Economic Growth and Productivity

Competition promotes productivity and economic growth

There is broad empirical evidence supporting the proposition that competition is beneficial for the economy. Economists agree that competition policy has an important role to play in improving the productivity and therefore the growth prospects of an economy.

At the most general level, these are the messages about the importance of competition to productivity and growth:

- Competitive and dynamic markets have increased productivity and promoted economic growth across the globe.

- Competition policy has an important role to play in improving the productivity, and therefore the growth prospects, of an economy.

- Where competition is strong, productivity is strong. In order to increase productivity, a business must become more efficient, control its costs, and develop new products that consumers want. In competitive markets, if firms do not improve their productivity they will lose customers to other firms and new entrants. Competition is a key driver of increased productivity by promoting efficiency, removing barriers to entry and exit, and encouraging innovation.

- Effective competition provides significant benefits for consumers through lower prices and better quality goods and services.

- When markets work well, firms thrive by meeting consumers' needs better and more effectively than their competitors, through innovation, increased productivity and a lower cost base.

Competition contributes to increased productivity through:

- ***Pressure on firms to control costs***. In a competitive environment, firms must constantly strive to lower their production costs so that they can charge competitive prices, and they must also improve their goods and services so that they correspond to consumer demands.

- ***Easy market entry and exit***. Entry and exit of firms reallocates resources from less to more efficient firms. Overall productivity increases when an entrant is more efficient than the average incumbent and when an existing firm is less efficient than the average incumbent. Entry – and the threat of entry –incentivizes firms to continuously improve in order not to lose market share to or be forced out of the market by new entrants.

- ***Encouraging innovation***. Innovation acts as a strong driver of economic growth through the introduction of new or substantially improved products or services and the development of new and improved processes that lower the cost and increase the efficiency of production. Incentives to innovate are affected by the degree and type of competition in a market.

- ***Pressure to Improve Infrastructure***. Competition puts pressure on communities to keep local producers competitive by improving roads, bridges, docks, airports, and communications, as well as improving educational opportunities.
- ***Benchmarking***. Competition also can contribute to increased productivity by creating the possibility of benchmarking. The productivity of a monopolist cannot be measured against rivals in the same geographic market, but a dose of competition quickly will expose inferior performance. A monopolist may be content with mediocre productivity but a firm battling in a competitive market cannot afford to fall behind, especially if the investment community is benchmarking it against its rivals.

References and links to studies that support the link between competition and productivity and economic growth:

Paolo Buccirossi, Lorenzo Ciari, Tomaso Duso, Giancarlo Spagnolo, and Cristiana Vitale, Competition Policy and Productivity Growth: An Empirical Assessment, The Review of Economics and Statistics, October 2013, 95(4): 1324–1336. This paper estimates the impact of competition policy on total factor productivity growth for 22 industries in twelve OECD countries over 1995 to 2005, finding a positive and significant effect of competition policy on productivity growth.

A synthesis of the theoretical and empirical debates on competition and growth is available in **Philippe Aghion and Rachel Griffith, Competition and Growth: Reconciling Theory and Evidence, MIT Press, 2008** (cites recent empirical studies point to a positive effect of competition on productivity growth, direct discussion of how the benefits of tougher competition can be achieved while at the same time mitigating the negative effects competition and imitation may have on some sectors or industries.) See also **Aghion P, Howitt P., The Economics of Growth, MIT Press 2009** and **Aghion P, Akcigit U, Howitt P. What Do We Learn From Schumpeterian Growth Theory? 2013. O**n South Africa, see **Aghion, Philippe, Matias Braun, and Johannes Fedderke. 2008. Competition and productivity growth in South Africa. Economics of Transition 16(4): 741-768**, which indicates that high mark-ups have a large negative impact on productivity growth in South African manufacturing industry.

Some of the most striking empirical work on competition and growth comes from the **National Competition Policy (NCP) in Australia**. In April 1995, the Australian government committed to the implementation of a wide-ranging National Competition Policy — that drew heavily on a blueprint established by an earlier independent inquiry, the "Hilmer Review." These efforts increased Australia's gross domestic product by 2.5 per cent, and the average household's income by A$7000 per annum. At the sector level, the results are equally impressive. For example, in the electricity sector, average real prices Australia-wide fell by 19 per cent, real port charges fell by up to 50 per cent, average telecommunications charges have fell by more than 20 per cent in real terms, etc. See, e.g., **Review of National Competition Policy Reforms, available at: http://www.pc.gov.au/__data/assets/pdf_file/0016/46033/ncp.pdf. See also Productivity**

Commission, Review of National Competition Policy Reforms, Inquiry Report No33., February, 2005, http://www.pc.gov.au/__data/assets/pdf_file/0016/46033/ncp.pdf

William Lewis, The Power of Productivity: Wealth, Poverty, and the Threat to Global Stability (2004), at 103. McKinsey Global Institute cross-sectional survey of industries in many nations revealed that "economic progress depends on increasing productivity, which depends on undistorted competition. When government policies limit competition . . . more efficient companies can't replace less efficient ones. Economic growth slows and nations remain poor."

For a general discussion of the competition and other policies and growth, see **Fred Hilmer, Learnings from Successful Competition Policy and Productivity, July 29, 2010**.

See also **OFT's Government in markets - Why competition matters – a guide for policy makers, http://www.oft.gov.uk/shared_oft/business_leaflets/general/OFT1113.pdf,** with examples from specific markets, including aviation, telecommunications, and products such as books, sports jerseys, glasses, etc. On competition and growth generally, see the **UK OFT's Competition and growth, November 2011, http://www.oft.gov.uk/shared_oft/economic_research/oft1390.pdf,** discussing the general evidence on the relationship between competition and growth, and describing the impact on growth of a number of specific competition interventions.

Competition and competition policy can contribute to growth, an improved innovation climate and increased quality and efficiency within the public sector. This link is examined in the context of the Nordic countries, in a report which includes a comparison between competition policy, legal instruments, and implementation of competition rules. See **A Vision for Competition, Competition Policy towards 2020, Report from the Nordic competition authorities, No. 1/2013, http://www.kkv.se/upload/Filer/Trycksaker/Rapporter/nordiska/Nordic_report__Vision_For_Competition_2013_webb.pdf.**

In countries where there is more dynamism in markets, measured by the presence of more fast growing and shrinking firms, productivity growth is significantly higher. See, for example, **Bravo-Viosca, A. and Criscuolo, C., (2010), Evidence on business growth dynamics, presentation and paper for the OECD Working Party on Industry Analysis, 8-9 November 2010.**

Competition raises managers' incentives to out-perform competitors and, therefore, is often associated with higher levels of total factor productivity. **Van Reenen, John (2011) Does competition raise productivity through improving management quality? International Journal of Industrial Organization, 29 (3). 306-316. ISSN 0167-7187**

A study of approximately 4000 mid-sized enterprises in the US, Europe, and Asia concluded that competition contributes to better managed firms. **Bloom, N., Dorgan, S., Dowdy, J., and van Reenen, J. (2007), Summary report: Management Practices and Productivity: Why they matter, Centre for Economic Performance and McKinsey & Co**.

An OECD estimated that new firms account for approximately 10% of all firms in a number of OECD countries, and that a similar share of firms exit every year. **OECD (2004), Understanding Economic Growth - A Macro-level, Industry-level, and Firm-level Perspective. OECD publishing.**

For studies that indicate the benefits of competition policy in a wider context, see:

The European Commission, *European Competitiveness Report 2008* (COM(2008) 774 final), estimates that if trade between Member States in the European Union were to be eliminated (for example, as a result of market sharing agreements or because of State erected barriers), average productivity would fall by 13 per cent.

UK's Overseas Development Institute report "Assessing the Economic Impact of Competition" The report discusses the findings of an ODI research project, which examined (1) how the policy framework of a country affects the degree of competition in any given product market, and (2) how the degree of competition affects market outcomes, such as price, competitiveness, innovation, and access to services. ODI conducted primary research in Zambia, Kenya, Ghana, Vietnam, and Bangladesh across four product markets: sugar, cement, beer, and mobile phone services. In addition to stating the research findings in each of these markets, the report draws interesting country comparisons of policy frameworks and market structures. The report concludes with policy recommendations for each country and a general discussion of the impact of competition on economic performance in markets. http://www.odi.org.uk/sites/odi.org.uk/files/odi-assets/publications-opinion-files/6056.pdf

Older empirical studies that point to a positive correlation between growth and product market competition include: **Stephen J. Nickell, Competition and Corporate Performance, Journal of Political Economy, Vol. 104, No. 4 (Aug., 1996), pp. 724-746** and **Blundell, R and Griffith, R and Van Reenen, J, Market share, market value and innovation in a panel of British manufacturing firms , Review of Economic Studies, 66(3) (228). 529-554 (1999).** See also **Michael E. Porter, The Competitive Advantage of Nations (1990), at 662.** This comprehensive multinational study of international competitiveness that "creating a dominant domestic competitor rarely results in international competitive advantage. Firms that do not have to compete at home rarely succeed abroad." and **Djankov and Murrell, Enterprise Restructuring in Transition: A Quantitative Survey, 40 Journal of Economic Literature 739-792 (2002).** This study indicates that very large benefits from competition policy can be observed in transition economies that provide a natural laboratory to consider the effect of competition. See also **Ahn, Competition, Innovation and Productivity Growth: A Review of Theory and Evidence, Economics Department Working papers No 37, OECD, document number ECO/WKP (2002).** Competition encourages innovative activities and increases productivity; dynamic long-run gains from competition are likely to dominate the short-run efficiency gains since firms will continue to innovate.