The Economics of European Integration

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Chapter 11

Competition Policy & State Aid

EU's role

- Exclusive competency of EU; Commission controls.
- 2 aspects: mergers & anti-competitive behaviour.
- Look at justification for putting competition policy at the EU level.
  - Spillovers (negative effects of one Member's subsidies on other Members' industry).
  - Need belief in 'fair play' if integration is to maintain its political support.
    - Witness recent 'protectionist' tendency of Member States to prevent foreign takeovers.

Recall: Economic Logic

- Integration: no-trade-to-free-trade: BE curve shifts out (to point 1).
- Defragmentation:
  - PRE typical firm has 100% sales at home, 0% abroad; POST: 50-50 .
  - Can't see in diagram.
- Pro-competitive effect:
  - Equilibrium moves from E' to A: Firms losing money (below BE),
  - Pro-competitive effect = markup falls,
  - short-run price impact p' to p^A.
- Industrial Restructuring"
  - A to E",
  - number of firms, 2n' to n",
  - firms enlarge market shares and output,
  - More efficient firms, AC falls from p' to p",
  - mark-up rises,
  - profitability is restored.
- Result:
  - bigger, fewer, more efficient firms facing more effective competition.
- Welfare: gain is "C".

Competition & State aid (subsidies)

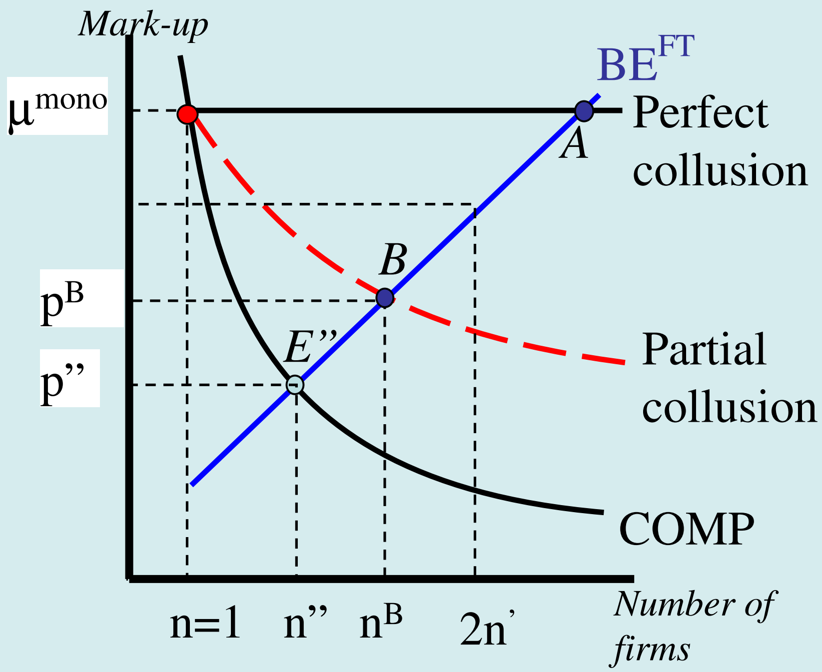
- 2 immediate questions
  - "As the number of firms falls, isn't there a tendency for the remaining firms to collude in order to keep prices high?"
  - "Since industrial restructuring can be politically painful, isn't there a danger that governments will try to keep money-losing firms in business via subsidies and other policies?"
- The answer to both questions is "Yes".
- Turn first to the economics of subsidies and EU's policy

Anti-competitive behaviour

- Collusion is a real concern in Europe.
  - dangers of collusion rise as the number of firms falls.
- Collusion in the BE-COMP diagram.
  - COMP curve is for ‘normal’, non-collusive competition
  - Firms do not coordinate prices or sales.
- Other extreme is ‘perfect collusion’.
  - Firms coordinate prices and sales perfectly.
  - Max profit from market is monopoly price & sales.
  - Perfect collusion is where firms charge monopoly price and split the sales among themselves.

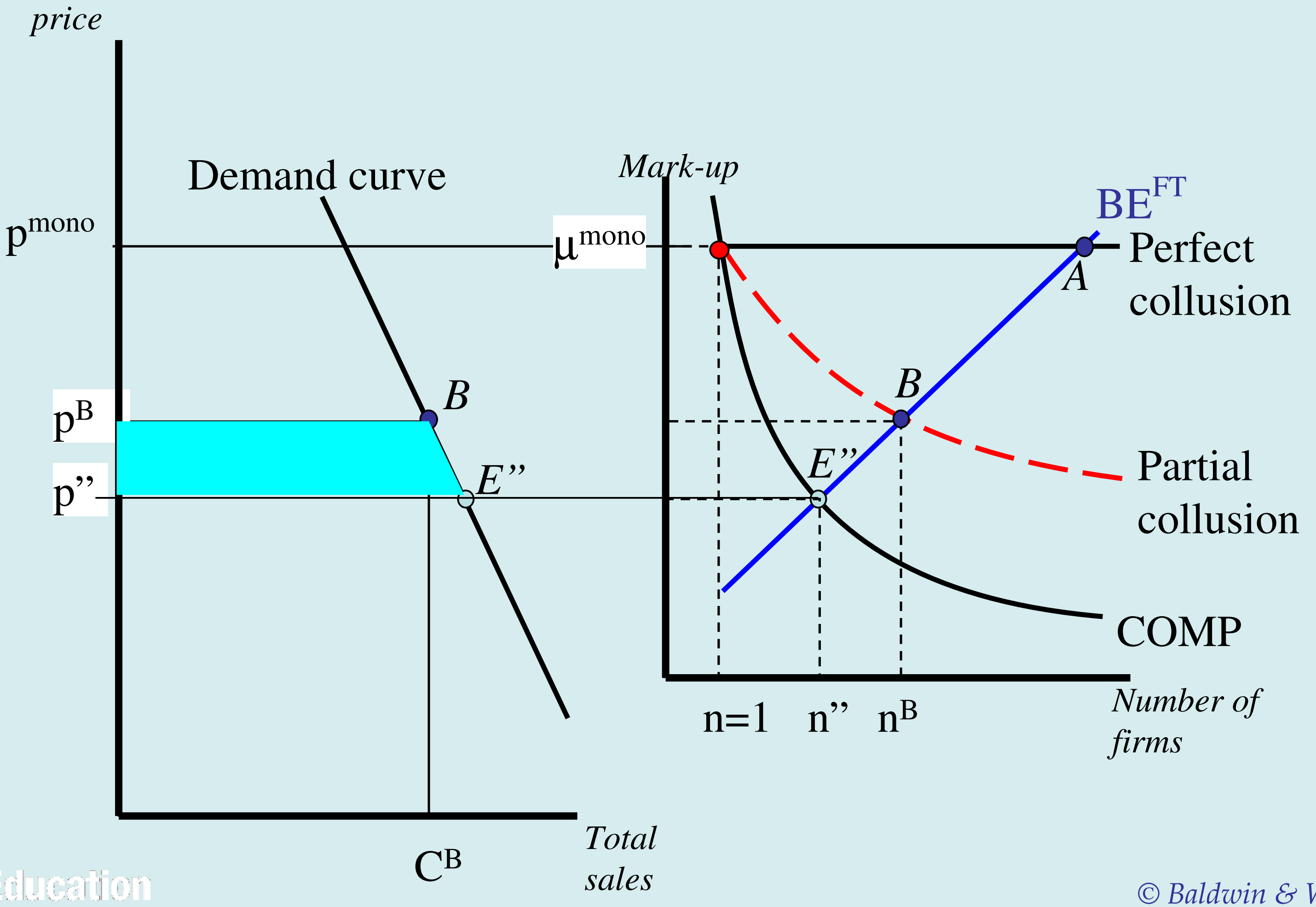
Economic effects

- Collusion will not in the end raise firm's profits to above-normal levels.
  - 2n' is too high for all firms to break even.
  - Industrial consolidation proceeds as usual, but only to n^B. Point B Zero profits earned by all.
- prices higher, $p^B > p''$, smaller firms, higher average cost.



Economic effects

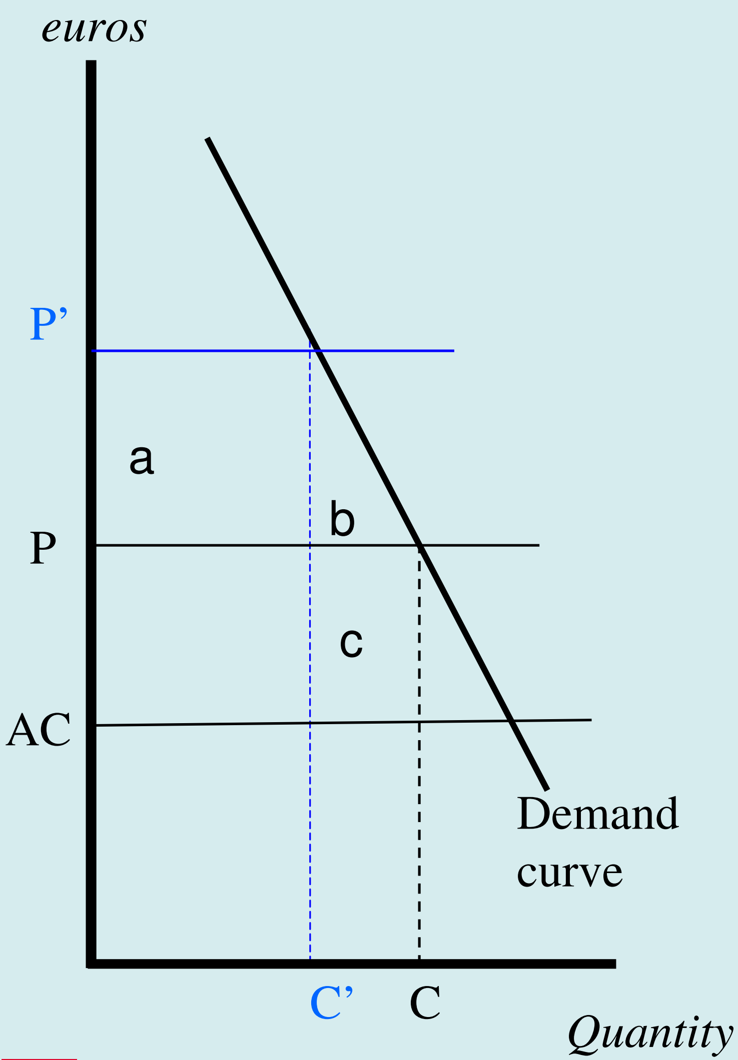
- The welfare cost of collusion (versus no collusion).
  - four-sided area marked by p^B, p", E" and B.



EU Competition Policy

- To prevent anti-competitive behavior, EU policy focuses on two main axes:
- Antitrust and cartels. The Commission tries:
  - to eliminate behaviours that restrict competition (e.g. price-fixing arrangements and cartels),
  - to eliminate abusive behaviour by firms that have a dominant position.
- Merger control. The Commission seeks:
  - to block mergers that would create firms that would dominate the market.

Economics of cartels



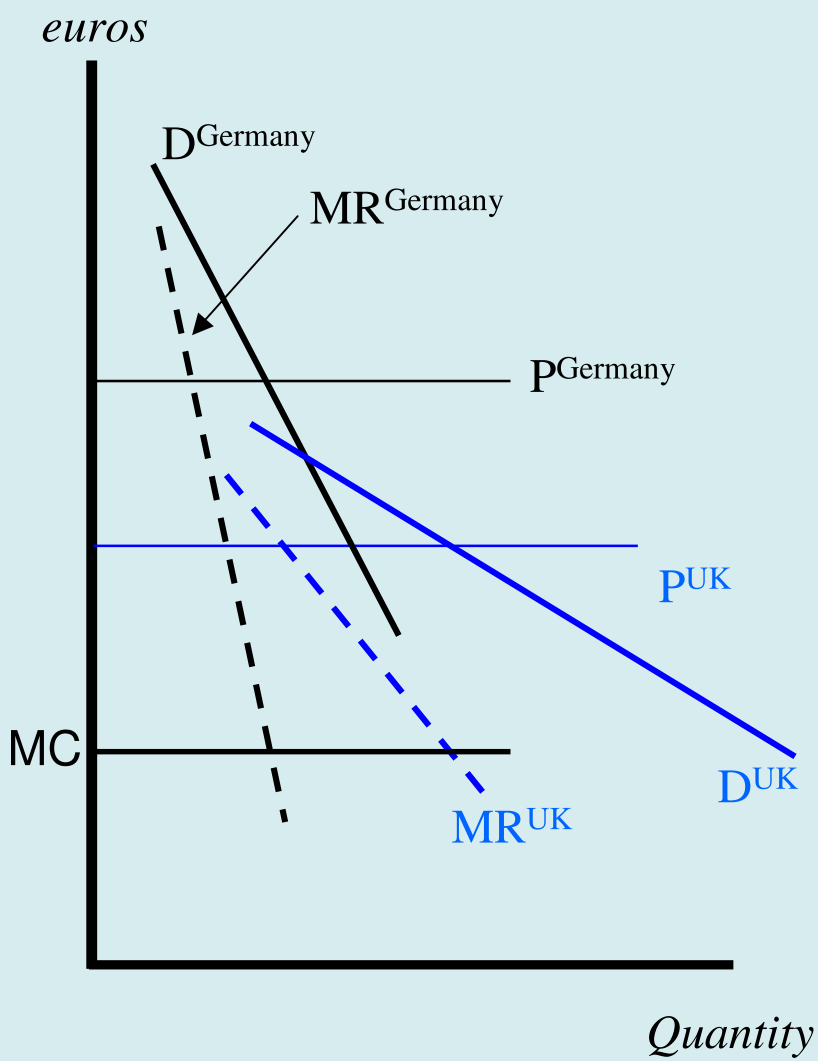
- Suppose price without cartel would be P.
- Cartel raises price to P'.
- ΔCS=-a-b; 'ripoff'
- ΔPS=+a-c
- Net welfare = -b-c ; "technical inefficiency"

The vitamin cartels (Box 11-1)

- In 2001, Commission fined 8 companies for vitamins cartels
  - vitamins A, E, B1, B2, B5, B6, C, D3, Biotin, Folic acid, Beta Carotene and carotinoids
- The European vitamins market is worth almost a billion euros a year.
- The firms fixed prices, allocated sales quotas, agreed on and implemented price increases and issued price announcements in according to agreed procedures.
- They set up a mechanism to monitor and enforce their agreements and participated in regular meetings to implement their plans.
  - Formal structure with senior managers to ensure the functioning of the cartels: the exchange of sales values, volumes of sales and pricing information on a quarterly or monthly basis at regular meetings, and the preparation, agreement and implementation and monitoring of an annual "budget" followed by the adjustment of actual sales achieved so as to comply with the quotas allocated.
- Hoffman-La Roche of Switzerland (cartel ringleader) received the largest fine (462m euros); BASF and Merck (Germany), Aventis SA (France), Solvay Pharmaceuticals (the Netherlands), Daiichi Pharmaceutical, Esai and Takeda Chemical Industries (Japan).

Exclusive territories

- More common anti-competitive practice is 'exclusive territories'.
- Nintendo example; high prices in Germany vs UK.
  - Germany's inelastic demand meant Nintendo wanted to charge a higher price than in UK.
  - Normally Single Market limits this sort of price discrimination (arbitrage by firms).
- Nintendo implemented a system that prevented arbitrage within the EU (illegal).
  - European Commission fined Nintendo and the 7 distributors 168 million euros.



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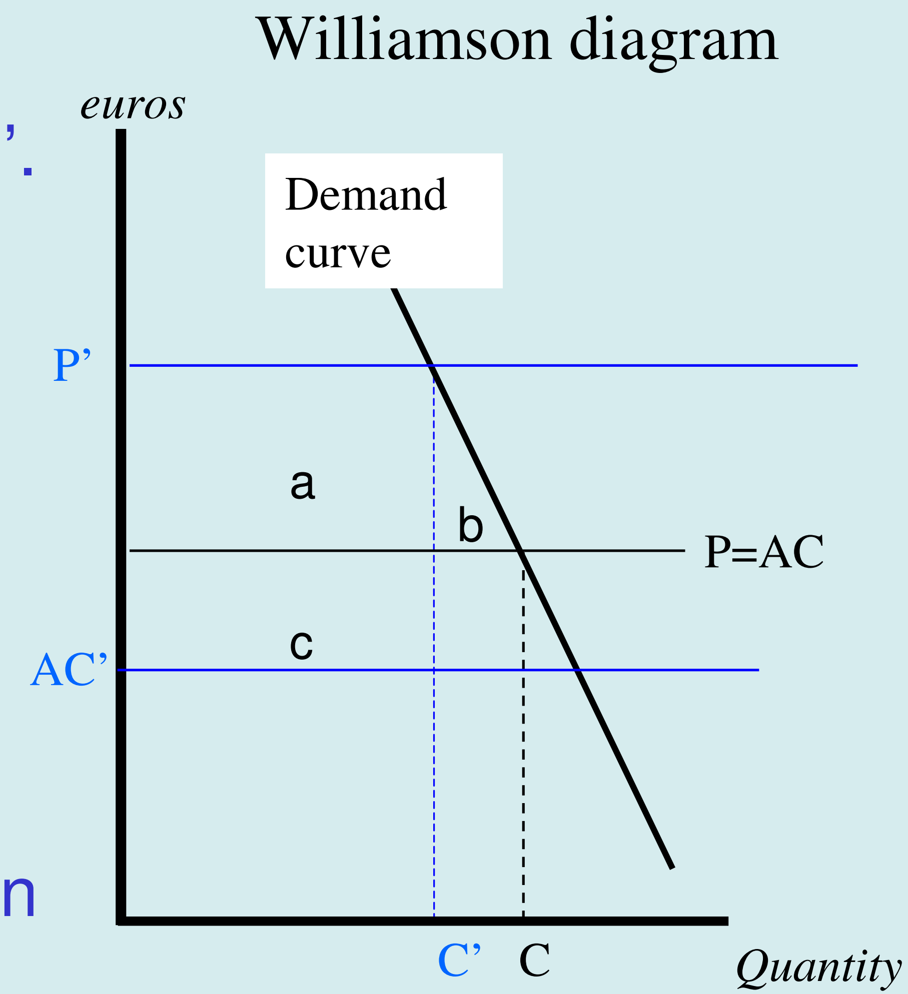
Abuse of dominant position

- Firms that are lucky or possess excellent products can establish very strong positions in their market.
- Not a problem, per se:
  - position may reflect superior products and/or efficiency,
  - e.g. Google's triumph.
- However dominance may tempt firm to extract extra profits from suppliers or customers.
- Or arrange the market to shield itself from future competitors.
- Illegal under EU law 'abuse of dominant position.'
- e.g. Microsoft with media software:
  - Charge high price of Word, etc. where the competition has been driven out of biz (WordPerfect, etc.), but give for free all software where there is still competition.

Merger control

- Initially P=AC.
- Merger implies lower AC to AC', but raises the price to P'.
- ΔCS=-a-b; 'ripoff'.
- ΔPS=+a+c.
- Net welfare = -b+c ; ambiguous, 'efficiency defence'.
- Laissez-faire (in US and increasingly in EU); if free entry then eventually P driven down to AC'.
  - As in BE-COMP diagram.



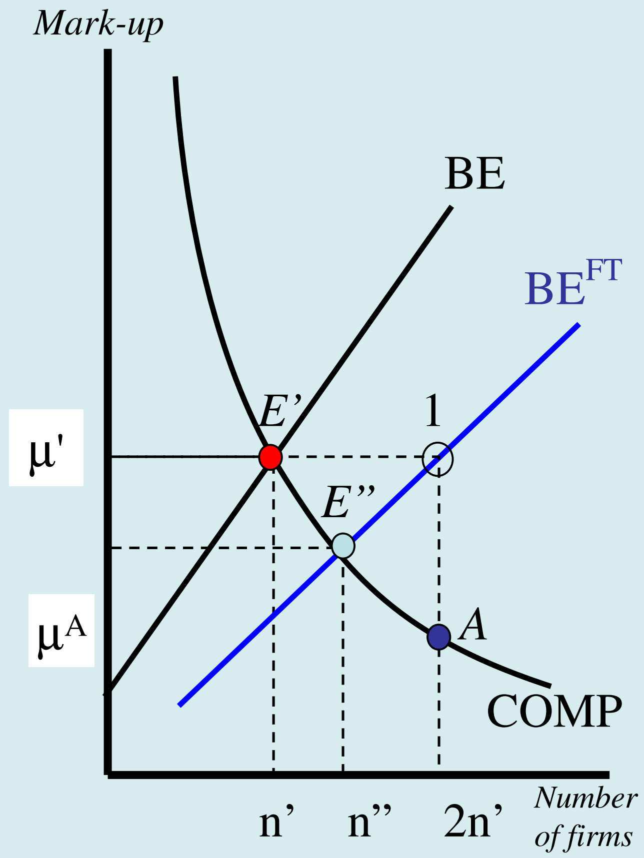
State aid economics

Look at two cases:

- Restructuring prevention.
- Unfair competition.

Restructuring prevention

- Consider subsidies that prevent restructuring.
- Specifically, each government makes annual payments to all firms exactly equal to their losses:
  - i.e. all 2n’ firms in Figure 6-9 analysis break even, but not new firms.
  - Economy stays at point A.
- This changes who pays for the inefficiently small firms from consumers to taxpayers.



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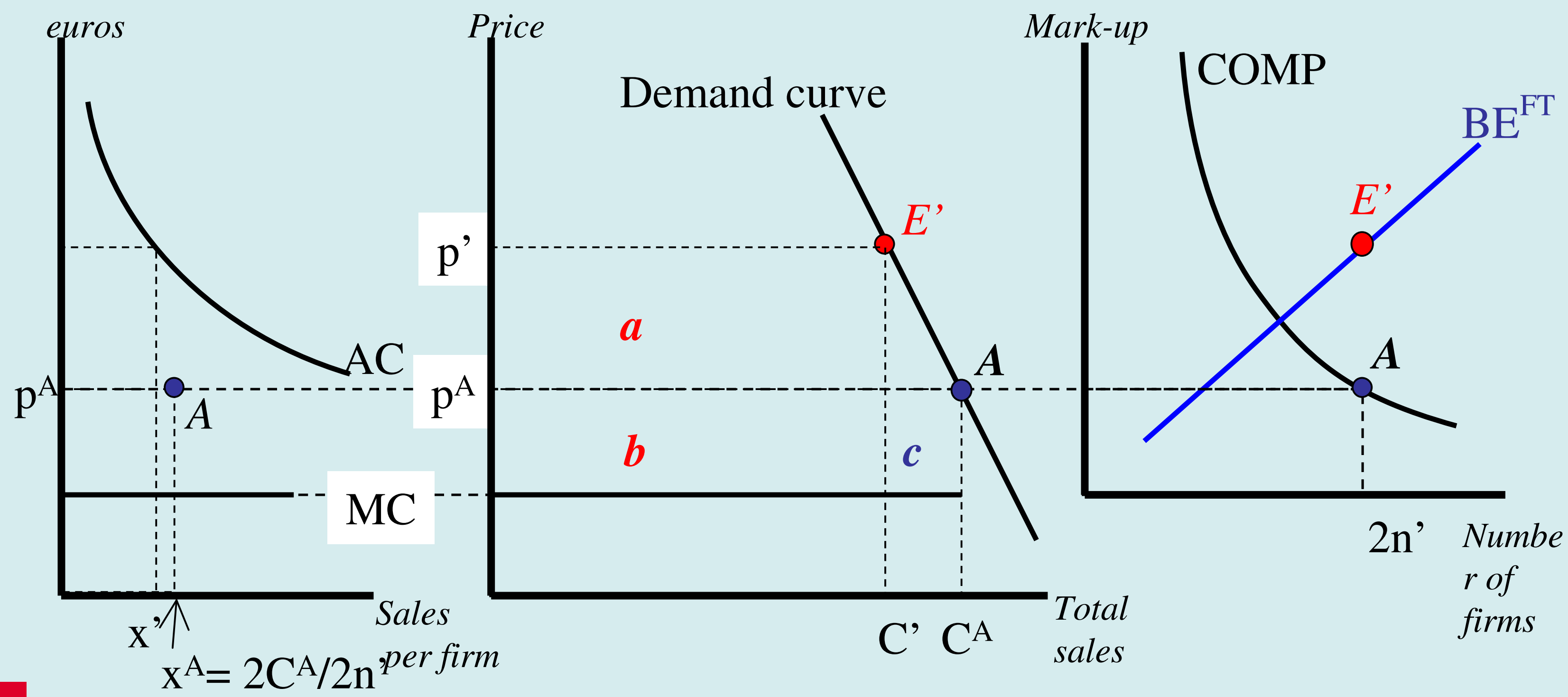
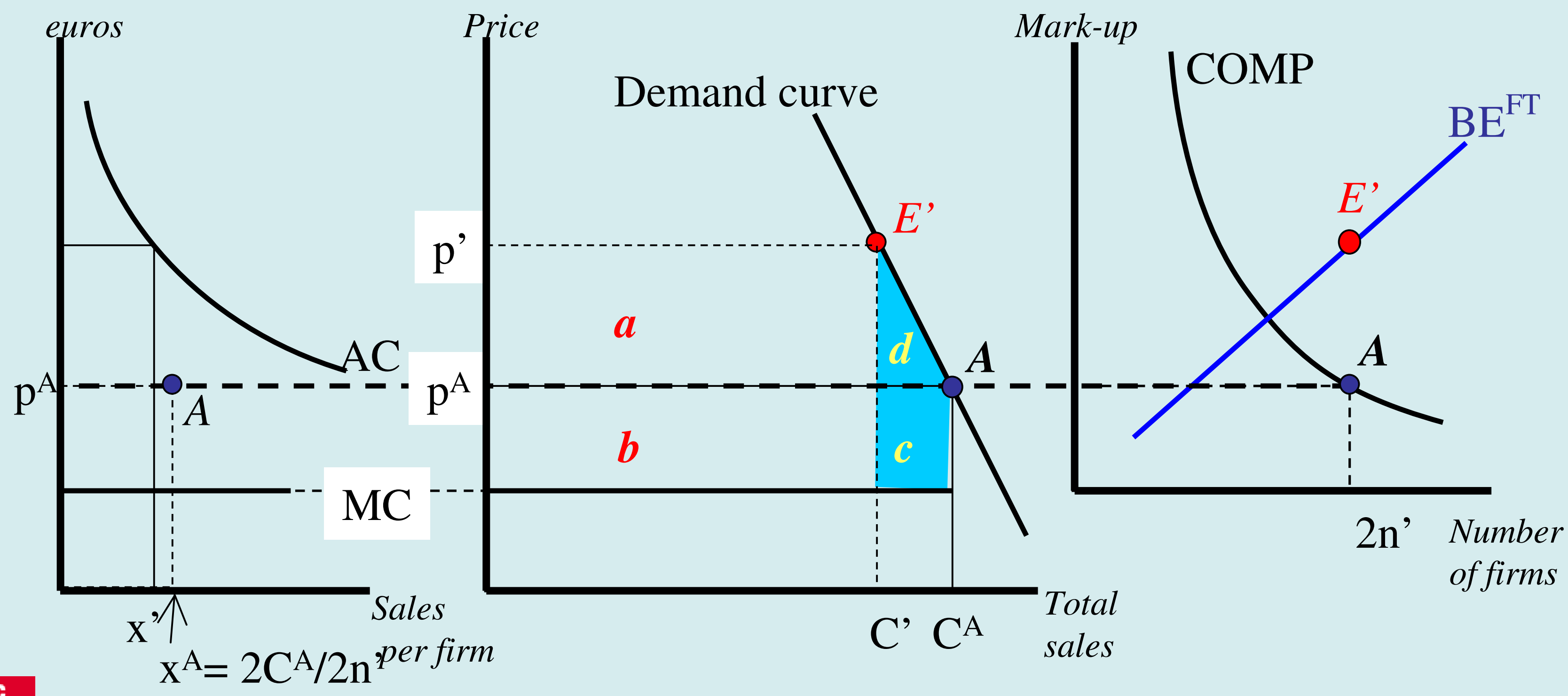
Restructuring prevention: size of subsidy

- Pre-integration:
  - fixed costs = operating profit = area "*a+b*".
- Post-integration: operating profit = *b+c.*
- ERGO: Breakeven subsidy = *a-c* .
  - NB: b+c+a-c=a+b.



Restructuring prevention: welfare impact

- Change producer surplus = zero (profit is zero pre & post).
- Change consumer surplus = a+d.
- Subsidy cost = a-c.
- Total impact = d+c.



Only some subsidise: unfair competition

- If Foreign pays ‘break even’ subsidies to its firms,
- All restructuring forced on Home,
- 2n’ moves to n”, but all the exit is by Home firms.
- Unfair.
- Undermines political support for liberalisation.

EU policies on 'State Aids'

- 1957 Treaty of Rome bans state aid that provides firms with an unfair advantage and thus distorts competition.
- EU founders considered this so important that they empowered the Commission with enforcement.