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Competition and Innovation Policy

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Competition and Innovation Policy

Philip Lowe *

Innovation and competition go hand in hand. Innovative markets are competitive markets and innovative companies succeed in them. In the European Commission, as in competition authorities across the world, our focus is on ensuring that this happens in the most efficient and fair manner.

In this article, I will aim to dispel a few myths about the relationship between competition and innovation policy, drawing my evidence from both well-established economic theory and DG Competition's day-to-day case practice. In doing so, I will open with a caveat: Competition policy cannot work miracles.

The true cornerstones of an innovation society are its education, its research and development ("R&D") policies, and its infrastructure. Businesses compete to provide consumers with goods and services, with the best choice and quality at the lowest costs. Innovation therefore depends on business initiative and enterprise. Good competition policies can complement these requirements. Such policies provide a solid framework for business to compete, but they cannot force businesses to compete.

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COMPETITION POLICY AS A FACILITATOR FOR INNOVATION

This debate about competition and innovation is part of a much broader economic discussion about how markets work and what role government should take.

The Schumpeterian school of thought is that competition policy, by attacking monopoly and putting checks on market power, risks undermining dynamic efficiency even as it supports static efficiency. Monopoly profits are the reward for innovation, but the destructive process of competition nevertheless ensures, without public intervention, that any generation of monopolist will soon be succeeded by another one.

The empirical evidence of the past few decades has worked against Schumpeter and in favor of Kenneth Arrow, who contends that in favoring monopolies Schumpeter underestimated the incentives for innovation that competition can offer. Monopolists tend to want to keep their monopolies by resorting to any measures that can keep new entrants out. Firms under competitive pressure from actual or potential competition, on the other hand, are less complacent and know that inventing a new product is their best strategy for maintaining and increasing their market share.

In a competitive market, new entrants know that innovation can help them to succeed in the market. Or, to use the American analyst David Isenberg's memorable metaphor: “The milk of disruptive innovation does not flow from cash cows.”

Next, I believe that the conflict between competition policy and innovation is regularly overstated. There is no inevitable conflict between the two. Both competition

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and innovation policy serve the same purpose, namely to ensure that true innovation is rewarded and to facilitate the innovation process.

Good competition policy supports innovation, acting as a safety net when markets do not work as well as they should and do not deliver the innovative products or services it is reasonable to expect. The challenge for policymakers worldwide is to strike the right balance between government intervention and allowing markets to find their own equilibrium. It is with respect to this balance that some have argued that the EC and U.S. approaches have diverged the most. However, even here, the differences should be seen in shades of grey, rather than in black and white.

To take the most high-profile example, the *Microsoft* case is often cited as evidence of division between the United States and the European Community. I would submit that the reality is that competition authorities on both sides of the Atlantic came to very similar conclusions about the tying of Microsoft's Windows Media Player into the Windows operating system. The actions taken in the European Community and in the United States, and the rulings handed down by the courts, all confirm the convergence and customer focus of European and American competition policy.

In both jurisdictions a rule of reason analysis was carried out, which looked not just at whether the potential consumer benefits outweighed the harm in the short run, but also at whether incentives to innovate would have been maintained in the long run. The European Court of First Instance ("CFI") confirmed the Commission's assessment that Microsoft's tying interfered with the normal competitive process which would benefit

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users by ensuring quicker cycles of innovation as a consequence of unfettered competition.[1]

The second part of the *Microsoft* case concerned the company's refusal to grant access to certain interoperability information. Here, the Commission argued that the ongoing refusal to supply this information was abusive and likely to lead to long-term consumer harm. The Commission therefore required Microsoft to provide interoperability information on reasonable terms to third parties. In this regard, it was accepted that Microsoft was entitled to charge for the interoperability information if it contained real innovation and was priced in line with market comparables.

The CFI confirmed the Commission's assessment that Microsoft's behavior limited the technical development to the prejudice of consumers and that it discouraged Microsoft's competitors from developing innovative operating systems to the prejudice of the consumer.[2] The CFI rejected Microsoft's argument that the disclosure of interoperability information would reduce or eliminate its incentives to innovate.[3] Microsoft itself has recently admitted that the disclosure of the relevant interoperability information will increase innovation and will be good for its customers.[4]

The fundamental principle underpinning both the Commission and the CFI's decisions was that competition policy has to focus on delivering consumer benefits. We are not defending competitors, but neither are we protecting dominant firms in all

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[1] *See* Case T-201/04, Microsoft v. Commission (CFI judgment of Sep. 17, 2007) (not yet reported), at para. 1088.

[2] *Id.* at para. 653.

[3] *Id.* at para. 701.

[4] *See* Kevin J. O'Brien, *Microsoft declares its troubles with EU over*, INT'L HERALD TRIB., Mar. 3, 2008, *available at* http://www.iht.com/articles/2008/03/03/business/msft.php.

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circumstances. We are protecting the competitive process, and we are keeping the doors and windows open for innovation.

Another area where innovation or hindrance to innovation is at stake and where competition policy can play a useful facilitating role is standard setting. Formal standards can confer on a particular technology a disproportionate degree of market power that an unscrupulous market player could then choose to abuse. For example, the owner of a proprietary technology essential to a standard might hide the fact that it holds essential intellectual property rights ("IPR") over the proposed standard, and only start asserting these rights after it has been agreed and other companies are locked in to using it and switching to a new standard, although theoretically possible, would be prohibitively expensive.

This practice, sometimes known as patent ambush, allows the company to extract an artificially inflated ex post value for its patented technology. It is a lucrative device, but one with clear negative repercussions for competitors, consumers, and the wider economy. There is therefore an important, pro-competitive rationale behind requiring disclosure of patents and patent applications in the framework of standard setting before a standard is set to avoid patent ambushes.

This is the basic motivation that continues to drive standard-setting organizations to insist that all IPR holders commit to licensing on fair, reasonable, and non-discriminatory ("FRAND") terms before a standard is adopted. Competition law enforcement should not stand in the way of such pro-competitive disclosures.

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Finally, investment in R&D is absolutely key to boosting innovation. Ernst & Young's European Attractiveness Survey 2007 made clear that more focus on R&D will play a key part in making Europe a more attractive place to do business. This is illustrated by Barcelona's R&D investment target of 3 percent of gross domestic product, two-thirds of which is expected to come from private sources.

But public support for R&D has to be appropriate, non-distortive, and impartial—giving taxpayers' money to favorite companies is no longer acceptable. Governments can and should create framework conditions that invite private businesses to invest in R&D and fund R&D investment that leverages private R&D spending. The EU state aid rules offer considerable scope for Member States to support business R&D and innovation. Since the entry into force of the new R&D and innovation guidelines in January 2007, the Commission has approved more than EUR 12 billion in new aid for research, development, and innovation.

In the European Commission, we recognize that we need truly to understand markets before we can make sound decisions about them. We have to ground our conclusions in strong economic analysis and that depends on capturing the true state of a market. But once a real competition problem has been identified, we should not shy away from acting swiftly in order to remove obstacles to innovation.

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