

Competition and growth

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COMPETITION AND GROWTH¹

EXECUTIVE SUMMARY

The central role of competition as a driver for economic growth and innovation is supported by a wide body of macroeconomic and sectoral evidence. We have long known that effective competition provides significant benefits for consumers through greater choice, lower prices, and better quality goods and services. Competition also drives growth because it provides strong incentives for firms to be more efficient than their rivals and to reduce their costs, and rewards innovation.

The role of competition in driving economic growth is especially important at times of moderate economic growth and fiscal constraints. With macroeconomic tools likely to prove insufficient and their use restricted by the need for fiscal consolidation, microeconomic instruments (such as the removal of unnecessary regulatory burdens and the protection and promotion of competition) become all the more important.

As well as the general relationship between competition and growth, this paper looks more specifically at how competition, and competition interventions by government or agencies, can contribute to the better utilisation of capital, labour and natural resources, and to increased innovation and better management. It also discusses the role competition policy can play in maximising competition's contribution to economic growth. It concludes that there are effectively two important arms of competition policy: that which is pursued by government itself, and that undertaken by the (usually independent) competition agencies.

Government can directly support and drive competition in a variety of ways. It can choose proactively to open up markets to competition, as has been done successfully with telecommunications and airlines. It can ensure that government regulation generally fosters competition, for example by maintaining

¹ This paper has been written by John Fingleton, Amelia Fletcher and Carmen Suarez, and has benefited from comments from other OFT staff.

consistency and stability of regulation, and taking care that it does not create barriers to entry for new business and innovative business models. More generally, the objective of promoting competition should also influence government's behaviour in public procurement, in subsidisation and industrial policy actions, and in ensuring competitive neutrality in taxation and other areas.

A strong consumer and competition regime is a key complement to this, ensuring that competition thrives in those markets already open to it, focusing on ensuring markets work well, and driving compliance through enforcement and other tools. Consumer policy should support active consumers who shop around and thereby drive competition over price and quality, and ensure that intense competition does not result in a 'race towards the bottom' in standards or in business aiming to gain a competitive advantage by obfuscating consumers.

Government faces many challenges in driving competition including the many competing demands on policy-makers, not least the fact that the benefits from competition emerge only over time and the strong resistance from incumbent interest groups that benefit from restrictions on competition.

Such challenges can be mitigated by a strong and effective competition regime. First, expert competition advocacy is crucial to ensuring that competition is a key focus in policy design and implementation. Second, competition authorities can provide advice on market design and policy reforms. Both these roles can support greater consistency in driving competition across government. This role can be particularly relevant in newly liberalised markets such as public service markets, where the introduction of choice and competition has the potential to deliver significant benefits for growth but where the details of market design can be crucial to delivering positive outcomes.

1 INTRODUCTION

- 1.1 Competition can be a crucial factor in driving economic growth in an economy, impacting on both efficiency and innovation.² This role of competition in driving economic growth is especially important at times of moderate economic growth and fiscal constraints. With macroeconomic tools likely to prove insufficient and their use restricted by the need for fiscal consolidation, microeconomic instruments (such as the removal of unnecessary regulatory burdens and the protection and promotion of competition) become all the more important.³
- 1.2 This paper sets out the general evidence on the relationship between competition and growth, and in particular describes the impact on growth of a number of specific competition interventions. More novel, though, is the paper's focus on the importance of competition for each of the factors underlying growth (natural resources, capital and labour), and on the two key processes affecting the way in which these resources are combined to generate growth (innovation and management).
- 1.3 The paper concludes by considering the role that government can play, both directly through its policy-making, and through the creation of an effective competition and consumer regime, within which the (usually

² The role of competition as a factor of growth has informed and continues to inform EU and UK competition policies. At the EU level, the Treaty of Rome refers to competition, not as an end in itself, but as a way to promote economic progress and the welfare of European citizens (the latter being one of the explicit objectives of the EC, as stated in article 2 of the TEU). In the UK, the 2001 White Paper 'Productivity and Enterprise: a world class competition regime', setting the scene for the introduction of the Enterprise Act, stated that 'vigorous competition between firms is the lifeblood of strong and effective markets', while the link between competition and growth has been further highlighted by the 2011 consultation on the future of the competition regime (BIS (2011), 'A competition regime for growth: a consultation on options for reform').

³ This is a message echoed by many commentators. See, for instance, McKinsey Global Institute (2010), 'From Austerity to Prosperity: seven priorities for the long-term in the United Kingdom', or Institute of Directors (2011), 'The Route Back to Growth'.

independent) competition and consumer authorities can act to promote and protect competition.

- 1.4 The focus of much of this paper is on the UK and the work and role of the UK Office of Fair Trading (OFT). However, the overall conclusions should be treated as more generic, providing potential lessons for other countries as well as the UK.

Competition as a driver of growth: key theory and evidence

- 1.5 Competition is well understood to be a key factor in driving growth. It does this in a variety of ways. Firstly, within firms, competition acts as a disciplining device, placing pressure on the managers of firms to become more efficient, hence decreasing 'x-inefficiency' (that is, the difference between the most efficient behaviour that the firm is capable of and its observed behaviour in practice). This is sometimes called the 'within-firm' effect.
- 1.6 Secondly, competition ensures that higher productivity firms increase their market share at the expense of the less productive. These low productivity firms may then exit the market, and are replaced by higher productivity firms, with the subsequent positive cross-firm impact on productivity. This is sometimes called the 'across-firm' effect. The relative importance of entry and exit in driving productivity can vary according to where a market sits on the product life cycle: entry and exit are more prominent, and have greater productivity-enhancing potential, at early stages of a product's life cycle. Entry and exit tend to have relatively lower effects on productivity in mature industries, and of the two it is exit that seems to have the more significant effect.⁴

⁴ Scarpetta, S., Hemmings, P., Tressel, T., and Woo, J. (2002), 'The role of policy and institutions for productivity and firm dynamics: evidence from micro and industry data', OECD Economics Papers, No. 329. This paper highlights how the replacement of low productivity firms (who exit the market) by high productivity firms is an essential part of the productivity (and growth) enhancing process. The issue is, in turn, particularly relevant when considering the impact of state aid and other barriers to exit on competition and, hence, growth.

- 1.7 Thirdly, and crucially, competition drives firms to innovate. Innovation increases dynamic efficiency through technological improvements of production processes, or the creation of new products and services. Innovation is traditionally seen as an engine for growth and productivity as, in the presence of competition, firms will aim to innovate to gain a cost advantage, to differentiate their products and/or to bring new products to the market place.⁵
- 1.8 Competition can also contribute to growth in other ways. By bringing down costs through 'within firm' and 'across firm' effects and by driving innovation, competition also reduces inflation rates, both at the sectoral and aggregate level, creating a more stable macroeconomic environment.⁶ Crucially, competition is also a defence against the entrenchment of vested interests and protectionism, contributing to the opening up of markets to new entrants, and increasing the attractiveness of a country as a recipient of foreign direct investment (with potential associated spillovers in the form of novel techniques and management systems).
- 1.9 The positive impact of competition on economic growth can be furthered by empowered consumers, with clear synergies here between competition and consumer policy. When consumers trust firms and markets (because of consumer protection) and when consumers actively choose and buy what is best for them (with the aid of consumer protection), then firms will compete fairly to deliver what consumers want, in order to gain business from each other.
- 1.10 Active consumers with the confidence to engage in markets will, in turn, act as a driver for economic growth. Firms can only gain from innovation

⁵ The relation between innovation and competition is a complex one, and one that is mediated through the intellectual property regime. See paragraphs 40 and ss. below.

⁶ See Przybyla, M. and Moreno, R. (2005), 'Does Product Market Competition Reduce Inflation?', European Central Bank, Working Paper Series, No 453. The evidence from EU countries shows a robust and significant negative link between competition and inflation, both at the aggregate and sectoral levels.

if consumers are active and willing to adopt these new products. In this respect, consumer protection can ensure that competition results in the 'right' kind of innovation, aimed at addressing consumer demand and improving processes, not at obfuscating consumers. This can be especially important in new or changing industries, where a dynamic of 'wrong' innovation can lead to a 'race towards the bottom' in standards, with low standards becoming the norm or where business might aim to gain a competitive advantage by obfuscating consumers.

- 1.11 Moreover, consumer policy has a role in the protection of vulnerable people, which can be hugely important, especially in times of economic uncertainty when consumer confidence can dampen demand.
- 1.12 The positive link between competition and growth is confirmed by a wealth of evidence.
- 1.13 At a macroeconomic level, there is strong evidence that policies to increase competition can stimulate economic growth and competitiveness.
 - Reforms introduced by the UK government throughout the 1990s aimed at reducing entry barriers, such as market liberalisation and interventions by competition authorities, had a positive impact on innovation and productivity in the UK.⁷ Entry or the threat of entry increased the incentive on existing firms to innovate or adopt new techniques in order to avoid the loss of market share. It also caused those firms that were less efficient to exit, raising economy wide productivity levels.

⁷ Aghion, P. Blundell, P., Griffith, R., Howitt, P and Prantl, S. (2009), 'The Effect of Entry on Incumbent Innovation and Productivity', in 'Review of Economics and Statistics', MIT Press, vol. 91(1), pages 20-32, October.

- Twenty to 40 per cent of total factor productivity differences between eight OECD countries can be explained by firm entry and exit.⁸
- Increased competition in the UK has been considered a major factor in explaining the narrowing in the productivity gap between British and German manufacturing.⁹
- In countries where there is more dynamism in markets, measured by the presence of more fast growing and shrinking firms, productivity growth is significantly higher.¹⁰

1.14 In addition, there is a wide range of empirical studies examining the links between competition, innovation and productivity that, on the whole, set out a positive relationship between the three.¹¹

⁸ Nickell, S. (1996). 'Competition and Corporate Performance', in 'Journal of Political Economy, volume 104, no 4, pp. 724 – 746.

⁹ Crafts, N. & Mills, T. (2003): 'TFP Growth in British and German Manufacturing, 1950-1996', Centre for Economic Policy Research, Discussion Paper No. 3078.

¹⁰ Bravo-Viosca, A. and Criscuolo, C., (2010), 'Evidence on business growth dynamics', presentation and paper for the OECD Working Party on Industry Analysis, 8-9 November 2010.

¹¹ For instance, Geroski finds (in Geroski, P. (1990), 'Innovation, Technological Opportunity and Market Structure' in 'Oxford Economic Papers, 42,, pp. 586 - 602) evidence against the hypothesis that increases in competitive rivalry decrease innovativeness. Blundell, Griffith and Van Reenen reveal (in Blundell, R., Griffith, R. and Van Reenen, J. (1995), 'Dynamic count data models of technological innovation' in 'The Economic Journal', 105 (March), pp. 333 – 344) a complex relationship between competition and innovation: at the firm level, dominant firms tend to innovate more, while at the industry level, concentration dampens innovation; to the extent that growing dominance increases concentration, the level of aggregate innovation will tend to fall. Griffith, Harrison and Simpson highlight (in Griffith, R, Harrison, R. and Simpson, H (2006) 'The link between product market reform, innovation and EU macroeconomic performance' in European Economy Economic Papers 243) that the effect of increasing competition on innovation is, within an industry, larger the closer to the global technological frontier (a scenario likely to relate to the situation in the UK).

1.15 At the micro level, examples of the positive impact of specific competition interventions on price, choice and innovation are also abundant:

- The liberalisation of European air routes by the European Commission facilitated the entry of a number of new low cost carriers. These carriers introduced new business models, including new booking methods and extensive use of outsourcing. In addition to increased consumer choice, the price of an economy class ticket provided by traditional carriers fell by over 66 per cent between 1992 and 2002.¹²
- The 1997 prohibition in the UK of the Net Book Agreement, an agreement between publishers not to supply books to retailers that priced below the publisher's net price, led to a dramatic reduction in the price of popular paperback fiction, with discounts on bestsellers and 'multi-buy' offers such as two-for-one now regularly being seen. In addition, it has helped promote and grow new efficient distribution models such as sales via the internet.¹³
- The deregulation of international telephone calls has provided consumers with greater choice of providers and significant decreases in the price of UK international calls, down 90 per cent over the decade to 2002.¹⁴
- The 2001 OFT intervention against Napp pharmaceuticals for abuse of dominance in the market for sustained release morphine resulted in

¹² Department of Trade and Industry (DTI), (2004), 'The Benefits from Competition: some illustrative UK cases'.

¹³ DTI (2004), *ibid.*

¹⁴ DTI (2004), *ibid.*

savings for the National Health Service in excess of £1.5 million per year.¹⁵

- A market study by the OFT recommending the elimination of administrative restrictions on entry in the retail pharmacy sector resulted, even with only partial implementation, in shortened travel and waiting times, and improved access to lower-priced over-the-counter medicines, with overall quantified net benefits conservatively estimated at £12-20 million per year. In addition, the market study also resulted in other (non-quantified) benefits including extended opening hours, and greater choice for consumers.¹⁶

1.16 Notwithstanding the evidence outlined above and the general consensus on the role of competition as a driver for growth, quantifying the links between specific competition interventions and growth remains a difficult task.¹⁷ With that in mind, the remainder of this document adopts an alternative approach that looks, at a more micro level, at the links between specific interventions and the key factors and processes driving growth. This alternative approach, illustrated by examples of OFT work, not only highlights the range of ways in which competition interventions impact on growth but also provides useful insights into the characteristics of a regime that best maximises competition's impact, including by addressing government intervention in markets.¹⁸

¹⁵ OFT (2011), 'Evaluating the impact of the OFT's 2001 abuse of dominance case against Napp Pharmaceuticals', OFT 1332.

¹⁶ OFT (2010), 'Evaluating the impact of the 2003 OFT study on the Control of Entry regulations in the retail pharmacies market', OFT 1219.

¹⁷ In addition to the usual challenges associated with isolating the impact on growth of specific policies, the relative small scale of most competition interventions (in relation to the size of the economy) and their diverse nature (both in terms of the type of intervention and the sectors under consideration) further hinders identifying the macroeconomic impact of specific interventions.

¹⁸ See, for instance, OFT (2010a), 'Government in markets: Why competition matters – a guide for policy makers', OFT 1113, for an overview of how government interventions can affect

2 IMPACT OF COMPETITION INTERVENTIONS ON FACTORS DRIVING ECONOMIC GROWTH

2.1 Growth in output (measured through Gross Domestic Product, GDP) is a function of both factors of production (natural resources, capital, and labour, to use the traditional taxonomy employed in most economic models) and the key processes by which these factors of production are combined to generate growth (most notably through the use of technology and management techniques). This can be concisely represented through the following production function:¹⁹

$$\text{Output} = f [\text{natural resources, capital, labour}]^{\text{technology, management}}$$

2.2 Changes in any of these factors can impact growth, either through an increase in the availability of and thus lowering the price of inputs, and/or by improving the way in which inputs are utilised and combined (that is, through improvement in management techniques and/or innovation in products or processes). Crucially, competition has a role to play in respect of the availability of factors of production and how they are utilised, hence delivering higher output at lower costs and impacting across the economy, as discussed below.²⁰

markets and how such interventions can be designed to minimise any negative effects on competition.

¹⁹ Other (less tangible and market-driven) issues impacting our economic environment and, hence growth, include the rule of law and the existence of a suitable institutional set-up, as highlighted by Douglass North's work linking the inability of societies to develop low cost effective institutions and economic stagnation (See North, D, (1991), 'Institutions' in 'The Journal of Economic Perspectives', 5(1), pp. 97–112). The relevance of the rule of law and institutional design in relation to the competition regime is discussed in the last section of this paper.

²⁰ Competition can also play a role in reinforcing the rule of law, hence further contributing to economic growth (see footnote 19 above).

Natural Resources

- 2.3 Where markets for natural resources work well, competition should act not only to ensure the availability of natural resources, at the best prices, but also, where resources are in short supply, to deliver an efficient allocation of such resources.
- 2.4 There are a multitude of examples where natural resource markets do not work well, including oil markets where OPEC acts as a cartelising device, and natural resource markets where state aid is prevalent in many countries. However, the importance of competition as a driver of efficiency and productivity is being increasingly recognised and becoming more embedded in the design and monitoring of natural resource markets. Examples include the increased emphasis on competition as a complement to regulation in utility markets, the input from competition authorities on the use of horizontal cooperation agreements for environmental objectives, or the high profile merger cases involving companies in these sectors.
- 2.5 This paper focuses on land (a natural resource that is used, to different degrees, in all economic activities) as an illustration of how competition (and competition authorities) can ensure that a factor of limited supply is used in the most productive way.²¹
- 2.6 When considering the markets for land in the UK, concerns arise in particular in respect to land use restrictions, and their impact on land availability and growth. The National Audit Office has identified planning

²¹ The analysis of land markets, while exemplifying the issues prevalent across other natural resource markets, allows us to focus (given the non cross-boundary nature of land) on competition interventions at the national level. The scope for and role of international institutions on ensuring competition in internationally traded commodities would merit a detailed discussion on its own and one that falls outside the objectives of this paper. See Bhagwatti, J. N, and Hudec, R. E. (1996), 'Fair Trade and Harmonisation: pre-requisites for free trade', MIT Press, for a discussion on these issues.

laws as creating the highest regulatory costs of any type of regulation.²² Similarly, recent work by McKinsey singles out planning restrictions as one of the main areas to be addressed in order to improve UK productivity, especially in light of the misperceptions surrounding the issue, the difficulties and uncertainty associated with the planning process, and the potential impact of planning on productivity.²³ This study claims that large-format stores can be five times as productive as traditional stores, but are limited in number in the UK due largely to restrictive planning regulations.

2.7 Competition authorities have two important roles to play in ensuring the efficient working of land markets, and the regulations that shape the functioning of those markets. Firstly, competition authorities have a direct role in ensuring that parties' private actions do not hinder competition by ensuring effective compliance with competition law. Enforcement action is an important element of this, as exemplified by the OFT's recent interventions against anti-competitive agreements in the construction industry.²⁴ However, softer compliance tools are also an important element. For example, when land agreements were recently brought within the coverage of UK competition law, having previously

²² National Audit Office (2007), 'Reducing the Cost of Complying with Regulations: The Delivery of the Administrative Burdens Reduction Programme'.

²³ McKinsey (2010), *Ibid.* The analysis seems to indicate that we do not face a land crisis, and points to the misperceptions surrounding land availability (both in terms of amount and type of land available for development) and the difficulties and uncertainties associated with the planning regime as important factors hindering the contribution of the planning regime to growth. The relevance of the latter is also supported by evidence from the 2008 review of the planning regime by Killian Pretty www.planningportal.gov.uk/uploads/kpr/kpr_final-report.pdf

²⁴ See, for instance, the OFT's investigation into bid-rigging in the construction industry in England: OFT (2009), 'Bid-rigging in the construction industry in England Affected market: Construction industry in England CE/4327-04 Summary of the infringement' available at www.of.gov.uk/OFTwork/competition-act-and-cartels/ca98/decisions/bid_rigging_construction

been excluded, the OFT published helpful guidance for affected businesses to aid compliance.²⁵

- 2.8 The second key role that competition authorities can play is as an advocate for competition, with a view to ensuring that any impact on competition (and consumers) is incorporated by government into policy analysis and regulatory proposals.²⁶ This role of competition authorities, as competition advocates, has increasingly become standard across the world. In the case of the planning regime, and given that planning restrictions can be an important barrier to entry and/or expansion, this involves encouraging government to give consideration to the extent to which restrictive planning regulation restricts the effective functioning of markets for land. This is important not only for growth but also for consumers, with Griffiths and Harmgart (2010) estimating that restrictive planning regulation leads to a loss to consumers of up to £10m per annum.²⁷
- 2.9 The OFT's advocacy role can sometimes be formalised through a full OFT market study, with recommendations to government a key output, or even through a market investigation reference to the UK Competition Commission. While planning has not been the core focus of any such OFT studies to date, planning issues have been explored in a number of

²⁵ The Land Agreements Exclusion Order excluded land agreements (such as leases and transfers of freeholds) from the prohibition contained in Chapter I of the Competition Act 1998, to the extent that they contained certain restrictions on the way in which land may be used, or how a right over land may be exercised. This Order was revoked by the UK Government with effect from 6 April 2011. The OFT's guidance on the application of competition law to land agreements (OFT (2011a), 'Land Agreements: the application of competition law following the revocation of the Land Agreements Exclusion Order', OFT1280a) is available at www.offt.gov.uk/shared_offt/consultations/land-agreements/land-agreements-guideline.pdf

²⁶ While recognising, of course, that the critical and sensitive balancing judgment that needs to be made on (potentially conflicting) policy objectives is left to government.

²⁷ Griffiths, R. and Harmgart, H. (2008), 'Supermarkets Competition in the UK and Planning Regulation'. Centre for Economic Policy Research, Discussion Paper 6713.

OFT market studies, including those focusing on groceries (2006), airports (2006), the homebuilding sector (2008), and organic waste (2011).²⁸ Planning issues were central to the analysis of market dynamics and were among the features referred to and considered by the CC in both the groceries and airports market investigations.²⁹

2.10 Finally, it should be noted that consumer authorities (often the same institutions as competition authorities) are also important for ensuring that the demand side of markets functions effectively and helps drive competition. In the case of land-related markets (including property and rental markets), effective consumer empowerment can be crucial for ensuring that markets work well and that land use is not distorted. These land-related markets can play an especially important role in growth, given that they can affect labour market flexibility. The OFT has used both its advocacy and consumer enforcement tools to ensure that housing markets (including those for rented and leasing properties) are reflective of, and reactive to, consumer needs and preferences.

2.11 Finally, it should be noted that consumer authorities (often the same institutions as competition authorities) are also important for ensuring that the demand side of markets functions effectively and helps drive competition. In the case of land-related markets (including property and

²⁸ See, respectively: OFT (2006), 'Grocery market: proposed decision to make a market investigation reference', OFT 838 (available at www.of.gov.uk/shared_of/reports/consumer_protection/of838.pdf); OFT (2006a), 'UK airports: Report on the market study and proposed decision to make a market investigation reference', OFT 882 (available at www.of.gov.uk/shared_of/reports/transport/of882.pdf); OFT (2008), 'Homebuilding in the UK: a market study', OFT 1020 (available at www.of.gov.uk/OFTwork/markets-work/completed/home1); and OFT (2011b), 'Organic Waste: an OFT market study', OFT 1372 (available at www.of.gov.uk/shared_of/market-studies/of1372.pdf)

²⁹ See, respectively: Competition Commission (2008), 'The supply of groceries in the UK market investigation', available at www.competition-commission.org.uk/rep_pub/reports/2008/538grocery.htm; and Competition Commission (2009), 'BAA Airports: final report', available at www.competition-commission.org.uk/rep_pub/reports/2009/545baa.htm

rental markets), effective consumer empowerment can be crucial for ensuring that markets work well and that land use is not distorted. These land-related markets can play an especially important role in growth, given that they can affect labour market flexibility.³⁰ The OFT has used both its advocacy and consumer enforcement tools to ensure that housing markets (including those for rented and leasing properties) are reflective of, and reactive to, consumer needs and preferences.³¹

Capital (Finances)

- 2.12 As with land, competition and consumer authorities have a clear role to play in ensuring businesses have access to finance at cost-efficient prices. Competition supports the efficient working of capital markets, impacting the availability and cost of capital, and also the price of (access to) capital. There is evidence that rivalry in the financial sector drives down intermediation costs and resulting in lower capital costs.³² Moreover, a strong and stable competition regime can increase the

³⁰ The impact of housing markets flexibility on labour mobility and unemployment is well recognised (See, for instance, Hughes, G, and McCormick (1991), 'Housing Markets, Unemployment and Labour Market Flexibility in the UK', in ' International Volatility and Economic Growth: The First Ten Years of The International Seminar on Macroeconomics', pp. 83 - 114))

³¹ In addition to the homebuilding market study (OFT (2008)), mentioned above, other interventions have aimed at facilitating informed transactions and reducing transactional costs include the Foxtons case (2010), preventing the use of certain sales and commissions terms in its letting agreements with consumer landlords, and the market study and follow-up work on sale and rent back (2009), resulting in statutory regulation of the sale and rent back sector by the Financial Services Authority. See www.of.gov.uk/OFTwork/consumer-enforcement/consumer-enforcement-completed/foxtons for details on Foxtons, and www.of.gov.uk/OFTwork/markets-work/completed/saleandrent, for details on OFT's work on sale and rent back. The latter provides an example of OFT advocating, and government accepting, an appropriate regulatory framework to improve the functioning of a market.

³² Stijn Claessens (2009), 'Competition in Financial Sector: Overview of Competition Policies', International Monetary Fund, Economic Working Paper series, WP/09/45

availability of capital by creating a more favourable market environment for investment.³³

- 2.13 The challenges associated with delivering capital are particularly relevant in the case of infrastructure, especially as this an area where the UK faces a number of challenges. McKinsey estimated, in 2010, that the UK would need to spend more than £350 billion over the next 20 years merely to maintain its existing transport infrastructure and a further £120 - 170 billion to support its energy infrastructure.³⁴ The OFT's stock-take of the control and ownership of UK infrastructure further highlights the positive impact competition can have, including from overseas firms investing in UK infrastructure.³⁵
- 2.14 Competition enforcement has an important role to play in creating these competitive conditions. A recent example in the UK is the 2010 OFT case penalising the sharing of price sensitive information between two major UK banks.³⁶ The merger regime is also important in preserving competition in financial markets, and competition regimes need to be alive to less familiar issues such as the way in which minority interests (minority share ownerships, interlocking directorships, loans to competitors and contracts for differences) can weaken competition.³⁷

³³ In this respect, both the role of competition as a factor driving macroeconomic stability and contributing to the prevalence of the rule of law are relevant.

³⁴ See McKinsey (2010), *Ibid*, for further detail. The extent of the challenge is highlighted by the fact that the UK is ranked thirty-third in a World Economic Forum survey of infrastructure quality, with more businesses rate infrastructure as a barrier to growth than they do workforce education and skills (see CBI Annual Conference Survey, 2010).

³⁵ OFT (2010b), 'Infrastructure Ownership and Control Stock-Take', OFT 1290

³⁶ See www.of.gov.uk/news-and-updates/press/2011/05-11 for further detail.

³⁷ OFT (2010c), 'Minority interests in competitors: a research report prepared by DotEcon Ltd', OFT 1218

- 2.15 Finally, the financial sector is also an area where the interaction between competition (supply side considerations) and consumer empowerment (demand side) is key, and therefore a number of OFT interventions have focused on the role of consumers in driving competition in the financial sectors.
- 2.16 For instance, the OFT's 2007 review of SME banking identified that, although there seemed to be few barriers to setting up, new firms trying to grow in this market face difficulties due to customers' low levels of switching, loyalty to incumbent providers, and attachment to a local branch.³⁸ Further OFT work also highlights how issues surrounding access to capital for SMEs and lending margins interact with regulation (including cross-national initiatives such as the new Basel rules).³⁹ Similarly, an OFT market study on equity underwriting identified a number of measures aimed at enabling companies and institutional shareholders to drive greater competition in the market.⁴⁰

Labour

- 2.17 Competition (especially when coupled with user choice) can also play a role in increasing the productivity of a country by ensuring that the economy has access to the right skills and in the right numbers. More specifically, the actions of a competition and consumer authority can

³⁸ Following the 2002 review of the CC's enquiry into SME banking, the OFT concluded that, although price controls had been successful in shifting prices to more competitive levels, there continued to be demand-side concerns. Given low levels of switching and lack of price transparency, the OFT argued that behavioural remedies (designed to make switching easier and faster, to make prices more transparent and to stop banks from bundling SME services with other services) were still required to empower SMEs in the market place. See OFT (2007), 'SME Banking Review of the undertakings given by banks following the 2002 Competition Commission report', OFT 937, for further detail.

³⁹ See, for instance, OFT (2010d), 'Review of barriers to entry, expansion and exit in retail banking', OFT 1282

⁴⁰ OFT (2011c), 'Equity underwriting and associated services', OFT 1303.

play a role in increasing labour participation, contributing to an efficient education system, and ensuring that labour incentives are (increasingly) aligned with a contribution to productivity and growth.

- 2.18 Competition enforcement has a direct role to play in ensuring that markets associated with labour participation and skills work well. A recent example is the OFT's 2009 enforcement action against price fixing and collective boycott by the Construction Recruitment Forum, a group of recruitment agencies involved in recruitment for the construction industry.⁴¹
- 2.19 However, the OFT's competition advocacy role is especially important in this arena, ensuring that policy makers fully consider the role that choice and competition can play in the provision of labour-market related services. In this respect, OFT work on the role of competition and choice in public markets has highlighted that competition and choice can be very powerful tools in driving both efficiency and innovation, in particular in employment services.⁴² Initial assessments of the UK Government's experiences in providing jobseekers with greater choice over who provides them with support into employment indicate that opening up the market to private and third party providers and extending choice has improved individuals' attendance, and increased their level of engagement.
- 2.20 In the case of higher education, an analysis of past experience suggests that choice and competition will require diversity of supply (or at least

⁴¹ See OFT (2009a) 'OFT Decision: Construction Recruitment Forum, Case CE/7510-06' available at www.of.gov.uk/shared_of/ca98_public_register/decisions/CE7510-06_Decision_290909_N1.pdf

⁴² Given the role of public policies and providers in labour and skills markets (including education), 'user choice' provides an opportunity to activate consumer preferences and choices, encouraging competition amongst providers. For further detail, see OFT (2010e), 'Choice and Competition in Public Services', OFT1214, and See chapter 5 (Employment Services) in OFT (2010f), 'Choice and Competition in Public Services – case studies: a report prepared for the OFT by Frontier Economics', OFT 1214case

the potential for multiple providers so that users can exercise a choice), an open supply side in which restrictions on entry and exit from the market are minimised, and appropriate funding and incentives (for example, linking providers' income to the number of users they attract/and or the outcomes they achieve, and granting flexibility and managerial autonomy to incentivise innovation or efficiency gains).⁴³ But, similarly to other markets, such as health, bringing competition to the marketplace also requires consumers to be able to play an active role - so information must be clear and choices not overly complex. These considerations have informed recent policy proposals in the area, including the 2010 Independent Review into Higher Education Funding and Student Finance, and the 2011 White Paper on Higher Education ('Students at the Heart of the System').⁴⁴

2.21 Finally, competition interventions can help to ensure that restrictions to competition do not reward particular professions with unduly high wages. Monopoly rents can result in talent being attracted to sectors that, while profitable, are not necessarily growth-generating.⁴⁵

⁴³ See OFT (2010e), 'Choice and Competition in Public Services – a guide for policy makers, OFT1214, and OFT (2010f), *Ibid.*

⁴⁴ The 2010 independent review of Higher Education by Lord Browne advocated the use of (student) choice to introduce competition in the higher education sector and granting more flexibility to universities in terms of financial arrangements and managerial incentives, while the 2011 White Paper 'Students at the Heart of the Systems' focuses on empowering students by providing better information (with an increased emphasis on student charters, student feedback and graduate outcomes), enabling a greater diversity of provision and facilitating institutions' responsiveness to student demand.

⁴⁵ See for instance, Murphy, Shleifer and Vishny for an analysis of the link between the allocation of labour across activities and growth. Their 1991 analysis ('The allocation of talent: Implications for Growth' in 'Quarterly Journal in Economics, Volume 106, number 2, pp. 503 - 530) controversially highlights the positive relationship between productivity growth across countries with the ratio of engineers to lawyers (with the latter considered as a example of 'rent seekers', with their wealth derived from the redistribution of wealth and not from wealth creation).

- 2.22 The retail pharmacy sector is a case in point, and one that resonates in many European countries. For instance, in Ireland, until recently, only fifty graduates from a Dublin University were able to open their own pharmacy outlet per year. Together with other restrictions on retail pharmacies, this resulted in some of most skilled students in the country working in a sector where, as a result of barriers to entry and other regulatory measures stifling innovation, entrepreneurship went mostly unrewarded and skills were not being optimally utilised to improve productivity.
- 2.23 Ongoing OFT work aiming to increase competition in the professions, such as in the legal and audit markets, should act to reduce monopoly rents and thereby ensure that incentives become increasingly aligned with entrepreneurship and impact on productivity.⁴⁶
- 2.24 Overall, then, competition interventions have a key role to play in ensuring that returns to labour are reactive to market fundamentals and aligned with their contribution to productivity and growth, and that the labour resources are efficiently allocated across the economy through market mechanisms.

Innovation

- 2.25 Technology plays a fundamental role in how factors of production are combined into final outputs. Innovation increases dynamic efficiency through technological improvements of production processes, or the creation of new products and services, with innovation being traditionally seen as an engine for growth and productivity.⁴⁷

⁴⁶ For further detail, see www.of.gov.uk/OFTwork/financial-and-professional/professional-services.

⁴⁷ See, for instance, Murphy, Shleifer and Vishny for an analysis of the link between the allocation of labour across activities and growth. Their analysis (Murphy, K. M., Shleifer, A., and Vishny, R.W., (1991) 'The allocation of talent: Implications for Growth' in 'Quarterly Journal in Economics, Volume 106, number 2, pp. 503 - 530) highlights the positive relationship between productivity growth across countries with the ratio of engineers to lawyers (with the latter

- 2.26 In the presence of competition, firms will aim to innovate to gain a cost advantage, to differentiate their products and/or to bring new products to the marketplace. Competition is, arguably, the strongest incentive for firms to innovate.⁴⁸
- 2.27 However, innovation requires appropriate rewards for successful innovations for instance, when innovations are significant enough, by placing the innovator in a quasi-monopoly situation, generating large rent opportunities⁴⁹ or by granting the innovator intellectual property rights. The link between competition and innovation is, therefore, a complex one, and one that is mediated by the intellectual property rights regime.⁵⁰
- 2.28 The complexity of the issues might have led some competition authorities to adopt a cautious approach to interventions in this area.⁵¹ However, competition authorities can play an important role in analysing market dynamics and, by adopting a robust effects-based approach, ensuring that innovation drives productivity to the maximum extent. Indeed competition authorities have a legitimate role intervening in

considered as a example of 'rent seekers', with their wealth derived from the redistribution of wealth and not from wealth creation).

⁴⁸ Intellectual Property Office (2011), 'Digital Opportunity: A Review of Intellectual Property and Growth', p. 11.

⁴⁹ Scherer and Ross (1990), 'Industrial Market Structure and Economic Performance', Houghton and Mifflin.

⁵⁰ John Vickers (2001), 'Competition and Innovation - A speech to the International Competition Policy Conference', available on http://www.offt.gov.uk/shared_offt/speeches/spe0701.pdf

⁵¹ The relationship between competition and innovation has frequently been characterised as an inverse U-shaped one - see, for instance, Aghion, P, Harris, C, and Vickers, J. (1997), 'Competition and Growth with Step-by-Step Innovation: An Example' in 'European Economic Review, Papers and Proceedings' XLI (1997), 771–782. However, recent work postulates that the relationship between competition and innovation is infrequently negative or hump-shaped (Greenhalgh, C., Rogers, M. (2010), 'Competition, Intellectual Property and Innovation', background paper to the IPO's 'Report for the Review of IP and Growth', available at www.ipo.gov.uk/ipreview-doc-h.pdf)

markets characterised by innovation to ensure that the dynamic benefits of competition materialise.

2.29 The OFT portfolio of interventions reflects this emphasis, with work on innovation-intensive sectors focused on those markets characterised by barriers to entry and high levels of concentration and/or discrete innovation developments (where the 'escape the competition effect' can potentially be stronger). For instance, a number of OFT competition enforcement cases have tackled the abuse of dominant position by incumbent firms against new entrants (NAPP, Genzyme, Gaviscon).⁵² In addition, the OFT's work on mergers in innovation-led sectors (such as pharmaceuticals, bioscience, and advanced manufacturing) also contributes to ensuring that mergers do not lessen competition, restricting innovation and economic growth, while recognising the benefits that mergers can sometimes bring to innovation and growth.

2.30 However, while it is important that competition authorities intervene when required, it is also important that they place appropriate limits on intervening ex post (that is, once innovating firms have been successful) when the potential to win ex post profits was precisely what drove the firm to innovate. In this respect, authority independence (and hence the ability to withstand pressure to intervene from interest groups and/or competitors) is crucial.⁵³

⁵² See, respectively: OFT (2001), 'Decision of the Director General of Fair Trading: CA98/2/2001, Napp Pharmaceuticals Holdings Limited and subsidiaries (Napp)', available at www.offt.gov.uk/shared_offt/ca98_public_register/decisions/napp.pdf; OFT (2003), 'Decision of Director General of Fair Trading: CA98/3/03, Exclusionary behaviour by Genzyme Limited', available at www.offt.gov.uk/shared_offt/ca98_public_register/decisions/genzyme.pdf; and OFT (2011d), 'Decision of the Office of Fair Trading: Abuse of a dominant position by Reckitt Benckiser Healthcare (UK) Limited and Reckitt Benckiser Group plc, Case CE/8931/08', available at www.offt.gov.uk/shared_offt/ca-and-cartels/rb-decision.pdf.

⁵³ In this respect, competition authorities should be able to assess the merits of an intervention, including (amongst other factors) whether the source of market power is the result of innovation or competition for the market. See, for instance, OFT (2010b), *Ibid*.

- 2.31 Competition authorities also have a key role in assessing the impact that government regulations and practices may have on competition and innovation. For instance, the OFT's recommendations on the UK Government's Pharmaceutical Price Regulation Scheme (PPRS) were aimed at ensuring that the scheme encourages business investment to focus on those drugs that deliver the greatest benefits for patients.⁵⁴
- 2.32 This role of competition as a driver of innovation and economic growth goes hand in hand with the OFT's role as a consumer authority, combating unfair trading practices. Having active consumers with the confidence to engage in markets will, in turn, act as a driver for economic growth, as firms can only gain from innovation if they can get their products to market, and consumers are active and willing to adopt these new products. Consumer protection can, therefore, ensure that competition results in the 'right' kind of innovation, one that is aimed at addressing demand and improving processes, not at obfuscating consumers. This can be especially important in new/changing industries and in emerging or developing countries, where a dynamic of 'wrong' innovation can lead to a 'race towards the bottom' in standards, with low standards becoming the norm, or to companies seeking to gain a competitive advantage over their competitors by obfuscating consumers.⁵⁵

⁵⁴ Similarly, our recommendations and subsequent work on the impact of regulations on the restrictions of entry in the retail pharmacy sector and on the estate agent sector have been informed by concerns about the extent to which new business models may be hindered by the existing regulations.

⁵⁵ The OFT's enforcement and markets work on Unfair Terms in Consumer Contracts Regulations (UTCCRs) and Consumer Protection from Unfair Trading Regulations (CPRs) as well as our work on advertising and pricing practices exemplify the relevance of this joint approach, and its role in ensuring, for instance, that the benefits from increased competition in the airline sector do not result in companies taking advantage of the 'grey area' of the law.

Management

- 2.33 Management also plays a major role in how factors of production are combined in the production of final outputs. If management is poor, then key inputs will be combined inefficiently, with a negative impact on output and, hence, on growth.⁵⁶
- 2.34 This positive relationship between competition and management quality is supported by economic evidence, with the relationship holding across countries and sectors.⁵⁷ Competition places pressure on managers to increase internal efficiency and improve processes, ensuring that their efforts are focused on growth-enhancing initiatives and not on other types of (personal) rent-seeking behaviour.⁵⁸ This role of competition is all the more important in the absence of other disciplining devices (for example, financial pressure and active external shareholders).⁵⁹
- 2.35 In addition to this effect at the firm level, competition increases the overall quality of management across a sector as higher productivity

⁵⁶ This is an area of particular concern for the UK in its drive to 'catch up' with the level of productivity of other countries. Joint research by McKinsey and the London School of Economics highlights the relatively poor performance of UK managers (UK management scores are 10 per cent lower, on average, than the US), with the UK having a 'long tail' of low-performing firms. See McKinsey and Centre for Economic Performance (LSE), (2007), 'Management Practice and Productivity: Why they matter', available at http://cep.lse.ac.uk/management/Management_Practice_and_Productivity.pdf.

⁵⁷ Bloom, N. and Van Reenen, J. (2010), 'Why do management practices differ across firms and countries?', in 'Journal of Economic Perspectives', Volume 24, number 1, pp. 203 – 224.

⁵⁸ This positive impact of competition is more pronounced when firms have principal-agent problems, as competition will evidence the link between efficiency and firm performance, contributing to a better alignment of managers' objectives with those of the owners or stakeholders. See, for instance, Griffith (2001), 'Product Market Competition, efficiency and agency costs: an empirical analysis', Institute for Fiscal Studies, Working Paper WP 01/12.

⁵⁹ Nickell, S., Nicolitsas, D., and Dryden, N. (1997), 'What makes markets perform well?' in 'European Economic Review', Volume 41, Issues 3-5, pp. 783-796.

firms (which tend to be better managed) increase their market share at the expense of less productive firms (which see their market share reduce or, in some cases, go out of business).

- 2.36 Competition enforcement has a role to play in ensuring that anti-competitive practices do not prevent the positive impact of competitive pressures on management, and hence on productivity and growth, from materialising. In addition, by adopting a consistent and proportionate approach to analysis and remedies, the merger regime can further contribute to ensuring that the market for corporate control effectively mediates the impact of competition on management and growth.
- 2.37 Other tools available to competition authorities can also play a major role in ensuring managers' efforts are focused on productivity-enhancing (growth-generating) initiatives. For instance, tackling public restrictions on competition can help to ensure that sectors, and their managers, are not sheltered from the impact of competition. In this respect, a consistent approach to embedding competition considerations in the design and implementation of policies can act as a deterrent against managers engaging in rent-seeking activities, where they lobby government to maintain their advantage rather than focusing on their customers' needs and, thereby, on driving productivity and growth.
- 2.38 The role of competition as a driver of better management and outcomes is also relevant in public markets.⁶⁰ As such, the ongoing process of market design in a number of public markets and the prevalence of mixed markets (characterised by the co-existence of public, private and, in some cases, third sector suppliers) provides competition authorities with an opportunity to advocate the appropriate use of competition as a

⁶⁰ Bloom, N., Propper, C., Seiler, S., and Van Reenen, J. (2010), examine English hospitals in the public (NHS) and private sectors, considering that closing hospitals is unpopular and less likely to happen in marginal constituencies, and find that competition increases management quality and so helps improve clinical outcomes (such as survival rates from heart attacks). See 'The impact of competition on management quality: evidence from public hospitals', Centre for Economic Performance, Discussion Paper No 983, available at <http://cep.lse.ac.uk/pubs/download/dp0983.pdf>

disciplining and rewarding device, independent of the type of ownership.⁶¹

- 2.39 In addition, as with the case of innovation, consumer protection can help to ensure that competitive pressures materialise in improved management practices aimed at delivering better or lower-cost products or services, not at obfuscating consumers.

In summary

- 2.40 This analysis of specific competition interventions illustrates how competition can increase the availability and lower the price of factors of production, and improve how they are utilised, hence delivering higher output at lower costs. Given that each sector of the economy can benefit from this positive impact through a variety of channels, we can conclude that competition interventions can have a profound and pervasive impact on growth across the whole economy.⁶²

⁶¹ OFT (2010e), *Ibid*, highlights the issues to be considered when assessing the effectiveness of competition as a driver of efficiency in public markets. OFT (2010g), 'Competition in mixed markets: ensuring competitive neutrality', OFT 1242, outlines the barriers to competitive neutrality (that is to ensuring a level playing field for public, private and third sector providers) and how they can be addressed.

⁶² While our analysis has focused on some salient illustrations, it is important to note that the impact of competition at the sectoral or market level is multi-faceted. For instance, the retail sector will be impacted by the level of competition in land markets (influenced, amongst other factors, by the planning regime), in capital markets (which will shape their access to finance, including for expansion purposes), and in labour markets. Moreover, competition will also influence the level of innovation and management performance in the sector. And crucially, retailing will also be impacted by the level of competition in other related sectors, given the overall rivalry for scarce resources across the economy.

3 MAXIMISING THE IMPACT OF COMPETITION ON ECONOMIC GROWTH

3.1 While the link between competition and growth and between competition interventions and the factors driving growth is widely acknowledged, less attention has been paid to the respective roles of government and competition agencies in this relationship, supporting and driving growth through the promotion of competition. The remainder of this paper will focus on those issues.

Role of government

3.2 Government can directly support and drive competition in a variety of ways, most notably by choosing when and how to intervene in markets.

3.3 At their most basic, markets are a mechanism for allocating resources. When markets work well, firms thrive by providing what consumers want, better and more cost-effectively than their competitors. As such, effective competition provides significant benefits for consumers through greater choice, lower prices, and better quality goods and services. Competition also provides strong incentives for firms to be more efficient than their rivals, reduce their costs and innovate, thereby helping raise productivity growth across the economy. On average, competition tends to provide better outcomes than alternative models.

3.4 But, left to their own devices, markets will not necessarily deliver the best outcomes for consumers, companies or government. In order to address this, government has a key role in setting the general legal and institutional frameworks within which markets operate. This includes establishing the 'rule of law', creating property rights, ensuring contracts are upheld, and (crucially) a consistent and effective competition and

consumer regime that tackles anti-competitive behaviours and structures and unfair trading practices.⁶³

- 3.5 By providing a stable and consistent high-level framework to operate in, governments can have a major effect on the effectiveness of competition. This will also enhance the attractiveness of that country for investment, driving further competition in the economy.
- 3.6 In addition to setting the general framework for markets to operate, government might intervene in specific markets. Sometimes this will be to address market failures, which restrict the efficient working of markets, such as where there are public goods, externalities, informational problems or market power.⁶⁴ On other occasions, government will intervene to achieve particular social objectives, such as poverty reduction or the improvement of the health and well-being of citizens. Government may also decide to intervene to help stabilise the economy following an unexpected economic disturbance or to help speed up the economic recovery following a downturn.⁶⁵
- 3.7 In deciding when and how to intervene in markets, government will be informed by the evolving understanding of the way in which markets

⁶³ In addition to the role of a competition authority (discussed below in further detail), the effectiveness of the competition regime will be crucially influenced by its institutional design. For instance, given the key role that courts can play in determining the deterrence properties of competition interventions, it is crucial that the courts provide effective (and efficient) oversight, checks and balances on the work of a competition agency. See International Competition Network (2006), 'Report on Competition and the Judiciary' and International Competition and ICN (2007), 'Competition and the Judiciary 2nd Phase Report – Case Studies (2007)'.

⁶⁴ See OFT (2009b), 'Government in Markets', OFT 1113, for a detailed discussion of these issues.

⁶⁵ In addition, governments might also decide to intervene to address the failures arising from previous government interventions (also known as 'government failure').

work, as well as the prevalent economic and political ideology (which, in turn, will influence government objectives).⁶⁶

- 3.8 Market intervention can take a variety of different forms. Government can take a proactive approach to opening up markets, with significant impact on the level of competition, consumers and the economy, as exemplified by the positive experiences of liberalisation in the telecommunications and airlines markets.⁶⁷
- 3.9 Government can also affect existing markets, either through direct participation (for instance, as a buyer or supplier of goods and services), or through indirect participation (for example, through regulation, taxation, subsidy or other influencing devices such as information campaigns).⁶⁸ In using these levers, government can crucially impact the working of markets and, therefore, the role of competition as a driver of economic growth.
- 3.10 However, government intervention in markets is not always specifically designed to achieve competition and growth. It is therefore important that government considers the implications of its policies for competition, and how it can best achieve its objectives with the least distortion to competition.⁶⁹ This is particularly relevant as the impact of government interventions in markets can be pervasive, especially as, on many occasions, the damage to competition and growth can only

⁶⁶ In doing so, government will also decide on any trade-offs resulting from different (and, on occasions, potentially conflicting) objectives. This is likely to involve, given the roles and responsibilities of specific government departments and bodies, some coordination and/or brokerage between different parts of government.

⁶⁷ See paragraph 15, *supra*.

⁶⁸ See OFT (2009b), *ibid*, for a taxonomy of governments' interventions in markets.

⁶⁹ In the UK, government is required to consider the implications of new regulation on competition as part of the formal Impact Assessment process (which needs to be undertaken before the adoption of any policy).

become obvious over time, and can be extremely difficult to remove or reverse.

- 3.11 For instance, government can foster competition by providing a stable and consistent regulatory framework for companies to operate in. It can also ensure that, when regulation is deemed necessary to address market failures, the impact on competition (either through directly or indirectly limiting the number or range of suppliers, the ability of suppliers to compete or reducing suppliers' incentives to compete vigorously) is duly considered and minimised.⁷⁰
- 3.12 Similarly, government can, by providing subsidies and imposing taxes which change the costs of some businesses and influence their production decisions, affect competition. For instance, subsidies and taxes can create entry barriers in a market (or, in the case of subsidies, increase barriers to exit), and/or allow firms to build and exploit market power. It is therefore crucial that, in designing subsidies and taxes, policy makers should consider carefully both the degree of competition in the market, and the way in which different approaches might affect this competition to minimise the potential negative impacts on competition.
- 3.13 Where government is a major buyer in a market, its purchasing decisions can have significant effects on competition. In some situations, Government can use its buyer power to encourage greater competition between suppliers, and play an important role in shaping markets, for example, through supporting new technologies or products. But governments should also be careful that procurement mechanisms do not discriminate against certain types of suppliers, particularly smaller

⁷⁰ In this respect, is it important that government considers whether regulation might be replaced by (less traditional) alternative measures which might be less restrictive of competition, including the provision of information to users and of choice mechanisms.

suppliers, creating barriers to entry, or that continuity of service does not automatically favour the largest supplier or public sector provision.⁷¹

- 3.14 While evident that government can play a crucial role in driving competition through interventions (or lack of intervention) in the market, doing so is not exempt from challenges. Firstly, competition needs to be considered from the early stages of policy design and throughout the policy-making process; this can present a particular challenge when the primary stated policy objectives are different from, and potentially perceived to be in conflict with, competition.
- 3.15 Secondly, and as a related point, consideration of the full competition impact of policies might be further hindered by the dispersed nature of policy making. This might not only result in the consideration of policies under a wide range of prisms that differ from that of competition (or, for the matter, of economic growth), but also lead to disregarding the impact that competition-distorting measures in one sector can create on other policies or sectors (including through the creation of precedent).
- 3.16 Thirdly, government will often face very vocal and influential resistance to competition-friendly policies from interest groups (typically incumbent businesses) that stand to benefit from restrictions on competition.
- 3.17 These challenges are not insurmountable, especially as competition authorities can play a crucial role in helping governments address them. As such, a final important role for government in terms of influencing growth in the economy is through the design of a suitable competition and consumer regime. By setting a framework and institutions with the ability to tackle private and public restrictions on competition and unfair trading practices, government can have a crucial impact on growth. It is

⁷¹ See OFT (2011d), 'Commissioning and Competition in the Public Sector', OFT 1314, for a detailed analysis on how commissioners and procurers in the public sector can leverage competition to support open and contestable markets.

to this role of competition authorities, which can be considered as complementary to that of government, that we now turn our attention.

Role of competition authorities

- 3.18 While our analysis above outlines the role of government in enhancing growth through promoting and protecting competition, the role of competition authorities is also crucial and complementary, helping to ensure vibrant competition across the economy.
- 3.19 A primary function of any competition authority will be to drive compliance with competition law. It does this partly through enforcement, with the sanctions associated with findings of infringement acting as crucial drivers of deterrence.^{72,73} However, a competition agency should also aim to change business behaviour more widely, by complementing targeted enforcement with the use of other tools, including help and advice to businesses wanting to comply with the law.⁷⁴

⁷² This has led the US Department of Justice to declare (in its Congressional Submission for Fiscal Year 2001) that '[] deterrence is perhaps the single most important ultimate outcome of the [Antitrust] Division's work. We are just as sure that it presents the most significant measurement challenges...' OFT (2007b), 'The Deterrent Effect of Competition Enforcement by the OFT', OFT 962, estimates the ratio of potential infringements abandoned or modified to the number of decisions during the period 2001- 2006, with values ranging from 4:1 for abuse of dominance, to 7:1 for (anti-competitive) commercial agreements.

⁷³ See, for instance, OFT (2007b), *ibid*, and OFT (2010h), 'Drivers of compliance and non-compliance with competition law', OFT 1227, for the relevance of financial penalties, sanctions against individuals, private damage actions and the reputation damage associated with enforcement as drivers of compliance.

⁷⁴ This will include the ability to explore new tools, such as the OFT's introduction of short form opinions (providing guidance, within a prompt timetable, to businesses seeking clarity on how the law applies to prospective collaboration agreements between competitors which raise novel or unresolved competition issues) or pursuing greater 'co-production' of outcomes with the private sector (for example, self-assessment by business).

- 3.20 In doing so, it is important not only that the authorities foster compliance with the law, but also that businesses are not unduly refrained from engaging in innovative, pro-competitive (and growth-enhancing) conduct, due to uncertainty as to whether that conduct is compliant with competition law. It is also important that the authorities' interventions are carried out in as efficient and streamlined a way as possible, for example through using early resolution mechanisms or staged decision-making.⁷⁵
- 3.21 Alongside the work of the competition authority, it is also important to highlight the complementary role of the consumer authority (which will often, to mutual benefit, be the same institution). As highlighted in our analysis, consumer authorities have a key role to play in fostering markets where active consumers play their role in competition, without being restricted by unduly high switching and search costs. They can also help to prevent competition from resulting in a 'race to the bottom' in standards or in firms competing by obfuscating consumers. With effective consumer policy, consumers will be more willing to trust and engage in new and unknown markets, and thereby help to support growth. Moreover, where consumer authorities retain a strong competition focus, this will help guard against over-zealous enforcement of consumer protection legislation to the detriment of business and economic growth.
- 3.22 Alongside a pure enforcement role, competition (and consumer) authorities can often examine, and address, wider market problems using a more holistic approach to assessment. In the UK, this is done through market studies. Such studies can identify concerns that arise because of the inherent characteristics of a market, which may be structural, or as a result of public restrictions on competition. The OFT's experience in this respect has been a positive one, allowing it to identify and address a wide range of competition concerns that would otherwise have gone

⁷⁵ By introducing a staged approach to decision-making, competition authorities will not only reflect business needs for timely resolution and certainty but also ensure that resources are not drawn into unnecessarily long processes.

untargeted with a narrower focus on pure competition and consumer enforcement tools. In many cases, this requires consideration of different policy issues and/or the interaction of market and policy dynamics.⁷⁶

3.23 It is also, however, important to recognise the function which competition authorities can play in respect of the government's wider role in promoting competition. While clearly government remains in charge of policy-making, competition agencies can help policy-makers consider the implications for competition (and consumers) of particular approaches to market design and policy reforms. This role can be particularly relevant in newly liberalised markets, or markets where the role of choice and competition is being enhanced, such as public service markets like health, schools, or further and higher education. In these markets, the introduction or enhancement of choice and competition has the potential to deliver significant benefits for growth, but where the details of market design can be crucial for delivering this outcome.⁷⁷

3.24 The advocacy function of competition authorities is not necessarily an easy one, as it requires not only the appropriate level and type of resources and evidence, but also the independence required to challenge interest groups (and government, if required) in a public manner.⁷⁸ It is, however, an important function, and highly complementary to the authorities' competition enforcement function. Because both public and

⁷⁶ Further detail on the range of OFT market studies is available on www.offt.gov.uk/OFTwork/markets-work

⁷⁷ Recent OFT work highlights the key factors to be considered when designing new markets or when opening existing ones to greater competition. OFT (2010e), *Ibid*, highlights the role of both demand side considerations (awareness of choice by users; ability to assess the relevant information, including role of intermediaries; and capacity to act and impact of incentives, ability to switch and role of transaction costs), and supply side factors (diversity of supply; supply side flexibility through exit, expansion and exit; and role of funding provisions and other managerial incentives).

⁷⁸ The role of competition authorities as advocate will be facilitated if anchored in robust analysis and aided by strong analytical capability and a body of evidence on the impact of (past) interventions.

private restrictions can be used to the same effect (namely, to restrict entry and rivalry in the market), the removal of one can often lead to increased reliance on the other.⁷⁹ Moreover, a competition authority that uses both enforcement and advocacy acts with more legitimacy, enhancing its ability to play a key role in the promotion of competition and economic growth.

- 3.25 Overall, then, the ability of competition authorities to use a wide set of tools to address competition concerns across a range of sectors plays a significant role in driving economic growth. And, by ensuring that diverse government initiatives are consistently examined through a single prism (that of ensuring that markets work to the benefit of consumers), competition authorities can help to provide a consistent policy framework and unifying focus for policies aimed at addressing different objectives and informed by disparate interests.
- 3.26 To sum up, both governments and competition agencies have different yet complementary roles in maximising the impact of competition as a driver of the efficient working of markets and, hence, of economic growth.

⁷⁹ Successful advocacy is needed to open regulated sectors to the full application of competition rules and their enforcement. But industries which have previously been insulated from competition and now find themselves facing increasing competition will frequently resort to anti-competitive practices to attempt to limit that new competition, giving rise to a greater need for enforcement. Conversely, where enforcement increases competition, the industry in question may resort to lobbying to have the sector protected from competition.

4 CONCLUSION

- 4.1 There is a substantial and growing body of evidence supporting the link between competition and economic growth, with competition driving growth through a variety of channels: contributing to a better utilisation of capital, labour and natural resources, and promoting innovation and better management.
- 4.2 Government and competition authorities have different, yet complementary, roles in driving competition (and hence growth).
- 4.3 Government impacts on competition and growth in a variety of ways, including by deciding whether to proactively open up markets to competition, or how to intervene in markets (and how to incorporate competition considerations in the design of those interventions). In doing so, government should aim to promote competition or, at least, to minimise any distortion to competition.
- 4.4 It can, however, be challenging for government to achieve all this, given the many competing demands on policy-makers, the sometimes dispersed nature of policy making, and the likely resistance of incumbent interest groups that benefit from restrictions on competition. In this respect, the role of government in promoting competition and growth needs to be complemented by a suitable competition and consumer regime.
- 4.5 As in the case of government, a competition authority can contribute to the promotion of competition and growth in a variety of manners. In addition to its role driving compliance with competition law, the use of consumer protection tools and of market studies can further enhance the impact of a competition authority on consumers and the economy at large.
- 4.6 In short, competition can play a crucial role in driving economic growth across the economy, doing so across a range of channels. In order to ensure that this role is maximised, competition needs to be jointly fostered by the actions of government and the competition authorities,

both playing a complementary role in tackling private and public restrictions on competition and ensuring fair trading practices. Only in that way can the overall aim of promoting growth across the economy be achieved.