Can Competition Policy Drive Growth in Europe?

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Introduction

Europe is confronting its most serious problem with economic growth for generations. Competition policy can play a role in resolving this. Productivity growth is essential for economic growth, and competitive markets contribute to productivity growth.[1]

As a competition community, we may not be focusing our reform efforts in the correct areas. We place too much emphasis on making small refinements to the existing system rather than on examining bolder policies such as those undertaken prior to 2003, or the even bolder ones when the competition rules of the Treaty of Rome were written.

There are three areas where the EU should consider radical change.

1. The EU should strengthen the prohibition on disproportionate State restrictions of competition by empowering all national competition agencies to enforce A106 (anticompetitive regulation) and A107 (anticompetitive state aid) of the European Treaty within the Member States.

2. National competition agencies and the courts should focus on dynamic competition factors such as entry barriers, switching costs, and innovation, rather than structural market shares.

3. The European Commission should integrate consumer policy in a single Directorate rather than its current fragmentation across Directorates; this would enable it to better address today's complex problems such as price discrimination, big data, and the Internet, and to work more closely with competition policy.

What does theory tell us?

Competition drives productivity through three effects: incentive effects, selection effects and innovation effects.[2]

- Competition gives firms incentives, at the margin, to cut prices, cut costs, and improve quality. Good companies grow by winning business from their competitors.

- Selection effects arise when less efficient firms fail totally, and are replaced by more efficient ones. Ease of entry and expansion for new players is a key facilitator.

- Innovation effects arise when a radically new or innovative product or service is brought to the market, often in a way that disrupts existing firms.

Under all three effects, the cost of the lack of competition is not only measured in terms of high prices for consumers. Firms that do not face competition are generally less efficient. They have higher costs and are often less responsive to their customers. They produce less with more. They are unproductive.

Further, in order to prevent competition undermining their cozy existences, they are also more likely to engage in wasteful “rent-seeking” and lobbying behavior.

Finally the impact of low competition in one sector can affect the whole economy through misallocation of resources. For example, sectors with weak competition often pay wages well above the market rate, resulting in a misallocation of talent that can persist for a generation.

Policy to improve competition should be expected to lead to greater productivity growth, especially over time.

What is the evidence?

The aviation sector provides a good example of how competition drives productivity growth to the benefit of consumers and the economy.

The liberalization of airline routes in the EU that started in the late 1980s contributed – between 1992 and 2002 – to an increase in flight frequency of 78 percent and a reduction in the lowest non-sale fare by 66 percent. Liberalization enabled low-cost carriers with a new business model to enter, forcing incumbent (usually state-owed) carriers to adapt or, in some cases, leave the market. In this way, it was not only those who flew on low-cost airlines who benefited - airfares across the sector fell. This is an example of how removing barriers to entry can increase competition, illustrating both the incentive and selection effects.

In February 2007, the UK Office of Fair Trading initiated consumer enforcement action against 13 airlines for quoting unavoidable costs, such as taxes and surcharges, separately from the base fare on their websites and in advertisements. These costs were added to the price at a late stage in the booking process and, as a result, the actual price paid by consumers could be significantly higher than the headline price. The OFT action ensured that all compulsory costs were included in headline prices of flights, facilitating consumer choice and increasing market contestability. A later independent evaluation suggested this had annual benefits of £131m.[3] This is an example of how incentive effects can also have large positive impact.

Many other markets could tell a similar story - including taxis, international telephone calls, and energy - where the removal of entry barriers and consumer switching costs have resulted in clear productivity growth.

What are the implications for European competition policy?

The framework in the EU has many of the key elements of an effective competition regime. Like most other jurisdictions, it has effective prohibitions against anticompetitive agreements, abuse of dominance, and anticompetitive mergers. The European Competition Network, whereby these laws are jointly enforced by the European Commission and the Competition Authorities of the Member States, is unique and works well. Unusually, and importantly, the EU also has a prohibition on anticompetitive state aid and anticompetitive state regulation. In all of this, the EU has been exemplary in refining and reforming its functions to make them more effective over time.

This framework has delivered substantial benefits to consumers and businesses across the EU, in part because of the broad range of complementary tools available to the Commission. Taking the benefits of airline competition as an example, the initial liberalization package was not fully effective, because national governments began to subsidize national carriers who could not compete, substantially blunting incentive and selection effects. However, from 2001, the Commission began to enforce state aid law more effectively, with the result that flag carriers could no longer be propped up by their national governments, and were forced to become far more efficient. In addition, the Commission used its abuse of dominance feature to prevent incumbent airlines from blocking entrants, and examined numerous joint venture and merger agreements in the sector, prohibiting those whose purpose was to soften the competitive pressure of liberalization.[4]

Despite these successes, there are at least three important areas where policy needs to develop.

Prohibitions on anticompetitive regulation

There are numerous disproportionate restrictions of competition at national, local and city levels which are too small and widespread to be capable of being tackled by the European Commission. For example, it is likely that many cities across Europe impose excessive regulation on taxis resulting in cost and detriment for local residents, businesses and tourists. Because of the fragmentation of regulation across the EU, and the local level at which regulations are enacted, European competition policy cannot drive competition in taxi markets as it did in airlines.

State restrictions on competition are often the most pervasive and the most difficult to remove because they are backed by powerful vested interests. But removing them can have huge benefits, as the airlines example shows.

A solution to this would be to empower national competition authorities in all Member States to enforce Articles 106 (regulation) and 107 (state aid). There is a precedent for this: in 2003, the EU empowered the national competition authorities to enforce Articles 101 (agreements) and 102 (abuse of dominance). This has been hugely successful.[5]

Dynamic focus

The focus of existing competition enforcement needs to be challenged. Both economic theory and evidence show that competition drives productivity effects as a dynamic process.[6] For this reason, policy should focus on improving market dynamics, stimulating price rivalry, reducing switching costs, and tackling entry barriers. While most current policy does this, there are some areas of concern.

- There is an excessive focus on market structure rather than market dynamics. For example, in the UK, the competition agencies have recently ordered company breakup in two separate markets on the basis of market concentration. UK politicians have called for market share caps and further restructuring in the energy and banking markets, both of which are currently subject to investigation by the CMA.

- Too much time is spent dealing with bargaining disputes in the supply chain that have little impact on consumers or economic growth. Consumer-facing companies that face intense competition will always put pressure on their suppliers to offer better value, higher quality, and more reliable delivery. This is simply the competitive process at work, and in all but the most extreme cases it should not be the role of competition agencies to intervene.

- Competition authorities should be cautious about relying heavily on evidence from competitors. In mergers, in particular, the level of complaints by competitors is likely to correlate with consumer benefit and productivity increases, not consumer harm. Competition authorities should prioritize their cases around the impact they have on consumers and economic growth, either directly because of the impact on the market in question or indirectly because of any deterrence effect that they may have across the economy.

- There is a risk of developing a fetish around numbers of cartel cases and high cartel fines. The performance of competition authorities should not be measured by case numbers or achieved levels of fines. Instead the focus should be on measuring the real effect on consumers and economic growth, as has been attempted in the UK for the past decade. While the focus on cartels is good, it should not be at the expense of other areas of enforcement, areas that may perhaps be less lucrative to the wider competition law community.

Integrating consumer policy

Europe needs to improve its consumer policy, and to join it up with its competition policy. Many of the biggest barriers to competition come from problems on the demand side of the market where consumers cannot easily compare prices or switch.

For example, the experience of competition in the airlines industry shows how improving consumer choice can have a large, positive impact on competition, and how the use of a range of complementary instruments can be necessary to achieve effective competition.

Consumer enforcement is not currently something to which the European Commission pays much attention. More importantly, what competencies there are in this area were fragmented in the second Barroso Commission and continue to be so in the Junker Commission. Improvements in coordinating consumer protection and competition enforcement would not just be good for economic growth, but might also help build public support for the single market.

This is particularly important in fast-moving online markets where novel issues arise and disjointed policy can have a significant negative impact on competition and growth. For example, many consumer-facing businesses now collect enormous amounts of data on their customers and, with the aid of technology, use behavioral economics and other marketing techniques to engage in sophisticated yield management – charging higher prices to consumers less likely to switch and focusing low price offers at the most active consumes. To demonstrate the importance of this, consider the speculation on October 7, 2014 around Dunnhumby, the Tesco-owned operation responsible for using customer data to drive intelligent pricing strategies.[7] A value of £2bn was mooted, representing nearly 15 percent of the value of the entire business.[8]

This price discrimination may be good for consumers overall. However, many competition authorities lack the tools necessary to assess this. There are also political risks for competition authorities. When such price discrimination tends to be progressive, as with airlines, politicians don't care. But when it is regressive, as it was with energy in the UK in 2008, it undermines politicians' confidence in competition and markets, and can lead to political intervention that harms the market process.[9]

Similarly, the new EU Competition Commissioner, Margrethe Vestager, has talked about the need for competition authorities to understand personal data. Many agencies lack expertise in this area. More importantly, without consumer enforcement powers, they lack the instruments to address many of the problems that may arise. The fragmentation of consumer policy across the new Commission may make this difficult. It would be unfortunate if the result was intervention to stop competition instead of intervention to make it more effective.

Conclusion

The current discussion about reforms to the EU's competition policy is worthwhile and should be pursued further. But they feel like increases on the intensive margin: tweaks to make the existing system work better. If competition policy in Europe wishes to play a key role in driving growth, it needs to change and face up to these challenges. We need to break new ground.

[1] Paul Krugman (1994). The Age of Diminishing Expectations. MIT Press.

[2] See Chad Syverson, 'What Determines Productivity?' (2011) 49 Journal of Economic Literature 326-365 for a more detailed account.

[3] See http://londoneconomics.co.uk/wp-content/uploads/2011/09/32-Evaluation-of-a-sample-of-OFTs-consumer-enforcement-cases.pdf

[4] See http://ec.europa.eu/competition/sectors/transport/reports/ for policy reports supporting the EU competition policy regarding air transport; http://ec.europa.eu/competition/consultations/2013_aviation_guidelines/index_en.htmlfor current draft guidelines on application of state aid to airports and airlines; andhttp://ec.europa.eu/competition/mergers/cases/decisions/M5747_20100714_20310_802534_EN.pdffor a non-opposition merger decision showing the level of detail of analysis even for non-interventions by the Commission on airline mergers.

[5] Wils, Wouter P. J., Ten Years of Regulation 1/2003 – A Retrospective (June 4, 2013). Journal of European Competition Law and Practice (2013 Forthcoming); presentation at the conference '10 Years of Regulation 1/2003' (Mannheim Centre for Competition and Innovation, 7 June 2013). Available at SSRN:http://ssrn.com/abstract=2274013.

[6] See Paul Klemperer Alfred Marshall lecture for a good description in relation to auctions (http://www.nuff.ox.ac.uk/users/klemperer/usingandabusing.pdf), and Sidak & Teece Favoring Dynamic Competition, Journal of Competition Law & Economics 2010 for a more general view.

[7] See http://www.bloomberg.com/news/2014-10-07/tesco-gains-most-in-six-months-on-speculation-of-dunnhumby-sale.html

[8] See http://www.ft.com/cms/s/0/da0ae8d6-4de6-11e4-adfe-00144feab7de.html#axzz3GgZRadHV

[9] See submission to the CMA from Stephen Littlechild et. al. (https://assets.digital.cabinet-office.gov.uk/media/53e38996e5274a261f000001/Stephen_Littlechild_et_al_submission_to_CMA_7_Aug_2014.pdf)