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## **OECD Global Forum on Competition**

### **THE OBJECTIVES OF COMPETITION LAW AND POLICY AND THE OPTIMAL DESIGN OF A COMPETITION AGENCY**

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## ITALY

### COMPETITION ORIENTED REFORM AND ANTITRUST AUTHORITY: ARE THERE GENERAL PRINCIPLES TO FOLLOW?

*Alberto Heimler\**

#### 1. The political economy of competition oriented reform and the role of antitrust authorities

A few years ago at a lecture during an antitrust course at the World Bank Joseph Stiglitz rightly emphasized the importance of structural policies for development, suggesting that privatization is not enough and that markets, in order to produce benefits to society, need to be made ready for competition, freeing them from unnecessary restrictions, licensing and alike, that are among the most damaging legacies of both colonial times and socialist experiences.

Indeed, we all know that a competitive environment creates the right incentives for promoting innovation and growth. New entrants fight for market share and by so doing they disrupt existing equilibria. Furthermore, if producers know that their market position can be weakened by competition, they will do their best to anticipate it, innovating, reducing prices and operating for the benefit of consumers. It is self evident that a competitive environment is beneficial to society, so why is it that the case for competition is so difficult to make?

First of all there are quite a number of well organized interested parties to any restriction of competition, especially to those that impede or restrict entry. Second, special interests are concentrated and gain substantially from any restriction of competition. On the other hand, losers from such restrictions are scattered across society each losing a minimal amount. Third special interests always picture competition as disruptive, while justifying restrictive regulations in terms of what are widely perceived as general interests objectives: employment, social cohesion, quality, universal service, market stability etc.

The difficulty for competition advocates is that they have to prove that there is no market failure warranting regulator intervention or that, if indeed there is one, it can be addressed with less intrusive solutions. Competition enhancing reforms have an effect on existing competitors, making it more difficult for the weakest to remain in the market or not to adjust, but it mainly create greater possibilities for new entrants. The net effect is strongly positive. However what people see most as the outcome of a competitive process is the challenges brought to the weakest competitors, more than the opportunities for outsiders.

This why the case for competition is relatively easier when the objective is to block a new proposal, while it is much more difficult to eliminate existing protections. These are considered like facts of nature.

Competition advocacy and competition enforcement are not in an either/or relationship. Both need to be undertaken in order for the authority to achieve a public reputation as a technical and

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independent body. While enforcement can exist without advocacy, advocacy is not effective without enforcement. Indeed enforcement represents the main mandate of antitrust authorities and if they do not enforce their laws effectively they are always subject to criticism, and public confidence is undermined.

Antitrust authorities cannot be alone in their advocacy efforts. Among potential allies are consumer associations, academia, the press. These are natural allies, but they need to be well informed in order to appreciate the nature and relevance of competition oriented reform. In this respect the example of other countries, if possible countries that are somehow similar in terms of development and culture, can be of great help. But also it is very important that antitrust authorities devote resources to make the public aware of their activity and of the harm caused by competition distorting legislation. In developing countries far too often antitrust authorities do not have the resources or a mandate to fully inform the public of their actions. As a consequence these authorities are quite often hardly known by the general public and the pro-competition message they deliver is poorly understood. Finally international agreements and constitutional norms constraining domestic legislation to be as competitive as possible, in so far as other public interest objectives are achieved, are very effective for imposing a competition oriented government agenda.

The rest of the paper, while addressing a number of market failures that come up in most countries, will provide a broad overview on the fundamentals of a pro-competition process of reform. The objective pursued in the paper is to present the arguments competition authorities can use in their advocacy functions.

## **2. The general principles of a competition oriented political agenda**

In a market economy the general rule is that competition should be left free to operate. Regulatory restrictions should be used only exceptionally and only when expected benefits are positive. Indeed regulation has to be introduced with a lot of care because it is never sure that regulators are able to deliver the benefits that are expected from them. The main reason for the lack of effectiveness of regulation is not capture, but the existence of very significant information asymmetries between regulators and economic agents. For example, regulators have enormous difficulties in assessing production costs incurred by monopolists or firms with market power (since they would have to rely on the regulated firm for the relevant information), nor they are able to easily monitor the quality of services. As a consequence it is very difficult for them to become effective price or quality regulators. As a consequence regulation should be introduced only if it is really necessary.

The problem of information asymmetries cannot be simply resolved by resorting to coercion. Regulation can however set up adequate incentives to economic agents to provide as much information as possible. First of all, regulators may need to grant regulated entities at least a portion of the benefits they expect to reap from their information advantage, since efficient regulation can yield enough resources to outweigh paying off such benefits. Second, whenever significant externalities or information asymmetries exist, regulators should seek adequate public participation in policy formulation, consulting all those who can provide relevant information – particularly when their interests are adversarial to those held by the regulated undertakings. Third, whenever economies of scale reduce the number of firms operating in the market, thus conferring upon them market power, regulators should be capable to intervene upon the horizontal and vertical organization of the industry, separating products and activities where such economies actually occur.

### **3. Public ownership, the role of privatization and the decision to separate**

In most of our economies public ownership remains quite common in a number of sectors like post, railroad, electricity, water supply, television. Public ownership is not neutral with respect to performance and efficiency. First of all, public enterprises have a much more flexible budget constraint than private ones and, as a consequence, have a much more relaxed attitude with respect to technical progress. Furthermore, they are characterized by a lack of transparency in corporate objectives so that it is not always clear what is it that they are pursuing. Finally they are protected from hostile takeovers, a very important source of efficiency for firms already operating in markets where the discipline of competition is generally low.

Privatization can play an important role in eliminating possible conflicts of interest between regulators and regulated companies, establishing a more transparent relationship with public administration. Furthermore, privatization can increase the efficiency of an undertaking to the extent that its exposure to the risk of acquisition will allow market forces to exercise control over its performance and that of its management. Nevertheless, market forces cannot fully operate if there are barriers to the contestability of control on such an undertaking. This is why so called golden shares, that limit the possibility of takeovers, strongly reduce the positive effects of privatization.

In any case, should competition be a viable option for a particular sector, privatizing a monopoly is not a very efficient solution. Of course efficiency increases with privatization also should a monopoly be privatized, however privatizing a restructured monopolist can lead to much greater increases of efficiency, both static and dynamic. This is why it is important that prior to privatization, the economic characteristics of all markets involved be carefully analyzed, in order to check whether, by appropriate horizontal and vertical separations, a competitive structure can be immediately created.

#### **3.1 Vertical separation**

In 2000 the Council of Ministers of the OECD adopted a recommendation to encourage measures for the structural separation of ownership. The recommendation invites member States to carefully consider the possibility of separating the ownership of competitive components from those still supplied under monopoly, mainly for the purpose of promoting a rapid achievement of a competitive environment in sectors, such as those of public utility, which traditionally have been isolated from the operation of market mechanisms. The OECD Council held that the experience of a number of countries, for example in telecommunications, electricity, air transport and postal services, was sufficient to demonstrate the favourable impact of structural separation. Naturally, such a separation cannot be mechanically and indiscriminately imposed, but must be evaluated on a case by case basis, according to the specific characteristics of the sector in question.

How is the decision whether to separate taken? In every decision there are trade offs to consider. In this case there is a trade off between the cost of separation (including the loss of possible economies of integration) and the benefits that could be achieved with integration. Of course, if there are other less invasive forms of regulation that would impose on the essential facility owner not to discriminate among its competitors, than vertical separation would be unnecessary. Indeed evidence shows that especially in markets where liberalization can in principle lead to strong competition, the incentive on the infrastructure owner to resist entry may be very strong. Furthermore, should the structure of costs be characterized by a prevalence of fixed vs variable costs, price regulation (that could both provide the right returns to the infrastructure owner and at the same time favour entry in the liberalized markets) can be very difficult to administer.

Separation can provide huge benefits in the liberalized markets. As a consequence we should not be very concerned if it is difficult to exactly identify the borders of the essential facility. For example in telecommunications, it may be difficult to exactly identify the natural monopoly elements in the local loop. Nonetheless this should not be an argument for not separating. In fact there is a trade off to be considered between the costs incurred by not being precise in defining the borders of the essential facility and the benefits nonetheless achieved through separation.

#### **4. Measures restricting market entry**

Since competition is mainly created by new entrants that try to gain market shares at the expense of other market participants, the more efficient way to reduce competition is by making entry difficult. In this perspective the most effective way to block entry is doing it by law. In such a case the block is complete and companies can be fully protected without violating any law. This is the reason why lobbyists are investing huge resources for introducing protectionist measures or to maintain them. For example in many countries existing operators are very active participants of commissions in charge of authorizing entry in markets like retail trade, gasoline distribution or road transport, where new competitors can be very disruptive of existing equilibria. Especially in developing countries restrictions can even go as far as granting exclusive rights, for example for imports, that have a very questionable effect on prices (which is the main reason they are granted) but certainly have a negative affect on competition between users of these imports.

A preliminary distinction can be made between quantitative restrictions, consisting in the pre-determination, direct or indirect, of a maximum number of undertakings (for example, by allowing a fixed number of operators in the market or by fixing a minimum distance between points of sale, or a ceiling on the total number of competitors) and qualitative requirements, which may consist of limitations in terms of type of university diploma, professional experience, passing an examination, or achieving a certain level of turnover before being allowed to operate.

##### **4.1 *Quantitative constraints***

In general, advocates of establishing quantitative limits on entry argue that this helps to guarantee a minimum level of quality. However there is no evidence of a direct link between the number of suppliers and the quality of supply. For example, if profits can be increased by reducing quality, then it is not clear why firms would not have the incentive to do so even in the presence of quantitative restraints. Furthermore, quantitative restraints have been justified as an instrument for making sure that existing competitors supply at least a given level of services. Also in this perspective establishing the number of suppliers increases the rigidity of the productive structure, generates higher prices for consumers and does not guarantee that a minimum level of services is indeed supplied.

In many countries there a number of activities where regulation continues to predetermine market structure by imposing quantitative limits on entry. For example, in retail trade, in road transport, in taxi services, in gasoline distribution, regional and local governments set up commissions (where representative of existing firms are present) that are in charge of authorizing entry. These commissions take decisions by making hypothetical assessments of the level of demand and are directly influenced by the interests of existing competitors.

Furthermore in many cases, municipalities establish the number of available licenses for taxi services, regulate the price of services and make sure that service is available during the entire day, at night and on holidays, assuming that the market would not be able to satisfy consumers. However, taxi drivers already present in the market have a predominant role in this regulation. The role they play is reflected in

the way all strategic variables (price and quantities) are identified. In many countries, including Italy, a peculiarity of the system of taxi service is that a license can only be granted to an individual and not to a company. Therefore, any attempt at liberalization is opposed by the individual taxi driver who considers the license that he holds to be an asset for his retirement. In Ireland, in order to overcome the opposition of existing taxi drivers, liberalization has been pursued by first granting existing license holders an extra license for free.

Finally in the medium and long distance passenger road transport industry, many countries operate a route by route monopoly, without ever having ascertained the existence of economies of coordination that could justify the maintenance of such exclusive rights. With respect to new routes, the interests of undertakings already present in the market, which could exercise an option right, are always taken into consideration. In other sectors, such as in pharmacies, a numerical limit is established on the basis of very strict parameters (in Italy one pharmacy for every 5000 inhabitants in municipalities with a population of up to 12,500 and a pharmacy for every 4000 inhabitants in other municipalities; moreover, pharmacies must be separated by no less than 200 meters), without having a general interest obligation to do so. Of course liberalization of pharmacies leads to substantial benefits to consumers only if pharmacies can compete on price, which also depends on the way patients are refunded for drugs and on the way pharmaceutical products are regulated (is it the wholesale or the retail price of drugs to be regulated?).

The only quantity limitations that are justified are those that are imposed only indirectly by the existence of objectively limited resources (frequency spectrum, use of public soil, etc.).

#### **4.2 *Qualitative requirements***

A decision to introduce qualitative requirements to access, must be based on an assessment of the risk that in their absence a significant reduction in quality would occur, on an estimation of the damage to consumers and of the cost and the probability of success of public regulation. The first prerequisite of good quality control regulation is that requirements identified were effectively good indicators of professional or technical ability. Frequently, however, the requirements provided by regulation are based on inputs (level and type of education, experience) rather than on output (actual quality of service). Therefore, the importance of the correlation between inputs and outputs needs to be examined beforehand and if such correlation is weak quality controls should be based on outputs. In any case the identification of an overall set of qualitative requirements for access can be particularly difficult in those sectors characterized by a high degree of product differentiation and rapid technical progress. Finally qualitative requirements for access to a market are insufficient to resolve all information problems connected with the elimination or reduction of possible risks arising from negligence or under-production. Regulations which are aimed at directly controlling actual firms behaviour are more appropriate to deal with this type of problem.

Keeping these considerations in mind, it is necessary to analyze on a case by case basis whether the problem of guaranteeing technical quality and professional skills can, at least in part, be resolved without regulation. In various cases, as for services like those of the plumber or the carpenter, protection from damages arising from inadequate service can easily be entrusted to private initiative without the need of any regulation. In order to resolve modest information asymmetries, spontaneous certifications of the providers' ability (for example, certification of participation in professional development courses) may be sufficient.

In those instances where the problem arising from information asymmetries is noticeable, regulation can establish a minimum access standard (for example in terms of education requirements), to which spontaneous certification on the provider's ability can be added. Such an approach could permit access to the market to a wide variety of services, characterized by various combinations of price and

quality, avoiding the uniform imposition of high prices and uniform quality. The possibility of advertising different conditions of supply appears to be of fundamental importance for providing suppliers with the right incentive to adopt such a system of endogenous certification.

In conclusion, qualitative restrictions to access, as for example in the professions, must be of a type to avoid that through them quantitative controls are surreptitiously introduced. This means that the control of qualitative requirements must be based on criteria which are proportionate and transparent and do not restrict competition any more than is necessary to achieve legitimate quality assurance objectives. In particular, the obligation of having acquired sufficient practical experience might also be met by passing a qualification course and not only by an apprenticeship in a professional office. Furthermore, registration in a professional association must only be obligatory when public control is needed both for access and for the exercise of the activity. To the contrary in those circumstances in which the same services can be carried out efficiently even by individuals who are not registered in an association and are therefore not subject to control, membership in a professional association should not be mandatory.

## **5. Regulating business activity**

Aside from access barriers, a number of other regulatory restraints are imposed on undertakings, not always in a justifiable manner. These include the regulation of prices and tariffs, limitations on the range of products to be sold and on the geographic area of activity, imposition of maximum number hours of opening, standards on product quality etc.

### **5.1 *Setting a floor on pricing***

In markets with a fragmented structure (among those, for example, one should include professional services), imposing minimum prices obviously produces negative effects on consumers. Furthermore such a regulatory practice cannot be justified under a public interest standard.

First of all, setting minimum prices does not eliminate the need of ensuring the professional or technical ability of those offering the service. In particular, a floor on pricing does not impede the supply of low quality products or services. Furthermore, a minimum price regime is often implemented to protect certain categories that would be damaged from competition. For example, prohibiting below cost sales protects small retailers from being exposed to what is perceived to be excessive competition from large retailers. Nevertheless, in regulating below cost sales, consumers are significantly damaged as they must pay more than they would have without the regulation. Finally, even the protected categories, in this example small retailers, can be damaged by these provisions, which limit their range of reactions to the competitive challenge by large retailers. Similar conclusions can be made for regulations which may limit the possibility of offering discounts on books sold by bookstores. These provisions, apparently enacted to protect small booksellers from competition by large bookstores, damage consumers and hinders the introduction of innovative services that may allow even these small bookstores to compete on better terms.

### **5.2 *Setting a ceiling on prices***

Establishing a maximum price, leaving firms free to reduce prices, presents fewer competition problems. Nevertheless, except for those cases of public utility monopolies or in certain instances of consumer protection such as for taxi service or for tow services on highways (monopolies at the margin), where effectively regulation of maximum prices could be necessary, the effective necessity of such regulation is questionable.

Establishing a maximum price by regulation makes collusion among undertakings easier, inducing them to align prices to the maximum provided by regulation. Furthermore, in order to set an efficient maximum price a regulator has to acquire information on cost and characteristics of demand that only firms might have, making him easily subject to manipulation. Finally a system of periodic estimation of the maximum price introduces an artificial rigidity in the market that is justified only in very special circumstances. Thus, in markets which are not monopolized (not even at the margin) and are subject to antitrust provisions prohibiting restrictive agreements and abuse of dominance, setting maximum prices is not an efficient regulatory measure. Any concerns of a social nature, for the purpose of allowing the needy to purchase certain products, can be resolved by other measures, such as the provision of specific forms of public transfers.

### **5.3 *Limitations on the range of products to be carried***

In certain sectors regulatory limitations restrict the range of products that a firm can supply. Such limitations are justified in terms of public interest, only where a joint production would bring about negative social effects (for example, with respect to health, conflict of interest, or market stability). The disadvantages of such regulatory limitations consist mainly in eliminating economies of scope, i.e. cost advantages derived from joint production, and in introducing elements of rigidity in the evolution of the market. Thus, such measures can bring higher prices for consumers and less innovation.

### **5.4 *Establishing maximum hours of opening***

This type of regulation is common in retail trade. It can be viewed as a limitation on the possibility of differentiating the service horizontally (the choice of the time of the day) or vertically (the choice on the number of hours).

Regulatory measures restricting the choice of retailers in terms of the time of the day to keep the shop open for a given number of hours worsen consumer welfare without clear reasons in terms of efficiency from a retailer's perspective. Indeed, the retailer knows best when his customers may prefer to shop, so restricting the possibility of opening at a certain time of the day restricts his profit opportunities. Analogously, restricting the number of hours a retailer is open to the public, reduces both consumers' choices and retailers' profits. These regulations on opening hours may increase the efficiency and profits of retailers only if they do not have an adverse impact on the amount consumer purchase, a very unrealistic assumption. Both for durable and non durables goods, retailers have to make their own calculation on the marginal profit they can achieve by staying open. A calculation that cannot be done once and for all by a regulator.

Of course introducing flexibility in opening hours requires also that a flexible labour market is in place. Otherwise small shopkeepers, not able to hire a worker just for the hours needed, would be strongly disadvantaged with respect to the big supermarkets.

### **5.5 *Minimum standards on quality of services***

Introducing a regulation on minimum quality standards may be appropriate in situations where relevant information asymmetries exist. However, most of the times, when the risk originating from low quality products is limited and when through experience customers can easily assess quality, the market can provide the right signals. In many instances, when regulation is necessary, standards are defined in an unsatisfactory manner, or compliance is not controlled efficiently. In such cases there is a risk that the imposition of quality standards will only create an increase in prices without a real improvement in quality.

In some sectors, an undertaking may have an interest in improving its reputation as a supplier of a product with a quality that is above a certain threshold. This interest can be pursued through measures of self-regulation, rather than by eliminating from the market the good or service of inferior quality (but which is less expensive). Undertakings will thus have the choice of whether or not to adhere to a predefined standard and to certify and advertise the compliance in the most useful manner.

## **5.6 *Service obligations***

Some service obligations may be imposed on undertakings for a number of reasons: guaranteeing a territorial presence (for example in mobile telephony), ensuring that a given product be offered at all times (food shops or taxi services), making sure that all goods available (all newspapers) reach the market. Consumer satisfaction or guaranteeing other interests, like the pluralism of information, are the main objectives pursued. In general service obligations can be imposed on all firms operating in the market. They reduce competition only when they are accompanied by other more direct restrictions of access.

Universal service obligations, which characterize most public utility industries, are commonly imposed to guarantee all consumers minimum quality levels for some fundamental services at an affordable price. Such obligations should only be imposed where market supply would otherwise be less than the 'socially desirable' level, which may change over time to reflect different policy goals (e.g. media pluralism or urban sustainability) or technological possibilities.

The extra costs of universal service requirements could be borne by taxpayers, when public authorities directly provide or subsidize the service, or could be paid by the non-subsidized customers of the firm. In this case the existence of universal service should not be an excuse for not granting access to competitors. On the other hand competitors should be allowed to come in the market and if necessary contribute to the financing of universal services. In this respect, it is important not to impose excessive burdens upon new entrants and to ensure the even treatment of competing firms. Whatever funding mechanism is chosen, it should be firmly based upon a careful analysis of the actual costs incurred to introduce the universal service requirements.

## **5.7 *Regulatory measures for the stability of financial markets***

Regulation of financial markets is primarily intended to secure the stability of the payments system and the financial industry as a whole. State intervention is commonly justified with reference to the significant information asymmetries between banks, their clients and other investors. For example, when bank insolvency occurs, it is necessary to avoid that depositors, unable to distinguish between solvent and insolvent banks, rush to close their accounts in the fear of a generalized bank crisis.

Risk-averting regulatory measures include deposit insurance, aimed at protecting depositors from the risk of insolvency, prudential policies to ensure that banks' balance sheets stay well balanced and pervasive forms of control of banks' shareholdings. Such regulation has proved successful, so that in the last fifty years no systemic crisis has ever occurred. However regulation should not reduce the incentive to efficiency of the banks, nor influence the risk profile of the undertaken investments.

## **6. *Conclusions***

This paper provides a brief description of possible regulatory restrictions of competition. The analysis has been quite general, dealing with most common forms of market failures: natural monopolies and information asymmetries. Some restraints of competition may also be introduced in the case of

externalities, as is the case, for example, for the protection of intellectual property rights. However this issue have not been considered. Furthermore, in most of our countries markets are distorted by trade restrictions and by the existence of significant state subsidies. Once again, these other important forms of regulatory restrictions have not been analyzed. The decision to refrain from discussing some of the most important distortions of competition that affect our economies (international trade restrictions and subsidies) was based on the consideration that these are mainly decided on broad political grounds and the role of competition authorities is generally not that relevant.

This has had other consequences as well. In particular the paper has only addressed the issues of introducing greater competition to public utility markets to competition, while only briefly on how to regulate final or access prices in monopoly. On the other hand, the paper has been quite thorough in identifying market failures with respect to information asymmetries, providing a strong criticism to the widespread practice of limiting the number of authorized firms in the market. Furthermore, other regulatory practices have been touched upon, like regulations limiting the possibility of firms in competitive markets to set the price they like or to be open when and as long as they like, or to set the quality of their products/services or to decide on the range of products they like to sell. Finally some considerations have been addressed with respect to the introduction of universal service obligations or to regulatory measures that guarantee financial market stability.

I know very well that I have been brief and probably not complete. I hope however that the problems and discussions presented may be useful for establishing the position of antitrust authorities when advocating for more competition in the face of thorough regulatory restraints.