Journal of the Statistical and Social Inquiry Society of Ireland
Vol. XXVII, Part I

SYMPOSIUM ON COMPETITION POLICY

JOHN FINGLETON
Trinity College, Dublin

(read before the Society, 3 March 1994)

---

1. INTRODUCTION

Competition policy in Ireland is at an important juncture. The 1991 Competition Act, which forms its principle basis, marked a major shift towards direct and systematic policy. As a result, many businesses and markets are being exposed to competition policy for the first time. Thus the type of competition policy which stems from this Act is still unfolding. The criteria being used are indicated by the details of the decisions of the Authority and interpretations by the Courts, though still few in number, are determining the scope of competition policy. Against this background of observation and learning, there is a process of evaluation and assessment. Academics, legal practitioners and business people have contributed to a general debate about the current operation and future direction of competition policy. At the time of writing, this process has been augmented by a proposal to make changes to the Act, which would include giving enforcement powers and improved investigation abilities to the Authority.

This symposium is a welcome opportunity to discuss and reflect on these issues and hopefully to contribute to this debate. It is particularly appropriate to have contributions from different professional perspectives to discuss a topic that lies at the nexus of economics and law and which has important consequences for business, legislators and society in general.

This paper attempts to summarise the contribution of economics to the scope, criteria and institutional features of competition policy. In some cases, this contribution is clear and prescriptive and in others it merely raises difficult questions which must be addressed, and for which there are no simple answers.

A number of strands of economic theory provide the theoretical underpinnings of competition policy. Microeconomic theory (typically using industrial organisation theory models) is used to determine day-to-day rules and decisions for competition

policy (section 2). General equilibrium theory is relevant to the role of competition policy in an economy-wide context (section 3). Incentive and regulatory theories are relevant to institutional aspects of competition policy (section 4). Finally, the main elements of present competition policy in Ireland are outlined and discussed (section 5).

Many features of the Irish economy point to the prevalence of anti-competitive behaviour, especially in the services sectors[1]. This paper does not address these issues but assumes that the need for competition policy is considerable and that sizeable potential benefits could result[2]. However, competition policy as currently operating may not fully realise these benefits. Instead, it may be costly on business with relatively small benefit for the consumer. The danger is that poor competition policy could damage support for this particular micro-economic policy in the long-run[3]. If the economy is to realise the full benefits of competition policy, it is vital that competition policy be monitored on an ongoing basis, and improved to make it more effective, efficient and systematic.

2. MICROECONOMIC THEORY AND COMPETITION POLICY

Microeconomic analysis of markets is concerned with interactions between the producers or firms and consumers who participate in the particular market. With perfect competition, each producer is a relatively small price-taker and price competition among producers maximises welfare as average cost is minimised (productive efficiency) and price is equal to marginal cost (allocative efficiency). However, in many other scenarios, firms have market power and can charge prices above cost and earn super-normal profit[4]. This allocative inefficiency or **market failure** results in high prices and low output. Ultimately, all market failures arise from externalities in the decision-making process whereby a firm's behaviour has social costs (or benefits) that are not included in that firm's decision. The typical solution to this market failure is to prohibit or restrict types of behaviour which are anti-competitive or welfare-reducing and this forms the basis of competition policy. In this manner, competition policy is directed towards the sources of market failure.

In practice, the distinction between competitive behaviour and anti-competitive behaviour is difficult to draw. The contribution of economics varies from reasonably clear results (e.g. horizontal price fixing by cartels reduces welfare) to the absence of any general rule if behaviour which is competitive in one scenario may be anti-competitive in another (e.g. vertical restraints have different welfare effects in different circumstances). Typically case-by-case analysis in the context of the particular features of a market is necessary. Economic theory will generally suggest which features are most relevant to the analysis and will often offer some assessment of the net benefit to the consumer of restricting a particular type of anti-

competitive behaviour. Here the net benefit is the gain from prices moving closer to cost and cost falling as competition makes firms more efficient (closer to minimum average cost and reduced X-inefficiency). A typical defence of anti-competitive behaviour is that a restriction of behaviour would increase the costs of the firm (e.g. exclusive dealing may reduce a firm's distribution costs). While this is something that an agency should take into account in assessing the net benefit, such claims are possibly inflated. In addition, if the effect of a restriction on the costs of a firm were fully taken into account, a firm could intentionally organise its costs to maximise this effect.

Economic theory also suggests that certain market structures are more likely to be competitive than others so that competition policy might not be applied in market structures where competition is inherently likely to be strong. This is a compelling argument, especially in view of the compliance costs which competition policy may impose on firms. Compliance costs may have some fixed element which a firm must bear independently of its size. In any case, where a market has a large number of small firms, the total compliance cost would likely be very large relative to the possible benefit that could be gained.

One possibility is to exclude markets with certain structural characteristics from the purveyance of the policy (like the *de minimis* feature of EC legislation), though such a rule could encourage "creative compliance" whereby firms might comply with the letter of the law without adhering to its spirit[5]. The other alternative is that policy allows the competition agency discretion about which markets should be included by giving it powers to initiate an examination of any market.

The arguments in favour of competition apply regardless of whether a firm is owned by the government or the private sector, and are strengthened by the possibility of a government-owned firm competing at an unfair advantage. Marketed public services where a firm is owned either entirely or partly by the government (e.g. telephones, electricity), fall clearly within the category where competition policy should apply. Insofar as the rationale for government ownership is often increasing returns to scale (e.g. high fixed costs of a national network), there is a tendency for monopolisation in the marketed public sector. Technological progress has reduced the incidence of economies of scale in many markets. Thus these markets are often those where the potential benefits of competition policy are greatest, adding further to the argument for subjecting marketed public services to competition policy[6]. Recent regulatory theory addresses many of the difficulties of ensuring efficiency and maximal competition in markets which retain elements of natural monopoly.

The distribution and profile of the costs and benefits of competition policy provide further support for its application in all markets. While the costs borne by firms are manifest, occur quickly and are easy for the firm to calculate, the benefits to the consumer are more obscure, difficult to evaluate and take some time in reaching

their final destination. In addition, with a small number of large firms (with experience of lobbying and rent-seeking), each bears a considerable share of the cost, whereas the benefits take the form of a small gain to a large number of diffuse and otherwise unconnected individuals or downstream firms. Competition policy, if applied systematically, would mean that firms bearing the costs would simultaneously benefit from competition policy in other markets (both from lower input prices and higher consumer expenditure), thus reducing the imbalance in lobbying power and making policy less divisive. More generally, the nature of the costs and benefits suggests that the competition agency needs to be strong, so as to minimise opportunities for rent-seeking behaviour. This may mean that policy should be biased in favour of rules over discretion[7]. In this regard, the political economy of competition policy is not unlike that of taxation reform where there are both gainers and losers and the profile of each group matters enormously to the practical implementation of policy. As with taxation reform, there is an additional difficulty if benefits are long-term or distant and the costs are current, which would tend to hinder consensus in favour competition policy.

In summary, therefore, microeconomic theory contributes to an understanding of both the criteria for and scope of competition policy. The theory suggests that the criteria for deciding whether behaviour is anti-competitive or not depend on the particular features of the market and provides tools and results for reaching decisions. Furthermore, it suggests that the scope of competition policy should be broad and potentially include all markets.

3. GENERAL EQUILIBRIUM ASPECTS OF COMPETITION POLICY

Microeconomic analysis of markets often involves a partial equilibrium methodology in that, to some extent, it does not fully consider the effects of behaviour on those outside the market in question. The first best solution recommended by analysis of the effects on the market participants only would be correct if there were no market failure (e.g. lack of competition) elsewhere in the economy. But by the theorem of second best[8], if there are market failures elsewhere, an analysis based solely on the producers and consumers in one market might not be appropriate.

An obvious example is that of an upstream market where some or all of the output is purchased by manufacturers of downstream products[9]. Increasing competition in the upstream market lowers costs in downstream markets. However, if competition does not prevail in these downstream markets, the benefits of competition policy may not be passed on to the final consumer and instead may be absorbed (at a lower level of overall benefit to society) within the downstream markets or other sectors[10]. In such cases, the decision on whether behaviour in the upstream market is anti-competitive

would not correctly evaluate these reduced benefits and, in some instances, an incorrect decision might be reached. Thus competition policy should be applied systematically in all sectors of the economy because the benefit in each market is greater if other markets are competitive and because decisions based on (partial equilibrium) analysis within the original market are more likely to be accurate and welfare improving.

Efficiency-enhancing cost reductions resulting from competition policy may have effects in other markets which may not be taken into consideration by the competition agency, as, for example, when a downstream market alters its demand for the (upstream) inputs it uses. Typically, competition policy results in higher output, and hence in greater demand for inputs so that the benefits in other markets would be positive. In these cases, there might be extra gains in an upstream market not considered by the competition agency in its assessment of the behaviour in the downstream market, and welfare reducing behaviour might in some (perhaps rare) instances not be prohibited when it should.

The effects in other markets could conceivably be negative. If an industry is extremely over-staffed, either in the sense of too many or inappropriately qualified people (perhaps because of new technology), increased competition would result in job losses (the labour market is an upstream market). This would not be a problem with full employment (equilibrium in the labour market) but with unemployment, and especially with hysteresis[11], the costs could be considerable. Thus the competition agency could prohibit behaviour which in the context of the market makes sense but in an economy-wide context would not[12].

It is not clear what the criteria of the competition agency in this context should be. Limiting the competition agency to consider only the direct consumer in the relevant market (even if this includes customers who are downstream firms) is clearly too narrow. If some broader definition is used, it is not clear whether it should be the final or ultimate consumer (i.e. anyone who purchases a final downstream product) or it should be the consumers as a whole.

If competition policy is applied systematically, then the ultimate consumer will be a good proxy for consumers as a whole. In addition, the use of the consumers as a whole as the relevant group would lead to a plethora of arguments for every competition case that would be difficult and expensive to evaluate and would provide incentives for undesirable rent-seeking.

In summary, general equilibrium theory highlights that competition policy in one market has effects in other markets. In particular, the outcome of case-by-case analysis in each market is more likely to be welfare improving if other markets are competitive (and without market failure). It thus adds considerable support to the arguments for widespread and systematic application of competition policy in all

sectors of the economy, and indeed to arguments for microeconomic reform more generally.

4. INSTITUTIONAL CONSIDERATIONS

The costs imposed by a competition agency's decisions (commercial costs and compliance costs) which have already been addressed are distinctly different from the **cost of competition policy** itself. This cost is largely determined by the government in the manner in which it establishes the competition agency. It is a public policy issue in the sense that it must be weighted against the aggregate benefit of competition policy in the economy as a whole. In any case, the cost of operating a given level of competition policy should be minimised. Although the consumer ultimately bears this cost, its magnitude is determined by its initial incidence (whether it is borne by the government or by firms). It may be decomposed as follows:

1. the legal and administrative costs or taking or defending a competition case;
2. delay costs which arise because a decision (which would improve welfare) is not reached quickly; and,
3. uncertainty costs because firms may not know what behaviour is permissible in their market scenario (this is likely to be higher in the short run and in the periods following legislative change).

These costs will be borne initially by actual and potential firms and passed onto the consumer in the form of higher prices. In each case, there is no mechanism by which firms could, if they wished, pay extra money to the competition agency in exchange for a higher level of service, even if this would represent an overall welfare gain[13]. The level of funding and other support for the competition agency should be balanced against the cost that would otherwise be imposed, initially on firms and eventually on consumers. This suggests that the resources devoted to the competition agency should be at the level where extra expenditure would not result in an equivalent reduction in the cost of competition policy.

If a competition agency makes incorrect decisions, inefficient firms may persist or efficient ones be may be disadvantaged with similar consequences. The accuracy of decision-making by a competition agency will depend on the quality of the information available, just as the evaluation of competition policy as a whole will depend on the quality of published information about firms' prices, market shares and other activities. Firms are at a distinct advantage in having access to information relevant to the decision. Not all of this information can be obtained, but that which exists should be available to the competition agency so as to improve the quality of its decisions. The inability of a competition agency to acquire such information would be indicative of regulatory capture at an earlier stage, namely in the design of

policy. Similarly, the absence of generally available and published information may represent considerable protection of anti-competitive behaviour. This suggests that the competition agency should be able to acquire information and, more generally, that firms should be required to publish data which would enable a general assessment of the level of competition.

In summary, the institutional design of competition policy affects both the size of the costs and benefits of competition policy and whether these costs and benefits are realised. With appropriately designed competition policy, benefits can be improved, costs reduced and the resulting larger net benefits realised. Economic theory identifies the institutional features of competition policy which are important to its effectiveness, namely the organisational structure, incentives and resources of the competition agency which implements policy. It does not ordain a precise optimal structure for competition policy, but perhaps suggests that these features should be subject to continual assessment and modification in the development of an effective and workable competition policy.

5. COMPETITION POLICY AND THE IRISH ECONOMY

Competition policy has been implicit in Ireland's industrial strategy since the 1960s and her membership of the EU (then EEC) from the 1970s. Thus competition policy emerged as an indirect effect of other policies and was confined to certain sectors of the economy.

As a result of **industrial policy**, exporting firms in the manufacturing traded sector were forced to compete in international markets and hence at international prices. Industrial policy has, in that time, consisted largely of providing direct and indirect support to this sector, often in the form of fiscal privileges and infrastructural support. It is tempting to suspect that much of this support was necessary to compensate firms for the high price of their domestically produced (and possibly imported) inputs, which in turn was due to lack of competition in the upstream domestic sector. If this argument is accepted, exposing the exporting sector to competition may have had little welfare effect *qua* indirect competition policy.

EU membership introduced **EU competition law**, in particular Articles 85 and 86 of the Treaty of Rome concerning agreements involving trade between member states and above a certain size (*de minimis* provision). This did not expose many additional Irish firms to competition policy.

Direct competition legislation has existed in the form of the Restrictive Practices Acts, 1972-1987[14] and the Mergers, Take-overs and Monopolies (Control) Act, 1978 (still in force). The **Restrictive Practices Acts** were directed towards the most

blatant abuses of monopoly power but may have failed to recognise that more subtle methods of achieving the same ends would be open to the relevant firms. In addition, they required an investigation by the Fair Trade Commission, making the process costly and cumbersome[15]. It is not clear that Restrictive Practices Acts had any significant positive effect on competition and, indeed, they may have had negative effects. For example, it is plausible that the Groceries Order encourages anti-competitive behaviour in that the minimum prices it sets may hinder healthy price-cutting and assist firms in maintaining collusive behaviour.

Thus Irish policy towards competition has been fragmented in the sense of only concerning a small range of markets, and largely indirect in that competition has often been a by-product of other policy objectives. That which was direct would appear to have been inefficient or even perverse.

The **Competition Act, 1991** marks a change from this general trend. This is the first and only piece of domestic legislation with competition policy as both intention and effect. It applies the principles of EU legislation to the Irish economy and established a new competition agency, the Competition Authority. It is limited in its application: the Authority has no enforcement powers, relies on being notified, has restricted investigation powers and no ability to impose fines. In addition, its decisions may be appealed to the High Court so that the High Court, in effect, may determine policy[16]. This feature may encourage appeasement rather than confrontation and may thus build negotiation into the decision-making process.

The Competition Act embodies many of the **criteria** discussed above. Case-by-case analysis is evident in the decisions of the Authority and decisions rely on economic analysis[17]. Although the Act refers to the "consumer", it is possible that this could be interpreted as the ultimate consumer.

The **scope** of the Act is determined by what constitutes an agreement between undertakings which, in turn, depends on legal interpretation of the Act. Following a Supreme Court decision in the case of *Dean vs. Voluntary Health Insurance Board*[18] the concept of an undertaking was taken to include non-profit organisations, suggesting that a wide variety of markets would come under the Act. Although the precise boundary is still unclear, it seems likely that many public sector activities would qualify as undertakings and be subject to the Act[19]. There is no *de minimis* provision and current implementation relies on notification which means that, to a significant extent, market participants determine whether their market will be subject to the Act. The proposed change in the legislation will remedy this in that the Authority will soon have enforcement powers and improved investigation abilities. Thus it is possible that the Authority may, to a significant effect, come to determine the scope of the Act.

A major constraint facing the Authority at present would appear to be that of resources. Despite a prolific output of decisions, there is an enormous backlog[20] which is imposing considerable costs on firms awaiting decisions. Some of this may be a start-up phenomenon, requiring extra resources in the short run to deal with the enormous bulk of initial notifications. Maintaining resources at existing levels, even in the absence of any changes, would still leave a major problem in the short run. In addition, the new enforcement powers and responsibilities proposed will necessitate additional resources to avoid the more serious problem of long-run policy failure. Otherwise, policy might appear to be pro-competitive but in practice have no power. Such a development could undermine the credibility of competition policy at an overall level as it would prevent the widespread application of the policy, constraining it only to the most serious and blatant abuses.

Finally, the Authority does not have powers to acquire information. An ability to carry out "dawn raids" would be a welcome development and would facilitate efficient and quick decisions. More generally, anti-competitive industries in Ireland (and other countries) shelter behind the absence of any requirement to publish data. For example, the Central Statistics Office fails to publish concentration ratios and other aggregate industrial data which would enable some measure of market structure and performance.

6. CONCLUSION

Economic theory makes contributions to several aspects of competition policy and, in particular, to the criteria which a competition agency should use in determining anti-competitive behaviour, the scope of competition policy in terms of the markets to which it should apply and the institutional features of the policy.

With regard to the **criteria of competition policy**, the contribution may be summarised as requiring that the competition agency be involved in case-by-case analysis, that it use economic analysis in its decisions, that it has the ultimate consumer as the relevant beneficiary and that it puts high weight on the interests of the (ultimate) consumer.

Theory suggests that the **scope of competition policy** should be broad and should apply to all markets, including those in which a public sector organisation is a participant. The exclusion of certain markets, either because their structure makes competition likely or because the competition agency does not wish to subject them to analysis, should be permitted.

Finally, the **institutions of competition policy** should be optimised. The competition agency should be funded adequately so as to reduce the burden of delay

and uncertainty on industry. It should be established in a manner that encourages effort and correct decisions and should have information acquisition powers. More generally, firms should be required to publish data. This would both encourage competition and facilitate the ongoing evaluation of competition policy.

The Competition Act, 1991 represents a substantial improvement on pre-existing policy. The Act, while welcome, has a number of shortcomings and the policy it implements is still in a learning and developmental stage. The proposal to give enforcement powers to the Authority represents a further improvement in competition policy and highlights the importance of continual assessment and modification in the development of competition policy which is credible and effective.

With regard to the criteria used in decision-making, it is clear that the decisions of the Competition Authority are based on economic analysis and results from microeconomic theory. It remains to be seen how robust these decisions will be on appeal to the High Court. Decisions by the High Court in this regard will be necessary both to establish the credibility or otherwise the Competition Authority's decisions and to determine the appropriateness of the criteria underlying them.

Several features of competition policy determine its scope. Firstly, the Act does not explicitly exempt any particular markets, and the Supreme Court has determined a broad definition of an undertaking which suggests that competition policy is applicable to most markets, including those for marketed public services. Secondly, the extent of the investigative and enforcement powers of the Authority determines the extent to which the Authority has discretion over the markets in which competition policy is focused. Thirdly, the level of resources devoted to the Authority acts as the main constraint on its activities and, as such, determines the scope of competition policy in practice.

It is important that the debate on competition policy focuses on these general issues. Competition policy offers the prospect of lower prices, higher output and greater employment in the long run. These potentially substantial collective benefits will only be obtained if the competition policy which emerges in Ireland is effective.

Footnotes

1. See OECD Ireland Survey and Fingleton (1993) *Competition Policy and the Irish Economy*, IBEC December 1993.
2. A recent study (Fitzpatrick J. and A. Somerville, *Competition* 1993, Vol. 2, Edition 2, pp. 54-55.) estimates the gain from competition policy at 1 per cent of GNP or £265 million.
3. The analogy with taxation reform is particularly apt in this context.
4. Buyers can also have market power (monopsony) with similar negative effects on welfare.
5. See McBarnett, D. and C. Whelan, "International Corporate Finance and the Challenge of Creative Compliance" in Fingleton J. (ed.) *The Internationalisation of Capital Markets and the Regulatory Response*, 1992, London, Graham and Trotman.
6. In the case of non-marketed public services, the same potential for inefficient monopoly and welfare-inferior outcomes exists, and hence the same need for efficiency enhancement arises. Actual competition cannot be introduced but other methods of increasing efficiency are in keeping with the rationale for competition policy, as with recent developments in efficiency in government in New Zealand.
7. The problem may still arise at the stage of framing the rules.
8. "If there is introduced into a general equilibrium system a constraint which prevents the attainment of one of the Paretian conditions, the other Paretian conditions, although still attainable, are, in general, no longer desirable", Lipsey, R. and K. Lancaster, "The General Theory of Second Best", *Review of Economic Studies*, 1956, Vol. 24, page 11. The "Paretian condition" is that price is equal to marginal cost (allocative inefficiency).
9. For a detailed analysis, see Fingleton, J., "Competition Policy and Employment: An Application to the Irish Economy", *Economic and Social Review*, Vol. 25, No. 1, October 1993, pp. 57-76.
10. For example, powerful public sector unions could absorb such benefits by suitable alteration of taxation. As the public sector is often an upstream market (e.g. electricity) this argument lends further support to the argument for the inclusion of the public sector within the aegis of competition policy.
11. Hysteresis refers to a ratchet effect whereby a negative shock increases unemployment but an equivalent positive shock does not reduce it by the same amount. If competition policy causes labour shedding, theory suggests that labour demand would be increased in other markets because of the lower prices charged. The stronger the hysteresis, the weaker is this argument.
12. A related issue is the (widely mis-understood and probably spurious) conflict between competition policy and industrial policy which seeks to build large firms to compete on international markets. If the good is traded, then the relevant market is international. If the firm produces many products and some are non-

traded, these non-traded markets could be subject to competition policy without hindering its position in the traded good market.

13. There is a potential Pareto improvement by which both the agency and firms could benefit which is prohibited. A suitable market mechanism is not obvious.
14. The 1987 Act brought areas such as banking and transport under the 1972 Act. By the end of 1990 there were 13 Restrictive Practices Orders covering 35 per cent of consumer expenditure and concerning practices such as predatory pricing and collusion.
15. Hogan notes that "the entire process took about two years, by which stage (a) the victims of this anti-competitive behaviour had probably been put out of business and (b) the wrong-doers had often long since moved onto uncompetitive behaviour of a hitherto unknown kind...". Hogan, G., "The Competition Act 1991" in Findlater, J., (ed.) *The New Competition Legislation,* 1992, Irish Centre for European Law, Dublin.
16. If so, then it is important that the High Court has a mechanism for economic analysis of these issues. Cooke, J., "The Competition Act and the Courts", IBEC *op. cit.* addresses these issues.
17. See Massey, P., "The Competition Act: An Economist's Perspective", in Schuster A., (ed.) *Key Aspects of Irish Competition Law and Practice* , 1994, Irish Centre for European Law, Dublin.
18. Supreme Court judgement (1992) 2I.R.319.
19. See Hogan, G. "The Competition Act 1991 and the Definition of an Undertaking" in Schuster *op. cit.*
20. See Lyons, P., "The Competition Act and the Authority's Work to Date" in IBEC *op.cit.*