

Competition Policy

George Symeonidis
University of Essex

The main objective of competition policy is to improve market efficiency by promoting or safeguarding competition between firms, and thus to minimise the resource misallocation effects of the exercise of market power. Economists usually distinguish between competition policy and regulation – with the latter referring to more direct government intervention in circumstances where effective competition is difficult or impossible because firms possess a lot of market power and are likely to abuse it.

High market concentration has traditionally been seen as a cause of concern, since it has been thought to facilitate the abuse of market power by firms. However, higher concentration need not be associated with less price competition and lower welfare. The opposite may sometimes be the case, as more intense competition reduces profit margins and the number of firms that can survive in an industry. So competition authorities should probably be less concerned with concentration than with ensuring that competition between firms is “effective”, i.e., firms do not collude or otherwise abuse their market power and there are no barriers to entry.

Design and implementation of competition policy

There are several difficulties with the design and implementation of competition policy:

- Firm conduct which may improve one aspect of market efficiency may also worsen another. For example, a horizontal merger between two firms may result in higher prices, but it may also lead to lower current costs or lower future costs or better products.
- In many cases, the effect of a particular business practice on efficiency may not be unambiguous in general. Examples of such practices are price discrimination, exclusive dealing agreements between manufacturers and retailers, and so on.
- Some practices, such as tacit collusion or predatory pricing, are difficult to detect, thus making the implementation of policy difficult even in cases where the welfare implications of firm conduct are relatively unambiguous.
- It is not always easy to know what degree of market power is acceptable in a particular industry, given the technological and other constraints faced by firms in the industry. Some degree of market power is necessary under conditions of increasing returns to scale, so that firms can cover their fixed costs, including investment and research costs. Moreover, a firm may possess market power because it is efficient or innovative, which surely cannot be bad in itself.
- Assessing the market power of firms (or the change in market power which has been or may be brought about by a certain action of the firms) may be complicated because of difficulties in defining the relevant product or geographical market, the

absence of precise information on firms' costs and perhaps also on demand parameters, and the need to take into account market dynamics that may influence the extent to which market power is likely to persist in time.

- The efficiency goal has not been the only objective of competition policy in practice. Other objectives may include the protection of small firms, the dispersion of economic power, and the maximisation of consumer welfare (as opposed to efficiency).
- Conflicts may also arise between competition policy and other government policies, such as industrial or trade policy. For instance, competition policy may clash with a policy of supporting the creation of strong domestic firms that are able to compete with foreign firms in some sectors.

Merger policy

Competition authorities can influence market structure in particular industries by preventing certain mergers between firms from taking place. The rationale for merger policy is that a consequence of many mergers is the creation of significant additional market power. In the case of horizontal mergers, the primary concern is the rise in market share. In the case of vertical mergers, the primary concern is the possibility that vertical integration hinders the access of non-integrated firms to outlets or sources of supply.

Even when a merger creates significant market power, it can have countervailing benefits, such as current or future efficiency gains. The merger may therefore be allowed despite its effect on competition. This can be justified if the merger is thought to result in lower costs, better management, improved R&D capabilities, or some other efficiency gain. Moreover, mergers may often be made necessary by exogenous changes in market conditions, such as competitive pressures due to economic integration. A merger may be allowed if it can be shown that one of the firms will otherwise go out of business.

Policy toward restrictive practices

Explicit or tacit agreements between firms to fix prices or to allocate customers or geographical areas are generally considered as detrimental for competition and are therefore prohibited in most competition laws. There are some exceptions, the most important of which concerns agreements to cooperate in research. The major difficulty regarding horizontal restrictive practices is detection. It is not easy to distinguish between collusive and non-collusive behaviour on the basis of the information typically available to competition authorities. For instance, parallel pricing, i.e. the similarity of prices and price changes, is not sufficient for concluding that collusion exists. The exchange of information on prices, costs, etc. between firms may facilitate collusion, but it may also improve the knowledge of market conditions and thus promote competition.

Policy toward the abuse of a dominant position

Competition authorities are not so much worried by the mere existence of market power as by the possibility that market power is used in a way that eliminates, restricts or distorts competition. Business practices that may constitute abuses of market power include 'excessive' prices, strategies that deter entry or expansion of

rivals, price discrimination, tying, predatory pricing, and vertical restraints. Some of these practices, such as price discrimination or vertical restraints, can have ambiguous welfare effects. Others, such as introducing new products or building capacity in anticipation of a rise in demand, can be legitimate competitive actions even if they also deter entry. And still others, such as predatory pricing, are definitely welfare-reducing, but are also difficult to detect. Most competition laws therefore recognise the need for detailed investigations on a case-by-case basis when it comes to assessing whether a firm or group of firms have abused their market power.

Further reading

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