COMPETITION AUTHORITY

Submission to the Enterprise Strategy Group

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1 INTRODUCTION

The Enterprise Strategy Group ("ESG") has called for submissions on the preparation of recommendations for enterprise strategy in Ireland for the medium term.

Vigorous competition in the form of low entry barriers and strong rivalry between competitors is essential for a competitive enterprise sector. In the medium term, competition promotes both the welfare of consumers in Ireland and the international competitiveness of Irish companies:

2 COMPETITIVENESS

According to the OECD, competitiveness is "the degree to which a nation can, under free trade and fair market conditions, produce goods and services that meet the test of international markets, while simultaneously maintaining and expanding the real incomes of its people over the long-term".

The World Economic Forum's (WEF) Global Competitiveness Report 2003-2004 shows that Ireland now ranks only 30th in the WEF league table. This represents a fall from 23rd place in 2002, and 11th in 2001. Ireland is ranked 13th of all 15 EU member states, ahead of Italy and Greece. At the same time, Eurostat figures show that consumer prices in Ireland went up by more than twice the EU average in the year ending December 2002[1]. This means that Ireland's cost base is rising faster than elsewhere in the EU, having a demonstrable effect on the competitiveness of firms operating in Ireland.

For example, the cost of 'housing, water, electricity, gas and other fuels' rose almost twice as fast in Ireland in 2002 as in the rest of the EU (3.7% in Ireland as compared to 1.9% in the EU), while the cost of post and telecommunications rose by 0.6% at the same time as it fell by 0.9% in the EU[2], thereby putting Irish exporters at a considerable cost-disadvantage internationally.

At the level of individual firms, in the medium term, competitiveness is determined by efficiency and innovation. In the short term, exchange rates can have a considerable effect, but exchange rate effects are more relevant to the short term than the medium term, and, in any event, the exchange rate is no longer an instrument available to Irish policymakers. Therefore, the realistic means of maintaining competitiveness is to focus on efficiency and innovation. Competition policy can play a major role in this regard.

[1] Eurostat figures reproduced in 'Review of Industrial Performance and Policy 2003', p.54.
[2] Eurostat figures reproduced in 'Review of Industrial Performance and Policy 2003', p.54.

3 COMPETITION POLICY, EFFICIENCY AND INNOVATION

Competition involves entry to markets, or a credible possibility of entry, and rivalry. It stimulates efficiency by putting pressure on individual producers to minimise their costs and the prices of their products. It encourages innovation by enabling producers with good ideas for new or differentiated products, or new methods of production or distribution, to bring their ideas to the market.

Competition *policy* aims to promote market conditions that are conducive to competition. In particular, it aims to ensure that competition works well for consumers. This contrasts with protectionism, or protecting 'infant industries', or the creation of 'national champions', all of which are focused on producers rather than on what the consumer wants.

Protectionism of any sort is likely to run counter to competitiveness in the medium term. The Department of Enterprise, Trade and Employment acknowledges this in the course of its description of the transformation of the economy 1960s-1980s by saying: "notwithstanding the shift to foreign direct investment, the legacy of past protectionist policies was an industrial base that was uncompetitive in European and global markets".[3] Any enterprise policy choice that has the effect of protecting producers from competition runs the risk of repeating this mistake. Furthermore, even to the extent that protected producers are not trading their products internationally, they directly affect the competitiveness of the economy by adding to the cost base.

National champion advocates argue that applying the principles of competition policy in small economies can be harmful because firms are precluded from achieving the necessary scale to compete internationally. The implication of this argument is that industrial policy would be designed to encourage national champions, to which normal competition rules would then not apply. There are, however, several reasons why the trade-off between competition and other policy goals in industrial policy can be considered small, or even non-existent.

Firstly, with regard to distribution, a sanguine position regarding a large or dominant firm depends critically on distribution and importation systems being open to competition, as this will mean dominant domestic firms are exposed to international competition in the domestic consumer market, not just in foreign markets. For this reason, small economies have all the more reason to apply competition rules vigorously in the importation and distribution sectors, and doing this would ease any adverse domestic implications for national champion firms. Furthermore, it should be noted that opening markets to international trade would not necessarily lead to greater competition in all parts of domestic markets, even where domestic industry supplies inputs to exporters. For

[3] DETE: Review of Industrial Performance and Policy 2003, p.34.

example, Ireland is extremely open to trade but is also reliant on non-traded services and infrastructure, which in many instances are not subject to competition.

Secondly, while monopoly profits could in theory have a beneficial effect by providing a source of funding for the investment necessary to allow a national champion to compete internationally, a number of criticisms of this argument can be made, as follows:

- Capital markets, rather than monopoly profits derived from domestic consumers, are a more efficient source of funds for investment abroad, and almost certainly result in more sound investment. Funds raised on capital markets, either via bonds or equity, impose obligations, controls and incentives on the shareholders and management of firms. By contrast where a firm has access to monopoly profits there is much less incentive to encourage sensible investment at home or abroad.
- If monopoly profits are necessary to fund a foreign investment, then in effect the investment is only viable because of a cross-subsidy from domestic consumers. Consequently the overall effect on the economy would be negative as, in effect, the merger would be financed by a tax on domestic consumers to subsidise competition in export markets.
- An alternative case might arise where a multi-product firm seeks to expand externally from a platform of a domestic merger but where in one product market the merger raises monopoly issues. (In this case, as opposed to the example above, the monopoly profit is not likely to be crucial to the viability to the merger and, if it is, the rationale for the merger must be weak). Rather than blocking the whole merger it would be more appropriate to apply competition remedies to the specific domestic market power problem.

Thirdly, it has been argued, by Michael Porter and recently also by the OECD, that the discipline earned by intense competition in the domestic market is the best stimulus to success abroad. Firms that have to compete domestically know how to cut costs, operate efficiently, please customers and win business. This experience gives them an enormous advantage when they expand into foreign markets. The example of Ryanair illustrates this point. Having developed a successful model as a new entrant into the UK-Ireland market, Ryanair is now expanding into the other European markets.

On a general level, using the aviation sector as an illustration, evidence suggests that competition can not only bring static benefits but can also drive higher productivity growth over time. Entry to the aviation market was allowed in the mid 1980s and state aid to Aer Lingus was finally stopped in 2001. The benefits of the market might be summarised as follows.

1 Lower prices resulted in more travel and gains to existing travellers. Initial price reductions by Aer Lingus would be described as ‘static’ gains. Further price reductions arising from lower costs are ‘dynamic’.

2 Further price reductions by Ryanair can be classified as dynamic because Ryanair entered with lower costs arising from greater operational efficiency and better yield management, etc.

3 The efficiency gains within Aer Lingus, greatest and most remarkable following the elimination of State Aid in 2001, are likely to have been both static and dynamic. Initial elimination of X-inefficiency and rent-seeking is static. After some time, however, it is likely that cost reductions are dynamic. For example, it could be argued that the move towards internet sales was dynamic in the sense that it arose more from the strong rivalry in an increasingly mature market than from the initial effect of entry. One of the most remarkable things about Aer Lingus has been the shift in management focus from political (external influence behaviour) to commercial or winning customers on the market. It is likely that this would be accompanied by reductions in internal influence behaviour whereby internal promotion will be based on contribution to productivity. External rent-seeking has long been recognised in Ireland as a serious inhibitor of efficiency[4], but less attention has been given to improved incentives within organisations that tend to accompany greater competition.

4 Much is made of the wider benefits associated with competition in aviation, such as, for example, increased tourism and lower costs for business.

5 Another benefit is the effect on competition in upstream markets for inputs. Most significant here is the effect on competition between airports. In other countries, small regional airports have been brought in to compete with established incumbents, where they have reaped most of the benefits. However, it is extremely unlikely that the current moves to have greater airport competition in Ireland would have happened if there were not strong competition between airlines. Ryanair and Aer Lingus are constantly trying to get a better deal on airport charges, and thereby driving competition in those markets. These gains may be static or dynamic depending on the starting position in the relevant input market.

6 Similar to the latter has been the positive effect in terms of shifting to Internet-based retailing technology.[5] Here, Ryanair was an enormously successful first-mover, suggesting a further dynamic efficiency whereby entrants are earlier and more successful adopters of new technology.

7 Competition in the airline market also had an important positive externality in terms of Internet usage. Many people in Ireland made their first purchase over the Internet from Ryanair or Aer Lingus.

The effect on employment from the liberalisation has not been quantified. Aer Lingus was seriously overstaffed, and it is quite likely that the extent of overstaffing was such that overall numbers employed by both airlines could fall, even while outputs soared. While this is tangible evidence of efficiency, it is politically problematic. But now there

[4] See for example Culliton Report (1992).
[5] See Enforcement Decision E/02/001 on The Reduction in Travel Agents' Commissions by Aer Lingus plc. Available at http://www.tca.ie.

appears to be increasing recognition that job creation elsewhere in the economy may mean that the overall effect on employment is positive.[6] This still leaves a question about the appropriate policy response to deal with the adjustment.

The success in aviation will not be repeated in every market, both because the initial conditions may not be so conducive and because rivalry works particularly effectively there.[7] But the example does illustrate a few important points.

- First, competition is not simply about static gains, but about delivering dynamic efficiency over time.
- Second, many of the peripheral benefits may not be fully anticipated at the outset, and it can be easy to miss some of them.
- Third, competition is not a zero sum game: it has benefited both consumers and shareholders. This is in sharp contrast to the simple static model where much of the consumer gain is perceived as being at the expense of shareholders.
- Fourth, entry is not enough: there must be a level playing field, and many of the biggest efficiency increases only resulted when State Aid was abolished. Put another way, competition must be implemented effectively if the full benefits are to be delivered. If the former monopoly remains protected, then efficiency gains will be slower.
- Fifth, private ownership matters less than competition. It is quite remarkable that a publicly owned company such as Aer Lingus could achieve the internal efficiencies it has achieved in the past two years. It shows that a publicly owned company with good management, correct incentives, strong competition and a level playing field can make substantial efficiency improvements. It is also important that there be a real possibility of bankruptcy, so that vigorous enforcement of EU State Aid rules is an essential element in ensuring that publicly-owned companies can achieve efficiency.

It is worth noting at this stage that, at the outset of the impact of competition on the aviation sector, it would have been difficult to anticipate all of the benefits that would arise, especially through dynamic effects.

Overall, sustained competitiveness requires concentrating on what the consumer demands and then responding to those demands in efficient and innovative ways. Doing this through the market, rather than through a centrally planned industrial policy, is at the heart of how competition works to the benefit, not only of consumers, but also, in the medium and long term, to the benefit of efficient and innovative producers. Ultimately,

[6] See "*Quality public services are central to the fair society*", speech by Pat Rabbitte, T.D., Monday 22 September 2003.
[7] The example is often used as the best illustration of hit-and-run entry in contestability theory.

efficient and innovative producers, engaged in competition with each other, and with the continual possibility of entry to markets, are more likely to lead to sustained competitiveness than a producer-led or industry-based strategic plan.

4 REGULATION

Regulation of economic activity can deliver benefits when it is proportionate and specifically designed to address a market failure. Market failure can arise from:

(1) asymmetric information;

(2) externalities in consumption or production;

(3) market power[8].

Inappropriate regulation can be inimical to the interests of consumers, producers and society at large. In particular, this can occur where competition is restricted in a manner that is disproportionate to the desired objective or where there is no clear public policy objective in the first instance. Other costs associated with inappropriate regulation include the costs to society of distortion of incentives and disproportionate administrative burdens.

It follows that it is necessary to ensure that regulations such as Acts of the Oireachtas, statutory instruments, licences, administrative practices and local authority rules are proportionate to policy objectives. In particular, any restrictions to competition should be no more than strictly necessary to achieve a transparent policy objective, and any economic regulation by Government should be targeted at market failures.

The OECD Review of Regulatory Reform in Ireland (2001) identified a number of sectors where regulation leads to inadequate supply of, or demand for, goods or services, leading to welfare shortfalls for either consumers or producers or both. The Review contains a number of recommendations for action, which, based on international consensus on good regulatory practices, and on concrete experiences in OECD countries, is likely to be lead to improvements in regulation in Ireland. Reference to those recommendations would be an essential element of drawing up a blueprint for enterprise strategy in Ireland.

In addition to recommendations related to specific product or service markets in Ireland, the OECD Report found that more work needed to be done on consultation processes, regulatory impact analysis, reducing administrative burdens, review of regulatory processes and the modernisation of state institutions. It is to be hoped that the forthcoming Statement on Better Regulation will deal with these issues but, in any event, the OECD recommendations are germane to the work of the Enterprise Strategy Group,

[8] A description of each type of market failure is contained in the Authority's Submission to Consultation on Better Regulation (2002) – available at www.tca.ie

and would help in creating the conditions in which companies can be productive and innovative, thereby contributing to competitiveness.

As a general guide, the *proportionality test* serves as a useful mechanism to ensure that the impact of regulation on the market is commensurate with a policy objective. Proportionality ensures that a regulation:

1. does not unduly restrict entry into, or rivalry within, a market;
2. does not unnecessarily create market power;
3. does not affect pricing mechanisms in a way that reduces incentives to compete;
4. does not allow a firm to use revenues generated a statutory monopoly to subsidize activities that it carries out in a competitive environment.

Ultimately, rigorous adherence to proportionate regulation would result in less red tape for businesses, and less restrictions to competition thereby improving productivity and facilitating the emergence of new business start-up, new production processes and new products.

5 CONCLUSIONS

The advantages to the economy of competition are such that enterprise strategy should be based on facilitating competition. Towards this end, an appropriate policy choice would be to vigorously ensure the removal of market restrictions that hinder competition. Government Departments and agencies have a significant role in this regard. Many needless restrictions emanate from statutes, and can be removed directly by government, e.g., quantitative licensing restrictions on public houses, the ban on below-cost selling of groceries, the limit on the size of retail outlets, and many others. The Competition Authority advocates for the removal of such restrictions, but any legislative change is a matter for the relevant Government Department or agency. Clearly, vested interests benefit from the status quo, but potential entrants to markets lose out, meaning that some enterprises that could make a contribution to growth and employment in the economy are being deprived of a chance to do so. The aviation example, described in section 3 above, is an instance of how competition can lead to not only static, but also dynamic, gains, many of which cannot be predicted at the outset, but which make a positive contribution to the economy.

More generally, there is widespread recognition that economic regulation needs to be targeted precisely at clearly identified cases of market failure, and existing regulation should be assessed in that light. This applies not only to internationally traded goods and services, but also to ‘input’ markets because performance in these markets has a direct effect on the industrial cost base. Furthermore, in the case of products and services that are not traded internationally, restrictions on competition have a negative effect on the welfare of consumers, and, to the extent that they increase prices, put upward pressure on the industrial cost base.

Emphasis on competition is clearly more appropriate than alternative approaches such as the promotion of 'national champions' or the implementation of rationalisation plans that artificially reduce competition in the market. The promotion of national champions, with policies that safeguard the interests of a number of well-established players, is a producer-led approach rather than a consumer-led one, and may inadvertently restrict entry by potentially efficient, or innovative, producers. In any event, to have an enterprise strategy that, to some extent, shelters enterprises from competition, would run counter to any ambition for Irish companies to be internationally competitive in the medium term: for them to compete abroad, one would expect that they should be able to compete at home.

A strategy of centrally coordinated structural reforms to reduce the number of players in a particular market can equate to collusive agreements between firms. If so, there is a possibility of an infringement of Section 4 of the Competition Act. Like any action that reduces competition, such a strategy can have a detrimental effect on consumers' welfare by way of higher prices and/or less choice. This in turn can further add to the overall cost base of the economy.

The Department of Enterprise, Trade and Employment points out on its website that, in relation to enterprise strategy, it currently seeks to "develop and support broad policies which will enhance the competitive advantage of enterprises operating in Ireland". Towards this end, an effective broad policy would be to allow competition to thrive in sectors where it has been restricted. An important first step in this regard would be to weed out inappropriate restrictions that have developed as a result of various kinds of regulation. That would have a broad and beneficial effect on consumers and productive enterprises alike. In this way, the facilitation of competition across the economy is strongly recommended as a central element of enterprise strategy in Ireland.