Competition and growth: the role of a competition agency

Competition is a crucial factor in driving economic growth. First, it places pressure on firms to increase their efficiency. Second, it ensures that more productive firms increase their market share at the expense of the less productive. These lower productivity firms may then exit the market, to be replaced by higher productivity firms. Third, in the presence of competition, firms will aim to innovate to gain a cost advantage, to differentiate their products, or to bring new products to the market place.

Competition also contributes to growth in other ways. There is evidence that it reduces inflation rates, both at the sectoral and aggregate level.[1] And it is a defence against the entrenchment of vested interests and protectionism, opening up markets to new entrants and increasing the attractiveness of a country as a recipient of foreign direct investment. The role of competition in driving economic growth is especially important in the current economic climate. With macroeconomic tools likely to prove insufficient, and their use restricted by the need for fiscal consolidation, microeconomic instruments (such as the removal of unnecessary regulatory burdens and the protection and promotion of competition) become all the more important. This is a message echoed by many commentators, including those from outside the competition regime.[2]

To fulfil its potential to contribute to economic growth, the OFT believes that an effective competition policy needs to address both public and private restrictions on competition. The restrictions on competition that can result from the actions of private agents – for example the creation of price-fixing cartels or abuse of market power by dominant firms – and the impact that they can have on efficiency and innovation are well known.

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[1] European Central Bank (2005), *Does Product Market Competition Reduce Inflation?* shows a robust and significant negative link between competition and inflation, both at the aggregate and sectoral levels.

[2] See, for instance, McKinsey Global Institute (2010) *From Austerity to Prosperity: seven priorities for the long-term in the United Kingdom*.

But it is also essential to recognise that governments can also have an adverse impact on competition, and as a result, the growth of a particular public sector. This can occur through overt actions, such as exempting certain sectors from the application of competition laws or granting subsidies to industries or individual players. It can also occur through more subtle forms of market intervention (for instance, by introducing regulations that, while aiming to achieve public policy objectives, provide an advantage to incumbents). That is not to say that governments do not have a role to play in markets – in many cases, the role of government is a legitimate and necessary one – as markets cannot exist without a framework of rules. Markets, left to their own devices, can also fail because of market power, information asymmetries or externalities.

However, government interventions can have unforeseen, yet significant consequences. As such, the full cost of intervention needs to be carefully assessed before deciding whether, how much, and how to intervene – especially as over-intervention, not under-intervention is usually the bigger risk. In this respect, competition agencies have an important role to play in the sometimes difficult task of helping policymakers consider **all** costs and benefits of a market intervention. This is essential for a number of reasons. First, there might be a bias in evidence. The benefits of government interventions might be easier to see than the cost of lost competition, especially as much of the evidence is likely to come from interest groups (which have the most to lose) and might be weighed in a certain direction.

Second, governments need to factor in (but frequently overlook) the benefits of dynamic efficiency, and the risks derived from preserving business models that are unsustainable, while blocking innovation and new entrants to the market. These benefits, while potentially significant, can be difficult to assess or rely on in advance and may take years to materialise.[3] As a result, they may be under-appreciated. Third, and crucially, the restriction on competition resulting from government intervention can result in a slippery slope – once 'rents' have been established in one sector, others may lobby government for similar treatment.

It is for these reasons that competition enforcement and advocacy are complementary. Successful advocacy is needed to open regulated sectors to the full application of competition rules and their enforcement. But industries

[3] One example of this would be the liberalisation of European air routes by the European Commission, which facilitated the entry of a number of low-cost air carriers. These carriers introduced new business models, including new booking methods and extensive use of outsourcing. In addition to increased consumer choice, the price of an economy class ticket provided by traditional carriers fell by over 66 per cent between 1992 and 2002.

previously insulated from competition and that find themselves facing increasing competition will frequently resort to anti-competitive practices to attempt to limit that new competition, giving rise to a greater need for enforcement. Conversely, where enforcement increases competition, the industry in question may resort to lobbying to have the sector protected from competition.

Enforcement also underpins advocacy work. A competition authority that has established its credibility and profile by bringing high-impact enforcement cases will have the credibility and public stature to engage in competition advocacy more effectively. A competition authority that both enforces and advocates will come across as more balanced – an authority with enforcement powers only would focus entirely on private restrictions and might be seen as anti-business or narrowly focussed. An authority with both functions can be seen as being consistently pro-competition, with broader legitimacy.

The OFT believes that effective advocacy and effective enforcement complement and reinforce each other. As such, it is essential that the design and capability of any competition authority reflects the need to tackle both private and public restrictions on competition, with enforcement and advocacy as two sides of the same coin. This view is supported by international organisations such as the OECD and the World Bank.[4]

Given these observations, the OFT considers that it is important that the Government reiterates its commitment to the new Competition and Markets Authority taking on a strong competition advocacy role, to complement its competition enforcement responsibilities. This will truly set the course for creating a 'competition regime for growth'.

Further reading:

'Government in markets' - http://www.oft.gov.uk/OFTwork/publications/publication-categories/reports/advocacy/oft1113
'Choice and competition in public services' - http://www.oft.gov.uk/OFTwork/publications/publication-categories/reports/advocacy/oft1214
'Competition and growth: how can government policy help?' - http://www.oft.gov.uk/news-and-updates/speeches/2011/1511

[4] The World Bank, OECD (1998): *A Framework for the Design and Implementation of Competition Law and Policy*