



# Output and price effects of enhancing services sector competition in a large open economy

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## Abstract

This paper studies the output and price effects of exogenous changes in the degree of competition. It is motivated by initiatives to enhance competition in services in the European Union. The paper shows that a higher degree of competition in the nontradable goods sector may have adverse implications for international price competitiveness. It highlights four channels through which enhanced competition in the non-tradable goods sector affects output and the general price level in a large, open economy (lower monopoly rents, higher wages, lower import prices, international wealth transfer) and assesses their relative importance. The conclusions suggest that the Single Market enhances output and reduces the general price level.

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## 1. Introduction

Regulatory reforms that succeed in increasing competition in previously sheltered industries may have significant economic benefits. The benefits of intensified competition are perhaps obvious: competition is supposed to lead to a more efficient allocation of resources and lower monopoly rents. But what are the pitfalls? Generally speaking, market regulation involves a government effort to reduce certain types of market failure (e.g. barriers to entry, asymmetric information, external effects, incomplete contracts), taking into account the presence of government failure (a lack of market incentives, accountability problems, bureaucracy, information problems, hold-up problems, distortionary taxation). The range of interesting micro-economic issues involved may explain that studies in regulatory reform often focus on the design of mechanisms and institutions, taking for granted that the benefits of regulatory reform for the targeted sector will directly translate to the macro level, rather than taking into account that there may be implications for other sectors and possibly even for other countries.

Enhancing competition is particularly relevant in continental Europe, where government intervention is traditionally more pronounced than in Anglo-Saxon countries and where the introduction of the euro has eliminated a channel of adjustment, implying that adjustment via market flexibility now has a more important role to play.<sup>1</sup> The degree of competition is especially low in services markets, which tend to be shielded from international competition. Therefore, these markets are priority fields of action for the competition authorities. Initiatives by the European Commission promote the completion of a truly Single Market where monopolies, price agreements between suppliers and preferential treatment of domestic suppliers by governments are forbidden by law. Moreover, EU member states are – albeit sometimes hesitantly – liberalising their network industries (telecom, energy, railways, water) and upgrading anti-trust legislation and enforcement.

This paper studies the effects of increasing the degree of competition in the services sector. Competition policy is likely to affect output and prices in the sector targeted by the competition authorities, but it may have effects on other sectors as well. Lower prices for the goods produced by the targeted sector may affect the real income of households and may give rise to a shift in demand between products of different industries which, in turn, may affect the demand for and supply of labour. Once we acknowledge that deregulating the shielded sector may have implications for the open sector, it becomes clear that in case of a large economy, such as the European Union, there may also be spillovers to other countries. Thus, third countries may benefit from, or be hurt by regulatory reform in Europe.

Understanding the macroeconomic consequences of microeconomic reform is of interest to fiscal and monetary policymakers alike. An improved ability to gauge the impact of deregulation on output and prices will help policymakers to assess the

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<sup>1</sup>The impression that competition in continental Europe is relatively low is confirmed by *Gonenc et al. (2000)* and *Van Bergeijk and Haffner (1995)*.

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