Competition and Industrial Policy

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OUTLINE

- I. Introduction / Motivation
- II. Economics behind Competition Policy
- III. Components of Competition Policy
- IV. Organisation and Reforms of Competition Policy
- V. Evolution of EU Industrial Policy

- Readings: **R. Baldwin – Ch. Wyplosz**: “The Economics of European Integration”, 4th edition. (Chapter 11, pp. 301-325).

I. Introduction / Motivation

Guess the missing piece of information

- Car glass cartel
  - From 1998-2003 companies accounting for 90 % of the **market for car glass** had a series of meetings to discuss target prices, market sharing, customer allocation
  - In 2008 four companies were fined ___ *(guess the amount of the fine)*, the highest for both an individual firm (Saint Gobain) and a cartel

- LCD cartel
  - In 2001-06 six Asian producers of LCD agreed prices and exchanged sensitive information on **large screens for TV and computer applications**
  - Commission fined the companies €649 m, ____ *(guess the name of the company)* received full immunity for reporting the cartel

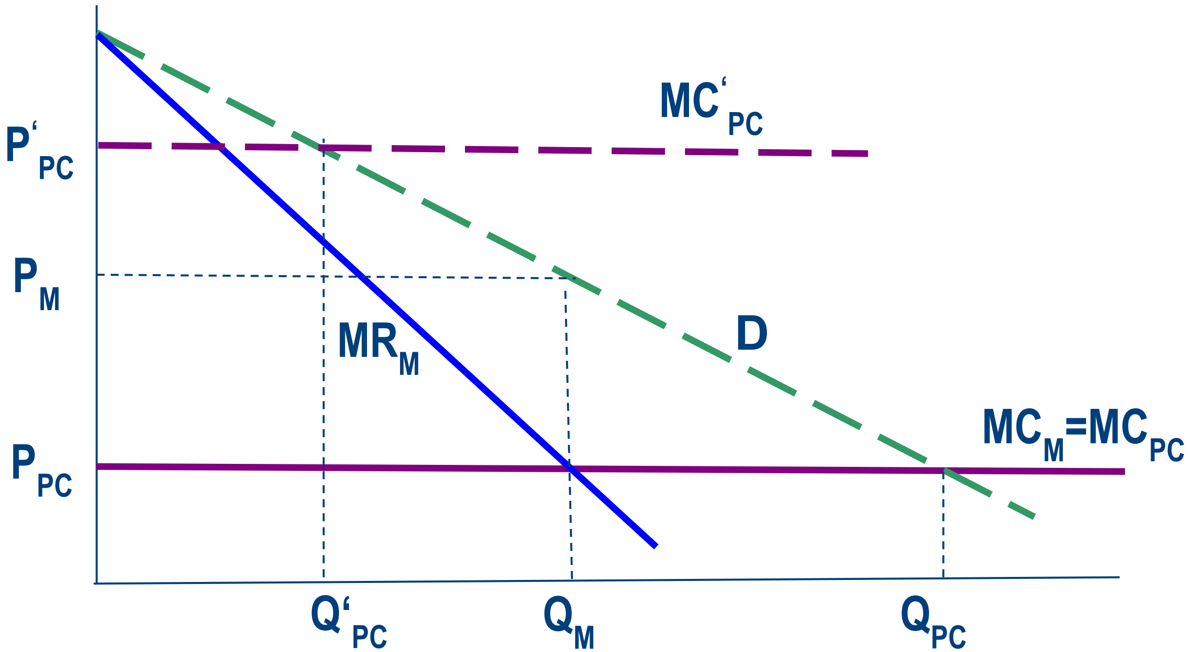
- Car distribution and repair system
  - Long-term practice of **selling cars through designated dealers** in specific territories justified by repair and maintenance requirements
  - In 2002 Commission proposed to eliminate this exemption arguing ____ *(which reasoning did the Commission use?)*

Competition needs protection

- Importance of competition
  - Rivalry among firms acts as an engine of innovation activity
  - Quality of price mechanism (precondition for allocation efficiency)
  - Benefits for consumers (lower prices, wider choice)
  - Important non-economic functions of healthy competition
- Market failures (MF) and government failures (GF)
  - MF: Self-interest of producers in limiting competition (innovation process is costly and uncertain, threat of exit, etc.); time-consuming and uncertain outcomes of market solutions based on product innovations
  - GF: Bureaucratic regulation stifles healthy competition; hidden support for national producers
- Competition policy aims at preventing distortions caused by private firms or by governments
  - Permanent debate about the content and forms of regulation
    - Illegal status of formerly legal private agreements (cartels)
    - Ban on many previously quite common forms of government assistance (interventionist industrial policies)

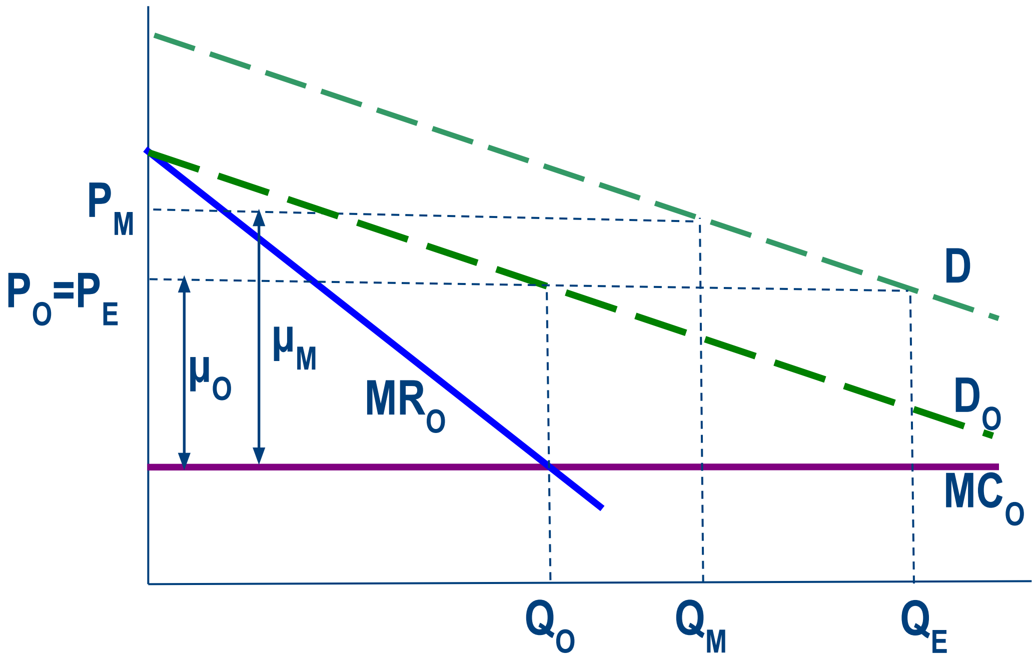
II. Economics behind Competition and Industrial Policy

Monopolistic equilibrium



- **Economic inefficiency of monopoly** (Q_M,P_M): marginal cost < price (utility derived from additional unit of production is higher than cost of producing this unit)
- **Economic efficiency of perfect competition** (Q_{PC},P_{PC}): marginal cost = price
- Other things equal ⇨ goods on monopolistic markets are sold at a higher price and in a lower quantity
- **Dynamic economic inefficiency of perfect competition** (Q'_{PC},P'_{PC}): higher marginal costs due to lower efficiency of large number of small producers

Oligopolistic equilib.m: Quantity competition



D ... total market demand
D_O ... residual demand
P_O ... market price
Q_O ... output of one producer
Q_E ... output of all producers
μ_M ... markup under monopoly
μ_O ... markup under oligopoly

Ολιγοπώλιο ... a market form wherein a market or industry is dominated by a small group of large sellers (oligopolists)

- **Cournot** proposes a static model of homogeneous product where a limited number of firms compete in a homogeneous product market. Its key assumptions are:
  - **firms aim at maximizing profits, consumers maximize their utility functions**
  - **consumers are passive and represented by an aggregate (inverse) demand function**
  - **firms decide independently a production level** (given their technologies).
    - There are n firms in the industry, there is neither entry into the industry nor exit from the industry.
    - The strategic variable of the firms is their production levels.
  - The interaction of aggregate output and aggregate demand determines the market clearing price typically, by means of an auctioneer.
  - **In game theory terms**, it is a one-shot, simultaneous move, non-cooperative game. We consider only pure strategies (= each player chooses a simple action).

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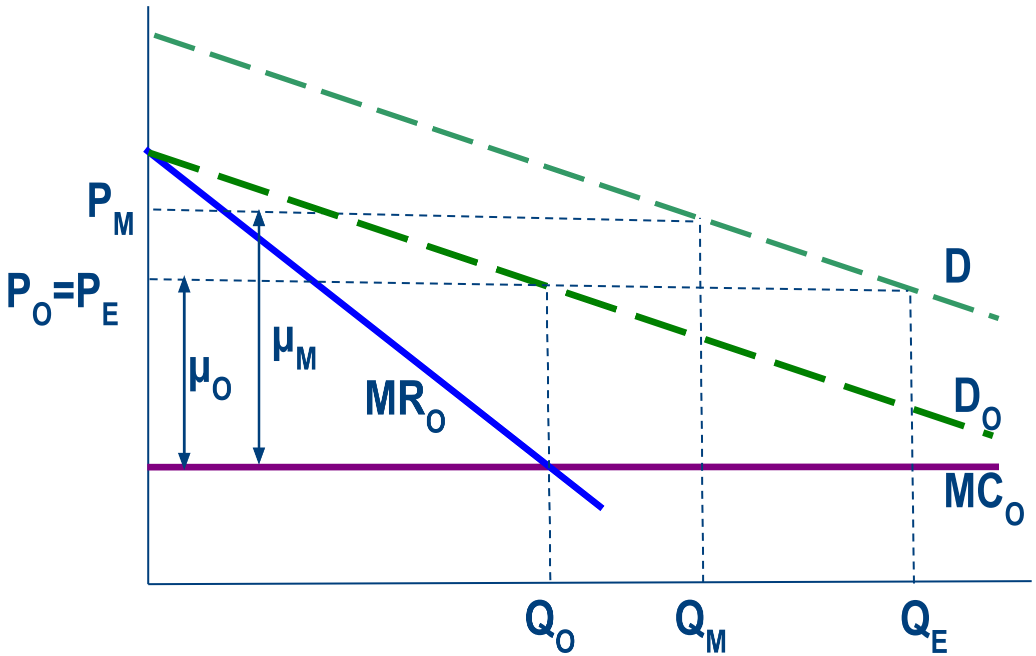

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- A higher number of competing producers pushes price down, increases total sales and lowers price mark-up (= measure of degree of monopoly)
- “Strategic” equilibrium in oligopolistic market (Q_O,P_O) requires that expectations of all oligopolists about behaviour of their competitors correspond to actual behaviour (Cournot-Nash equilibrium)
  - Supply price of any of oligopolists P_O should be the supply price of other producers
- Strategic games played by oligopolists encourage collusive behaviour

Reasons for EU competition policy

- Proper functioning of the internal market
- Potential conflict between national jurisdictions
  - Various legal systems and different cultures in law enforcement (regulatory competition)
  - **Anglo-Saxon model** stressing high degree of market liberalisation versus **continental model** with traditionally important role of government in economy
  - **New member states** suffering from discontinuity in building institutional structure of market economy
  - **Costly coordination**: losses from time-consuming compliance procedures, inconsistencies in application of European competition law
- Governments as source of discrimination
  - **Painful restructuring cost** (protectionist government actions aimed at loss-making firms and job protection)
  - **Support for "national champions"** (ability to withstand competitive pressures of American and Japanese giants)
  - -> Risk of hidden trade restrictions vis-à-vis other EU countries

III. Components of Competition Policy

Component 1 – anticompetitive agreements

- **Cartel agreement** is an agreement among firms trying to prevent, restrict or distort competition
- **Examples of unlawful horizontal agreements** (HA)
  - **HA: competitors are operating at the same level of supply chain**
  - *Write down 3 examples*
  -
  -

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  - Fixing purchasing price
  - Fixing selling price
  - Limiting or controlling production, markets, technical development or investment

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- Examples of **unlawful horizontal agreements** (HA)
  - HA: competitors are operating at the same level of supply chain
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  - Limiting or controlling production, markets, technical development or investment

- Examples of <u>**unlawful vertical agreements**</u>
  - **VA: agreement between manufacturers and distributors**
  - *Write down 1-2 examples*

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  - Resale price maintenance (manufacturer and its distributors agree to sell the manufacturer's product at certain prices)

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  - Exclusive purchasing
  - Resale price maintenance (manufacturer and its distributors agree to sell the manufacturer's product at certain prices)
- Allowed agreements among firms
  - Agreements which **contribute to product improvement and distribution of goods** (joint financing of research and production)
  - Some **exclusive relationships between producers and retailers** (justified by suitable storing and selling, better customer advice, prevention of free riding, etc.)
  - Companies involved form **a small combined share of the market**

Component 1 - enforcement

- Difficulties in proving collusive behaviour
  - **Gentlemen‘s agreement** (informal agreement typically oral relying on honour for its fulfilment rather than being enforceable)
  - **Difficult interpretation** puzzles (every agreement in some respect restricts or impairs competition)
  - **Price leadership** (outcome may appear collusive without firms actually having to collude)
- Commission‘s investigative powers
  - Penitent (leniency programme) = total or partial immunity for a firm that submits evidence sufficient for finding infringement
  - On-site inspections: EC can enter premises, take copies of records related to the business, seal the business premises, etc. (dawn raids)
- Fines: an instrument for punishment and deterrence
  - Gravity and duration of the infringement (aggravating and attenuating circumstances) are taken into account
  - Maximum level is capped by 10 % of annual turnover of a firm
  - Right to appeal to the ECJ

Component 1 – selected cases

- Car glass cartel
  - From 1998-2003 companies accounting for 90 % of the market for car glass had a series of meetings to discuss target prices, market sharing, customer allocation
  - In 2008 four companies were fined **€1.4 bn**, the highest for both an individual firm (Saint Gobain) and a cartel
- LCD cartel
  - In 2001-06 six Asian producers of LCD agreed prices and exchanged sensitive information on large screens for TV and computer applications
  - Commission fined the companies €649 m, **Samsung** received full immunity for reporting the cartel
- Car distribution and repair system
  - Long-term practice of selling cars through designated dealers in specific territories justified by repair and maintenance requirements
  - In 2002 Commission proposed to eliminate this exemption arguing that **ordinary competition will deliver benefits needed by consumers**
- Wood Pulp case
  - A group of firms tended to adjust prices by similar amounts at about the same time
  - In 1993 EC maintained that there was collusion, ECJ overruled the decision on the basis of **insufficient evidence** (consequence of transparent prices in an oligopoly market)

Component 2 – abuse of dominant position

- Policy focused on monopolies and oligopolies
  - **Advantages of large firms over small ones** (economies of scale, financial strength, competitiveness on global scale)
  - **Indicators of dominance**: market share (indicative threshold 40 %), existence of entry barriers, presence of countervailing powers, extent of vertical integration, etc.)
  - **Unlawful** is not to win a dominant position but **to abuse the dominant position**
- Examples of illegal practices
  - Charging unusually high prices
  - Charging unusually low prices (predatory dumping)
  - Creation of entry barriers into industry
  - Applying dissimilar conditions to equivalent transactions with trading partners
  - Making contracts subject to supplementary obligations
  - Bundling non-related transactions into one contract
- Sanctions
  - Penalties
  - Cease and desist orders (request to halt an activity and not to take it up again later)
  - Forced break-up of company (never imposed so far)

Component 2 – selected cases

- Volkswagen
  - Commission discovered that this company was discouraging dealers in Italy from selling to customers resident in other EU countries
  - Fine €90m, other manufactures (Mercedes, Opel Nederland, Peugeot) were fined for similar practices
- Microsoft
  - Number of issues: tied sales of Media Player and Internet Explorer with Windows, refusal to share interoperability information
  - So far the software giant was fined €1.68 bn
- Intel
  - Abuse of dominant position by making payments or discounts to manufactures who sold computers containing only Intel chips or who cancelled or postponed launches of computers with non Intel chips
  - Commission fined Intel €1.06 bn and ordered to cease these practices immediately
- Coca-Cola
  - Abuse of dominant position by concluding exclusive contracts with retailers preventing them to sell carbonated soft drinks from other suppliers
  - Coca-Cola proposed a set of commitments to address the main issues

Component 3 – merger control

- Prevention or amendment of mergers which might strengthen dominant player with potential harmful effects on competition
  - Introduced later in 1989
- High sensitivity of regulation
  - Regulatory focus on large companies (impact on jobs, competitiveness on world markets, prestige of captains of industry, etc.)
  - **Anti-competitive consequences** of merges must be carefully compared with **benefits for consumers**
  - Mergers are important aspect of **consolidation of the internal market** (cross-frontier business expansion)
  - Blocking mergers may lead to international disputes
  - 2001-2002: CFI (Court of First Instance) abrogated some decisions of European Commission (criticised for style of reasoning, handling of evidence, low quality of economic analysis)

Component 3 - procedure

- Notification
  - Commission **must be informed** about intention of any merger with EU dimension
  - **Smaller mergers** may fall under the remit of MS‘ competition authorities
    - Observed thresholds: combined turnover of all merging firms, market share
    - Referral mechanism = transfer of cases between EC and MS at the request of the company or the MS
  - **One-stop shop concept** = notification in one location instead of communicating with several competition authorities in the EU
- Possible results of investigations
  - Clearance without conditions
  - Approval subject to remedies (selling part of the business, licencing technology to another company, etc.) whose fulfilment is subsequently monitored
  - Prohibition

Component 3 – selected cases

- Ryanair takeover of Aer Lingus
  - Commission refused takeover arguing that dominant position would be created on many routs to or from Ireland
  - Ryanair's proposed solution to restore competition was seen inadequate
- Friesland Foods and Campina
  - Merger of two main dairy cooperatives in Holland was approved under condition that Friesland Foods sells its fresh dairy product business and Campina sells a cheese plant and two long-life dairy drinks
- General Electric and Honeywell (2001)
  - Commission blocked international merger approved by US anti-trust authorities
- High-profile cases of **successful appeals** against blocked mergers
  - Schneider and Legrand (EC: negative impact of the deal on competition in electrical equipment, CFI: serious procedural errors and insufficient use of economic reasoning)
  - Takeover of First Choice by British Airtours (EC: reduced number of tour operators might impede competition; CFI: no significant barriers of entry to other operators, decision was based on factual errors)
  - Tetra Laval and Sidel (EC: using dominant position in the packing sector to obtain a dominant position in machinery for making PET bottles; CFI: no evidence of this type of behaviour)

Component 4 – control of state aid

- Prohibition on granting advantages in any form **on a selective basis** to undertakings by national public authorities
  - General measures applied to all firms are not regarded as state aid (taxes, employment policies, etc.)
- Examples of state aid
  - Subsidies, tax concessions, capital investment
  - Preferential purchases of goods and services
  - Preferential loans (maturities, interest rates, guarantees)
- Legal forms of assistance
  - Support for small and medium-sized enterprises
  - Aid to depressed regions (aspect of social cohesion)
  - Research and development (externality argument)
  - Natural disasters or exceptional occurrence
  - Restructuring of enterprises (temporality, transparency, selectivity, appropriateness)
  - Promotion of important projects of common EU interest

Component 4 – procedure

- Notification
  - State control requires **prior notification** of all new aid measures to the Commission
  - **Aid granted prior to accession** must be brought in line with the EU law
- Final decision
  - Measure does not represent an aid or is compatible with the internal market
  - Measure is found compatible with the EU law but its implementation is subject to stated conditions
  - Measure cannot be implemented -> MS is ordered to recover the aid that has been already paid out

Component 4 – selected cases

- Public support for Spanish textiles
  - Intention of Spanish government to give an €800m public support to the Spanish textile and clothing sector
  - Commission has not approved the subsidy after an in-depth analysis of its impact on competition in Spain and the EU
- State aid to German public banks
  - Since 1897 German Länder governments have guaranteed debt of Landesbanken and Sparkassen
  - 1996 first criticism by Commission provoked strong opposition from German politicians, attempts to amend the Treaty to protect public banks
  - 2002 Germany agreed to phase out the guarantees by 2005 for new liabilities and by 2015 for existing liabilities
- Alstom case
  - In 2003 France informed Commission about a commitment of the state to subscribe a capital increase worth of €600m, Commission gave France five days to renounce the measure
  - In 2004 Commission agreed a package of government aid of €3.2 bn on condition that Alstom disposes business of about €1.5 bn

Component 5 – liberalisation

- Opening up markets with services exclusively provided by national organizations
  - **Utilities**: rail transport, seaports, electricity, gas, postal services, telecommunications, media
  - Strong arguments for natural monopoly (network goods provided efficiently through one network)
  - Provision of services in name of public interest even when this is not profitable (transport accessibility, network of post offices)
  - Opening up these markets to competition may bring benefits to consumers (lower prices, new services)
- Methods
  - **Legal separation** of the provision **of the network from the commercial services** using the network (railway, electricity, gas)
  - **Termination of exclusive rights t**o provide a given service (postal services)
  - Appropriate **state compensation** for loss-making services
  - Additional regulation is still needed to ensure proper functioning of public services

IV. Organisation and Reforms of Competition Policy

Organisation of competition policy (1)

- European Commission - central role in implementation of the EU competition policy
  - **Policeman**: authority to open cases on basis of complaints and to conduct own investigations (including "dawn raids"), right to demand information
  - **Arbiter**: talks with firms on remedial measures if breaches of law are detected
  - **Prosecutor**: brings charges if breach of law continues
  - **Jury**: decides guilty or not guilty
  - **Judge**: decides on type of punishment (fines are revenue to EU budget)
  - **Enforcer**: oversees execution of punishment

  - Extraterritorial principle: application of competition law to foreign firms as precondition for entry to EU market
  - **Accusation for insufficient checks and balances**

Organisation of competition policy (2)

- National Competition Authorities (NCAs)
  - Bodies for enforcing European competition law and complementary national measures
  - In case of conflict EU competition law prevails
  - Risk of diverging interpretation of law and differentiated implementation
  - Potential influence of national lobby
- Court of First Instance (CFI)
  - Established in 1986 (Single European Act)
  - Appellate authority with less formal procedures and narrower specialisation on competition cases
- European Court of Justice (ECJ)
  - Supreme appellate authority
  - Custodian of integrity of European law
  - Major principle: market integration (break-through verdicts)
- National courts
  - Right to administer competition cases

Reforms of competition policy

- Modernization directive (effective since May 2004)
  - **Applicable to cartel agreements and dominant position**
  - Routine notification of agreements no longer required, responsibility of companies for compliance with EU law
  - **Block exemptions**: list of acceptable agreements compatible with EU law
  - **Safe harbours**: market thresholds below which companies need not worry about compatibility with EU law)
  - **Guidelines defining hard core restrictions** that are prohibited
  - Right of Commission to enter or take over cases (disagreements among NCAs, slow hearing, decision to use a case for establishing a new doctrine)
- European Competition Network (ECN): Commission and competition authorities of all member states
  - Exchange of information about new cases and decisions
  - Coordination and mutual assistance in investigations
  - Exchange of evidence
  - Definition of principles for allocation of cases among various authorities

V. Evolution of EU Industrial Policy

Approaches to industrial policy

- Industrial policy is composed of measures carried out by governments with the aim to increase competitiveness of manufacturing industry
  - Wider interpretation includes agriculture and certain services
- Market-oriented approach
  - The most effective way of promoting competition is by allowing market mechanism to operate freely as possible
  - Attention should be focused on eliminating distortions to competition: removing trade barriers, preventing abuse of monopoly power, ensuring non-distorted state aid, improving business climate, etc.
- Interventionist approach
  - Government actions should support certain strategic firms or industries in order to enhance their productivity and competitive advantage (infant industry argument)
  - Assistance to declining industries to avoid losses of jobs
  - Criticism: high cost of protection, difficulties in picking winners, risk of politicisation, slowing down structural adjustment, etc.

Evolution of EU industrial policy (1)

- Rome Treaty
  - Based on market-oriented approach (removal of trade barriers, creation of common market, setting out competition policy, etc.)
  - Interventionist approach in coal and steel, agriculture and transport
  - Different prevailing ideologies in member states that failed to converge (German vs. French or Italian tradition)
  - Little consensus on what Community industrial policy should be
- 1970s: period of eurosclerosis
  - Interventionist policies for specific distressed sectors (steel, shipbuilding, textiles)
- 1980s: shift towards promoting hi-tech industries
  - Community research and development programs: ESPRIT (information technology), JET (thermonuclear fusion), RACE (advanced communication technology) – questionable impact on competitiveness
  - Eureka (European Research Co-operation Agency): public support for firms to launch high-tech products and increase competitiveness in key areas
  - Focus on promotion of R&D assistance to SMEs

Evolution of EU industrial policy (2)

- Bangemann Memorandum1990 - formulation of broad principles of EU industrial policy
  - Horizontal approach: shift away from selective interventions for individual firms and industries **towards creating prerequisites for smoother market adjustment**
  - Major goals of industrial policy: maintenance of competitive environment, speeding up structural adjustment, ensuring level playing field
  - Key measures: R&D promotion, better use of human resources, better conditions for development of business services, support of SMEs
- Current situation
  - Horizontal approach continues to dominate in EU approach (knowledge, innovation, entrepreneurial capacity)
  - Programmes still aimed at specific requirements of several sectors (steel, textile and clothing, shipbuilding, automobile industry, aerospace, communication and information technologies, etc.)
  - Adopted **measures trying to avoid direct interventions**, focus on reducing capacity, limiting use of state aid, promoting technology, assisting regional and social adjustment, promoting environmental objectives
  - **Revival of an activist industrial policy** as a result of strengthened competition at the world level (promotion of European champions, resistance to foreign takeovers)

OPEN QUESTIONS:
what's your own opinion?

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Competition policy is a fascinating and complex topic where multiple points of view and multiple disciplines come together. You may like to answer the following questions:

- Should 'sensitive tenders' (tenders with national security issues) be subject to an oversight by a supranational EU body?
  - Think of a tender for a nuclear power plant.

- Is the European Commission better described as a benevolent ruler or rather as a power-seeking entity?
  - Give pros and cons.