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COMPETITION POLICY, INDUSTRIAL POLICY AND NATIONAL CHAMPIONS

Contribution from Norway

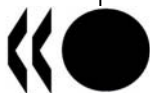
-- Session I --

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COMPETITION POLICY, INDUSTRIAL POLICY AND NATIONAL CHAMPIONS

--Norway--

1. Introduction

1. During the last decades we have witnessed increased globalisation of the world's economy. Trade barriers have been broken down and enabled us to exploit huge benefits from increased competition and international trade. Important progress has also been made in international coordination and harmonisation of competition rules and practices, although much work remains in this area.

2. Recently the international financial crisis poses a serious threat to this positive development, at least in the short run. The danger is now that the current crisis will bring this positive trend to a halt and induce world economies to be more protective, at least in the short run. Instead of focusing on the long term benefits from competition and international trade in a globalised economy, many fear that world leaders will focus on short-term national interest and the protection of local industries and labour markets.

3. The long term consequences of the current crisis may still be many. First we run the risk of increased general mistrust of market based solutions, which in turn also may influence competition policy. Second, we may experience that public interference in free markets may become more acceptable. We have seen many and large rescue packages for the banking sector which for the most part are sensible, but the danger is that also other industries would be covered by this. This could lead to a phase of state aid race where national governments seek to improve the competitiveness of local industry by granting them subsidies. We clearly see such tendencies within the car industry world wide. Moreover, efforts toward international convergence of competition policy may experience a setback, not only in the US-EU relations but also when it comes to implementing modern competition policy in emerging economies such as China and India.

4. There is also a danger of politicising competition policy which would mean a setback for effects-based and bureaucratic competition enforcement. Examples of this are already starting to pop up worldwide, and the danger is that this tendency will continue. The lifting of normal merger control for the Lloyds TSB takeover of HBOS in the UK may serve a case in point. In this case the OFT found serious competition concerns with the proposed takeover and referenced the case to the Competition Commission. However, in late October 2008 the UK Secretary of State cleared the merger without reference to the Competition Commission.

5. Finally, national states may be tempted to promote national champions to alleviate short run economic problems, even in the absence of market failure.

6. Event though the current financial crisis may involve a temporary setback to globalisation and increased international competition, it is hard to imagine that this will be a permanent trend. After all, the crisis is largely due to improper regulation of the financial sector and unwise policies, and not too much competition. When the current crisis blows over, the efforts to globalise markets will continue. The question then is whether promoting national champions to counter this short run crisis, is a good long run solution.

7. The national champion debate is also inherently linked to industrial policy (see Seabright, 2005; Falck and Heblich, 2007). One way to define industrial policy is (Foreman-Peck (2006): "state intervention that affects, or is intended to affect, industry but not other economic activities directly." The rationale for industrial policy is normally perceived as to correct market failures. One of the central elements of the EU's Lisbon Strategy is "... to make EU the most competitive and dynamic knowledge-based economic

region of the world.” One way to fulfil this goal is to promote European or national champions through industrial policy.

8. National champions can be categorised with at least four different types (Cohen, 1995; Falck and Heblich, 2007): Chicks, lame ducks, big project firms and strong firms. Strong firms are the real champions: competitive and technologically advanced firms. Lame ducks are lagging behind in technology and competitiveness, while big-project firms operate in strategic fields targeted by local governments.

9. There is strong evidence that radical innovations are more frequently introduced by new firms rather than incumbents (Audretsch, 1995). Hence, industrial policy targeting high-tech chicks (infant industries) should promote diversity and small and medium sized industries to promote experimentation and variety. Hence a national champion policy towards chicks is almost deemed to fail. Lame ducks are found in non-competitive environments and declining industries, historically protected from international competition. Optimal industrial policy towards these firms often is to allow them to die and to support the process of structural change.

10. Big-project firms are in many respects similar to lame ducks, but the need to support these firms is not found in poor economics performance or market failure. Instead the justification is strategic and firms from the energy or military sector are often involved. Hence, in fact the only scope for industrial policy should be to promote the real champions, i.e. firms that operate on or close to the technological frontier that has the potential to be highly competitive on the world market. The question is whether these firms are an industrial policy issue?

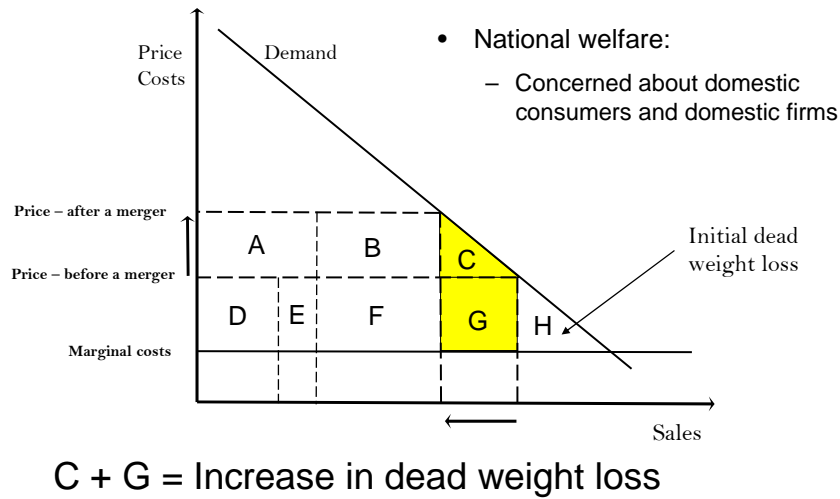
11. The current financial crisis may tempt policy makers to promote national champions as a short run remedy even in the absence of market failure. This could for instance be done by introducing lax merger control. The question is whether lax competition policy is a good long term solution to the current crisis. The next section explores some theoretical arguments for creating national champions though lenient merger control.

2. A theory of national champions

12. The basic question explored in this section is the effects of lenient merger control to promote a national champion. I will illustrate the theoretical effects by constructing a very simple example which I will gradually make more complex and realistic. The main ingredients of the examples will be some merging firms and some firms that are outsiders to the merger. I will distinguish a situation with a closed economy, which can be thought of as the financial crisis, where all relevant firms are domestic. This will be contrasted with a second scenario with an open economy where some firms are owned by foreigners. The latter can be thought of as a more globalised economy. The focus will be on how any proposed merger will affect national welfare in the two settings, i.e. we are concerned about both domestic consumers and domestic firms' profits.

13. To make it really simple, consider first a national market with three symmetric firms with constant marginal costs in an industry. The market is characterised by some form of imperfect competition. The economy is closed and all firms are owned nationally. Then consider a proposed merger between two of the firms involving no cost savings. The standard effect of the merger will be a price increase followed by an increase in the dead weight loss. This can be illustrated as in Figure 1 below.

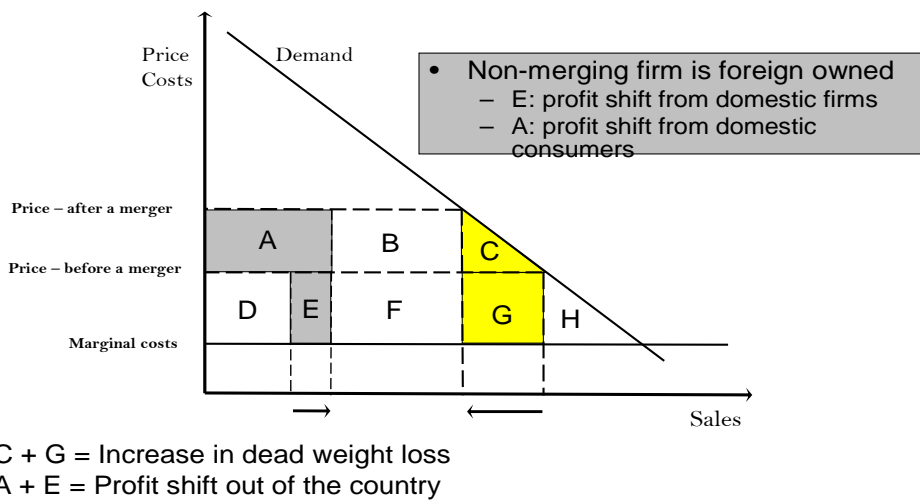
Figure 1. Effects from a national merger in a closed economy



14. Before the merger the joint profit of all three firms is $D + E + F + G$. After the merger the joint profit is $A + B + D + E + F$. Hence, the increase in profit is $A + B - G$. Consumers have lost $A + B + C$ due to increased price. Hence, the loss to society from the merger is $C + G$.

15. Then consider a similar merger in an open economy. Recall that now (the outsider) is a foreign-owned firm. This situation is illustrated in Figure 2.

Figure 2. Effects from a national merger in an open economy



16. We see that the consequence for consumers is the same; the price increases by the same amount as before. The joint profit is also the same, but now some of the profit ends up with the foreign firm. Area E in the figure is the profit shift from the domestic to the foreign firm. When the merging firms contract their joint output, the outsider (foreign firm) will expand output and earn more profit. In addition, some of the reduced consumer surplus is now transferred out of the country as profit to the foreign firm. This is illustrated by area A in the figure. Thus, the loss in national surplus from the merger is now $C + G$ (the dead weight loss) plus $A + E$, where the latter stems from the fact that the outsider to the merger is a foreign owned firm.

17. The lesson we can learn from this simple example is that a merger between domestic firms to create a national champion is generally detrimental to national welfare, and more so in an open economy where outsiders may be foreign firms. Hence, from a national perspective we should be more sceptical to national mergers in open economies than in closed economies.

18. Clearly, this is a very simple example and we need to develop this further. An obvious objection is that if the merger involves substantial cost synergies the result may differ. However, this depends largely on the nature of the cost savings involved with the merger. If the savings are predominantly fixed costs – for instance due to savings of a head quarter – there will still be a price increase and a profit loss out of the country as in our first example. On the other hand, if the savings are made in variable costs, we might experience a price decrease following the merger. However, in order to achieve a price decrease, the savings in variable costs have to be quite substantial. Moreover, the profit loss out of the country still counts negative for the national surplus even in this case. There is no clear evidence of substantial and systematic cost reductions from mergers. For instance, in the banking industry there are studies suggesting that economies of scale are exhausted for quite small operations. The implication for merger policy is that claims about cost savings should be met with sound scepticism unless they are backed by convincing documentation. Also, one should focus on savings in variable costs more than fixed cost savings.

19. Another potential objection is that the domestic market may be a part of a larger international market. One example is the common Nordic spot market for electricity. Can this be an argument for being more lenient towards domestic price-increasing mergers? Clearly, if the country is a net importer of electricity, the answer is clearly no. However, if the opposite is true – i.e. the country is a net exporter; domestic welfare might increase even with a price-increasing merger. The reason is of course that the increase in profit for national firms from exports may outweigh the negative impact domestically. In the Nordic electricity market Norway is on average a net exporter, but this is about to disappear. This means that nationally it can be beneficial to allow domestic mergers, especially if the price-cost margin is very low at the outset. However, it is clear that consumers will always lose from a price-increasing merger. With a consumer standard for evaluating mergers, this can never be beneficial. Moreover, allowing mergers for this reason will be a beggar-thy-neighbour policy, and other countries may be tempted to do the same. The result would be a prisoners' dilemma where all countries are worse off compared to the situation where no countries pursued such a policy. This illuminates the need for supranational competition policy where all national states coordinate their policies.

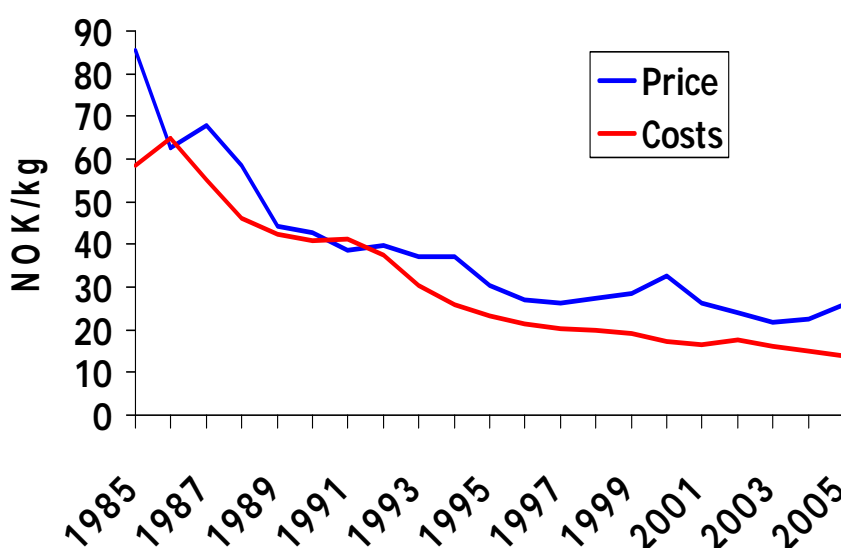
20. Yet another scenario is that a merger between two domestic firms may be a move to prevent a takeover from a foreign firm. If we allow such an international merger we must recall that the outsider will be a domestic firm. The profit shift will be as above, but this time into the country. A question that arises is whether the cost savings are larger or smaller with an international merger than with a domestic merger. There are at least two reasons why an international merger may induce more costs savings. First the domestic firm may get access to knowledge and more efficient technology from the multinational firm. Second, an international merger may lower wages as some competition may be induced between trade unions in different countries, as the merged firm may threaten to move production from one country to

another. Therefore the price increase following an international merger may very well be smaller than the price increase from a domestic merger.

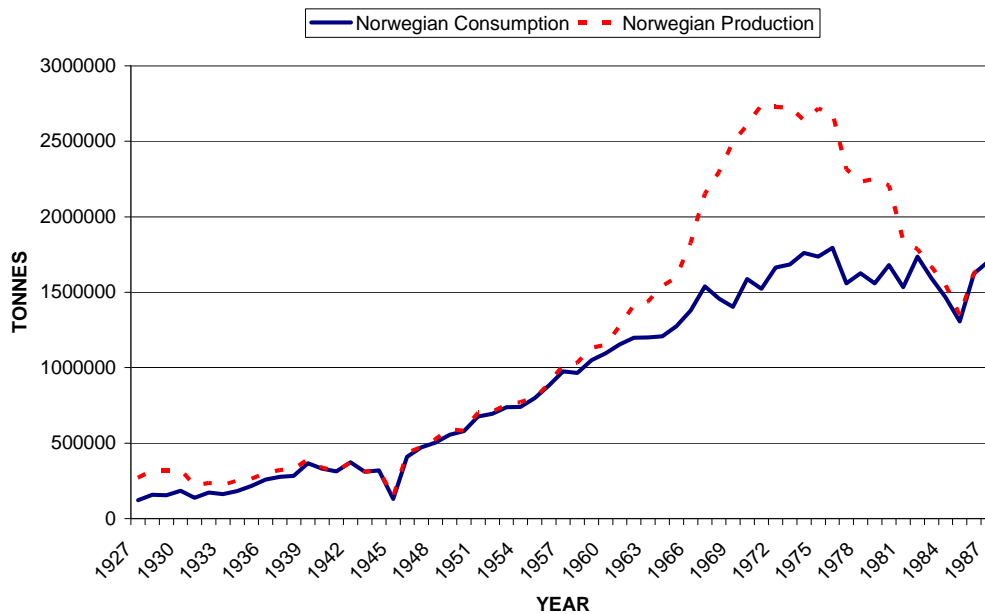
2.1. Examples

21. Two examples from the Norwegian market might help illustrate the point above. In the Norwegian industry for farmed salmon the government imposed a restriction on ownership and thereby prevented the development of a national champion. In spite of this the Norwegian salmon industry has experienced a considerable international success. Between 1990 and 2001 the sales of Norwegian salmon tripled and costs and prices dropped substantially over the same period. This development is illustrated in Figure 3 below.

Figure 3. Prices and costs for Norwegian farmed salmon 1985-2006



22. A different example is the rather sad story of the Norwegian cement industry. For a long time, this industry escaped antitrust scrutiny which enabled the industry to sustain a national price cartel from 1923 to 1967. The cartel was set up in a way that the market shares for the different producers were distributed according to each producer’s share of total capacity. To no one’s surprise, this setup induced the firms to overinvest in capacity, which the firms did especially after World War II. This of course led to huge costs and the price that could be obtained on international markets did not cover the costs associated with the expansion in capacity. Figure 4 below depicts domestic production relative to Norwegian consumption of cement.

Figure 4. Domestic production and consumption of cement 1927-1988

3. Conclusion

23. Industrial policy to promote national champions should be motivated and based on the existence of a market failure. However, absent market failures, policy makers may still be tempted to promote national champions for a variety of reasons. The current financial crisis is one reason why policy makers may be extra tempted to promote national champions. The financial crisis will pass, and then the process of globalisation will continue. Hence, the question is whether promotion of national champions to solve a short term problem is a good long term solution.

24. Globalisation in the long run involves increased international competition, but also increased competition for acquisitions. The question then is whether policy makers should help their national champions by introducing lenient competition policy to allow already large domestic firms to grow even larger? In the same vein, should national policy makers try to avoid foreign acquisitions of national champions?

25. As I have illustrated through theory and examples there is scant evidence that a policy of promoting national champions will be beneficial for national welfare even in the short run, and much less so in the long run. On the contrary, one might argue that fierce competition at home will induce firms to be innovative and cost efficient. This in turn, will pave the way for success in an international market. Moreover, promoting national champions by one state may induce neighboring states to pursue the same policy. If so, the only consequence will be concentrated national markets and potentially serious harm to consumers.

26. Thus promoting national champions in the short run to counter the current crisis may be potentially very damaging in the long run. Creating national monopolies will certainly harm consumers by increased prices at home. This could - in principle - be justified if the international success of a national champion would feed back to the domestic market. However, it is not a straightforward issue that a

national champion will be successful internationally, and even if it were, it is not clear whether this success would be channelled back domestically. It is tempting to paraphrase Gerosky (2005): “Competitive markets create champions, not governments.”

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