Council of the European Union

Brussels, 29 March 2019
(OR. en)

7991/19

COMPET 291
MI 309
IND 113
RC 11

NOTE

From:	European Commission
To:	The High Level Working Group on Competitiveness and Growth
Subject:	Competition, competitiveness and the Single Market

Delegations will find in Annex a European Commission note on competition, competitiveness and the Single Market, in view of the meeting of the High Level Working Group on Competitiveness and Growth on 11 April 2019.

ANNEX

Competition, competitiveness and the Single Market

The higher the levels of competition within the EU's Single Market, the greater the benefits the Single Market will deliver to consumers, business and workers and the EU economy as a whole. Competition allows consumers, both businesses and households, to enjoy lower prices, a broader variety of products as well as greater innovation. Even if goods and services can circulate freely, consumers will not be able to benefit from lower prices if firms have strong market power to fix their mark-ups (i.e. the difference between their prices and costs).

However, competition is neither pervasive nor permanent over time. It cannot be taken for granted. It is not the normal "state of nature" by default. For example, a report published by the Council of Economic Advisers (CEA)[1] under the Obama administration warned about substantial growth in market power and falling competition in the US. This report triggered inquiries about the possibility of similar trends in Europe. Evidence suggests that the decline in competition detected in the US is also present in the EU, although the increase in concentration appears to be less pronounced in Europe. Some argue that the gap between the US and Europe in this regard is due to more procompetitive enforcement and regulatory structures in Europe[2].

In parallel, however, within the EU there are challenges related to market access and cross-border trade in goods and provision of services, which has an impact on the pan-European competitive landscape.

At the global scale, the emergence of newly developed economies working under asymmetric competition conditions in their internal markets in comparison with Western economies could tilt the global competition balance in favour of firms from those countries. Technological developments are also modifying competition conditions, sometimes drastically.

[1] Council of Economic Advisers (2016), Issue Brief, *Benefits of Competition and Indicators of Market Power*, April.

[2] "How EU Markets Became More Competitive Than US Markets: A Study of Institutional Drift" by Germán Gutiérrez† and Thomas Philippon (July 2018).

Therefore, realistic and prudent policy-making for competitiveness and the Single Market requires a regular assessment of whether and to what extent competition will contribute to ensure the achievement of the intended impacts.

This note aims at opening a discussion that can shed light on the overall state of competition in the goods and services markets where EU business operate and the impact this has on Single Market and competitiveness policies. First, it looks at the relationship between competition and the Single Market. Secondly, the note discusses the links between sluggish productivity growth and the recent evolution of competition. Finally, it delves into the impact of new technologies and digitalisation on competition conditions.

At the outset, it should be stressed that the focus of the note is on sectoral and industrial competition; its aim is not to address competition policy and/or the actual impact of different instruments of competition policy on the degree of market competition.

Sectoral competition and the performance of the Single Market

There is a close relationship between the Single Market and competition.

- Single Market integration delivers benefits to consumers by removing barriers to the free movement of goods, services, capital and people. The removal of barriers has a competition-enhancing effect. It broadens the markets accessible to firms and consumers. In this way, it dilutes the monopoly power that may have prevailed in national markets prior to integration.

- Preserving competition as integration progresses continues to be necessary to ensure a well-functioning Single Market. The removal of barriers to trade will not have the intended effects if firms – e.g. those with strong market power - are able to engage in anticompetitive behaviour to stifle market competition. In a similar way, State measures protecting domestic firms from the competition of other EU players in the form of unjustified subsidies, or barriers to market access would also impair the proper functioning of the Single Market.

There is thus a mutually reinforcing relationship between the Single Market and competition. This parallelism between competition and deeper economic integration is also reflected at sectoral level. It is commonly accepted that integration of EU markets for manufactured goods is deeper than in service markets. Consistent with this perception, recent evidence indicates that concentration and market power are higher, and have increased more, in services than in goods markets.

Competition and competitiveness

There are also strong links between competition and competitiveness. Experience and evidence show indeed that competition at home boosts competiveness, at home and abroad[3].

When examining the relationship between competition and competitiveness, it should however be noted that the context is significantly different depending on whether we consider competition within the EU or in global markets.

[3] See e.g. "International Trade and Domestic Competition: evidence from Belgium" by Maria Caterina Bramati, Alberto A. Gaggero and Edna Solomon, 2015 finding links between domestic competition and expert performance.

In the global context, competition conditions and market access are quite different across countries and they have been diverging in recent years. Given the high level of openness of the EU to the rest of the world, the competitive performance of EU firms depends on their ability to compete on fair terms in global markets. Unfortunately, this is not always the case. In an increasing number of areas of the world, various barriers prevent EU firms from competing on equal terms with local firms. All too often, EU firms must compete in global markets with firms receiving high levels of uncontrolled subsidies. The monopolisation of strategic inputs also hampers their ability to compete on fair terms. In some cases, EU firms do not have access to important parts of national markets such as public procurement. In such circumstances – i.e. where competition and access to markets are absent - efforts to invest or innovate to improve competitiveness are discouraged. Thus, to respond to such unfair practices distorting the global playing field, policy intervention through appropriate and effective instruments may be necessary.

Within the realm of the Single Market, competition contributes to competitiveness by creating incentives for companies to invest and innovate and by giving businesses access to inputs on competitive terms. However, research in recent years has pointed to several signs of a decline in several parameters of market competition, in particular in the US but also – to a lesser extent - in Europe. The indications include, among other things, higher profit margins and higher rates of concentration (the latter being more pronounced in the US than in Europe), a gap that some observers consider to be in part the result of a more procompetitive regulatory and institutional framework in Europe.

At the same time, competition in Europe is frustrated by restrictions to market access and cross-border trade in goods and provision of services.

Such a decline in competition could reduce the incentive to improve productivity, the main long-term driver of competitiveness.[4] As the period of declining competition has coincided with a period of sluggish productivity growth in both the EU and the US, attempts have been made to establish links between these two secular trends. There are different possible connections.

First, limited competition tends to reduce incentives to invest, innovate and increase efficiencies[5]. In monopolistic environments, the quality of management tends to deteriorate, business dynamism decays and organisational slack tends to grow within corporations. From that point of view, growing market power might be at the origin of the deteriorating productivity performance.

Secondly, sluggish productivity growth seem to characterise concentrated industries, a development which is consistent with other observable secular trends such as a falling share of labour in income distribution and wealth, increasing polarisation of wages and concentration of profits in a small number of firms (although income and wealth disparities have increased less in Europe compared to the US). Low productivity may also be caused by restrictive and anticompetitive regulation creating protective "moats" around certain industries. A recent study suggests that higher levels of anticompetitive regulation are associated with higher levels of market concentration and market power[6].

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4 Among others, they include changes in the degree of enforcement of competition tools, the existence of high and increasing overhead fixed costs, changes in the regulatory environment having an impact on firm entry/exit and behaviour and the increasing importance of intangible capital.

5 See OECD Factsheet on how competition policy affects macro-economic outcomes (October 2014) (available at http://www.oecd.org/daf/competition/2014-competition-factsheet-iv-en.pdf).

6 "Standing up for Competition: Market Concentration, Regulation, and Europe's Quest for a New Industrial Policy" by Oscar Guinea, Senior Economist and Fredrik Erixon, Director at ECIPE, ECIPE Occasional paper, No 1/2019, pp. 12-17.

New Digital Technologies and Competition

New digital technologies drive productivity growth and competitiveness but they have also been identified as a source of market power. Concentration and mark-ups are higher in those sectors where new digital technologies are more intensively used and broadly diffused. Economies of scale and scope, as well as the nature of the new technologies, help to explain why large firms invest more and draw more benefits from the use of digital technologies than small firms. According to some observers, these developments have given the rise to "Superstar Firms" dominating "winner takes all" markets.[7]

The impact of new digital technologies goes beyond market concentration effects. The changes are qualitative rather than merely quantitative in nature. New technologies and business models are transforming market competition. For instance, the collaborative economy is changing the market structure of the hotel sector due to different impacts on different segments of the sector.[8] To take another example, on-line shopping has modified the pricing behaviour of bricks and mortar retailers, making prices increasingly transparent and uniform across locations and increasing the frequency of price changes.[9]

The introduction of platforms, big-data and complementarities between new technologies are changing competition in unprecedented ways. They raise new policy challenges. A recent report advocates strong pro-competition policies that open up opportunities for innovation, and counter the forces that can lead to high concentration and a single winner[10].

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7 John van Reenen (2018) "Increasing Differences between firms: Market Power and the Macro-Economy" CEP Discussion Papers dp1576, Centre for Economic Performance, LSE.

8 Georgios Zervas, Proserpio D., and Byers J.W. (2017) "The Rise of the Sharing Economy: Estimating the Impact of Airbnb on the Hotel Sector". Journal of Marketing research, Volume: 54 issue: 5, page(s): 687-705.

9 Alberto Carvallo (2018) "More Amazon Effects: Online Competition and Pricing Behaviour", NBER Working Paper No. 25138, October.

10 See "Unlocking digital competition – Report by the Digital Expert Competition Panel" set up by the UK government (March 2019).

Questions for discussion:

The HLG is invited to review the evidence on the evolution of competition and to discuss the potential implications of this trend on competitiveness and the Single Market.

1) *Is the current concern about increasing concentration in Europe justified? To what extent do the barriers to Single Market integration shield sectors from competition in the Single Market, thereby making European firms less competitive abroad?*

2) *Which dimensions of Single Market and EU industrial policy issues should be addressed as a matter of priority to tackle the effects of the increase in concentration?*