Objectives of Competition Policy and Other Public Policies

Course: The Economics of Regulation and Competition

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26.02.2019

- A number of objectives have inspired competition policies.
- After introducing the concept of economic welfare, we will briefly
  - mention some other objectives,
  - and comment upon the possible contradictions between them and the welfare objective.

(Economic) Welfare

- Standard measure to measure how well an industry performs
- It is a measure that aggregates the welfare of different groups
- In each industry, welfare is given by the sum of
  - Consumer surplus:
    - The surplus of an individual consumer is the difference between the consumer's valuation for the good considered and the goods price
    - CS: an aggregate measure / the surplus of all consumers
  - Producer surplus
    - The surplus of an individual producer is the profit it makes by selling its product
    - PS: sum of all profits made by the producers in the industry

(Economic) Welfare

- Other things equal, when ➚P, ➘CS, and ➚PS
- In general, when ➚P, the increase in the profits made by the firms do not compensate the reduction in the CS.
- The welfare is the lowest when the market price equals the monopoly price.
- Monopoly price : highest price that a firm might want to charge
- The welfare is the highest when the market price is equal to the unit cost of production

(Economic) Welfare

- The concept of welfare overlooks the issues of income distribution among consumers and producers
- This is not income distribution is irrelevant, but it is a different issues from an economic point of view.
- The welfare measure, specifically, is a summary measure of how efficient an industry is and does not address the question of how equal or unequal income is distributed , something which can be dealt with other measures
  - E.g., possible to use distribution schemes…
- Also, the concept of welfare should not only be interpreted in a static sense
  - FUTURE WELFARE AS WELL AS CURRENT WELFARE MATTERS

Consumer Welfare

- In most circumstances, a decrease in Welfare is accompanied with a decrease in the consumer surplus; e.g., cartels
- Yet, this is not always the case
- Consider a merger that allows the fixed costs of the firms to decrease
- This can increase Welfare because of larger profits
- However, the merger also leads to higher price and, therefore, lower Consumer Surplus (Consumer Welfare)
- Hence, it may be a good idea to prioritize the Consumer Surplus

Defense of Smaller Firms

- Not necessarily in contrast with the objective of economic Welfare
  - if it is limited to protecting these types of firms from the abuse of larger firms
  - or giving them a small advantage to balance the financial and economic power of larger rivals
- However, artificially helping firms to survive when they are not operating at an efficient scale of production is in contrast with economic welfare objectives

Promoting Market Integration

- EU competition law de facto forbids price discrimination across national borders
- A per se rule which forbids firms to price discriminate across countries is not justified on economic Welfare grounds and in some cases can even work paradoxically against the degree of market integration

Economic Freedom

- As we have seen, to guarantee economic freedom is probably the main rationale behind competition laws in Germany.
- Possible contradictions between such an objective and the objective of economic efficiency
  - the most obvious source of contrasts arises in vertical restraints, for instance in contracts and clauses imposed by a manufacturer upon the retailers of the good it produces.
  - Although territorial restraints, resale price maintenance and other practices often find strong justification in economic efficiency terms (for instance, by making sure that they would not set prices above those which are optimal for the manufacturer), it is straightforward that they limit the economic freedom of retailers

Fighting Inflation

- Macroeconomic events might affect the implementation of economic policy.
- Fighting inflation, for instance, has been indicated as one reason for introducing control over cartels in Germany.
- However, it seems doubtful that competition law might efficiently be used to attain such purposes.
- If firms are colluding, then breaking a cartel would give a one-time reduction of prices, rather than contributing to a permanent decrease of inflation.
- In an environment where all prices are continuously increasing, it is likely that firms would react to a common shock on the prices of inputs by simultaneously and independently increasing prices, even in the absence of collusion

Other Public Policy Factors Affecting Competition

- The brief historical account we saw shows that
  - due to social, political or strategic reasons, competition authorities and courts often adopt weaker stances on competition issues than economic considerations alone would have suggested

Social Reasons

- Competition rules have sometimes been relaxed to smooth social tensions
- Great depression: US laws were implemented in a more lenient way with the view that some price agreement would help firms to avoid bankruptcy, thereby easing social tensions caused by the unemployment
- Crisis cartels: are sometimes tolerated by the EC
- Pursing such an objective maybe understandable but
  - This may be unfavorable for other groups that are already hit by recession, such as consumers or even other firms using inputs or intermediate goods

Environmental Reasons

- Environmental reasons can also be taken into consideration in the enforcement of the European Competition Law.
- In a previous decision, for instance, the Commission has approved an agreement among producers and importers of washing machines which together account for more than 95% of European sales
- The agreement aims among other things at discontinuing production and imports of the least energy- efficient washing machines, which represent some 10-11% of current EC sales.
- The agreement removes one of the dimensions along which sellers compete, and as such it might negatively affect competition and increase prices (as a general rule, the most polluting machines are also the least expensive ones).
- However, EC decided that the agreement will benefit society in environmental terms

Competition Policy: A definition

- Competition policy (or anti-trust policy) is not easy to define.
- A possible definition: competition policy is the set of policies and laws that ensure that competition in the market is not restricted in a way that is detrimental to the society.
- This definition is empty unless one specifies what "detrimental to the society" means; e.g., Economic Welfare
- Competition policy is the set of policies and laws that ensure that competition in the market is not restricted in such a way as to reduce economic welfare

Competition and Industrial policy

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Intelligent government regulation

- In a market economy, the state is at the heart of economic life.
- How? Ideally through...
  - Public procurement: the state/government is a buyer and therefore organizes competition between suppliers for
    - Construction of public buildings
    - Transport (highways, railroads, and mass transit in cities)
    - Hospitals / Defense / Other government activities
  - The state is the legislative and executive power
    - It gives permission to
      - Open supermarkets/ Issue taxi licenses / Grants land rights to airlines
    - It licenses spectrum to telecommunications, radio and television operators
    - Note that the government's legislative and executive power directly influences the prices consumers pay for
        - Shopping
        - Travel
        - Phone calls
        - Favorite programs

Intelligent government regulation

- In a market economy, the state is at the heart of economic life
  - Public procurement (satin alma): the state/government is a buyer and therefore organizes competition between suppliers for
  - Legislative and executive power
  - Referee of market
    - The government encourages competition, which guarantees innovation and affordable prices
      - It sets the rules through competition law, works through competition authorities to prevent abuses of dominant position
      - Prohibits agreements and mergers that would cause prices to rise too much.
  - Regulator of Sectors (e.g., telecommunications, electricity, postal service, railroads…)
    - The state ensures that monopolies or highly concentrated markets do not exploit users

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  - Regulator of Sectors (e.g., telecommunications, electricity, postal service, railroads…)
  - Financial Supervisor
    - Ensures that banks and insurance companies do not take too many risks to increase their profit at the expense of savers -or tax payers if the financial institution has to be bailed out.
  - Signatory of international treaties
    - Regarding, in particular, world trade.
    - This role determines the exposure of sectors of the industry to foreign competition

Government regulation

- Yet, the state might not fulfil these functions properly because
  - it may be negligent
  - Or, more often, influence of strong organized lobbies
    - Rather than protect users or tax payers (majority but apathetic-kayıtsız), the state prefers to remain in good favor with the lobbies
- Special interest groups are particularly influential when it comes to restrictions/prohibitions on competition.
  - Surprising? From shareholders to employees, businesses want to block new competitors or get financial compensation from the government if they lose exlusive access to a particular market
  - It is more of a surprise to see that the state gives in to such demands
  - Who are the victims of this lack of competition?

Government regulation

- In every country, consumers and taxpayers have little influence compared to special interest lobbies
  - European legislation
    - Pan-European competition rules and other regulations governing economic activity
    - These rules made it possible for many countries to modernize their economies by protecting their politicians from the power of interest groups
- A striking example is the diverging trajectories of Poland (as well as Estonia) and Ukraine
  - Similar economic levels before
  - Poland joins EU
    - EU competition law made it possible to prevent monopolies from forming when the economy was liberalized (Estonia went further with liberalizing its markets)
    - Partly, because of political corruption, the opposite happened in Ukraine

What is the purpose of competition policy?

- We praise the merits of competition.
  - But competition is rarely perfect (market power)
- Advocates of competition, as well as its detractors, sometimes forget that competition is not an end in itself
  - If competition leads to inefficiency, it must be eliminated or corrected
- But how does competition serve the society?

How does competition serve the society?

- There are three main benefits
  - Affordability
  - Innovation and efficiency
  - Integrity

How does competition serve the society?

- Affordability
  - Lower prices for consumers – the most obvious benefit!
  - Consider a monopoly/cartel: It can increase its prices and will only lose a few of its customers
    - This would hold for a dominant company
      - Private and seeking profit
      - Public and most often seeking revenues to cover high production costs
    - This would cause people to have less purchasing power and consume less
  - The entry of competitors puts downward the pressure on prices and makes consumers less captive

How does competition serve the society?

- Affordability: Examples
  - Taxi industry in France
    - High prices
    - Poor-quality service
    - Shortage of available vehicles
    - The entry of Uber (although controversial) has increased competition
  - The airline deregulation in Turkey
    - 1983: The first part of the deregulation gave private enterprises to establish airlines and airport operators
    - 2003: The second one gave rights to airline companies to operate domestic routes independently.
    - Since 2003 competition has increased and prices fell

How does competition serve the society?

- Affordability: Examples
  - Cell phone or the Internet in African countries
    - Competition between companies has provided more affordable telecommunications
  - An example of the adverse effects of restricting competition
    - France’s Raffarin and Galland Laws of 1996
      - The Raffarin Law made it illegal to open a new supermarket of more than $300m^2$ without government authorization.
        - This law was supposed to restrain the power of large supermarkets but immediately the value of shares in the big chains went up!
        - The opening of large supermarkets was blocked for 10 years
      - The Galland Law banned supermarkets from passing on to consumers the price reductions
        - This led to supermarkets to stop discounting
      - Who loses? Who gains?

How does competition serve the society?

- Affordability: Final examples
  - Protection against international competition
    - Opening up the European market to competition from imports drastically changed the organization of the automobile industries and productivity
      - France; Renault and Peugeot-Citroen sharply increased their efficiencies
  - China’s accession to the WTO in 2001
    - Following this there was a sharp increase in innovation and productivity in textile companies threatened by the Chinese competition
- The effects are not negligible for consumers

How does competition serve the society?

- Innovation and Efficiency
  - Competition
    - encourages businesses to produce more efficiently and innovate.
    - Promotes a diversity of approaches and experiments, giving rise to new technologies and business models, as we can see ONLINE
  - Productivity gains can be broken down into
    - Gains in existing businesses
      - Which improve when spurred by competition
    - Gains through creative destruction
      - When inefficient enterprises disappear and are replaced by more productive startups.
      - In the US and in France, at least a quarter of the productivity growth is estimated to be attributed to this

How does competition serve the society?

- Innovation and Efficiency
  - We already know that lack of competition makes life easy for companies, their executives and employees, who enjoy the tranquility in a protected market
    - Monopoly rents!
  - But monopolies
    - Tend to have high costs
    - Usually generate little innovation
      - They really don't need to innovate because the executives face no criticism in the absence of competition

How does competition serve the society?

- Innovation and Efficiency
  - Innovation in products and customer service are not simply due to <u>extraordinary technical advances.</u>
    - Taxi example: Uber, SnapCar, Lyft, and others using a mobile app to link drivers and passengers
      - Have introduced simple ideas for which users are voting overwhelmingly with their feet and wallets
      - Geolocation makes it possible to follow the driver's route to the destination and work out how long it will take to arrive. This traceability protects the consumer
      - Paying with a preregistered debit card using an app that sends an electronic receipt direct to the user simplifies the payment process and makes it easier for business travelers to reclaim their expenses.
      - Another innovation: Feedback. It allows drivers and users to build a reputation for courtesy and punctuality.
        - Providing a bottle of water or letting passengers recharge their cell phone are hardly technologically revolutionary.
      - However, taxi companies had either never thought of these innovations or just did not bother to introduce them.

How does competition serve the society?

- Integrity
  - When there is competition, companies cannot obtain monopoly rents through government regulations. Therefore, they do not spend large sums on rent seeking
    - Recall: rent seeking imposes costs on society because they are not productive and lead to monopoly rents due to the privileges they lead to
  - Corruption represents the extreme quest for rents
    - Import controls in developing countries
      - Licenses are granted by government officials who have powerful friends and enrich themselves at the expense of everyone else.
      - <u>If the goal is to limit imports, </u>better to0
        - levy a tax
        - Allocate quotas to the highest bidder (***competition***) through a government auction, whose revenues would go to the state

Targeted Industrial Policy

- The question of the state's role in organizing industry is a longstanding political debate
- Some politicians are sensitive to the demands of the business leaders who want to have access to public funds
- Others sincerely think that attempting to develop or save specific industries that they believe are creating wealth and jobs is in the general interest
- Most economists show lack of enthusiasm toward industrial policy

A blind approach

- Picking winners
  - Politicians and voters lack information about the technologies, sectors, and businesses that will produce tomorrow's economic wealth
  - At best, the government choose more or less at random; at worst, they favor certain pressure groups
- White elephant projects:
  - Anglo-French Concorde (taken out of service in 2003)
  - Groupe Bull (a French computer company that aimed to compete with IBM;s supercomputers and way kept alive by public funds),
  - Malaysia's unsuccessful BioValley project

A white elephant is a possession which its owner cannot dispose of and whose cost, particularly that of maintenance, is out of proportion to its usefulness. In modern usage, it is an object, building project, scheme, business venture, facility, etc., considered expensive but without

A blind approach

- Clusters
  - Many countries have invested in industrial clusters
  - Goal is to promote a specialist research and industrial complex (in fields like biotechnology and medicine, software, or nanotechnology)in a small geographical area
  - But such government interventions often fail to achieve their objectives that are numerous
  - This results in a scattering of resources
  - We must face the fact that most imporatnt hi-tech clusters usually form spontaneously.
    - Kendall Square are near MIT – temple of biotechnology.
    - MIT had no medical school but it did have several famous biologists on its faculty

A blind approach

- Clusters
  - It seems obvious that significant technological innovations will be necessary to limit climate change to a tolerable level
  - Yet, no one really knows which technologies will achieve this.
  - It is hard to imagine governments choosing the winning technology in these conditions
  - The same goes for nanotechnology, biotechnology, and future technologies in general.

A blind approach

- Clusters
  - Whether privately or publicly funded, best on technology are inheritely risky.
  - Not surprising that governments sometimes make the wrong choice
  - On the other hand, it is important to recognize our mistakes and not continue to support projects that are failing
  - The money can be used to finance other investments
  - Yet, governments often yield to the temptation to solve problems by throwing money at them
    - To show that they were right after all
    - Or to satisfy the very pressure groups

A blind approach

- Clusters
  - It is very difficult to stop public projects
  - Beneficiaries of subsidies end up organizing to prevent the flow of money from drying up even when the subsidy is no longer justified
  - Thus, private financing can have an advantage in this regard.
  - It knows where to stop funding what is no longer fruitful or necessary, and when to redeploy the money to more promising uses

A blind approach

- Although the failures of industrial policy mentioned above are anecdotal, a similar situation also holds for the success stories
  - Airbus (competition with Boing), DARPA (Arpanet network → Internet, Global Positioning System)
  - Contribution of industrial policy to the development of economies such as South Korea and Taiwan
  - State plays a fundamental role by granting (competitive) financing, for example to some American Universities such as MIT, Caltech, Harvard…
  - Yet, successful government interventions are rarely motivated by consideration of industrial policy
  - Much more often, they are motivated by national objectives, such as defense

Which Industrial Policy?

- Given the lack of rigorous evidence, what can we conclude?
- Whether or not we like industrial policies, governments will continue to pursue them
- Whatever our opinion of them, we have to try to make such initiatives as successful as possible accepting that our knowledge will continue to evolve

Which Industrial Policy?

- Guidelines (Dani Rodrik)
  1. Identify the reason or the market failure, in order to be able to respond more effectively
  2. Use independent, appropriately qualified experts to select projects to receive public funding
  3. Pay attention to the supply of research capability as well as the demand for it
  4. Adopt a neutral industrial policy that does not distort competition between companies
  5. Evaluate interventions after they have taken place, and publish the results;
     - Include a “sunset clause” which ensures that support can be withdrawn if the policy is not working or is no longer needed
  6. Involve the private sector closely in the risk taking
  7. Bear in mind how the structure of the economy is evolving