Competition as an Engine for Productivity and Prosperity

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Last week, I was privileged to attend the second inauguration of President Obama. He said many stirring things, but the one that resonated the most for me was when he said, "a free market only thrives when there are rules to ensure competition and fair play."

President Obama has a lot on his mind these days – the economy, unemployment, a war in Afghanistan, a divided Congress, and more. Should we be surprised that competition policy made it on to this list? Not at all. He understands that competition is what makes free markets work, and that in turn is the source of American productivity, innovation, competitiveness, and national prosperity. We ignore it at our peril.

I. The Relationship Between Competition, Productivity, and Prosperity

Beginning in 1990, the McKinsey Global Institute, lead by William W. Lewis, undertook a twelve-year study of the economic performance of thirteen nations, seeking to understand what it is that makes some countries rich and other countries poor. The study showed that levels of productivity made the difference between rich and poor. That, by itself, should not be surprising. But what caused the difference in levels of productivity? The answer proved to be undistorted competition in product markets. Reporting on the study, Mr. Lewis says, "[m]ost economic analysis ends up attributing

[1] The views expressed herein are those of the author, and do not necessarily represent the views of the Federal Trade Commission or any individual Commissioner. The author is grateful to former FTC Chairmen Deborah Platt Majoras and William E. Kovacic, whose words helped inspire mine.

most of the differences in economic performance to differences in labor and capital markets. This conclusion is incorrect. Differences in competition in product markets are much more important."[2]

I'd like to look at two particular implications of these findings. The first is that innovation benefits consumers through the development of new and improved goods, services, and processes. An economy's capacity for invention and innovation helps drive its economic growth and the degree to which standards of living increase. Competition, of course, is what motivates innovation. Innovation requires research and an active process of trial and error, and it's costly. Without competition, there is little incentive for firms to make the needed investments in innovation. Without innovation, economic growth stagnates. Let me illustrate: many of you are carrying Smartphones, I-Phones, BlackBerrys, Android devices, and the like. These did not just spring from the earth, like mushrooms after a summer rain. They were developed at great cost by firms like Apple, RIM, and Google, who saw it as necessary to survive. Those who innovated best prospered, those who did not became footnotes in industrial history. Innovation comes from the threat of annihilation by the competition. Competition is thus an essential ingredient for innovation and prosperity. Without it, there is only stagnation.

The World Bank noted, in the 2005 World Development Report, that "barriers to competition benefit some firms but deny opportunities and increase costs to other firms and to consumers. They also weaken incentives for protected firms to innovate and improve their productivity. Increasing competitive pressure can increase the probability of firm innovation by more than 50%"

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[2] William Lewis, The Power of Productivity: Wealth, Poverty, and the Threat to Global Stability (2005).

The second implication is for competitiveness. Michael Porter, in his seminal work on The Competitiveness of Nations, wrote that “Few roles of government are more important to the upgrading of an economy than insuring vigorous domestic rivalry. . . Firms that do not have to compete at home rarely succeed abroad.”[3] This should be intuitively obvious: Brazil’s football teams have not dominated the World Cup for decades by being sheltered from tough opponents and lying on the beach at Copacabana. Their players got to where they were by playing and beating the best at home, and then doing the same abroad. It works the same way in international commerce. Boeing, BMW, Hyundai, Samsung, and Intel succeeded abroad by competing at home and then taking a winning formula on the road. Tupolev and Lada did not have the benefit of that tempering process, and have not achieved the same global footprint.

We have occasionally ignored these lessons ourselves, and we learned hard lessons as a result. In 1933, we were in the midst of the great depression. President Roosevelt persuaded the Congress to pass the National Industrial Recovery Act. This law essentially legalized cartels and suspended enforcement of our antitrust law. It authorized firms to establish “industrial codes” that were subject to nominal government review and were enforceable by the government. Industry responded by doing exactly what you might expect: they established cartels that restrained price and constrained output, all justified in the name of preventing “disruptive” and “wasteful” competition. What was the effect? I’ll quote Christina Romer, a distinguished economist at Berkeley and former Chairman of the President’s Council of Economic Advisors: “The more important effect of the NIRA was to diminish the responsiveness of price changes to the deviation of output from the trend. . . . It prevented the economy’s self-correction mechanism from

[3] M. Porter, The Competitive Advantage of Nations (1990), p. 662.

working. Thus, the NIRA can be best thought of as a force holding back recovery." One academic found that output was depressed by 10% due to the NIRA. In the end, the NIRA made the depression longer and more severe than it would otherwise have been.[4]

II. Enabling Fair Competition Through Competition Laws and Enforcement Agencies

In an ideal world, government would simply get out of the way and let firms compete and develop their own routes to prosperity. But we don't live in an ideal world, and we need rules to ensure that firms don't engage in conduct that makes competition impossible, which inspired President Obama's reference to rules to ensure fair play. Let me continue with my football metaphor. In some ways, a well-written competition law and a properly-resourced competition agency are like the rulebook and the referee in a football game. The game, of course, is all about the players, the teams, and the coaches – or in this case the firms. The competition agency is like the referee who tries to call a fair game, one in which competitors will succeed or fail based on whether they can innovate and produce goods that consumers want at a price they are willing to pay, and to do so more efficiently than the other team. Goals are scored when innovation results in profits. Fouls are called when teams try to get ahead through some kind of exclusionary scheme that undermines the forces of competition, like holding a competing player.

If the referee calls a fair game, everyone thinks about the players and not the referee, and that's how it should be in commerce as well as football. While the referee should ideally be unseen, we all know that there are controversial plays from time to time, and the referee will come in for his share of criticism. The referee needs to strike a

[4] Christina Romer, "Why Did Prices Rise During the 1930s?" Journal of Economic History, 59(1), 167-199, p. 197; Jason Taylor, "The Output Effects of Government Sponsored Cartels During the New Deal," Journal of Industrial Economics, 50, 1-10 (2002).

difficult balance between allowing an open and competitive game and letting players show what they can do, while making sure that anticompetitive practices they don't undermine the legitimacy of the game. That's equally true in football and in competition law. However, in the business world, a fair game benefits the innovative and talented competitor, and for that reason the successful business and the competition agency ought to see each other as joined by common interest.

Fouls have real costs, and we have some pretty good examples of those costs. Our neighbors in Mexico provide the best illustration. In Mexico, one firm holds about 80% of the market for wireline telecommunications service, and about 70% of the mobile market. Through the use of interconnection fees, the dominant firm was effectively able to monopolize the market. The result was that telecommunications services cost more in Mexico than they do in any other OECD country, and the rate of telecommunications and broadband penetration in Mexico was lower than any other country. According to a recent OECD study, the monopolization of the sector cost the Mexican economy about $129.2 billion per year.[5] When you divide that cost among the Mexican population, that works out to about $1,150 per year for every Mexican man, woman, and child. That's real money in Mexico. What kind of growth might be stimulated if that money was released into the Mexican economy for consumption and investment? I should add that the Mexican Federal Competition Commission, the counterpart of the AMCU, has recently adopted measures to improve the situation.

All of this is more easily said than done. An effective agency needs to be able to apply economic analysis to business conduct. It has to have sufficient independence to

[5] OECD Review of Telecommunication Policy and Regulation in Mexico (2012), available at http://www.oecd.org/sti/broadbandandtelecom/50550219.pdf.

be able resolve cases on basis of law and economics, while at the same time remaining accountable to the public. It needs to be able to attract and retain sufficient human capital – this stuff is not easy. It needs to have sufficient powers to enforce its decisions. And above all, it needs to be perceived as fair and transparent. An agency that is perceived being arbitrary quickly loses its legitimacy with the public and with potential investors. But bestowing an agency with the ability to achieve its purpose requires a measure of political determination. It requires empowerment by a commitment at the highest levels of government to make competition a centerpiece of its economic program. That's why we were gratified to hear President Obama's words last week. And it is why our Mexican neighbors were gratified to hear their new President announce that competition would be at the center of his "Pact for Mexico" program on his first day in office last month.

III. Addressing Anticompetitive Government Action

Addressing private anticompetitive conduct is an important part of a sound competition strategy, but it addresses only part of the problem, because many of the most serious threats to competition come from government itself – usually with the encouragement of private firms. Governments are able to erect barriers to competition that are far more durable and pernicious than private restraints. This is even more true in a country with a history of deep state control of the economy. The ties between formerly state controlled firms and government often remain deep.

Engaging in private anticompetitive conduct is risky for firms: predatory pricing requires the predator to lose profits in the short term; collusive behavior risks being undercut by cheating within the cartel; and the risk of detection and legal punishment is very real. By contrast, persuading the government to adopt an anticompetitive restriction is much less risky: the costs of lobbying are low, and the process of lobbying is generally protected under the law; the government even enforces the restriction. This makes the cost – to the anticompetitive party – of implementing the restriction very low, and the ability of the competition agencies to intervene is limited.

Some producers cloak their requests for anticompetitive government action in terms of consumer protection when, in reality, they are trying to avoid market forces. While they claim to be protecting consumers, the relationship between the restrictions they propose and the purported benefit to consumers is often poorly defined. For example, we have seen requirements that only licensed eye care professionals can sell replacement contact lenses via the Internet. These requirements supposedly protected consumers' eye health, but promoters of the requirements never said how. Lenses could only be sold after being prescribed by a doctor and optometrist, and the benefit of having a doctor package the prescription was never made clear. What the restrictions really did was protect the doctors and optometrists from lower-cost competitors. We see this kind of thing all the time, and the common theme is that established providers ask government to protect them from new and innovative forms of competition.

That kind of conduct gets a red card when private businesses do it on their own, and when they get governments to do it for them, it doesn't make the conduct any less harmful. However, in our case we don't have the same tools available when government conduct is the source of the problem, so we have to use other strategies.

Whether behind the scenes or publicly, the FTC, often in cooperation with the DOJ, continually advises federal and state legislatures, other federal agencies, and courts about the likely effects of their actions on consumers and markets. To this end, we focus on two areas: facilitating entry and making it easier for consumers to get useful information. Although the first is a traditional antitrust concern and the second is a traditional consumer protection topic, both are ultimately aimed at encouraging competition and promoting consumer choice. Our approach centers on helping our lawmakers and regulators better understand the true costs and benefits of proposals for restriction of competition and to advocate for more pro-competitive approaches. Other than a competition agency, there is typically nobody else in the government that has the institutional incentives and expertise. Other countries go even farther, and give competition authorities the authority to review regulations and proposed legislation that impact competition or even to take action against anticompetitive regulation.

IV. Competition Law and Policy in Ukraine

Most of what I have said today is about our experience in the United States, because that's what I know best. Competition and free markets benefit not only our consumers, but our businesses as well. A competitive market strengthens our firms to compete in global markets, and it creates incentives for them to innovate and develop new products and services that benefit us all. But we are not gathered here to talk about the United States, we are here to talk about Ukraine and more particularly, the draft National Program of Competition in Ukraine.

The draft strikes me as being entirely consistent with the principles I have just described. It recommends building a legal infrastructure that would support competition in markets, especially infrastructure markets, in which competition has been lacking. It promotes reduction of barriers to entry and encouraging entry into new markets. It promotes modernizing competition law and practice to match world standards, and would facilitate harmonization of law and practice with your natural trading partners in the European Union. All of these are good things. The draft appears to be well thought through, and reflects modern understanding of how real competition can benefit the people of Ukraine.

The challenge will be putting it into practice. A writer for the Financial Times, Martin Wolf, said a few years ago, "Free and fair competition sounds simple to achieve. Nothing is further from the truth: competition upsets intellectuals who glory in the notion of state benevolence, bureaucrats who administer government programs, businesses that receive state favors and, in short, all those who gain, directly or indirectly, from distortions. Competition benefits often despised outsiders against those who are well-connected and entrenched. It also requires the courts and government to work honestly. The surprise may rather be that some countries became rich than that so many are poor."[6]

Competition produces winners and losers, just as a football game does. It will surely benefit consumers and the overall well-being of the economy. It will hurt those who are inefficient and those who cannot or will not respond to what markets ask them to produce. Our own experience shows that groups who stand to lose through increased competition are very quick to recognize the danger to their own interests and organize themselves accordingly. The benefits, however, are more diffused throughout the economy and there is often no one group with corresponding interests in protecting competition. Without clear leadership, vision, and will, the result can be a political mismatch. It is a continual battle for us, and I know it will be for you as well. I wish you, and the consumers you hope to benefit, the best of success.

[6] M. Wolf, The Tyranny of Vested Interests, Financial Times (January 17, 2006).