

A Blow to Free Competition in the Chilean Pharmaceutical Industry

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The pharmaceutical sector in Chile has played a major role in a questionable chapter of the country's history ever since March, when the Court of Free Competition (TDLC) accused the Ahumada, Cruz Verde and Salcobrand pharmacy chains – which together have 92% share of the market – of colluding to raise the prices of 222 critical medications between December 2007 and April 2009.

The charge made by the Court led to an exhaustive investigation by the Fiscalía Nacional Económica (FNE), the national prosecutor for economic crimes, which oversees free competition in the country. The agency used documents and telephone calls to prove that during that time period, the three chains agreed clandestinely to raise the price of some medications by as much as 97%. Most notably, this included products for treating epilepsy, diabetes, anemia and ulcers, as well as vitamin supplements and contraceptives. As a result, the TDLC imposed fines of US\$15 million on each company, the maximum amount stipulated by Chilean law in these sorts of cases.

Indignant consumers immediately came out into the streets to protest, causing physical damage to the pharmacies' local outlets. They called on the public not to consume the medications that these chains provide, and to buy only from their local Chilean competitors. In the aftermath, sales of stock market shares for Ahumada, Cruz Verde and Salcobrand suffered a 43% collapse in March, compared with the same month in 2008. Meanwhile, sales of their smaller competitors grew by 35% in March.

“Clearly, the individual firms that were involved as well as their owners have been affected very negatively by the rejection by consumers, which has led to a decline in their market shares,” says Jaime Campos, professor of economics at the University of Santiago in Chile (USACH). “This should favor the entry of new competitors and the expansion of those competitors that are already established.”

Beyond the impact on the companies involved, there is another issue: Chilean consumers are now wondering why the principle of free competition has failed in a market that was supposedly regulated.

Ethics and Incentives

According to Guillermo Patillo, professor of economics in USACH, “Theoretically, the best world is one that is perfectly competitive, but it is hard to find that in reality for several reasons: Great efficiency in scales of production

obliges companies to meet the needs of large portions of the market; problems of transparency of information; and various kinds of barriers to entry. So it is not strange that in practice, the dominant market structure is one of oligopoly only rarely are there perfect cases of monopoly.” Patillo believes that this does not mean that oligopolistic companies have significant power in the market. “In many cases, their power is very slight, or better said, it disappears whenever there is a possibility of international competition.”

Nevertheless, Patillo recognizes that there are markets in which oligopolistic companies do have significant power “and can expand it, colluding to behave as a monopoly. This sort of action increases their profits, reduces the well-being of consumers and significantly distorts the functioning of the market, so it must be punished. Without doubt, this is fundamentally an ethical problem, since it goes against existing legislation and is an outrage against the well-being of society.”

Orlando Balboa, professor of economics at USACH, believes that, at times, free competition is not practiced primarily because of a problem with incentives. Generally speaking, he says, “firms recognize that it is better, in terms of economic benefits, to achieve some sort of cooperation among themselves that limits competition, especially when it comes to pricing. This cooperation is made easier when markets are concentrated; when there are barriers to entering the market; by the frequency with which consumers make purchases; when demand is inelastic; and when there is some sort of social network among owners and managers of the companies.”

Market Concentration

Campos agrees with Patillo and Balboa, noting that “both market concentration and a lack of ethics are necessary conditions for the failure of free competition.”

El Mercurio, the Chilean daily, recently published a report entitled, “An Examination of the Concentration of Economic Sectors in Chile.” The report warns that in addition to the pharmaceutical industry, other sectors that are highly concentrated include the airlines, the food industry, cable television, food and banking. In the report, Ricardo Jungmann, executive director of the Center of Free Competition at the Catholic University in Chile, states that “in no way is concentration synonymous with collusion.” The report notes that concentration can wind up transforming itself into something poisonous, especially in markets where there are barriers to entry.

That’s why concentrated sectors are being carefully scrutinized by the Court. Last year, it rejected a merger between two large Chilean retailers — Falabella and D&S — because it believed that the merger would create a mega-retailer that would endanger free competition in the sector.

Collusion in the Rest of the World

According to Fernando Coloma, professor at the Catholic University of Chile’s institute of economics, “In many markets, we are not close to the competitive paradigm, so it doesn’t seem to me necessary to start from the premise that free competition is failing. What is certain is that in some markets, competition is endangered. It should be noted that this is not unique to Chile; these sorts of situations also exist in the developed world. In Europe and the United States, despite the existence of strong regulations about competition, there are numerous examples of charges of collusion and anti-competitive behavior.” Coloma adds that in Chile, “they are now rigorously prosecuting conduct that runs contrary to competition, and that has become publicized.”

Campos agrees that there are a significant number of cases in the European Union where companies have been sanctioned for collusive practices. “One quite famous case involved the art auction houses of Christie’s and Sotheby’s, which were officially involved in colluding to set the commissions they charged between April 1993 and February 2000.

Joseph E. Harrington, professor of economics at Johns Hopkins University, cites a 2006 study, “How Do Cartels Operate?” which provides characteristic examples of collusion, emphasizing the production and sales of choline chloride. According to Harrington, this substance is a component of the Vitamin B complex, used in feeding farm-

raised birds and hogs. Its producers, mostly Americans, Canadians and Asians, agreed to raise the price of the product, which they exported mostly to Latin America. That alliance lasted from 1992 to 1998.

Another case Harrington describes involves the investigation of the production and commercialization of vitamins for human consumption. European and Asian manufacturers forged an agreement that lasted ten years (between 1989 and 1999). It substantially increased the price of vitamins A and E sold to customers in Europe.

In this regard, Patillo notes, “Economics has advanced a great deal in its analysis of these practices and the development of quantitative techniques to detect them and prove them. But, adequate progress has not yet been achieved in Latin America, so the challenges there are still significant. Our investigative skills and the breadth of our evidence can be expanded.”

Civil and Criminal Penalties

Coloma notes that in Chile, regulation of free competition has made progress, but efforts are still inadequate. “I believe that the FNE and the TDLC should be provided with more funding so they can pay for specialized studies about topics related to free competition where they are involved.”

José Miguel Sánchez, professor of economics at the Catholic University of Chile, maintains that “anti-monopoly legislation in this country has been at a very high level. Decree law 211 of October 1973 was applied without modification until 2004, when many aspects of the original regulations were strengthened. I believe that this shows the legislation has worked well.”

Campos adds, “Anti-trust institutions have improved significantly in Chile since 2003, especially with the creation of the TDLC and the strengthening of the [FNE]. This is a very substantial change from what existed beforehand.”

Balboa goes even further, stressing that anti-competitive conduct should not only be punished with civil sanctions – fines – but should also be punished with criminal penalties, such as jail time. After the collusion between pharmacy chains became public knowledge, the government of President Michelle Bachelet began to work on a proposal for a law that would expand the prosecutorial functions of the TDLC with respect to criminal penalties.

According to Coloma, the story of the Chilean pharmacies has become an opportunity to strengthen competition in that country. “Among various measures to strengthen it, we should mention the fact that authorities could make more effort to remove barriers to entry in specific markets — for example, so that supermarkets could now sell medications without medical prescriptions. Or, at a public and parliamentary level, the authorities can create a favorable environment for discussing the regulatory and institutional aspects that would lead to improvements in the functioning of the market economy.”

Recently, troubled Chilean consumers have moved more forcefully against Cruz Verde and Salcobrand. In an unexpected turn of events, Ahumada recently revealed that it had colluded with the other two chains. In contrast, Cruz Verde and Salcobrand have continued to deny the existence of any alliance aimed at raising prices.

As a result of Ahumada’s confession, the agency decided to reduce the penalty for Ahumada from the initial US\$15 million to about US\$1 million, while also obliging the company to develop a code of ethics that would provide disincentives for any behavior that threatens free competition. However, this measure has been broadly rejected by the public at large, which considers it unfair — and this has, in turn, triggered another debate on the subject of fairness.