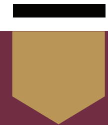
ESMT Competition Analysis

On the difficult relationship between competition policy and public enterprises

What can be learned from recent developments in the field of European state aid control?



The Swedish Competition Authority
The Pros and Cons Conference
Competition in/by the Public Sector

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Stockholm, 13 November 2009

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Public enterprises under European competition law

Some theoretical predictions: Properties of mixed oligopoly equilibria

Thought experiment: Applying state aid rules to public enterprises

Conclusions

Public enterprises under European competition law

- The Directorate General of the European Commission holds a dual position with respect to competition policy enforcement
  - On the one hand it enforces competition policy principles vis-à-vis firms
    - Article 81
    - Article 82
    - Merger Guidelines, etc.
  - On the other hand it oversees government interventions which have the potential to distort competition in the Community
    - Article 86
    - Article 87
- The dual role of the Commission becomes most transparent in the case of public enterprises
  - They are subject to direct enforcement of the competition policy principles in their role as an ‘undertaking’
  - And – in parallel – any measures of its shareholders, the government, is scrutinized under comparable principles

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Application of competition law to public firms in their role as an undertaking

- In general EC competition **law applies equally** to public enterprises and to private firms (Article 295 of the EC Treaty)
  - Commission has to apply competition law independently from the ownership status of the firm
- Public firm can escape competition policy enforcement only if it is not considered an ‘undertaking’
  - Competition laws apply to undertakings only
- In order to be an undertaking an entity must be **engaged in an economic activity**.
  - This is defined as “any activity consisting in offering goods and services on a given market”
  - Broad definition comprising also potential competition
  - An activity directly related to essential functions of the state is exempted from the application of competition law

An entity may be an ‘undertaking’ in certain circumstances but not in others as it is the particular activity and not the institutional body which defines its legal status

Article 87 (state aid)

- Article 87 regulates specific **interventions of the state** in favour of undertakings
- Two stage approach:
  - Establishment of **jurisdiction** (transfer of resources, economic advantage, distortion of competition, effect on trade)
  - Establishment of **compatibility**
    - As a conceptual framework for evaluating state aid measures, the EC Commission implemented a general balancing test consisting of three steps:
      - Does the state aid address a **market failure** or other objective of common interest?
      - Is the state aid **well targeted** (i.e. is the aid an appropriate instrument, does it provide an incentive effect and is it kept to the minimum necessary to achieve the effect)?
      - Are the **distortions of competition** due to state aid sufficiently limited
    - Is the **overall balance positive**?

→ The test balances the positive (steps 1 and 2) and negative (step 3) effects of state aid

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The refined economic approach to state aid - the total welfare standard

- **The total welfare standard**
  - The common element for exempting aid under Article 87(3) is that the aid is in the **common interest**
    - In economic terms 'common interest' encompasses the "welfare of all stakeholders and in particular on the welfare of the recipient, its competitors, consumers but also input suppliers (for instance labour)."
    - Two fundamental aspects:
      - **Efficiency** (efficiency objectives relate to situations where the market does not produce the outcome desirable from a total welfare perspective, that is state aid is required to **remedy a market failure**)
      - **Equity** (equity objectives relate to how welfare is distributed)
    - State aid analysis normally focuses on efficiency considerations only (disregarding the equity considerations)

In contrast, competition policy analysed under articles 81 and 82 normally applies the **consumer welfare standard**

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Application of competition law to state measures in favour of (public) firms

- Depending on circumstances, both an undertaking and the State can be found responsible for violations of competition law
  - When the potentially anticompetitive behaviour is due to an **autonomous decision** taken by the public firm, then articles 81 and 82 apply and the firm is responsible for the violation
  - If certain firm conduct of an undertaking is **forced by the binding state legislation**, the undertaking can escape liability by invoking the “state action defense”
    - In such cases the responsibility for the anticompetitive conduct is shifted to the state
    - Article 86(1) together with articles 81 and 82 prevents the states from imposing legislation that would lead to anticompetitive behaviour of regulated undertakings
  - If the anticompetitive behaviour is **induced** rather than imposed, both State and the undertaking may be found liable for violation of competition law

Exceptions to competition law reach

- In the context of state aid, public service obligations (**services of general economic interest**), subsidies given to a company providing the public service do not constitute state aid in the sense of Article 87(1) when specific conditions are met.
  - Interestingly, one of the criteria in certain circumstances requires direct comparison of efficiency of a private and a public enterprise
- **Exclusively social objectives** provide another escape for state-owned entities from competition laws
  - The concept of undertaking does not cover bodies that pursue an exclusively social objective
  - Somewhat "grey area"
    - Sometimes whether an undertaking operating in such a field engages in economic activity is dependent on the facts of the case

→ **European competition law provides closed legal framework to assessment of competitive conduct**

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Major differences between private and state-owned firms

- Differences in objectives: profit maximization vs. other objectives
  - Private firms are usually assumed to maximize their profits
  - What are the objectives of state-owned firms?
    - Welfare maximization?
    - Output maximization (subject to a budget constraint)?
    - Unemployment minimization?
- Incumbency
  - Advantages (e.g. access to cheaper financing, implicit government guarantees, cross-subsidies)
  - Disadvantages (e.g. lock-in in long term labour contracts that increase costs, legacy pension plans, etc.)
- Closer ties to the government
  - Ability to lobby politicians, influence over legislation and regulation
  - Captive government customers
- State-owned firms are often considered less efficient:
  - Less efficient production technology
  - For a given technology, inefficient mix of production inputs (e.g. overutilization of labour to decrease unemployment)
  - No credible takeover threats to improve efficiency

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Effects of mixed oligopolies on output and prices

- Regardless whether the objective function of a state-owned firm is welfare maximization, output maximization or employment maximization, in general it leads to the similar outcome
  - **Increased output**
  - **Lower prices**
- This effect is in general desirable, as firms in a private oligopoly with market power usually produce not enough output and charge too high prices
- It is however possible that state owned firm produces too much output and charges prices that are too low from the welfare maximization standpoint
  - Especially true with increasing marginal costs
    - State-owned firm with a zero-profit constraint may price at average cost rather than marginal cost, so total output may be larger than socially optimal
    - Industry cost allocation may be inefficient (state-owned firm producing output above optimal scale)

Effects of mixed oligopolies on industry structure, entry and exit

- The expanded output by the state-owned firm may have an impact on industry structure
- The crowding-out effect may cause some private competitors to exit
  - May be beneficial if there is an excessive entry
  - Results in increased concentration in the industry
  - Some results in the economic literature suggest that such indirect regulation of market structure more by more efficient than direct regulation (Brandão and Castro (2007))

Effects of mixed oligopolies in differentiated good markets

- In general in differentiated goods market firms try to differentiate as much as possible from their competitors, to reduce the effects of price competition
  - For example, in a Hotelling duopoly model, private firms choose extreme locations
  - This maximizes consumers' transportation costs
- In a presence of a state-owned firm, private firms may chooses more central location, which lowers the total transportation costs (Cremer et al. (1991))
- In general the theoretical results are inconclusive

Effects of mixed oligopolies on incentives to innovate

- Theory predicts that because of externalities state-owned firms generally have better incentives to invest in R&D than private firms
- For example, in the case of innovation leading to cost reductions:
  - With spillover effects invented cost reductions are easily duplicated by all firms and hence R&D investments do not substantially increase profits and private firms have limited incentives to invest in R&D
  - Without spillover effects, there is usually excessive R&D spending due to the duplication of effort (similar to excessive entry). In this case, R&D spending by a state-owned firm may reduce incentives to innovate by the private firms and hence reduce the inefficient duplication of effort

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How do mixed oligopolies arise?

- Liberalization of formerly state-owned monopolies
  - Example: telecommunications
  - Often such mixed oligopolies remain heavily regulated industries – need to consider relationship between regulation and competition policy
- State intervention in failing private firms, bailouts, nationalization
  - Examples: banking, car manufacturers
  - What are the long term consequences?
- State entry into a private market to stimulate competition
  - Example: local (municipal) broadband providers
  - Using public resources to subsidize entry
    - What is the market failure?
    - Why is entry by private firms not profitable?

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Analyzing public firms as a form of state intervention

- We consider a thought experiment by interpreting public firms as a form of state intervention and applying state aid test described earlier
  - Does the intervention address a market failure or other objectives of common interest?
  - Is the intervention well targeted (i.e. is it an appropriate instrument, does it provide an incentive effect and is it kept to the minimum necessary)?
  - Are the distortions of competition sufficiently limited so that the overall balance is positive?

Does the intervention address a market failure or other objectives of common interest?

Types of inefficiencies

- Market power: quantities are too low and prices are too high relative to social optimum
- Some markets are characterized by suboptimal number of firms, for example excessive entry may be a problem
- Cost allocation within the industry may not be suboptimal
- In differentiated markets private firm may provide suboptimal levels of product variety
- Private firms may have suboptimal incentives to innovate:
  - Insufficient (due to spillover effects)
  - Excessive (due to R&D races)

Possible effects of state involvement

- State owned enterprises may lead to increase in output and lower price
- The public firm may have an impact on industry structure, usually preventing entry, causing exits and increasing concentration
- Asymmetric allocation of output may be inefficient in decreasing economies of scale industries
- The crowding out-effect of a public enterprise will typically reduce product variety
- Involvement of public entities in research and development activities may be beneficial:
  - Internalizing spillover externalities
  - Reducing duplication of R&D costs

Theoretical literature on mixed oligopolies illustrates that in some circumstances public firms may address market failures (improve efficiency)

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Is the intervention well targeted and commensurate?

- In the field of public ownership it is in particular the question of whether public ownership is the appropriate instrument to reach the policy objective
  - Is public ownership an appropriate instrument, does it provide an incentive effect and is public intervention kept to the minimum necessary?
- Example: Public companies often operate in a partially (*ex ante*) regulated environment
  - Is the public firm a remedy to regulatory failures?
- Broadband Guidelines:
  - "Where the market does not provide sufficient broadband coverage or the access conditions are not adequate, state aid may play a useful role."
  - "In this respect, the Commission has noted in previous decisions that whilst ex ante regulation has in many cases facilitated broadband deployment in urban and more densely populated areas, it may not be a sufficient instrument to enable the supply of broadband service, especially in underserved areas where the inherent profitability of investment is low"

→ Justifying state aid by **regulatory failure** broadens the scope of state aid considerably

Provisions to assure the temporary scope of such kind of "double regulation" are required

Potential negative effects on competition and trade

- Several potential **theories of harm** have been identified, that are specific to the field of state aid. They include:
  - disrupting the dynamic incentives of undertakings and crowding out effects
  - supporting inefficient production
  - exclusionary practices and enhancing market power
  - effects on the localization of economic activities across Member States
- Only one of the four potential distortions directly addresses market power related concerns
- The focus on production efficiencies brings efficiency considerations much more in the centre of the competitive assessment than it is true for other areas of competition policy

This will require complementary skills to be developed within the competition authorities

Is the overall balance positive?

Pros:

- The state should be intervening only when it believes that private enterprises are not serving the market, i.e. if there is market failure
- State intervention may be necessary to provide infrastructure, that the private market fails to provide
- The state is more oriented toward consumer and social (total) welfare than is the private sector
- State initiatives can be an important economic stimulus for the community
- State-involvement may generate additional revenues for communities

Cons:

- State involvement initiatives can undermine general EU competition policy
- Advantages of state-owned firms may cause market distortions
- Shift of risks from investors to taxpayers: from a financial perspective, state involvement has often frequently fallen short of projections and over budget requiring subsidies later
- The interaction with ex ante regulation is delicate (should the state intervene directly to correct regulatory failure rather than market failure?)
- Conflict of interest: in regulated mixed oligopoly markets, it may not be appropriate to have the regulator (the state) compete with the entities that it regulates

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- First, a **consumer welfare standard** - applied in most jurisdictions in the field of competition policy - may require adaptation to remain useful when applied to public firms. A thorough assessment of public firms under a **total welfare standard** is therefore welcomed.
- Second, the question of whether the 'public firm' as a regulatory instrument is the **best regulatory instrument available** for reaching the policy goal shall be assessed carefully. In case of an existing regulatory body, i.e. existence of sector specific regulation, intervention by state subsidized competition seems inferior and requires strong justifications.
- Finally, **specific theories of harm** exist in the field of state interventions which are not typical under a traditional competition policy perspective, e.g. its strong focus on crowding-out effects, concerns of keeping inefficient market structures alive or distorting dynamic incentives. Reviewing a case from that perspective might provide additional insights.

Thank you!

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