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ROUNDTABLE ON COMPETITION NEUTRALITY

-- Note by Pierre-André Buigues, University of Toulouse --

16-18 June 2015

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More documents related to this discussion can be found at www.oecd.org/daf/competition/competitive-neutrality-in-competition-enforcement.htm.

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CHALLENGES ARISING FROM STATE INTERVENTIONS IN THE MARKET: EFFECTIVENESS AND DISTORTIONS OF COMPETITION

*Note by Pierre-André Buigues**

1. A large number of governments have introduced extensive subsidy programs and State interventions with a multiplicity of objectives to justify these interventions. Amongst the main objectives, government wants to allow consumers to purchase goods and services at prices lower than those offered by a perfectly competitive private sector and to raise producers' incomes beyond those that would be earned without State intervention (Schwartz and Clements, 1999).

2. The paper is divided into the following parts. The first part covers the cross country comparison issues of State intervention. The second part assesses the types of distortion introduced by State intervention and their effectiveness. The last part presents the conclusions.

1. Complexity of 1) defining what is State intervention in the market and 2) the cross-country comparisons

3. For economist, the measurement of the economic impact of State intervention is quite difficult. The cross-country comparison of the economic impact of State intervention depends on the definition of what is State intervention and assumptions on what is the market equilibrium without State intervention. Moreover, what can be defined and measured as State intervention may only be a fraction of what is spent in the real economic world by governments.

4. One of the main problems is that there is no commonly accepted definition and measurement of subsidy and State intervention. In theory, a large majority of subsidies can be grouped in the following categories:

- Cash subsidy: direct government payments to consumers or producers
- Credit subsidies: government guarantees, interest subsidies and soft loans (credit subsidies)
- Tax subsidies: reduction of specific taxes
- Equity subsidies: government equity participation
- In-kind subsidies: government provision of goods or services at below market prices

5. Other State interventions have a similar economic impact than the above subsidies:

- Procurement interventions: government purchases of goods and services at above-market prices.
- Regulation interventions: government regulatory actions that change market price.
- State-owned enterprises (SOE) are also quite often recipients of subsidies to maintain loss-making SOE in the market. Government may intervene also on utility companies to oblige them to sell their products or services at low prices (railway, energy e.g.).

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6. The problem of cross country comparison is that the definitions of State intervention in the market and subsidies used by international organizations are quite different:

- *Definition of subsidies in System of National Accounts:* National account statistics published by government are the most complete standardized information on subsidies¹ However, National accounts statistics reveal only direct payment to enterprises but not less obvious form such as tax subsidies, equity subsidy procurement and regulatory subsidies
- *Definition of subsidies in the WTO:*² WTO Members should notify all specific subsidies covering all goods sectors but subsidies to the services sector are not covered by WTO. Moreover, there are important differences between the notifications of the different countries (frequently no quantitative information is available).
- *Definition of subsidies in the EU:* In the EU: State aid is defined in Article 87(1) EC Treaty as a state intervention through transfer of State resources that effectively confers advantages by favoring certain economic activities or certain undertakings and that distorts competition and trade within the common market³.
- *The economic evaluation of the total amount of subsidies per country:* As many differences exist between the different definitions and approaches used by international organizations, the economic evaluation of the total amount of subsidies per country is quite different for SNA, WTO and EU: Firstly, general economic measures are covered by SNA but are not considered as state aid in the EU scoreboard. Secondly, subsidies which compensate for services of general economic interest are considered as subsidies by the SNA but are not included in the State aid scoreboard. Thirdly, soft loans guarantees, equity subsidies and tax subsidies: are covered by the State Aid scoreboard but not by the SNA⁴. The WTO notification database has a much wider coverage of different forms of subsidies than the SNA but the WTO notification database has a much narrower coverage than the SNA, as services are not included in the WTO notifications.
- *The impact of State intervention on the real economy:* The economic evaluation of the impact of State intervention on the real economy is not an easy task. The observation of the hypothetical market equilibrium without government intervention is not possible in practice. As a consequence, the quantitative evaluation of the deviation from any benchmark equilibrium that result from government intervention is quite complex.

¹ OECD defines subsidies as “current unrequited payments that government units, make to enterprises on the basis of their production activities or the quantities or value of the goods or services which they produce, sell or import”.

² The definition of the WTO contains three basic elements: a) a financial contribution by b) a government or any public body within the territory of a Member which c) confers a benefit to the recipient of the contribution. All three of these elements must be satisfied in order for a subsidy to exist. Only “specific” subsidies are subject to the SCM Agreement (Agreement on Subsidies and Countervailing) measures disciplines (e.g. enterprise-specificity, industry-specificity).

³ To qualify as state aid, a measure needs to satisfy all the criteria listed under article 87(1): *Cost to public resources, Economic advantage, Selectivity, Effect on competition and trade*. The State aid reports classify the different state aid according to their principal objectives sectoral aid, and horizontal aids (R&D, SME, Regional aid, Employment aid, Environment and energy saving).

⁴ The State Aid scoreboard (COM (2006) 761 final p.27) presents the share of each aid instrument in total aid for manufacturing and services. Grants which are the only instrument covered by the “subsidy” approach of the SNA represented only 50% in the period 2003-2005 for the EU25. Tax exemptions represented 40% of the total aid and the other instruments all together (equity participation, soft loans, tax deferrals and guarantees) only 10%.

- *Different models of State interventions:* Independently of the total amount of subsidies, the countries are characterized by different models of State interventions (Buigues and Sekkat, 2009): The first model is found to be primarily “soft” in nature, consisting of advisory support, encouragement of partnerships, and dissemination of best practices. The policy management is generally decentralized and the public support programs are provided by agencies, wholly or partly funded by central government. This is the case of “Anglo-Saxon” approach which is characterized by a low level of subsidy. The second model is more interventionist. Public support is characterized by large amounts of subsidies to companies and in some cases the State is a shareholder in many enterprises. Generally, the Government has a clear responsibility of deciding strategic industrial priorities, and competitiveness remains a very sensitive issue in the public debate. This is the case of France and other continental Europe countries.

2. Effectiveness and potential distortive effects of State interventions

7. State intervention in the market can be aimed at a variety of political or economic objectives, such as addressing market failures, promoting regional income equality preventing the disappearance of a specific firm or industry perceived as essential for the country, raising incomes and reducing prices for households. What are the distortive effect of these State interventions and their effectiveness?

2.1 Market failures and horizontal subsidies

8. One of the main rationales for public interventions principally lies in the necessity to offset some market failure which can take the form of imperfect competition, technological, information, coordination and other externalities. It is the most frequent justification for subsidies based on the idea that the social value of some activities exceeds their private value.

9. However, as notes Rodrik (2006) there are two fundamental arguments that cast doubts on governments’ capacity to correct market failures: information issues and incentives. The first point refers to the fact that governments might not be able to substitute for the decentralized information processing that markets can achieve. The second point relates to elections, lobbying (and capture) and corruption. Thus, the fear of market failures must be balanced with the risks of government failures. Available papers on government failures (Dewatripont and Seabright, 2006, Lambert and Kosenoky, 2006, Aydin, 2007, Ades and Di Tella, 1997)) confirm that the risk of government failure in pursuing public support to industry is real and might be very costly for public finance and tax payer.

10. Empirical investigations focusing on the effectiveness of subsidies based on market failures justifications mainly concern the capacity of subsidies to speed up the pace of the technological progress (either through R&D or productivity). Most of the studies examining the impact of the public support with respect to its capacity to enhance total factor productivity come up with inconclusive results (Harris and Robinson, 2004, Bergström, 1998, Gual and Jódar, 2006, Skuras et al., 2006). In fact, there is hardly any strong evidence that subsidies are able to induce a significant increase in TFP, especially in the long-run. When a positive change is observed in productivity level, increase in productivity comes generally from more investment in physical capital (which may replace some workers). Moreover, there are cases when the subsidy only replaces private funds that could be otherwise invested.

2.2 Firm location and regional subsidies

11. The objective of regional subsidies is to attract economic activities and firms in poor regions based on the assumption that this will decrease regional inequality, increase employment, wages, and productivity in those regions.

12. Most of the studies examining the impact of subsidies on firm location come up with mixed results (Kokko and Gustavsson, 2004, Mayer, 2004, Devereux et al., 2007, Wren, 2005, Midelfart and Overman, 2002). The available literature points several conclusions. Market's incentives (market size, infrastructure, natural resources, etc.) for agglomeration appear to be much stronger comparatively to the government interventions' ones. The capacity of State measures to influence firms' location is weak. However, if the efficacy of state aid is examined with the respect to jobs creation, the positive results seem non negligible although estimation of the cost of employment creation remains highly controversial and sensitive to methods of estimation employed.

2.3 *Firms and industry in difficulty, rescue and restructuring subsidies*

13. These subsidies are often a defensive industrial policy as the goal is to prevent the disappearance of a specific firm or industry perceived as essential for the country. Examples of industry include support to banking, airlines or carmakers.

14. The main concern is that provision of subsidies to specific firms or specific sectors may create capital misallocation. Such subsidies may shift production towards less efficient firms or sectors and finally to increase the total production costs for the whole economy. On the one hand, efficient firms' incentive to be innovative are likely to be lowered if they expect that their competitive advantages will be offset by the subsidies granted to the less efficient firms and on the other hand less efficient firms may decide very risky investments as they expect government subsidies if they fail.

15. Available evidence from empirical studies is limited. London Economics (2004) presented the results of an ex-post evaluation of the impact of rescue and restructuring state aid in the EU on firms' performance. Of the 71 companies having received rescue and/or restructuring State aid, more than a third currently have the same legal status that they had at the time of the aid award, whilst almost a third have ceased operations. The rest either changed their name or were bought by other companies.

2.4 *Price regulation to respond to social concern*

16. As opposed to prices set exclusively by supply and demand, with price regulation, final consumer prices are established by a governmental authority. The objective of this price regulation in electricity market is generally to respond to social or industrial policy concerns, and the result is that households or energy intensive industrial sectors receive implicit subsidies.

17. If the level of regulated prices is set too low, the main concerns are the following: First, the price fails to provide the right signal to energy consumers which may imply over-consumption of electricity. Second, the low level of regulated price might hamper the process of market opening by discouraging new companies from entering the market. Third, suppliers might not be able to recover their costs and could face losses. The result is inefficiencies in the overall energy system. (European Economy, 2014). Moreover, determining the right regulated prices require full information on the cost structure of the industry, which is increasingly difficult.

3. Conclusion

18. The effectiveness of State interventions policies and their impact (distortion of competition in the market) remains seriously under-researched although they represent large amount of funds, affect domestic resource allocation decisions, competitiveness and income distribution. The first problem is that it is quite difficult to present the existing State interventions onto one set of information that could be used for empirical investigation. The second problem is that, faced with the multiplicity of objectives of State interventions and their interrelationships, it is increasingly difficult to analyze empirically to what extent a specific program is a success or not and its impact on competition.

19. Although still very limited, the empirical literature shows that there is hardly any solid evidence that State interventions can induce a significant increase in productivity, especially in the long run and it seems that the ability of public support to influence the location of firms is weak.

20. What countries can do to address the effectiveness and the distortions of competition that State interventions may create?

21. Firstly, the effectiveness of State interventions is highly dependent on the ability of the administration to perform regular evaluations and to adopt a "value for money" approach. Evaluations should be mandatory. That may imply also to limit magnitude and duration of each program, abandoning those programs that are not bringing value for money and concentrating State interventions in a few programs.

22. Secondly, more transparency of State interventions is also needed. This would serve the double purposes of enhancing government accountability and enabling public authorities to learn from each other's.

23. Finally, it should be quite helpful to request competition authorities to provide opinions on the competition effects of State interventions adopted by governments.

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