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What is competition policy for?

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Introduction

Competition law is an evolving phenomenon. Within the last few years many countries around the world have been modifying, updating or in other cases introducing for the first time laws on competition policy. My own country, the United Kingdom, is no exception to this and the European Union, within whose laws it also operates, always seems to have some aspect under review.

Jamaica has been a leader in the region and amongst developing countries in enacting a competition law and setting up the Fair Trading Commission. Other members of Caricom seem to be waiting to see what Jamaica. I am here as part of the CEPA team to try to understand more the setting within which Jamaican policy needs to operate. It is my first visit to your beautiful island, but I hope it will not be my last. I am honoured to be asked to present this lecture and it is a great pleasure to be here today.

The project, funded by the Public-private infrastructure fund of the World Bank - was designed to ask whether the people of Jamaica are getting value for money in their economic regulatory institutions. A rider to that is, how can we move forward? I am not here today to answer either of those questions, as our work is not yet at that stage. In fact I should issue a disclaimer. The views in this lecture are my own personal views and do not represent those of CEPA, or the UK Competition Commission. Furthermore I am speaking in generalities. Nothing I say should be taken as making specific reference to industries or firms in Jamaica, or comments on public policy which are always carried out in a specific context.

I think it is always useful when presented with a complex task to go back to basics, and this is what I want to do now, by asking what is competition policy for. This naturally gives rise to other issues, ones which are at the heart of our project here.

In the UK the average moderately informed person might in response to a question about competition policy, if they heard about it at all might say something like “it is about controlling big business”, or “protecting consumers” but there is something misleading about both of these answers, as I am sure the professionals from the FTC and related bodies would be the first to point out.

In order to get at a more useful assessment I think we need to examine the benefits – and possibly the disbenefits – of competition. But first we will start by looking at the idea of the market economy.

The market economy

The BBC television broadcasts many old programmes. In the last two years their favourite was “The Good Life”, in which a middle class person gives up the rat race in order to be self-sufficient in his own back yard. The central joke comes from the fact that it is very difficult to achieve even a basic standard of living purely off your own resources. The standard of living we have derives from our ability and willingness to trade with others. By trading we can take advantage of individuals’ special skills, and different regions natural resources. In another more recent non-fiction programme the presenter makes ends meet in trading favours and produce with neighbours, but also from his fees from the TV programme and book spin-offs.

When people list the essential features of human beings maybe they should not look at tool usage, or language, but the invention of trading. Archaeological sites often reveal evidence that international trade pre-dates civilisation itself. Markets seemingly spring into being and become self-perpetuating in an almost spontaneous way. They very rarely need government intervention for their creation or efficient operation!

Limitations to markets

Some economists take their belief in markets to the extreme. When I was working in the USA in the 1970s I knew one who set up a market for household chores between him and his wife.. There would be a monthly auction in which each would set a valuation on the task and the one that idea would chores would be allocated according to these bids.

In order to have markets working efficiently the first thing we need is clear property rights and a system of law for enforcing them. If there is one thing that will slow down China’s apparently inexorable rise it is its slowness in creating a judicial system which ensures that individuals are allowed to retain the fruits of their endeavours.

The price system will operate much better if we have appropriate macro-economic policies. Pre-war cartels in the UK were sometimes a Canute-like attempt to stop disruptive price deflation caused essentially by mistaken macro-economic policies.

Once we have these important aspects of policy in place, things will still not be as good as they might. Markets do have well-known limitations, which within the world of economics are generally held to justify the possibility of government intervention even in a strongly market-orientated setting . These limitations are public goods (such as national defence), externalities (such as pollution and congestion), asymmetric information, and monopoly.

Competition

Much of the traditional support for markets was based on the theory of trade and specialisation. Although we know that the insights of Adam Smith, the 18th century moral philosopher, who is usually quoted in this contest, are essentially correct, the theory as you will see it developed in most undergraduate text books is essentially static: for a given state of technological knowledge, competitive trade leads to the biggest increase in well-being for society as a whole.

But one of the biggest insights of the 20th century is the finding that if we want to improve the state of technology, the most effective method is through competition. In other words, competition brings important dynamic elements to bear. For example my own PhD thesis examined the UK car market, at that time dominated by domestic producers names such as Rover, Jaguar, Morris, Austin, Triumph. Although I found price competition was muted there was vigorous competition through the improvement of specification. Later, when international competition became important we saw another dimension of non-price competition – enormous improvements in reliability.

Looking back over the 20th century we can see the process at work in many sectors – pharmaceuticals, computer systems, electronic appliances. I would like to quote from a talk given by my old friend, co-author, and former student the late Paul Geroski, who died at a tragically young age last year, having made major contributions both to scholarship and the development of UK competition policy in his role as Deputy, and later Chairman of the Competition Commission.

"Competition is a process of rivalry between firms each seeking to win customers business. This rivalry may occur in a number of ways –some firms compete on price, some focus on developing the quality of existing products or services, while others use entrepreneurial or research skill to develop new products or services. When competition is vigorous the rivalry ensures that no part of the market remains unexplored, no aspect of the offer made by producers to consumers remains untested. The consequences of this are that prices will typically be bid down to an efficient level of costs, a diversity of product offerings will come on the market that matches the heterogeneity of consumer needs and tastes, and the rate of innovation will be high."[1]

Anti-competitive behaviour

However, Professor Geroski then goes on to point out that from the point of view of firms in the market, competition appears as a mixed blessing. Although we benefit from markets in which we act as purchaser or as a supplier from competition as a producer it seems we have to work harder for our money. There is a temptation to do things that will eliminate this competition. Historically there have been a number of responses, including murder, burning down our rival's factory, doing other things to dissuade rivals from entering my markets, agreeing with others not compete, getting the government to grant me a monopoly, or if all else fails merging our assets and activities. (In fact if you read Stephen Levitt's book *Freakonomics* you will find out that gangsters in the crack cocaine trade on the South Side of Chicago would use murder as a competition reduction device, and I am told that there was some burning down of factories in of the former Warsaw Pact countries in their transition to market economies.)

Of course we are guided and constrained by personal morality but economists – and moral philosophers – try to look beyond this. A society that allowed murder would be

[1] "Is competition policy worth it?" Paul Geroski, Chairman Competition Commission September 2004. Mimeo, available on CC website

intolerable, one where burning down rivals factories was regarded as normal would quickly descend into poverty, and from a certain philosophical perspective that is why we outlaw them[2].

For the other approaches to eliminating competition neither morality nor the general public policy implications are quite so clear, and this is why we need law to guide us.

Let us look first at persuading others not to enter my market. I can dissuade others from entering my markets by offering, on a permanent basis, far better value for-money than my rival would be able to do. This is clearly value-enhancing entry deterrence. However, if my price reduction is on a temporary basis for just as long as the threat of entry remains especially if it is in a particular geographic market targeted on the new entrant's market, matters are less clear. A competition authority might need to consider whether this amounts to predation, destroying value in a manner analogous to the firm that burns down its rival plant.

The next category to consider is agreements with others. If I get an agreement not to compete with others who produce goods or services which are substitutes for my own output that will clearly destroy competition and is illegal *per se* in most jurisdictions of which I am aware. This is not a matter of morality but of practical law. The Daily Telegraph in the UK was indignant that leading private schools were to be sanctioned for transgressing the cartel provisions of the UK Competition Act 1998.

The next category is licensed monopoly. If I get the government to grant me a monopoly this might be good public policy if I am supplying a network good such as clean water or mains sewerage services; but good public policy will ensure that my ability to exploit this monopoly power is limited by appropriate contracts or regulation. This is the case economists refer to as natural monopoly, other examples being (in the UK) mains gas and electricity distribution, and arguably the last half mile of the fixed telephone network. However, when Charles I was selling monopolies as a substitute for recalling parliament and voting taxes this was regarded as misbehaviour.

The final category of anti-competitive action is merger. If I merge my business with another there may be no significant lessening of competition in the relevant market, so this would achieve the same ends as horizontal agreements which as we have seen, are normally illegal without exemption.

The role of competition policy

Competition policy has two main strands. The first, but perhaps less obvious, is sometimes referred to as advocacy, which has a public face and an intra-government aspect.

The public face means explaining to people throughout society why competition is so beneficial. Fortunately nowadays we have lots of examples where we can show dramatic improvements in well-being from elimination of monopolies –for example in telecommunications services and airlines.

[2] See Richard Posner's Book on the Economics of Law for a master exposition of this point of view.

The intra-government aspect is equally important. Many government policies have competition implications, and Competition authorities such as the US Federal Trade Commission, the UK Office of Fair Trading, and the EU DG Comp have an important role in advising other parts of the government on the competition implications of proposed legislation, something that is easily forgotten in the rush to find a solution, but something which may be difficult to undo once enacted since property rights may be created which may be expensive to unwind. For example, the poor quality and value for money on British Motorway Services is partly a consequence of historic decisions to grant sole rights to service operators. Subsequent attempts to introduce competitive elements have had limited success because of the original policy decision to grant monopoly franchises. Arguably the case for in-built elements of competition would nowadays be made at the Green paper (consultation) stage of the legislative process through competition advocacy by the authorities. The public gains to effective competition advocacy can be enormous but difficult to quantify.

The second and more visible broad strand of policy is of course competition law itself, covering matters of scope of powers, detailed provisions, governance matters, and working practices of the competition authorities. Although quantification is difficult, we can get a measure of the orders of magnitude involved by looking at the savings to consumers. For example Paul Geroski reports a transfer to consumers of £373m in one large case on which the Competition Commission spent £2.88m. “The Ready Mix Cement cartel in Germany generated damages of Euros 112m, the hydro-power case in Norway yielded damages of E140 and the hotel association cartel in Spain caused E180m in estimated harm.

Notice that in some of these cases, such as cement and hydro business, would be the direct losers, and consumers would suffer indirectly. In the case of hotels, businesses such as restaurants offering complementary services would also suffer from the anti-competitive behaviour.

It is widely recognised that the main gains are indirect since well conducted cases, with detailed and transparent documentation, teach other members of community how to behave.

Competition policy and the global economy

One of the first tasks in any competition inquiry is often to define the relevant market, which has both a product and a geographical dimension. Many businesses today operate in a global market. This will often mean either that there will be no local competition issues or that the issues need to be dealt with at a supra-national level.

So what is competition policy for? It is not to “control big business”, since most businesses – even large ones – will never have any dealings with competition authorities. If they do it will typically be an isolated occasion, unlike regulation.

It *is* about consumers, but not exclusively so, since the beneficiaries of an effective policy are largely business themselves. (Also reflected in the composition of complaints.) One of the largest beneficiaries of the recent into mobile telephone termination charges was in fact BT.

If I have to summarise what CP is for, it is to build confidence in the country that one will not be subject to anti-competitive behaviour by competitors. One's suppliers and customers will be constrained in their ability to overcharge reduced because one knows that competition with rival is fair.

The benefits are far greater than the measured price reductions. Building confidence means that people will be more willing to set up their own business, that overseas companies will be more willing to take part in joint ventures or bring business in your country. The evidence gathered by Michael Porter, the Harvard guru of Business and Corporate strategy, is that countries with effective competition policies grow faster than those without. They produce companies which, having learned how to compete at home are ready to become world-class companies in the global economy.

However, around the world there are a number of obstacles to the development of competition at the rate that may be desired. They include:

- Insufficient staff trained in the economics and law of competition policy
- Vested interests, often representing dominant incumbents, who wish to subvert the effective operation of competition policy
- Insufficient understanding of the role of competition policy amongst opinion formers and politicians

I hope this lecture will go a small way towards dispelling some of the myths and misunderstanding surrounding the subject.

John Cubbin is Professor of Economics at City University in London, where he introduced one of the first MSc programmes in Regulation and Competition which covers both economics and law. He has written or co-authored books on mergers and economic performance, market structure and performance, and the measurement of public sector performance, as well as a large number of articles and consultancy reports. Professor Cubbin is a part time member of the UK Competition Commission and an associate the consultancy firm CEPA .