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Economics Revision Focus: 2004

A2 Economics

European Union Competition Policy

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Revision Focus on European Union Competition Policy (A2)

A2 Syllabus Requirements

Candidates should know the general features of UK and EU competition policy. They should be able to evaluate the costs and benefits of such policies. Examples of real world applications of such policies should provide contexts in which candidates can evaluate the use of economic models to explore economic behaviour and further develop their appreciation of the behaviour of firms in concentrated markets.

"Ronald Coase said he had gotten tired of anti-trust because when the prices went up the judges said it was monopoly, when the prices went down they said it was predatory pricing, and when they stayed the same they said it was tacit collusion."

William Landes, "The Fire of Truth: A Remembrance of Law and Econ at Chicago", JLE (1981)

EU competition policy applies only to **inter-country trade,** targeting the behaviour and conduct of firms that could frustrate the process of EU integration through trade in goods and services – it is an important feature of the development of the EU single market

Competition policy in the EU is governed by the principle of **subsidiarity**. Each member state has its own competition legislation relating to the exercise of restrictive practices and the abuse of a dominant position within their own countries. So for example in Britain, we often focus on the work undertaken by the Office of Fair Trading (www.oft.gov.uk) and the Competition Commission (www.competition.gov.uk) in implementing the 2001 UK Competition Act.

The Main Aims of Competition Policy

The aim of EU competition policy is promote competition and create a single market which transcends national boundaries. Competition policy aims to ensure

- Wider consumer choice
- Technological innovation
- Effective price competition

There are four pillars of EU competition policy

1. **Antitrust & cartels:** This involves the elimination of agreements which restrict competition (e.g. price-fixing agreements, or cartels) and of abuses by firms who hold a dominant position in a market
2. **Market liberalisation**: Liberalisation involves introducing **fresh competition** in previously monopolistic sectors e.g. energy supply, telecommunications and postal services together with new arrangements for car retailers inside the single market
3. **State aid control:** We are focusing here on the control of state aid measures by Member State governments to ensure that such measures do not distort competition in the Single Market (e.g. the prohibition of a state grant designed to keep a loss-making firm in business even though it has no prospect of recovery).

4. **Merger control:** This involves the investigation of mergers and take-overs between firms (e.g. a merger between two large groups which would result in their dominating the market)

Anti-Trust Policy - Abuses of a Dominant Market Position

A firm holds a dominant position if its economic power enables it to operate within the market **without taking account of the reaction of its competitors or of intermediate or final consumers.** In appraising a firm's economic power in the marketplace, the EU Commission considers its market share and other factors such as whether there are credible competitors, whether the firm has ownership and control of its own distribution network and whether it has favourable access to raw materials.

Holding a dominant position is not wrong in itself if it is the result of the firm's own effectiveness and competitiveness against other businesses. But if the firm exploits this power to stifle competition, this is deemed to be an anti-competitive practice which constitutes abuse.

A good recent example of this was the investigation by the EU Commission into the alleged abuse of market power by **Microsoft**. Microsoft was accused by the Commission of continuing to abuse its monopoly in the software market. The investigators alleged that Microsoft bundled Media Player with Windows, unfairly damaging rival programs such as Real Networks' RealPlayer and Apple Computer's QuickTime.

Anti-Competitive Practices:

Anti-competitive practices are best defined as strategies designed deliberately to limit the degree of competition inside a market. Such actions can be taken by one firm in isolation or a number of firms engaged in **explicit or implicit collusion**.

Mario Monti has been pro-active in investigating allegations of cartel behaviour among businesses within the single market. Since 1998 there have been numerous investigations in industries such as chemicals, banks, pharmaceuticals, airlines, beer, and paper, plasterboard, food preservatives and computer games!

Examples of anti-competitive practices

1. **Predatory pricing** financed through **cross-subsidization** (not all price discrimination is anti competitive though – much of it is simply a genuine attempt to remain competitive in a market)
2. **Vertical restraint** in the market:
    a. **Exclusive dealing**: This occurs when a retailer undertakes to sell only one manufacturer's product and not the output of a rival firm. These may be supported with long-term contracts that bind a retailer to a supplier and can only be terminated by the retailer at great cost. Distribution agreements may seek to prevent instances of parallel trade between EU countries (e.g. from lower-priced to higher priced countries)
    b. **Territorial exclusivity**: This exists when a particular retailer is given the sole rights to sell the products of a manufacturer in a specified area
    c. **Quantity discounts:** Where retailers receive progressively larger price discounts the more of a given manufacturer's product they sell - this gives them an incentive to push one manufacturer's products at the expense of another's in order to widen their own profit margins
    d. **A refusal to supply**: Where a retailer is forced to stock the complete range of a manufacturer's products or else he receives none at all, or where supply may be delayed to the disadvantage of a retailer

3. **Creation of artificial barriers to entry**: Through advertising and marketing and brand proliferation
4. **Collusive practices:** These might include agreements on market sharing, price fixing and agreements on the types of goods to be produced.

Practices are not prohibited if the respective agreements "contribute to improving the production or distribution of goods or to promoting technical progress in a market. Examples include:

- Development of industry standards /technical standards of production and safety
- Research joint-ventures and know-how agreements which seek to promote innovative behaviour

Market Liberalization

The main principle of EU Competition Policy is that consumer welfare is best served by introducing competition in markets where monopoly power exists.

Frequently, these monopolies have been in network industries for example transport, energy and telecommunications. In these sectors, a distinction must be made between the infrastructure and the services provided directly to consumers over this infrastructure. While it is often difficult to establish a second, competing infrastructure, for reasons linked to investment costs and economic efficiency (i.e. the natural monopoly arguments linked to economies of scale and a high minimum efficient scale) it is possible and desirable to create competitive conditions in respect of the services provided.

The Commission has developed the concept of separating infrastructure from commercial activities. The infrastructure is thus merely the vehicle of competition. While the right to exclusive ownership may persist as regards the infrastructure (the telephone or electricity network for example or the supply of gas and electricity to the individual household and business), monopolists must grant access to companies wishing to compete with them as regards the services offered on their networks (telephone communications or electricity supply).

State Aid in Markets

The argument for monitoring state (public sector) aid given to private and state businesses by member Government is that by giving certain firms or products **favoured treatment** to the detriment of other firms or products, state aid disrupts normal competitive forces. According to the EU Competition Commission, neither the beneficiaries of state aid nor their competitors prosper in the long term. Often, all government subsidies achieve is to delay inevitable restructuring operations without helping the recipient actually to return to cost and non-price competitiveness. Unsubsidised firms who must compete with those receiving public support may ultimately run into difficulties, causing loss of competitiveness and endangering the jobs of their employees. Ultimately, then, the entire single market will suffer from state aid, and the general competitiveness of the European economy is imperilled.

Under the current European state aid rules, a company can be rescued once. However, any restructuring aid offered by a national government must be approved as being part of a feasible and coherent plan to restore the firm's long-term viability.

Government aid designed to boost research and development, regional economic development and the promotion of small businesses is normally permitted.

European Merger Policy

The control of mergers and acquisitions is one of the pillars of European Union competition policy. Corporate restructuring is a fact of life. There is a natural tendency for markets to consolidate over take through a process of **horizontal and vertical integration.**

The main issue is whether a proposed merger or takeover is thought to lead to a **substantial lessening of competitive pressures in the market** and risks leading to a level of market concentration when collusive behaviour might become a reality.

When companies combine via a merger, an acquisition or the creation of a joint venture, this generally has a positive impact on markets: firms usually become more efficient, competition intensifies and the final consumer will benefit from higher-quality goods at fairer prices.
However, mergers which create or strengthen a dominant market position can, after investigation, be prohibited in order to prevent ensuing abuses. Acquiring a dominant position by buying out competitors is in contravention of EU competition law.

Companies are usually able to address the competition problems, normally by offering to divest (sell or offload) part of their businesses.

Evaluating the factors behind approving or rejecting a merger within the EU

Consider a situation where the EU Competition Commission is asked to investigate the grounds for approving or blocking a merger between two European businesses

Often a merger is allowed to progress without any intervention by the competition authorities when the economic benefits of allowing the integration to take place are significantly greater than the potential costs. Here are some of the main justifications for approving a merger between two businesses:

(1) Efficiency arguments

- **Static efficiency**: Mergers may result in the exploitation of further internal economies of scale and therefore improved productive efficiency (cost savings)
- **Dynamic efficiency**: Increased profits can be used for R&D into new products and new production processes (innovation) creating long term dynamic efficiency; provides funds for capital investment

(2) The role of the capital markets:

The capital markets will sort out mergers which eventually fail to deliver the promised benefits. If unsuccessful mergers occur, corporate raiders are always ready to kick out the unsuccessful management who are not making enough profit for shareholders (consequently the share price will fall). The survival of the fittest ensures efficiency by keeping management on their toes (reducing X-inefficiencies).

It is argued that this is a more effective mechanism than government intervention which will only make matters worse because of the potential for government failure.

(3) Market contestability arguments:

There has been a huge growth of interest in the concept of contestable markets and this tends to complement the free market approach to mergers. By concentrating on removing entry barriers to a marker, monopolies and mergers can only remain dominant by producing good products efficiently

(4) The capital investment argument:

Lower costs and a bigger combined business may prompt higher levels of capital investment which is good news for the productive capacity of the EU economy

(5) The globalisation argument

Mergers and takeovers can reinforce and improve the competitive position of EU companies relative to non EU companies (a countervailing power to dominance of giant US firms) – this is increasingly important in industries that are becoming truly globalised and where increasing returns to scale / falling LRAC is an important ingredient of competitive advantage

(6) Mergers and takeovers as a means of enhancing economic integration within the EU:

Mergers and takeovers are an inevitable consequence of the creation of a single market – perhaps the EU competition authorities should take a benign view of mergers if they have at their core, the aim of creating businesses large enough to provide goods and services to a community of over 370 million people (soon to be close to 500 million with EU enlargement)

Economic arguments for not approving a merger:

Under what circumstances might the EU Competition Authorities block a merger/takeover or insist on some form of redress before permitting it to proceed?

(1) Monopoly power:

Mergers and takeovers create monopolies and market dominance; consumers are exploited and resources misallocated if there are significant entry barriers inhibiting competition leading to market failure and a deadweight loss of economic welfare. In practice, there are always barriers to market contestability especially in industries where set up (fixed / overhead) costs and sunk costs are high.

(2) Mixed evidence on benefits of mergers:

The evidence is mixed as to whether mergers improve companies' performance, either in terms of profitability, or cost savings – indeed many of the claims for increased efficiency and economies of scale made prior to a merger or a takeover prove to be exaggerated with the benefit of hindsight.

(3) Imperfections in the capital markets:

The market for corporate control does not work optimally. Unsuccessful managements in poorly performing businesses may remain in place for a long time. Shares are mainly held by financial institutions but whilst they are the owners, they do not run the companies on a day to day basis. This means there is a divorce of ownership and control with managers pursuing their own interests (salary and welfare) rather than maximising profits for the shareholders.

(4) Employment effects

Mergers and takeovers nearly always lead to rationalisation as part of a process of cost cutting but may be at the expense of jobs (possibility of structural unemployment) and fewer outlets / choice for consumers (an issue of equity)

The vast majority of cases referred to the EU competition authorities are cleared. Since 1990 the commission has vetted more than 2,300 deals, blocking only 18 mergers!

Most mergers and takeovers take place in technologically dynamic industries – this has important implications for competition policy. Will a merger act to enhance or slow down the pace of innovation and levels of investment. Each investigation has to be considered on a case by case basis. The EU is making modifications to merger rules to make them more flexible and transparent ahead because of the entry into the EU in May 2004 of ten new Member States. All current EU competition rules will apply in those countries from this date.