists.

While we assess only the impact of providing full leniency, we do not believe that the intuition behind the results is tied to leniency being full. We conjecture that, as long as σ^* exists, results will go through if, in equilibrium, firms use leniency in response to cartel collapse (that is, $\theta < \sigma^*$) and penalties are higher as a result of leniency (that is, $\sigma^* < \omega$).

5.2. Leniency Programs and Increased Cartel Rate

In this section, we show that a leniency program can be counterproductive. When penalties are not severe enough and the amount of resources saved by prosecuting a leniency case are not large enough, then the introduction of a leniency program raises the cartel rate.

Theorem 4. Assume that

$$\int_{\underline{\eta}}^{\bar{\eta}} \{1 - H(\phi_{NL}^*(\sigma_{NL}^*, \eta))\} C_{NL}(\sigma_{NL}^*, \eta) g(\eta) d\eta > 0, \quad (13)$$

so without a leniency program, there are cartels that collude and internally collapse. Generically, if $\lambda > qr$, then there exists $\hat{\gamma} > 0$ such that if $\gamma \in [0, \hat{\gamma}]$, then the cartel rate with a leniency program strictly exceeds the cartel rate without a leniency program.

In understanding the forces that drive this result, first note that a leniency program can affect the cartel rate by disabling active cartels (that is, shutting them down) and by deterring new cartels from forming. A leniency program can have a perverse effect because, while it generally promotes deterrence, it can result in fewer cartels being shut down.

Prior to the introduction of a leniency program, the CA is discovering, prosecuting, and convicting cartels through nonleniency means. While some of the cartels that are convicted will just so happen to have internally collapsed, many of them will have been active, in which case it is their prosecution and conviction that shut down the cartels. When a leniency program is introduced, cartels that collapse race for leniency, and these leniency applications make up part of the caseload of the CA. Of particular note is that leniency cases are coming from dying cartels, and thus their prosecution is not shutting down active cartels. However, these leniency cases add to the CA's caseload and thereby result in less success in prosecuting nonleniency cases; if one of those cases had led to a conviction, it would have disabled a well-functioning cartel. In essence, leniency cases—which do not shut down active cartels—are crowding out nonleniency cases—which generally do shut down active cartels. If leniency cases do not save much in terms of prosecutorial resources (that is, λ exceeds qr) then this crowding-out effect is significant, and the end result is that many fewer cartels are shut down when there is a leniency program.

This is not the end of the story, however. Because of the leniency program, a dying cartel is now assured of paying penalties because one of its members will enter the leniency program and aid the CA in obtaining a conviction. In contrast, without a leniency program, only a fraction of those cartels would have been discovered and penalized (the fraction is σ_{NL}^*). Thus, a leniency program raises the expected penalties for a cartel in the event of its death, which serves to deter some cartels from forming. However, if penalties are not large enough (that is, γ is not sufficiently great), then the number of additional cartels deterred because of the leniency program is small in comparison with the reduction in the number of cartels shut down because leniency cases crowd out nonleniency cases. As a result, on net, the cartel rate is higher. Thus, in spite of the leniency program apparently working in the sense of eliciting leniency applications, it is counterproductive in that the latent cartel rate is higher.

Theorem 4 shows that, for any value of r (the fraction of possible nonleniency

cases that the CA chooses to prosecute), the cartel rate is higher with a leniency program:²¹

$$C_L(qrs_L^*(r)) > C_{NL}(qrs_{NL}^*(r)), \quad \forall r > 0. \quad (14)$$

Recall that $\sigma = qrs$, and expression (14) makes explicit the dependence of the conviction rate s on r . If the CA chooses its caseload to minimize the cartel rate, the optimal prosecution policies with and without a leniency program, respectively, are

$$r_L^* \in \arg \min_{r \in [0,1]} C_L(qrs_L^*(r)) \quad \text{and} \quad r_{NL}^* \in \arg \min_{r \in [0,1]} C_{NL}(qrs_{NL}^*(r)).$$

It then follows from expression (14) that

$$C_L(qr_L^*s_L^*(r_L^*)) > C_{NL}(qr_{NL}^*s_{NL}^*(r_{NL}^*)).$$

This leads to the following corollary.

Corollary 5. Under the conditions of theorem 4, a leniency program raises the cartel rate even if the CA chooses its caseload to minimize the cartel rate.

In concluding this section, let us argue that the sufficient conditions in theorem 4 for a leniency program to raise the cartel rate could plausibly hold in some jurisdictions. A leniency program raises the cartel rate when a leniency case takes up enough resources that there is a crowding out of resources for nonleniency cases and penalties are not so severe that they significantly deter cartel formation.

With regard to the first condition, the Directorate General for Competition (DG Comp) of the EC was initially overwhelmed with leniency applications, which could well have significantly limited the availability of resources for prosecuting other cases (Riley 2007, pp. 1–2): “DG Competition is now in many ways the victim of its own success; leniency applicants are flowing through the door of its Rue Joseph II offices, and as a result the small Cartel Directorate is overwhelmed with work. . . . It is open to question whether a Cartel Directorate consisting of only approximately 60 staff is really sufficient for the Commission to tackle the 50 cartels now on its books.” Furthermore, the impact of a leniency program on enforcement through other means is a concern emphasized in Friederiszick and Maier-Rigaud (2008). Both authors were members of DG Comp, and their paper recommends that the DG Comp increase nonleniency enforcement methods such as being active in detecting cartels. Consistent with these views, Kai-Uwe Kühn, who was chief economist of the EC, expressed at the Searle Research Symposium in September 2010 that leniency cases seem to be as long and involved as nonleniency cases. It is then quite plausible that jurisdictions

²¹Theorem 4 does require that for any value of r , expression (13) is satisfied, which is not very restrictive because whether a cartel collapses is partly the result of forces unrelated to the CA. For example, even in the absence of a CA, all cartels will collapse with positive probability when $\bar{\pi}$ is sufficiently high and $\eta > 1$.

with an active leniency program could experience weakened nonleniency enforcement because of the crowding out of nonleniency methods of enforcement.

With regard to the second condition, many countries have set legal caps on fines that, for cartels in reasonably sized markets, are likely to be far below the incremental profit from colluding and thus do little to deter cartel formation. For example, the maximum penalty in Chile is around \$25 million per defendant. By way of comparison, there is currently a case against a suspected cartel in the wholesale chicken market that has annual sales on the order of \$1 billion. Even more paltry are caps of around \$7 million in Mexico (at least until 2011, when the cap was increased) and \$5 million in Japan (International Competition Network Cartels Working Group 2008).

In sum, there is at least anecdotal evidence to suggest that leniency cases could be reducing the rate at which a CA shuts down active cartels because resources are diverted from nonleniency enforcement and that penalties could be at sufficiently low levels that the threat of a race for leniency does not substantively deter cartel formation. It is then plausible that some jurisdictions could experience a higher cartel rate because of having introduced a leniency program.

5.3. *Leniency Programs and Decreased Cartel Rate*

As just shown, a leniency program is not assured of reducing the frequency of cartels; it can increase the cartel rate. One tactic that a CA can take to avoid this outcome and ensure that a leniency program serves the cause of fighting cartels is to set up a procedure to expeditiously handle leniency cases. Theorem 6 establishes that if leniency cases save sufficient resources—relative to nonleniency cases—then a leniency program will lower the cartel rate.

Theorem 6. If $\sigma_{NL}^* \in (0, \omega)$, then there exists $\hat{\lambda} > 0$ such that if $\lambda \in [0, \hat{\lambda}]$, then the cartel rate is weakly lower with a leniency program, and if assumption 1 holds, then the cartel rate is strictly lower with a leniency program.

While this result is not particularly surprising, it is important to understand why it is true. It is not just that the crowding out of nonleniency enforcement is reduced—and thus nonleniency enforcement does not fall as much—but rather that the rate of nonleniency enforcement can be higher.

Key to a leniency program raising the cartel rate is that leniency cases are consuming valuable CA resources, which detracts from nonleniency enforcement. However, if leniency cases can be handled with few resources, then they will not crowd out many nonleniency cases. Although there will still be some crowding out—which would suggest that nonleniency enforcement would still be harmed, and thus fewer cartels would be shut down by the CA—there is a mitigating effect from the enhanced deterrence of cartel formation due to a leniency program. By increasing the penalties that a cartel can expect to pay when it collapses (and cartel members subsequently race for leniency), a leniency program results in fewer cartels forming. With fewer cartels forming, there will be fewer nonleniency

cases. Thus, nonleniency enforcement could be stronger (that is, $\sigma_L^* > \sigma_{NL}^*$) because, while there are fewer resources for nonleniency cases because of the presence of leniency cases on a CA's docket, there are also fewer nonleniency cases.

To appreciate how nonleniency enforcement can be stronger when λ is sufficiently small, consider the extreme case of $\lambda = 0$, so that leniency cases require no resources. (As results are continuous in λ , the argument will also apply when λ is sufficiently low.) Holding the cartel rate fixed at the level without a leniency program, we see that a leniency program enhances nonleniency enforcement because there is no crowding out (because $\lambda = 0$), and there are fewer nonleniency cases because some of them are handled as leniency cases. Given that nonleniency enforcement is stronger and expected penalties are higher, the cartel rate is lower, which means that there are fewer nonleniency cases, and this serves to enhance nonleniency enforcement more. This feedback effect initiated by a leniency program—the existence of fewer cartels leads to fewer nonleniency cases, which leads to stronger nonleniency enforcement, which leads to fewer cartels—ultimately results in both a lower cartel rate and stronger nonleniency enforcement. This feedback effect suggests that there may be a large return to reducing λ by streamlining the handling of leniency cases.

A CA can also be assured that a leniency program will lower the cartel rate if it is introduced in a jurisdiction for which enforcement is already very weak as reflected in a low likelihood that a cartel will be even considered for prosecution. In that case, a leniency program is sure to be beneficial.

Theorem 7. There exists $\hat{q} > 0$ such that if $q \in [0, \hat{q}]$, then the cartel rate is weakly lower with a leniency program, and if assumption 1 holds, then the cartel rate is strictly lower with a leniency program.

If nonleniency enforcement is largely absent prior to the introduction of a leniency program, then a leniency program cannot have much of a crowding-out effect for the simple reason that there are not many nonleniency cases to crowd out. Hence, if a CA is not actively engaged in enforcement prior to introducing a leniency program, then a leniency program is sure to be effective in reducing the frequency of cartels.

It is worth noting that theorem 7 is the one result that does depend on there being full leniency ($\theta = 0$). If $\theta > 0$, then as $q \rightarrow 0$ and $\sigma (= qsr) \rightarrow 0$, the leniency program has no effect because no firm would use it. This comment highlights the complementarity between leniency and nonleniency enforcement: if $\sigma < \theta$, then a leniency program is irrelevant because the chances of being caught through nonleniency means are sufficiently low to make applying for leniency not in a firm's interests. The efficacy of a leniency program depends on cartel members believing that there is a sufficient chance of them being caught and convicted by the CA.²²

²² A caveat is appropriate here because we have assumed that firms achieve the Pareto-superior equilibrium when it comes to applying for leniency; that is, if there is an equilibrium in which no firms seek leniency, then that is the equilibrium on which firms coordinate. However, experimental

5.4. Interindustry Variation in the Impact of a Leniency Program

Our analysis has shown how a leniency program impacts the frequency of cartels. A leniency program can lower the cartel rate by resulting in some cartels no longer forming and reducing average cartel duration for those that do form. The focus thus far has been on the aggregate cartel rate, but, as the analysis in this section will reveal, a leniency program can have qualitatively distinct effects across industries.

Recall that industries vary with respect to the parameter η , where a higher value of η means a higher increase in profit from cheating on the collusive arrangement. A higher value for η could be because, for example, there are more firms (assuming Bertrand price competition) or a higher price elasticity to the firm's demand function. When η is higher, the greater incentive to deviate means that the cartel is less stable in the sense that it will internally collapse for a wider set of market conditions ($\phi(Y, \sigma, \eta)$ is decreasing in η). This property has two implications. First, industries with sufficiently high values of η are unable to cartelize (and recall that $\hat{\eta}$ denotes the highest value for η such that a cartel forms with positive probability). Second, when cartels are able to form ($\eta \leq \hat{\eta}$), average cartel duration is lower when η is higher. It is straightforward to show that average duration for a cartel in a type- η industry is

$$C(\sigma, \eta) = \frac{1}{1 - (1 - \sigma)H(\phi^*(\sigma, \eta))}$$

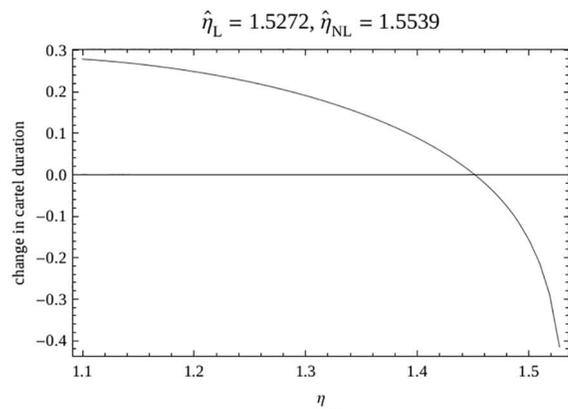
and that $\phi^*(\sigma, \eta)$ is nonincreasing in η and is decreasing in η if $\phi^*(\sigma, \eta) \in (\underline{\pi}, \bar{\pi})$. Hence, average cartel duration is decreasing in η . It is useful to note that an industry type's cartel rate $C(\sigma, \eta)$ and its average cartel duration $CD(\sigma, \eta)$ are monotonically related:

$$C(\sigma, \eta) = \frac{\kappa[CD(\sigma, \eta) - 1]}{1 + \kappa[CD(\sigma, \eta) - 1]}.$$

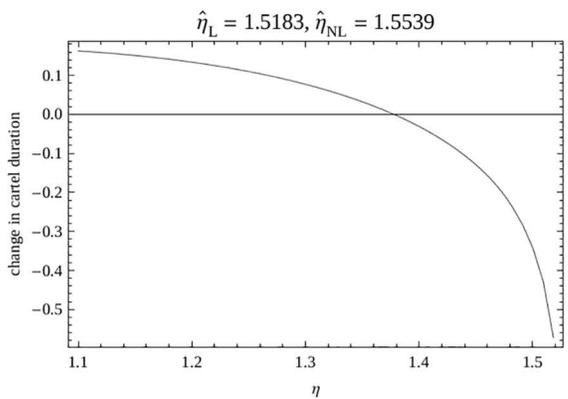
Thus, in assessing how the effect of a leniency program varies across industries, we can consider its influence either on the cartel rate or on cartel duration.

Given that there is interindustry variation in the presence and duration of cartels prior to a leniency program, it is natural to examine how the impact of a leniency program varies across industries. In particular, could a leniency program make the environment less hospitable for collusion in some industries while making it more hospitable in other industries? To initially address this question, we conduct numerical analysis. We provide results both for when the probability of conviction is linear in caseload and when it is a concave then convex function

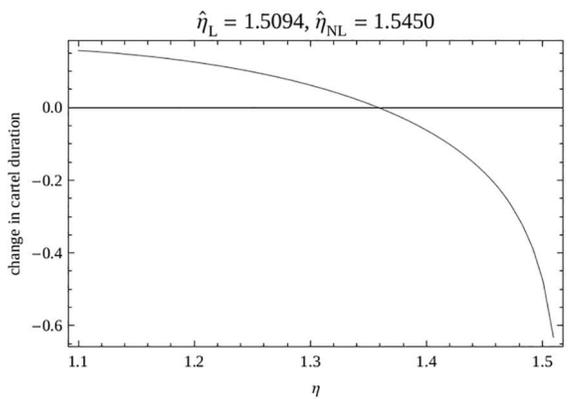
evidence suggests that a leniency program can be effective even when $\sigma = 0$ (Bigoni et al. 2012). In that case, a firm is presumably applying for leniency out of concern that a rival will apply for leniency, which is sensible for the rival only if it possesses a similar concern.



(A) $\gamma = .7$ and $\lambda = 1.0$

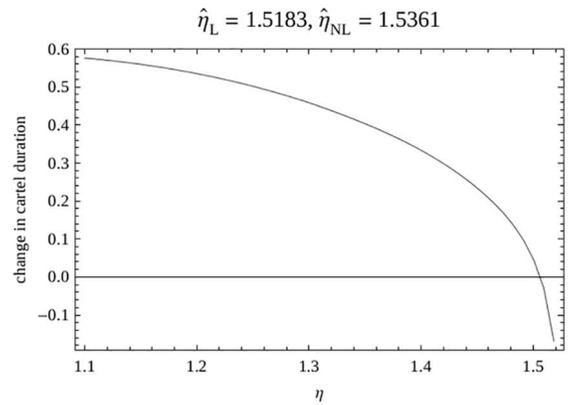


(B) $\gamma = .8$ and $\lambda = 1.0$

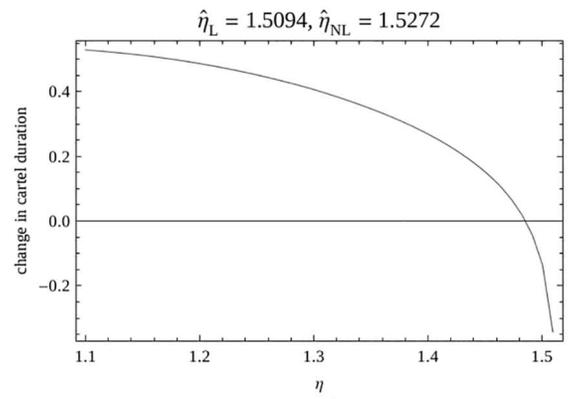


(C) $\gamma = .9$ and $\lambda = 1.0$

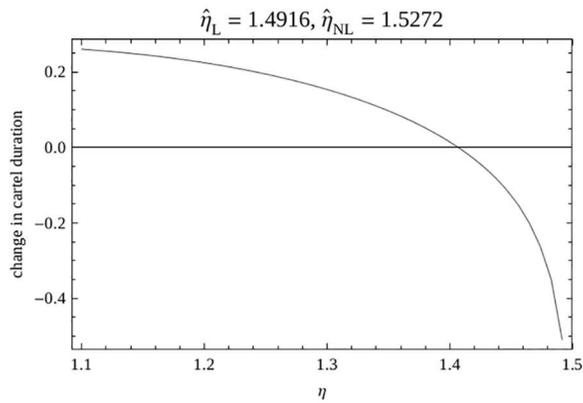
Figure 2. Change in cartel duration with linear probability of conviction



(A) $\gamma = .7$ and $\lambda = 1.0$



(B) $\gamma = .8$ and $\lambda = 1.0$



(C) $\gamma = .9$ and $\lambda = 1.0$

Figure 3. Change in cartel duration with convex and concave probability of conviction

of caseload. Details as to parameterizations and numerical methods are in the online appendix.

Figures 2 and 3 report the change in average cartel duration due to a leniency program for each industry type $\eta \leq \hat{\eta}$. First note that the introduction of a leniency program reduces $\hat{\eta}$ and thereby shrinks the range of industry types for which a cartel forms with positive probability; for example, in Figure 2B, $\hat{\eta}$ falls from 1.55 to 1.52. A reduction in $\hat{\eta}$ is found for almost all parameterizations, although there are a few cases in which a leniency program increased $\hat{\eta}$. Second, for those industries that do cartelize with positive probability, a leniency program has a differential effect across industries depending on whether the industry produces relatively stable cartels (η is low) or unstable cartels (η is high). The effect of a leniency program on average cartel duration (or the cartel rate) is decreasing in η , so industries that produce less stable cartels tend to experience a bigger drop in cartel duration than industries with more stable cartels. This property is apparent in Figures 2 and 3, where the change in average duration is decreasing in η , which holds as well for all other parameterizations considered. Even more, a leniency program can result in longer duration for the most stable cartels (that is, the change in duration is positive when η is low) while shutting down or shortening the duration of the least stable cartels.

Property 1. A leniency program generally reduces the range of markets that are able to form cartels. The effect of a leniency program on average cartel duration is decreasing in η , so markets with less stable cartels experience a bigger decline in average cartel duration. This differential effect can be so significant that a leniency program reduces the average cartel duration of relatively unstable cartels and, at the same time, increases the average cartel duration of relatively stable cartels.

To understand what is driving the differential effect of a leniency program across industries, recall that dying cartels use the leniency program. Once market conditions are such that collusion is no longer incentive compatible, firms stop colluding and race to apply for leniency. Of course, only one firm receives leniency, with the remaining firms paying full penalties. Because the leniency program then ensures conviction when the cartel dies, expected penalties are higher with a leniency program. At the same time, the flow of leniency applications can weaken nonleniency enforcement by reducing the likelihood of being prosecuted and convicted outside of the leniency program. In sum, expected penalties can be higher through the leniency program and lower outside of the leniency program. Which of these effects is more important depends on an industry's type. Firms in markets that support relatively unstable cartels know that there is a significant chance that the cartel will internally collapse, which will induce a race for leniency. Thus, those cartels are especially harmed by the higher penalties coming from a leniency applicant, and therefore they are worse off after the introduction of a leniency program. In contrast, firms in markets that support relatively stable cartels are less concerned with a race for leniency because cartel collapse is un-

likely (and such a race ensues only in that event). The greater concern for a highly stable cartel is with nonleniency enforcement, and, if that is weaker by virtue of the crowding-out effect of a leniency program, expected penalties are lower and, therefore, the environment is more hospitable for collusion.

To complement these numerical results, we can prove that the least stable cartels are harmed by a leniency program when nonleniency enforcement is not weakened and that the most stable cartels are benefited by a leniency program when nonleniency enforcement is weakened. Theorem 8 shows that if a market produces sufficiently stable cartels, then the impact of a leniency program is determined by how it influences nonleniency enforcement. If the introduction of a leniency program strengthens nonleniency enforcement, then the cartel rate (or average cartel duration) for highly stable cartels declines, while if it weakens nonleniency enforcement, then the cartel rate (or average cartel duration) rises. These highly stable cartels are not concerned with the higher penalties coming from a race for leniency—because a race is unlikely for those cartels—and instead are concerned with whether they are more or less likely to be prosecuted and convicted outside of the leniency program.

Theorem 8. Assume that $\underline{\eta} = 1$ and $C_{NL}(\sigma_{NL}^*, \eta), C_L(\sigma_L^*, \eta) > 0$; then

$$\lim_{\eta \rightarrow \underline{\eta}} [C_L(\sigma_L^*, \eta) - C_{NL}(\sigma_{NL}^*, \eta)] = \frac{\kappa(\sigma_{NL}^* - \sigma_L^*)}{[1 - (1 - \kappa)(1 - \sigma_L^*)][1 - (1 - \kappa)(1 - \sigma_{NL}^*)]}.$$

Hence, for values of η close to 1, $C_L(\sigma_L^*, \eta) < C_{NL}(\sigma_{NL}^*, \eta)$ if and only if $\sigma_L^* > \sigma_{NL}^*$ and $C_L(\sigma_L^*, \eta) > C_{NL}(\sigma_{NL}^*, \eta)$ if and only if $\sigma_L^* < \sigma_{NL}^*$.

The next result shows that, unless nonleniency enforcement is weakened, a leniency program is sure to destabilize the least stable cartels. Industries for which $\eta \in (\hat{\eta}_L(\sigma_L^*), \hat{\eta}_{NL}(\sigma_{NL}^*)]$ are able to collude in the absence of a leniency program but are not able to do so with a leniency program.

Theorem 9. If $\sigma_{NL}^*, \sigma_L^* \in (0, \omega)$, $\sigma_L^* \geq \sigma_{NL}^*$, and $\hat{\eta}_{NL}(\sigma_{NL}^*) \in (\underline{\eta}, \bar{\eta})$, then $\hat{\eta}_L(\sigma_L^*) < \hat{\eta}_{NL}(\sigma_{NL}^*)$.

In sum, the institution of a leniency program can increase expected penalties and, as a result, shorten cartel duration (or prevent cartels from forming at all) in industries for which collusion is least stable, while it can lengthen cartel duration in industries for which collusion is most stable because nonleniency enforcement is weaker. Thus, this theory predicts that a leniency program can result in fewer cartels forming but that those that form last longer.

Finally, these results could be the basis for a test of whether a leniency program is weakening nonleniency enforcement, which is a crucial condition for a leniency program to increase the cartel rate. A candidate marker is that a leniency program results in the most stable cartels having longer duration and the least stable cartels having shorter duration. For example, consider the change in av-

erage duration before and after instituting a leniency program for the X percent of cartels with the longest duration and the X percent of cartels with the shortest duration, for some $X \leq 50$. If the former increases and the latter decreases, this is consistent with weaker nonleniency enforcement. Proper development of this test requires further work, however, because it is stated in terms of the duration of cartels, while the data will be the durations of discovered cartels. Given that a leniency program affects the discovery process, if the chances of discovery are correlated with the change in duration, then the change in duration for discovered cartels will be a biased measure of the change in durations for cartels (see Harrington and Wei [2014] for an examination of selection bias with regard to data on discovered cartels). A second source of possible bias is that the least stable cartels may no longer form, in which case they will not be present in the post-lenieny data. The framework of this paper can be used to take account of those biases and develop a proper test of whether a leniency program is weakening nonleniency enforcement.

5.5. Robustness

In concluding this section, let us investigate the robustness of the result that a leniency program can raise the cartel rate (theorem 4) with respect to the assumption that the CA pursues all leniency cases. For this purpose, let x denote the fraction of leniency cases that the CA takes on and consider $x < 1$. If a firm applies for leniency and the CA chooses not to accept the application, then the CA cannot prosecute the case (or, if it does, then the court will annul any penalties).²³ Recall that when all members apply for leniency on a cartel's death, the expected penalty to a cartel member is ωF . If now only a fraction x of leniency applications are accepted, then the expected penalty is reduced to $x\omega F + (1-x) \times 0 = x\omega F$. This creates a serious enforcement problem when the value of x is low. If x is such that $x\omega F < \sigma F$, then expected penalties are lower under a leniency program (in contrast to our assumption that they are higher), in which case it becomes easier for a leniency program to raise the cartel rate. Furthermore, if x is set too low, then active cartels will also apply for leniency because they know that there is a good chance that the application will be denied, which then prevents the CA from prosecuting them. Thus, there are compelling reasons for the CA not to pursue too few leniency cases and thereby keep x reasonably high.

Next suppose that the CA pursues a large fraction of leniency cases but not all of them, and further suppose that $x\omega F > \sigma F$, so expected penalties are higher with a leniency program. This changes the analysis in the determination of the equilibrium value of σ . From equation (12), for the case of full leniency ($\theta = 0$), σ^* is now the fixed point to

$$\sigma = qrp(\lambda xL(\sigma) + qr[C(\sigma) - L(\sigma)]).$$

²³ Email from Kevin Coates, head of the cartels directorate unit of the European Commission, to Joseph Harrington, July 29, 2014.

The term $L(\sigma)$ is the mass of leniency applications from which the CA pursues $xL(\sigma)$ leniency cases. Of the $C(\sigma) - L(\sigma)$ cartels that did not apply for leniency, the CA discovers a fraction q of them and prosecutes a fraction r of those cases. It can be shown that the condition in theorem 4 is now $\lambda x > qr$ instead of $\lambda > qr$. For example, if $\lambda \simeq 1$, so leniency cases take roughly as many resources as nonleniency cases, then a leniency program raises the cartel rate when penalties are sufficiently weak and $qr/x < 1$. The latter condition is satisfied if the rate at which the CA takes on leniency cases is at least as great as the rate at which it takes on nonleniency cases ($x \geq r$), which seems reasonable given that the success rate for a leniency case exceeds that for a nonleniency case. Thus, as long as the CA is sufficiently attracted to leniency cases relative to nonleniency cases, then the cartel rate will be higher with a leniency program when penalties are sufficiently weak and the resource savings in prosecuting a leniency case are sufficiently small.

6. Concluding Remarks: Policy Implications and Future Research Directions

The fear or apprehension—in other words, the deterrent effect of past prosecution—is what drives the Leniency Program at the end of the day. And my concern is that most of the cases that are brought today . . . are generated exclusively from firms that have decided to come forward and seek leniency applications. . . . I am worried that the success of the Leniency Program combined with budget constraints that your Division faces will in effect give you incentives to pursue only the companies that come forward. . . . [A]s I know from personal experience, some of the most egregious and harmful of the cartels may have nobody coming forward. (Senator Bill Blumenthal [US Senate 2013])

[A] regime wherein cartelists may fear being exposed by their co-conspirators in exchange for leniency, but where they face no real danger of otherwise being detected, is lopsided and thus less effective both as a detector of and a deterrent to bad behavior than if resources were more evenly allocated between deterrence and detection. . . . [T]he Division should be mindful that relying too heavily on leniency may be detrimental to its overall goal of decreasing harmful cartel activity. (Dixon, Kate, and McDavid 2014, pp. 4, 6)

These sentiments are common. While there is recognition that a leniency program is an immensely valuable tool in the arsenal of a CA, concerns arise when it is the only tool. Underlying this concern is that using leniency applications and convictions—of which the US Department of Justice and the EC have in ample supply—does not provide a reassuring measure of performance. The real issue is whether fewer cartels are forming and persisting.

We investigated the concerns expressed by both practitioners and scholars by constructing a framework within which to examine how a leniency program in-

fluences the intensity of enforcement through nonleniency means and how both forms of enforcement affect the frequency of cartels. Holding nonleniency enforcement fixed, we find that a leniency program generally lowers the cartel rate, which is consistent with previous theoretical and experimental research. However, when nonleniency enforcement is endogenized, a leniency program can either decrease or increase the cartel rate. Whether there are more or fewer cartels depends on the extent to which leniency applications shift CA resources away from pursuing cases without leniency applications to cases with leniency applications. In particular, introducing a leniency program into an environment in which penalties are low and leniency cases consume resources comparable to those of nonleniency cases is predicted to result in a higher frequency of cartels.

Our analysis suggests some feasible policies that can make it more likely that the introduction of a leniency program will have the desired effect of reducing the presence of cartels in an economy. A leniency program shifts resources from prosecuting active cartels to prosecuting dying cartels, which is counterproductive in terms of shutting down cartels. Prosecution of dead cartels can still be beneficial, however, when it enhances deterrence. Indeed, a primary appeal of a leniency program is that it will cause cartel members to believe that there is a higher probability that they will end up paying penalties, but this will substantively deter cartel formation only if penalties are sufficiently severe. It is then important that the institution of a leniency program be accompanied by appropriately high penalties. Failure to do so can mean that a leniency program is not just ineffective but counterproductive. A second key complementary policy to a leniency program is a CA's budget. With firms coming to the CA for leniency—instead of a CA having to actively look for cases—there may be a temptation to reduce the resources of a CA. This would be a mistake. If resources are constrained, then the attention given to leniency cases will have a crowding-out effect on nonleniency enforcement; this can allow the more stable cartels to avoid prosecution longer and can increase the presence of cartels. A CA's budget and a leniency program should be thought of as complements—not substitutes—and, accordingly, budgets should be expanded and processes should be streamlined to more effectively handle leniency cases so as to maintain a strong enforcement presence for cartels that do not apply for leniency.

While the focus in this paper is on assessing the impact of a corporate leniency program, the framework is flexible enough to evaluate other competition policies, for example, assessing the impact of screening for cartels, which can be represented as an increase in the probability that a cartel is discovered q (see Harrington [2007] for an argument for screening) or endowing the CA with some amount of resources and considering their allocation across discovery (reducing q), prosecution (increasing the probability of conviction s), and penalization (increasing penalties γ). The model can also be enriched to give the CA more powers by, for example, allowing the penalty to depend on the actual duration of the cartel (rather than the average duration) or allowing the CA to observe an industry's type η and then select cases on those grounds; in particular, it would want to take

cases with lower η because cartels tend to be more stable in those markets, and thus shutting them down is more important.

Perhaps the most intriguing extension is modeling the CA's objective and exploring optimal policy design when the CA is motivated by career concerns. If we think that the members of the CA act to maximize some observable measure of performance, then, given that the cartel rate is not directly observed, it is not clear that there is an incentive scheme that will induce it to minimize the cartel rate. A more reasonable objective might be for it to maximize the number of convictions or the total amount of fines. In that case, the ultimate effect of a policy change can depend on how it is implemented by the CA. Better understanding the strategic behavior of a CA and how it impacts the efficacy of competition policy is an important avenue for future research.

References

- Apestequia, Jose, Martin Dufwenberg, and Reinhard Selten. 2007. Blowing the Whistle. *Economic Theory* 31:143–66.
- Aubert, Cécile, Patrick Rey, and William Kovacic. 2006. The Impact of Leniency and Whistle-Blowing Programs on Cartels. *International Journal of Industrial Organization* 24:1241–66.
- Bigoni, Maria, Sven-Olof Fridolfsson, Chloé Le Coq, and Giancarlo Spagnolo. 2012. Fines, Leniency, and Rewards in Antitrust. *RAND Journal of Economics* 43:368–90.
- Blatter, Marc, Winand Emons, and Silvio Sticher. 2014. Optimal Leniency Programs When Firms Have Cumulative and Asymmetric Evidence. Working paper. University of Bern, Department of Economics, Bern.
- Borrell, Joan-Ramon, Juan Luis Jiménez, and Carmen García. 2014. Evaluating Antitrust Leniency Programs. *Journal of Competition Law and Economics* 10:107–36.
- Bos, Iwan, and Frederick Wandschneider. 2013. A Note on Cartel Ringleaders and the Corporate Leniency Program. *Applied Economics Letters* 20:1100–1103.
- Brenner, Steffen. 2009. An Empirical Study of the European Corporate Leniency Program. *International Journal of Industrial Organization* 27:639–45.
- Bundeskartellamt. 2010. *Effective Cartel Prosecution: Benefits for the Economy and Consumers*. Bonn: Bundeskartellamt.
- Chen, Joe, and Joseph E. Harrington, Jr. 2007. The Impact of the Corporate Leniency Program on Cartel Formation and the Cartel Price Path. Pp. 59–80 in *The Political Economy of Antitrust*, edited by Vivek Ghosal and Johan Stennek. Amsterdam: Elsevier.
- Chen, Zhijun, and Patrick Rey. 2013. On the Design of Leniency Programs. *Journal of Law and Economics* 56:917–57.
- Choi, Jay Pil, and Heiko Gerlach. 2012. Global Cartels, Leniency Programs, and International Antitrust Cooperation. *International Journal of Industrial Organization* 30:528–40.
- Choi, Yun Jeong. 2011. An Empirical Analysis of the Corporate Leniency Program in Korea: Its Amendments in 2005. *Korean Journal of Economics* 18:255–81.
- Dijkstra, Peter T., Marco A. Haan, and Lambert Schoonbeek. 2011. Leniency Programs and the Design of Antitrust: Experimental Evidence with Unrestricted Communication. Working paper. University of Groningen, Faculty of Economics and Business, Groningen.
- Dixon, Megan, Ethan Kate, and Janet McDavid. 2014. Too Much of a Good Thing? Is

- Heavy Reliance on Leniency Eroding Cartel Enforcement in the United States? *CPI Antitrust Chronicle* 2:2–6.
- Dong, Ailin, Massimo Massa, and Alminas Žaldokas. 2014. Busted! Now What? Effects of Cartel Enforcement on Firm Values and Policies. Working Paper No. 2014/38/FIN. INSEAD, Fontainebleau, France. http://www.insead.edu/facultyresearch/research/details_papers.cfm?id=32942.
- Ellis, Christopher J., and Wesley W. Wilson. 2001. Cartels, Price-Fixing, and Corporate Leniency Policy: What Doesn't Kill Us Makes Us Stronger. Unpublished manuscript. University of Oregon, Department of Economics, Eugene.
- Friederiszick, Hans W., and Frank P. Maier-Rigaud. 2008. Triggering Inspections Ex Officio: Moving beyond a Passive EU Cartel Policy. *Journal of Competition Law and Economics* 4:89–113.
- Gärtner, Dennis L. 2014. Corporate Leniency in a Dynamic World: The Preemptive Push of an Uncertain Future. Working paper. University of Bonn, Graduate School of Economics, Bonn.
- Ghosal, Vivek, and Joseph Gallo. 2001. The Cyclical Behavior of the Department of Justice's Antitrust Enforcement Activity. *International Journal of Industrial Organization* 19:27–54.
- Hamaguchi, Yasuyo, Toshiji Kawagoe, and Aiko Shibata. 2009. Group Size Effects on Cartel Formation and the Enforcement Power of Leniency Programs. *International Journal of Industrial Organization* 27:145–65.
- Hammond, Scott D. 2005. An Update of the Antitrust Division's Criminal Enforcement Program. Paper presented at the American Bar Association Section of the Antitrust Law Cartel Enforcement Roundtable. Washington, DC, November 16.
- Harrington, Joseph E., Jr. 2007. Behavioural Screening and the Detection of Cartels. Pp. 51–68 in *European Competition Law Annual 2006: Enforcement of Prohibition of Cartels*, edited by Claus-Dieter Ehlermann and Isabela Atanasiu. Oxford: Hart.
- . 2008. Optimal Corporate Leniency Programs. *Journal of Industrial Economics* 56:215–46.
- . 2012. Corporate Leniency with Private Information: An Exploratory Example. Pp. 28–48 in *Recent Advances in the Analysis of Competition Policy and Regulation*, edited by Joseph E. Harrington, Jr., and Yannis Katsoulacos. Cheltenham: Edward Elgar.
- . 2013. Corporate Leniency Programs When Firms Have Private Information: The Push of Prosecution and the Pull of Pre-Emption. *Journal of Industrial Economics* 61:1–27.
- Harrington, Joseph E., Jr., and Myong-Hun Chang. 2009. Modelling the Birth and Death of Cartels with an Application to Evaluating Antitrust Policy. *Journal of the European Economic Association* 7:1400–1435.
- Harrington, Joseph E., Jr., and Yanhao Wei. 2014. What Can the Duration of Discovered Cartels Tell Us about the Duration of Cartels? Working Paper No. 14-042. University of Pennsylvania, Penn Institute for Economic Research, Philadelphia.
- Hinloopen, Jeroen, and Adriaan R. Soetevent. 2008. Laboratory Evidence on the Effectiveness of Corporate Leniency Programs. *RAND Journal of Economics* 39:607–16.
- Houba, Harold, Evgenia Motchenkova, and Quan Wen. 2009. The Effects of Leniency on Maximal Cartel Pricing. Discussion Paper No. 2009-038. Tilburg University, Tilburg Law and Economics Center, Tilburg.
- International Competition Network Cartels Working Group. 2008. *Setting of Fines for Cartels in ICN Jurisdictions*. Report to the Seventh International Competition Network Annual Conference, Kyoto. Luxembourg: Office for Official Publications of the European Communities.

- Klein, Gordon J. 2010. Cartel Destabilization and Leniency Programs: Empirical Evidence. Discussion Paper No. 10-107. Centre for European Economic Research, Mannheim.
- Koh, Sae Ran, and Jinook Jeong. 2014. Leniency Program in Korea and Its Effectiveness. *Journal of Competition Law and Economics* 10:161–83.
- Kwoka, John. 1999. Commitment to Competition: An Assessment of Antitrust Agency Budgets since 1970. *Review of Industrial Organization* 14:295–302.
- Lefouili, Yassine, and Catherine Roux. 2012. Leniency Programs for Multimarket Firms: The Effect of Amnesty Plus on Cartel Formation. *International Journal of Industrial Organization* 30:624–40.
- Marshall, Robert C., Leslie M. Marx, and Claudio Mezzetti. 2013. Antitrust Leniency with Multi-product Colluders. Unpublished manuscript. Pennsylvania State University, Department of Economics, State College.
- Marx, Leslie M., and Claudio Mezzetti. 2014. Effects of Antitrust Leniency on Concealment Effort by Colluding Firms. *Journal of Antitrust Enforcement* 2:305–32.
- Miller, Nathan H. 2009. Strategic Leniency and Cartel Enforcement. *American Economic Review* 99:750–68.
- Miranda, Mario J., and Paul L. Fackler. 2002. *Applied Computational Economics and Finance*. Cambridge, MA: MIT Press.
- Motchenkova, Evgenia. 2004. Effects of Leniency Programs on Cartel Stability. Discussion Paper No. 2004-98. Tilburg University, CentER, Tilburg.
- Motta, Massimo, and Michele Polo. 2003. Leniency Programs and Cartel Prosecution. *International Journal of Industrial Organization* 21:347–79.
- Riley, Alan. 2007. Developing Criminal Cartel Law: Dealing with the Growing Pains. *Competition Law Review* 4:1–6.
- Rotemberg, Julio J., and Garth Saloner. 1986. A Supergame-Theoretic Model of Price Wars during Booms. *American Economic Review* 76:390–407.
- Sauvagnat, Julien. 2013. Prosecution and Leniency Programs: The Role of Bluffing in Opening Investigations. Working paper. Toulouse School of Economics, Toulouse.
- Silbye, Frederik. 2010. Topics in Competition Policy: Cartels, Leniency, and Price Discrimination. PhD dissertation. University of Copenhagen, Department of Economics, Copenhagen.
- Spagnolo, Giancarlo. 2005. *Divide et Impera: Optimal Deterrence Mechanisms against Cartels and Organized Crime*. Unpublished manuscript. Stockholm School of Economics, Stockholm.
- . 2008. Leniency and Whistleblowers in Antitrust. Pp. 259–304 in *Handbook of Antitrust Economics*, edited by Paolo Buccirossi. Cambridge, MA: MIT Press.
- Stephan, Andreas. 2008. An Empirical Assessment of the European Leniency Notice. *Journal of Competition Law and Economics* 5:537–61.
- US House. Committee on the Judiciary. 2007. Statement of Thomas O. Barnett, Assistant Attorney General, Antitrust Division, before the Task Force on Antitrust and Competition. 110th Cong., 1st sess. September 25.
- US Senate. Committee on the Judiciary. 2013. *Cartel Prosecution: Stopping Price Fixers and Protecting Consumers*. Hearing before the Subcommittee on Antitrust, Competition Policy, and Consumer Rights (statement of Senator Bill Blumenthal). 113th Cong., 1st sess., November 14.
- Zhou, Jun. 2011. Evaluating Leniency and Modeling Cartel Durations: Time-Varying Policy Impacts and Sample Selection. Working paper. Bonn University, Department of Economics, Bonn.