The case for competition policy in difficult economic times

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THE CASE FOR COMPETITION POLICY IN DIFFICULT ECONOMIC TIMES

I. Summary Messages

- **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.
  - 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.
  - The recent economic crisis appears to have shaken faith in markets and in competition policy. There are accusations that unfettered competition has contributed to the crisis. However, the evidence points to the contrary.

- **Effective competition and competition policy can aid economic recovery.**
  - Economic downturns, although temporary, increase protectionist pressures to relax competition with long run effects.
  - Relaxing, suspending, or eliminating competition policy during an economic crisis can inadvertently harm consumers and producers by slowing, rather than promoting economic recovery.
  - History demonstrates that the costs of restrictions on competition are substantial, often only become evident in the long run and can be extremely difficult to remove or reverse.
  - More effective competition and competition policy should be part of the solution to make markets work better in the future.

- **Competition policy can usefully inform broader policy objectives.**
  - As governments design economic recovery measures, competition agencies can offer useful advice and insight on likely effects in the market and help ensure that the full benefits of competition are properly understood and taken into account in policy-making.

- This might include countering protectionist measures that would relax competition for incumbent producers and advising government on the economic costs and benefits of alternative proposals.
- For example, as governments consider a range of reforms to the regulatory framework governing financial markets, it is important that they are mindful of the competitive impact of those regimes and seek to promote greater levels of competition in affected markets, relying on competition agencies to provide guidance on how they can achieve that end.

II. Background Supporting Points

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

1. Economists agree that competition policy has an important role to play in improving the productivity (and therefore the growth prospects) of an economy, regardless of the position of that economy in the business cycle. Competition policy also enhances consumer welfare. Competition policy involves the application of legal rules and public advocacy (mainly through relationships with other governmental entities and by increasing public awareness of the benefits of competition) to promote a competitive marketplace.

2. When markets work well, firms thrive by meeting consumers' needs better and more effectively than their competitors. Competition provides strong incentives for firms to be more efficient than their rivals, reduce their costs and innovate, thereby helping raise productivity growth across the economy. Effective competition provides significant benefits for consumers through greater choice, lower prices, and better quality goods and services.

3. Empirical evidence supports the proposition that competition is beneficial for the economy. For example:

   - A number of studies have quantified the gains of procompetitive deregulation. Some examples are given below; however, many more studies demonstrate similar findings in other countries and across various industries.

     - In one study, the Australian Productivity Commission found that the procompetitive reforms to infrastructure in the early 1990s led to price changes that boosted Australia's gross domestic product by 2.5 per cent, and the average household's income by A$7000 per annum.

     - The European Commission has found that the liberalization of the European telecoms markets from 1998 has brought more competition to the markets, and in turn brought major benefits to consumers in the form of lower prices and better services. Similarly, a study in the United Kingdom found a 90 per cent reduction in the cost of international telephone calls between 1992 and 2002 as a result of deregulation.

     - Over the same period, the increased liberalization of the European aviation market increased flight frequency by 78 per cent and lowered the cost of non-sale fares by 66 per cent.

- For a compilation of empirical research supporting the proposition that competition enhances productivity, see chapter 5 of UK Office of Fair Trading, *Competition and Productivity*, available at www.oft.gov.uk/shared_oft/economic_research/oft887.pdf.

- 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.

- 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.)

- Djankov and Murrell, *Enterprise Restructuring in Transition: A Quantitative Survey*, 40 Journal of Economic Literature 739-792 (2002). (Very large benefits from competition policy observed in transition economies that provide a natural laboratory to consider the effect of competition.)

- 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.")

- Michael E. Porter, *The Competitive Advantage of Nations* (1990), at 662. (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.")

Effective competition and competition policy can aid economic recovery.

4. The recent crisis in global financial markets has led some observers to question the effectiveness of markets and competition. However, studies do not reveal any link between competition (or competition policy) and the financial and economic crises that began in late 2008.

5. In short, there is general agreement among economists that competition policy has a strong role in improving the productivity and overall health of the economy, and that neither competition nor competition policy is to blame for current economic ills.

6. A highly competitive financial sector, appropriately regulated in light of the lessons of the past, will be more conducive to positive future economic outcomes than a non-competitive or weakly competitive financial sector.

7. There are many reasons for policymakers to be wary of calls to relax competition policy in recession or during economic crisis.

8. While a relaxation of competition policy may appear, at least superficially, to be a relatively 'cheap' option (in that it will not involve spending funds from taxpayers), it is an inefficient means to assist firms in financial difficulty. A relaxation will weaken firms' incentives to be more efficient, render them less competitive internationally (see discussion of Lewis and Porter research findings, above), and penalize successful firms.

9. State support and special policies that protect incumbent firms from competitive pressures through artificial barriers can also lead to distortions of competition: in addition to weakening the recipient's incentives to be more efficient, competitors' incentives will be affected as results are achieved by state support rather than business decisions.

10. Relaxing competition policy is an ineffective, and even counterproductive, means to boost the economy and encourage recovery. A downturn requires firms to adapt and change and competition provides adequate incentives for this to take place. Competition policy is designed to counteract market failure, and in particular the anticompetitive exercise of market power.

    - Firms with market power have incentives to restrict output, to raise prices, and to reduce their levels of investment and innovation.

    - In general, therefore, policies which result in increased market power can prove counterproductive, since further restrictions in output and productivity are likely to exacerbate the effects of recession and slow the recovery.

    - These policies can also reduce the ability of new firms to enter the market and further hinder growth.

- History demonstrates that a temporary relaxation of competition policy would be hard to reverse. This is partly because the costs of the relaxation would tend to fall on the customers of firms, who are often a large and disparate group of individuals; while the benefits will typically flow to a smaller group, namely the shareholders and management of certain firms in the industry in question. These firms will have a much stronger incentive than numerous unaffiliated consumers to organize and expend resources to air their views.

- Restrictions on competition are also typically less transparent than other more direct policy instruments, and thus their effects are harder to spotlight and critique.

11. Consistent with these observations, past government policies to relax competition policy in periods of economic crisis have been economically harmful.

12. For example, one policy response to the Great Depression in the U.S.A. was the National Industrial Recovery Act of 1933 (NIRA). The NIRA attempted to suspend certain aspects of the U.S. antitrust laws and permitted firms to collude to fix prices and quantities in some sectors provided that industry raised wages above market-clearing levels. It is a widely held view among economists that these policies did not help the economy recover from the Great Depression and may even have exacerbated the Depression.

    - Christina Romer, current Chair of the President's Council of Economic Advisors in the U.S.A., concluded that the NIRA diminished the responsiveness of price to output and thus "prevented the economy's self-correction mechanism from working."

    - Cole and Ohanian, *New Deal Policies and the Persistence of the Great Depression: A General Equilibrium Analysis*, 112 Journal of Political Economy, no. 4 (2004) find "that New Deal cartelization policies are a key factor behind the weak recovery, accounting for about 60 percent of the difference between actual output and trend output" and lengthened the Great Depression by seven years.

    - Harkrider, *Lessons from the Great Depression*, 23(2) Antitrust (Spring 2009), states that "firms in cartelized industries are unlikely to innovate, especially where such innovation leads to new products and competitors that are likely to challenge incumbents. Thus, it is perhaps not surprising that according to one study, there were few, indeed, almost no, new products introduced in the late 1920s and 1930s that could drive increases in consumer spending or investment".

    - Sakakibara and Porter, *Competing at Home to Win Abroad: Evidence from Japanese Industry*, 83(2) Review of Economics and Statistics 310 (May 2001), "find robust evidence that domestic rivalry has a positive and significant relationship with trade performance measured by world export share, particularly when R&D intensity reveals opportunities for dynamic improvement and innovation. Conversely, trade protection

> [which by its nature lessens competition] reduces export performance. These findings support the view that local competition — not monopoly, collusion or a sheltered home market — pressures dynamic improvement that leads to international competitiveness."

13. In summary, far from being harmful, competition policy is central to economic recovery, and more important than ever in these difficult economic times. Structural reforms coupled with appropriate competition and regulatory policies would appear to be the best approach to promoting economic recovery. Competitive industries, under most conditions, utilize resources more efficiently, are more innovative, and produce more output at lower cost than industries where competitive pressure is weak. Setting aside competition law temporarily during a recession would act as a drag on economic recovery and would be difficult to reverse, due to lobbying by the beneficiaries of reduced competition.

14. Admittedly, the process of firm failures in a recession can be painful, particularly where the impact of firm failures is geographically concentrated. Many economists believe that the most effective policy response to deal with the negative consequences of firm exits is to focus state support on the adjustment process, such as through retraining workers to allow them to move quickly to other, more productive, firms or industries. Maintaining inefficient firms by relaxing competition policy is regarded as a less effective approach, because it misallocates resources and tends to reduce efficiency and innovation, to the detriment of consumer welfare and productive efficiency.

15. In addition, at a time when people are concerned with growing unemployment it is important to note that there is no evidence that increased competition would lead to net employment losses. For example, in the wake of opening the air transport sector to competition, between 1992 and 2001, direct airline employment in Europe rose by 6%. (See study by the UK Civil Aviation Authority on *The Effect of Liberalisation on Aviation Employment* (2004), available at www.caa.co.uk/docs/33/cap749.pdf.)

Competition policy should inform broader policy objectives.

16. There clearly is a role for competition authorities to ensure that competition issues are taken into account in the wider policy arena and to provide a counterweight to calls in favor of relaxing competition policy, such as those that have been seen in previous economic crises.

- Competition authorities should seek to assess the impacts of their interventions on competition in a systematic way, for example, through competitive impact assessments.

- Competition agencies already with a developed competition advocacy programme can be a source of advice to agencies with fewer resources dedicated to competition advocacy. See, for example, UK Office of Fair Trading, *Government in Markets* (2009), available at www.oft.gov.uk/shared_oft/business_leaflets/general/OFT1113.pdf.

- Moreover, multilateral bodies such as the International Competition Network (which has a working group dedicated to competition advocacy: see the 2002 Report on Advocacy and Competition Policy prepared by the Advocacy working group at www.internationalcompetitionnetwork.org/media/library/conference_1st_naples_2002/advocacyfinal.pdf) and the OECD (see the OECD's Competition Assessment Toolkit, www.oecd.org/competition/toolkit) have materials on competition advocacy that can be used by interested agencies.