



# On the role of empirical industrial organization in competition policy<sup>☆</sup>

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## ABSTRACT

In this paper I consider the role of empirical industrial organization (IO) in competition policy. In particular, I consider the effect of the institutional setting in which competition policy is developed on the diffusion of ideas and techniques emerging from the empirical IO literature. In doing so my aims are two fold. First, I aim to understand the areas of competition policy most likely to provide fertile ground for future work, and those which are less likely to have an impact. And second, I hope to make a small step towards ensuring that the important potential synergies between competition policy and empirical IO are more fully developed – to the benefit of both communities and, more importantly, the public. This paper necessarily draws heavily on my experience in the UK, but many remarks may resonate more generally.

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## 1. Introduction

In very broad terms, the picture of the role of economics in competition policy is a happy one. And indeed, this paper will of course conclude that IO in general and empirical IO in particular are tremendously important for competition and regulatory investigations (see also [Davis and Garces \(2010\)](#)). That said, at the moment while theoretical IO is playing a central role in competition policy, elements of empirical IO in particular are arguably under-achieving in actually affecting both policy and practice in many competition and regulatory agencies across the world. It is interesting to consider the reasons that this may be the case and, if so, where best to focus efforts to (i) expand use of the available tools and (ii) develop new ones.<sup>1</sup>

By empirical IO, I will mean in particular–careful empirical analysis of individual cases—a type of analysis which is the current modus operandi for most, but not all, of the empirical IO literature.

Broadly, competition policy as actually practiced ‘on the ground’ is collectively determined by the actions of people in at least five places: (i) By government and parliament developing and adopting legislation; (ii) through case selection within competition agencies; (iii) through guidance issued by competition agencies; (iv) by the

staff and decision makers within agencies deciding individual cases, and subsequently (v) by the decisions of specialist tribunals and courts that make judgements about whether agencies have done their job properly. In what follows I will collect these disparate venues into two broad groups and discuss each in turn. First, those competition policy structures that arch across cases and second those which relate to the way decisions within cases are made.

A central point of this paper is that the institutional constraints associated with each of those arenas (i) differ, (ii) effect the likely impact of case-specific empirical work, and (iii) are important to consider when undertaking or valuing the likely contribution of academic work in affecting competition policy and practice.

## 2. Competition policy: structures that arch across cases

### 2.1. Legislation

The government effectively plays two primary roles in competition policy. First, it sets the overall legislative framework within which independent competition agencies operate and second, on individual cases, it exercises any powers it has retained under the legislation.<sup>2</sup>

<sup>☆</sup> The views expressed in this paper are solely those of the author and do not necessarily reflect those of the CC. This paper was originally developed for talks at the Institute of Fiscal Studies, Econometrics of Scanner Data Conference 23rd March 2010, Cenmap and the EARIE conference in Istanbul September, 2010. Thanks for helpful comments are due to participants at those conferences. In particular Rachel Griffith, Aviv Nevo, Marc Rysman, Jorge Padilla, Ariel Pakes and Carl Shapiro as well as Alison Oldale and Jozsef Molnar at the CC and Chris Walters and Matthew Bennett at the Office of Fair Trading (OFT) made helpful comments and suggestions.

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<sup>1</sup> Note the social incentives in the production of academic work may well not be the same as the private (often publication) incentives to do so.

<sup>2</sup> The primary legislation in the UK for general competition law currently comprises the Competition Act 1998 and the Enterprise Act 2002. To illustrate the division of powers, note that independent competition agencies typically determine whether mergers will ‘Substantially Lessening Competition.’ (result in an SLC). However, the Secretary of State (SoS) can serve an ‘intervention notice’ under Section 42 of the Enterprise Act stating that there is another relevant ‘public interest’ criteria for evaluating the merger. Doing so has the effect of bringing the ultimate decision on an individual case back to the SoS. Examples include the BSKyB/ITV merger (public interest relating to media plurality) and Lloyds/HBOS (public interest relating to financial stability).

Legislation defines the institutional structure/design,<sup>3</sup> the scope of the regime,<sup>4</sup> the substantive tests applied<sup>5</sup>; the powers of the agency in both information gathering and remedies arenas<sup>6</sup> and the degree of intrusiveness of any appeals process.<sup>7</sup> In many of these important practical areas there is a very limited amount of work in the mainstream economics literature, particularly in the empirical literature.

One potentially important explanation is that legislation sets up a framework suitable to be applied to a potentially large number of cases, while cross-industry work has reduced in popularity quite considerably in the academic literature. In the UK, government economists will certainly read academic papers such as those studying the 'effect of competition on productivity' (see for example [Nickel \(1996\)](#); [Aghion et al. \(2005\)](#)) to inform discussions about the scope and nature of the competition regime – but the literature remains sparse. Careful empirical analysis of individual cases, at least when reported as individual stand-alone papers, will probably find it very difficult to influence these debates directly.

Decision makers within government (e.g. ministers or ministry officials) and parliament, and indeed those who influence legislation such as business representatives, voters, journalists and consumer organizations are highly unlikely to be specialists in empirical IO or have any idea about the literature. Indeed, many will not even have had much exposure to economic ideas more generally, let alone the specifics of competition economics. Thus for empirical IO research to have influence beyond professional economist staff within agencies and government it is vital that the academic community strongly support engagement with policymakers more broadly than, say, through the pages of *Econometrica*. Publishing in high quality academic journals is important—because of quality certification—but publication itself is extremely unlikely to change policy absent a far broader engagement.

## 2.2. Case selection

Competition agencies have limited budgets and so must set priorities. For example, the OFT's *Prioritisation Principles*<sup>8</sup> provides guidance on case selection in the UK. Case selection is cross-case and thus, in significant degree, cross-industry. I'm not aware of work from empirical IO driving individual investigation decisions, but in principle independent high quality academic work reporting a particularly ill-performing market could do so.

<sup>3</sup> In the UK, there is currently a vertical split wherein OFT does the preliminary investigation and decides whether the CC should launch a more in depth investigation for mergers and market investigations. In the US, the institutional design includes a horizontal split between the FTC and DoJ while the vertical distinction is associated with the term 'second request'. The UK government are currently consulting on whether to merge the OFT and CC giving a single competition agency following for example France.

<sup>4</sup> For example, tests for qualification for mergers by revenue or market share ; whether the regime involves compulsory notification (US) or voluntary notification (UK) and whether the regime covers single firm conduct (US, EU) or also market or sector inquiries (UK, EU). More generally the scope of the regime will be influenced by governments since (i) agency funding decisions can affect the 'amount' of enforcement and (ii) reference decisions for particular industries may lie (at least in part and/or in practice) with particular ministers. Politicians more generally also affect the scope of the regime – for example the degree to which sensitive sectors like health and education are exposed to competition and competition law.

<sup>5</sup> For example whether the merger results in a "substantial lessening of competition" (SLC: US, UK) or Substantial Impediment to Effective Competition (SEIC: EU). Before 2003, the UK system involved a broader 'public interest' test for evaluating a merger. Recent theory papers examining these topics include [Nocke and Whinston \(2008, 2010\)](#) and [Armstrong and Vickers \(2010\)](#).

<sup>6</sup> Information gathering powers can include dawn raids, or be limited to internal documents or indeed only to make requests for information. Agencies may make decisions or alternatively only make recommendations to government. On the remedies side, agencies may have power to impose behavioural or structural remedies and/or punishments in the forms of fines or prison.

<sup>7</sup> Some recent work by [Katsoulakos and Ulph \(2009\)](#) begins to explore this area.

<sup>8</sup> OFT *Prioritisation Principles* [http://www.of.gov.uk/shared\\_of/about\\_of/oft953.pdf](http://www.of.gov.uk/shared_of/about_of/oft953.pdf).

More broadly, IO has clearly had a significant impact on case selection. For example, in the area of vertical restraints policy has certainly moved considerably over time and also varies across jurisdictions. However, despite clear long-term differences in policy across jurisdictions and ambiguity from theory, such evolutions of policy have clearly not always been driven by the empirical literature – as [Lafontaine and Slade \(2005\)](#) note while summarizing the empirical literature on vertical restraints quite recently "the empirical evidence is somewhat fragmented." (page 13).

## 2.3. Guidance documents

Competition and regulatory agencies, aiming to provide a degree of legal certainty, publish guidance documents describing how they will go about their statutory tasks.<sup>9</sup> For example, substantive merger guidance describes the way in which an authority will go about analysing a merger: The approach that will be taken to market definition, to the factual and counterfactual (situation with and without the merger respectively) and, in addition, the central ways in which a competition agency thinks mergers can potentially harm competition. Such a document must be applicable to a wide range of circumstances and industries.

The empirical IO literature has had an impact on discussions around some of the topics relevant for merger analysis. Perhaps most prominently around merger simulation ([Hausman et al., 1994](#); [Nevo, 2000](#)) although currently only a relatively small number of cases currently use full merger simulation<sup>10</sup> and typically to provide confirmatory rather than determinative evidence.

Somewhat in contrast, IO theory work has clearly impacted very broadly the substantive guidance documents. A paper, or more usually a literature, that clearly identifies a set of sufficient conditions for a merger to be problematic for consumer welfare allows guidance documents to summarize the testable propositions required for a particular Theory of Harm to be established. Whether those circumstances are satisfied in an individual case is of course an empirical question.

Potentially the rich computational models developed in the empirical literature<sup>11</sup> could in future influence guidance more if authors attempt to establish computational results analogous to the 'if-then' results of theory. Such an approach would involve attempting to provide testable hypotheses under which (say) a merger would harm consumers. To provide such policy guidance, one would probably want to simulate a computational model's results for a wide range of parameter values rather than estimating a single one and then consider the performance of policy rules.<sup>12</sup>

<sup>9</sup> In appeals, courts often place significant weight on whether an agency has followed its guidance. See eg. The Competition Appeals Tribunal (CAT) for example in its judgement in the Tesco appeal (*Tesco Plc v. Competition Commission 237-2053*. Case documents available at: <http://www.catribunal.org.uk/237-2053/1104-6-8-08-Tesco-Plc.html>). Thus guidance plays a role in the ways in which legislation is interpreted—at least in the short and medium term—and clearly, in doing so, it can affect policy on the ground.

<sup>10</sup> A full merger simulation—undertaken by the agency—would probably only be practicable at phase 2. However, only a very small number of mergers are evaluated at phase 2 in most jurisdictions. For example, in the UK, the OFT scrutinised 80 mergers at phase 1 (down from 210 in 05/06) and referred 8 of those mergers to the CC for more in depth analysis during 2008/9. There are of course some instances of simplified merger simulations being used at phase 1 by the parties to an investigation. For example, in the 2010 merger between Cadbury and Kraft the parties presented evidence to the EU authorities from a Nested Multinomial logit model for chocolate. (LECG presentation at the Association of Competition Economics 2010 conference: <http://www.competitioneconomics.org/>.) For more examples see Chapter 8, [Davis and Garces \(2010\)](#).

<sup>11</sup> See [Pakes and McGuire \(1994\)](#) and [Benkard et al. \(2007\)](#) and references therein.

<sup>12</sup> Recent examples of this approach are provided by [Besanko et al. \(2010\)](#) and [Davis \(2010\)](#).

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