

# **IRISH COMPETITION POLICY AND THE MACROECONOMY**

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## **Abstract**

The failure to recognise the importance of competition policy and the non-traded sector in economic development has contributed to a situation in Ireland in which the implementation of competition policy has proceeded at a slower pace than is required. There has been an implicit acceptance of the proposal that the pursuit of an appropriate industrial policy creates employment while the pursuit of an appropriate competition policy destroys employment. This paper attempts to correct this gross misconception; the implementation of an appropriate competition policy in the non-traded sector would increase, rather than decrease, total employment.

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## I. Introduction

The failure to recognise the importance of competition policy and the non-traded sector in economic development has contributed to a situation in Ireland in which the pursuit of competition policy has proceeded at a much slower pace than required. Economic policy in Ireland appears to be based on the mercantilist notion that the internationally trading sectors of the economy are the engines of growth. For example, a recent report to the government, which dealt with the largely non-internationally traded service sector, argued that, "Non-traded activities are in effect dependent on the internationally traded sector. ... Those activities that are internationally traded determine the rates at which the economy can grow." (Department of Employment and Enterprise, 1993)

The non-traded sector continues to be economically discriminated against vis-à-vis the traded sector. One of the cornerstones of Irish industrial policy, once the economy adopted an outward-oriented strategy in the early 1960s, was Export Profits Tax Relief. As a result of representations from Brussels this was replaced by a special low rate of corporation tax (10 per cent) for the manufacturing sector in 1981. In comparison, the services sector continues to pay the standard rate of corporation tax (36 per cent).<sup>1</sup> In addition, the vast bulk of grant aid to business goes to the manufacturing sector. The agricultural sector continues to be subsidised by the Common Agricultural Policy while the construction sector is bolstered by mortgage interest tax relief, urban renewal schemes and the non-existence of an effective residential property tax. The net result is economic discrimination against the services/non-traded sector. This is reflected in the fact that the share of market services in Ireland's GDP is the lowest among EU member states (1993 figures).<sup>2</sup>

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<sup>1</sup> The 1996 Budget introduced a lower rate of corporation tax (currently 28 per cent) which applies to the first £50,000 of a firm's profits.

<sup>2</sup> To some extent these numbers are distorted by the practice of transfer pricing in the manufacturing sector.

Competition policy in a small open economy is particularly relevant for this services/non-traded sector since the traded sector operates in an environment of international competition. However, the Competition Authority has a staff of less than twenty persons while the staff of the three industrial policy authorities is comprised of over one thousand persons.<sup>3</sup> The active pursuit of competition policy would be welfare-enhancing not only in terms of increased output and reduced prices within the non-traded sector itself but also because of knock-on effects in the traded sectors; the prices of non-traded goods are important determinants of the success or failure of the traded sector, both through their impact as intermediate inputs and through their effect on wage demands and hence on the factor costs payable by the traded sector.

The mercantilist perspective has been bolstered by the implicit acceptance of the proposal that the adoption of an appropriate industrial policy creates employment while the adoption of an appropriate competition policy destroys employment. This paper attempts to go some way towards correcting this gross misconception. Following an overview of competition policy in Ireland, it is argued that the active pursuit of competition policy in the non-traded sector would increase, rather than decrease, total employment.

## **II. Competition Policy in Ireland Prior to 1991**

Legislation to prohibit restrictive business practices in Ireland was first enacted in 1953 with the Restrictive Trade Practices Act which established the Fair Trade

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Nevertheless, Ireland's poor employment creation record in the 1980s is ascribable to poor performance in the services sector relative to the EU average.

<sup>3</sup> However, the recent appointment of a Director of Enforcement to the Competition Authority, the imminent appointment of a number of economists and solicitors to the staff of the Competition Authority and the proposed setting up of a Telecommunications regulatory agency is suggestive of a change in approach.

Commission. Legislation was based on the "control of abuse" principle with restrictive practices considered on a case-by-case basis. Services, apart from distribution, were excluded from the domain of the legislation. The 1972 Restrictive Practices Act extended the legislation to include professional services, but other sectors such as banking, the supply of electricity, the provision of public transport and the services of local authorities continued to be excluded. The Minister (Industry and Commerce), on the advice of the Commission, could issue a Restrictive Practice Order to cover a particular trade. The 1987 Restrictive Practices (Amendment) Act brought the previously-excluded service sectors, apart from local authorities, within the domain of the legislation. Restrictive Practices Orders covered markets which accounted for about 35 per cent of consumer expenditure by 1991 (OECD, 1993a p.71).

A failing of competition policy in Ireland over past decades was that it had been Order-led; for sectors of the economy not covered by an Order, it remained legal to engage in price-fixing and market-sharing and no Order existed in respect of any professional service. Repeated enquiries were carried out into the behaviour of several trades as new practices emerged requiring new enquiries culminating in new Orders. The compliance of Irish businesses with respect to these Orders is also questionable, as evidenced by 1988 data revealing that a majority of petrol stations, restaurants and pubs outside the Dublin region failed to comply with price display orders.<sup>4</sup>

Policy towards mergers and monopolies was (and, to a large extent, is) dictated by a separate piece of legislation - the Mergers, Take-overs and Monopolies (Control) Act 1978. The Minister for Enterprise and Employment (previously known as Industry and Commerce) had (and, to a large extent, has) sole jurisdiction over

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<sup>4</sup> The Groceries Order which prohibits below-cost selling in the groceries market remains in force. Cost is, however, defined as "net-invoice" cost which may differ from actual cost. See Walsh and Whelan (1996) for an analysis

acquisitions and mergers. All proposed acquisitions and mergers involving two parties with gross assets above £10m and/or gross turnover above £20m had to be notified to the Minister for approval. Although this Act could also have been used to impose severe sanctions on monopolies no such sanctions were imposed (Massey and O'Hare, 1996, p.105).

### **III. The Competition Act 1991**

The Competition Act, which came into force on October 1, 1991, introduced a prohibition-based system of competition law to Ireland. Articles 85 and 86 of the Treaty of Rome are mirrored in Sections 4 and 5 of the Competition Act. Section 4 of the Act refers to anti-competitive agreements between undertakings and restrictive trade practices are prohibited under Section 4(1). Exemptions, through the issuing of licences, can be granted under Section 4(2) if the restrictions promote economic progress, consumers receive a fair share of the resulting benefits, the restrictions do not eliminate too much competition and no unnecessary restrictions are included in the agreement. Section 5 of the Act refers to the abuse of a dominant position. The Competition Authority was established under the Act to play a supportive and advisory role; it had no enforcement powers. It had no power to investigate agreements either on its own initiative or as a result of complaints by third parties. The onus was placed on injured third parties to take an action in the High Court for an injunction or damages; there have been very few court actions claiming breaches of the Act.

Agreements between undertakings must be notified to the Authority in order to obtain a certificate (where, in the opinion of the Authority, the notified agreement does not offend) or a licence. A large number of commercial agreements have been notified to, and considered by, the Authority. As of the end of 1994, the Authority

had dealt with 805 of 1,270 notified agreements.<sup>5</sup> Although there have been very few outright refusals by the Authority, some refusals were very significant; licences were refused for minimum resale price maintenance agreements in the case of books and for stock exchange rules on fixed minimum commissions on gilts. One quarter of notified agreements were either withdrawn or found "offensive" although less than 4 per cent of agreements were ultimately refused a certificate or licence. Almost 51 per cent of notifications decided upon were certified although some of these agreements had to be amended before certification.<sup>6</sup> One-third of the agreements were covered by one of the following category licences subsequently issued by the Authority: exclusive purchase agreements between suppliers and individual filling stations for motor fuels, exclusive distribution agreements and franchise agreements; these (vertical) agreements involve firms engaged at different levels of the production and distribution process. These category licences mirror block exemptions issued by the European Commission. The Authority's view, which is in line with the European Commission's view, is that non-price vertically restrictive agreements offend against Section 4(1) but if "constructed properly" satisfy the requirements for the issuing of a licence. Vertically restrictive agreements containing price restraints do not appear capable of meeting the Competition Authority's requirements for the issuing of a licence.

Much discussion has focused on whether the EU block exemptions should have been incorporated into the legislation. Their inclusion would have eliminated the need for a significant number of agreements to be notified and would have reduced the Authority's workload.<sup>7</sup> A more fundamental weakness was the absence of an active

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<sup>5</sup> This section draws on Massey and O'Hare (1995).

<sup>6</sup> Almost 55 per cent of the 407 agreements certified by the Authority involved shop lease agreements, the vast majority in respect of retail outlets in shopping centres; clauses restricting the types of retail business are deemed essential for the successful development of shopping centres.

<sup>7</sup> Examples exist whereby the EU block exemptions have been incorporated into the domestic legislation of EU member states (Massey and O'Hare, 1996 p.117). It should be noted, however, that some of the exclusive

state enforcement mechanism. Although Section 6 allows the Minister to take action to obtain an injunction for breaches of the Act, no such actions have been brought (although in 1995 the Authority advised the Minister that an action should be brought in a case involving the newspaper industry).

The Minister (Enterprise and Employment) may request the Competition Authority to give its views on a proposed acquisition or merger. The Authority, however, is required to consider not only the effects of the proposed acquisition or merger on competition but also the effects of the proposed acquisition or merger on the level of employment, regional development and other economic and social variables. Somewhat controversially the Competition Authority has also asserted its independent right to examine proposed acquisition and mergers under Section 4(1) and it is conceivable that they could be examined under Section 5.

#### **IV. Enforcement Powers: The Competition (Amendment) Act 1996**

The passing into legislation of the Competition (Amendment) Bill 1996 is suggestive of a significant change in emphasis. The primary aim of this legislation is to provide more effective enforcement of competition policy. It is now a criminal offence not to comply with the conditions of a licence granted by the authority. This Act criminalises anti-competitive behaviour and allows for prison sentences of up to two years and fines of up to 10 per cent of a firm's world-wide turnover. New powers of search and greater rights of discovery, including the right to conduct a "dawn raid", have been granted to the holder of the newly-created post of Director of Competition Enforcement and the ability to initiate prosecutions, both civil and criminal, now resides with the Authority. Furthermore, it can now carry out studies without being requested to do so by the Minister.

## **V. Competition Policy and the Traded Sector**

At a European level Articles 92 to 94 of the Treaty of Rome refer specifically to state aids. Article 92 appears to forbid state aids although - "Aid to facilitate the development of certain economic activities or certain economic areas..." may be considered compatible with the common market "where such aid does not adversely affect trading conditions to an extent contrary to the common interest." This suggests that grant aid at a broad level is allowed. Article 93 outlines procedures for introducing or altering state aids and Article 94 outlines the details with respect to qualified majority voting by the Council in the context of state aids.

In the context of industrial policy, limits are placed on state aids with respect to grants for initial investment (e.g. capital grants and loan guarantees) and operating aids (e.g. marketing aids). The lower rate of corporation tax (10 per cent) has been approved by the Commission until 2010. Special tax rates with respect to the Irish Financial Services Centre (IFSC) have been approved until 2005. This 10 per cent tax is seen as a state aid but aid to manufacturing in Ireland is within EU limits for Objective 1 regions.

Overall state aid to industry in Ireland as a percentage of GDP fell from 2.7 per cent in the 1986-88 period to 2.0 per cent in the 1988-90 period (OECD, 1993a, p.81). These figures can be contrasted with equivalent EU figures of 2.2 per cent and 2.0 per cent, respectively. State aid (inclusive of tax expenditures) to the manufacturing sector, however, is very high in Ireland. The Irish figure, as a percentage of GDP, went from 6.4 per cent for the 1986-88 period to 4.9 per cent in 1988-90, compared to EU averages of 4.0 per cent and 3.5 per cent for equivalent periods (OECD, 1993a, p.81). Grant aid for fixed investment as a percentage of initial investment was close to the EU average but grant aid for fixed investment in terms of job creation

targets was very high by EU standards and very close to allowable limits.

## **VI. The Scope for Competition in the Non-traded Sector**

Recent OECD (1993a) survey on competition within the non-traded services sector in Ireland is informative. Allowing for lags in domestic price adjustment to exchange rate fluctuations, and for different indirect tax rates, the aggregate price level for private consumption in 1985 was found to be 8 per cent above that of the UK, and by 1990 it was 10 per cent higher. Three consumer areas in particular stood out. These were (i) food, beverages and tobacco, (ii) transport and communications, and (iii) medical and health care.<sup>8</sup> The survey also noted the existence of entry-barriers to the following job categories: engineering, accountancy, architecture, surveying, auctioneering and the estate agency business. The survey commented on the system of fee-determination, the existence of advertising agreements and restrictions on the provision of services in a number of markets. The survey also referred to the high ratio of retail to wholesale outlets - figures for 1988 in Ireland and the United Kingdom were 7.9 and 2.3, respectively - which the survey claimed is indicative of an environment supportive of collusion. Certainly wholesale margins are high relative to those at the retail level.

Within the semi-state services sector the Report of the Industrial Policy Review Group (1992) highlighted the need for "... greater competition in air services, telecommunications and energy supply.". The Report noted with disapproval the use of cross subsidies in the cases of Whitegate oil products and the fertiliser industry and encouraged the use of "... explicit subsidy for social services ...".

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<sup>8</sup> Fingleton (1995) contains an illustrative example from the drinks market which appears to show the effect of the single market programme as well as the lack of competition in the non-traded services sector - in the period between 1986 and 1994 the real price of draft stout (e.g. Guinness) in public houses increased by 1.6 per cent per annum while the real price of packaged stout (in off-licences) decreased by 1.8 per cent per annum.

Articles 37 and 90 of the Treaty of Rome refer to the public sector and semi-state monopolies. According to Article 90 the existence of a state monopoly is not in itself contrary to the Treaty but the manner in which it is exercised could breach the Treaty. Post and electricity services are defined as public services and fall within the remit of Article 90. Article 37 prevents state monopolies from discriminating against nationals of other Member States. The European Union envisages total deregulation of the telecommunications market by 1998 (Ireland has, however, "successfully" lobbied for a two year partial derogation) and the liberalisation of all postal services, except internal letter deliveries. European Council Directives also exist to improve the transparency of gas and electricity prices and to ensure the possibility of the transit of gas and electricity between member states; open tendering was introduced for the construction of a new electricity-generating facility in Ireland. To some extent, events are overtaking policy in the area of the semi-state bodies as witnessed by the arrival of new technologies in the post and telecommunications area and the de facto deregulation of the inter-city bus segment of the public transport market.

In summary there appears to be a competitive lightly-taxed traded sector supported by activist industrial policy and a non-competitive heavily-taxed market services sector (e.g. banking, legal services and insurance) supplemented by an excessively regulated publicly-owned enterprise sector in Ireland.

## **VII. The Macroeconomics of Competition Policy**

One of the most important questions to be asked of competition policy concerns its welfare effects. While consumers would clearly gain from lower prices, one of the factors inhibiting the introduction of strong pro-competition measures is the fear of substantial job losses in the sectors to be deregulated; in the presence of labour market rigidities these job losses might not be offset by job gains

elsewhere in the economy.<sup>9</sup> There is also the fear that opening up these sectors to foreign competition may result in profits being captured by foreign competitors.

These issues are addressed in turn in the rest of this paper. In the context of inflexible labour markets, it is initially assumed that real wages are rigid. The types of rigidities that arise in conventional modelling of trade union behaviour are then discussed. Finally, the profit-shifting argument is addressed.

### **VIII. Effects of Competition and Deregulation under Real Wage Rigidity**

Competition policy is modelled as being equivalent to trade liberalisation; prices are reduced as monopoly positions are eroded and domestic firms that cannot compete at the lower international prices lose market share and shed labour.<sup>10</sup> In this model it is assumed that the real wage (the nominal wage relative to the consumer price index) stays constant. The only macroeconomic effect allowed is that declining prices of deregulated services and utilities which translate (through a reduction in the consumer price index) into lower wage demands for the rest of the economy, which therefore expands.

Specifically, consider a small open economy that produces two potentially internationally-tradable goods: one of these is produced under competitive conditions and trades at world prices ( $p_c$ ), while production of the other good is regulated. Regulation, by assumption, raises price ( $p_r$ ) above international levels.

Real wage rigidity implies that the function,

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<sup>9</sup> See Fingleton (1993) for an exclusively theoretical analysis of some of these issues.

<sup>10</sup> This is, of course, an overly pessimistic view to begin with, since trade liberalisation will typically reduce output in the formerly protected sectors while deregulation will frequently, through the erosion of monopoly positions, lead to an expansion of output and employment in these sectors.

$$(1) \quad w = F(p_c, p_r)$$

is linearly homogenous, where  $F()$  is related to the consumer price index;  $F_1, F_2 > 0$ , and  $w$  is the nominal wage. The reduction in  $p_r$ , the price of the goods produced in the regulated sectors, gives rise to a less-than-proportionate decrease in  $w$ ; domestic output and employment in the deregulated sectors is reduced. The wage shock, however, is transmitted to the competitive sectors of the economy, so  $w/p_c$  falls, and output ( $Y_c$ ) and employment ( $L_c$ ) are raised.

Policy in the present model therefore reduces employment in the deregulated sectors and raises employment in the rest of the economy. The net effect on aggregate employment,  $L$ , is therefore ambiguous at an *a priori* level. The effect can be calculated using equation (1) and the definition of  $L$ :

$$(2) \quad L = L_c(w/p_c) + L_r(w/p_r)$$

where both derivatives are, of course, negative. Aggregate employment will fall or rise depending on whether the following condition is met or broken:

$$(3) \quad [e(L_r; w/p_r)/e(L_c; w/p_c)][e(w; p_c)/e(w; p_r)][L_r/L_c] > 1$$

The functions on the left-hand side are the elasticities of sectoral labour demands and of wage demands. Total employment is therefore more likely to fall, the greater is the elasticity of labour demand and the initial level of employment in the sectors being deregulated, and the lower the influence of these prices on wage demands (the latter obviously being related to the share of these goods in private consumption). This is a standard condition in the small-open-economy literature.

On the assumption that the sectors being deregulated are (i) utilities, (ii) distribution and (iii) transport and communications, we can make use of the following illustrative numbers:

$$e(L_r; w/p_r) = 1.0;$$

$$e(L_c; w/p_c) = .82;$$

$$e(w; p_c) = .68;$$

$$e(w; p_r) = .32;$$

$$L_r/(L_r + L_c) = .35;$$

$$L_c/(L_r + L_c) = .65.$$

The competitive sectors we assume consist primarily of manufacturing. The manufacturing-sector labour-demand elasticity is derived from Bradley, Fitz Gerald and Kearney (1993). This is likely to be an underestimate, as we are ignoring in this calculation the components of services which are not being deregulated, and these, like the sectors to be deregulated are likely to have higher labour-demand elasticities than manufacturing. This assumption therefore generates overly pessimistic conclusions in the present case.

Bradley, Fitz Gerald and Kearney (1991) find that the labour-demand elasticities for service sectors are "generally higher than those observed for the manufacturing sector". We set the elasticity of labour demand in the sectors being deregulated at a value of unity. This value of unity is derived from Bradley, FitzGerald and Kearney (1991) and Denny, Hannan and O'Rourke (1995). As distribution is by far the largest of the sectors to be deregulated, its relatively high elasticity brings the average elasticity towards unity. The higher this elasticity is, the greater the job losses predicted as a result of deregulation, and

the higher therefore is the imputed initial level of featherbedding. The present exercise will generate these imputed numbers.

The calculation of the impact of prices on wage demands requires the share of the sectors being deregulated in the Consumer Price Index. The impact of  $p_r$  on wages we assume to be around .32, and the impact of  $p_c$  to be around .68. Finally we need sectoral employment shares in total industrial plus market services employment. Utilities comprise around 2% of this aggregate; distribution around 23.5%, and transport and communications around 9.4%. The share of  $L_r$  is therefore 0.35 and the share of  $L_c$  is 0.65.

This yields a value of around 1.4 for the elasticities condition in equation (3) above, indicating that deregulation of the economy would reduce employment if the mechanism focused upon in the present model were the only one in operation. If, for example, electricity prices played an insignificant role in consumer spending then manufacturing wage demands would hardly be affected by electricity deregulation; if this were the only effect of deregulation then the (assumed) loss in electricity-sector jobs would dominate any gain in manufacturing employment.

The imputed levels of over-staffing can also be calculated from this simple model if prices fell by 10 per cent as a result of the opening up of these sectors to foreign competition. The above equations imply that the elasticity of total employment with respect to  $p_r$  is:

$$(8) \quad (dL/L)/(dp_r/p_r) = \\ e(L_r; w/p_r)e(w; p_c)[L_r/L] - e(L_c; w/p_c)e(w; p_r)[L_c/L]$$

Plugging in the estimates discussed above we see that a 10 per cent fall in  $p_r$  results in a fall of around 0.67 per cent of (industrial plus market services) employment. In this scenario, around 2.4 per cent of the workforce would be laid off from the S-sector (implying that around 17,000 jobs represent featherbedding), while only 1.7 per cent of the workforce would find jobs in the expanded M-sector (through the reduction in real product wages in that sector). This represents a net loss of around 7,000 jobs.

It must now be recognise, however, that the reduction in consumer prices, the sole mechanism taken into account so far, is only one of a number of factors determining the overall outcome. Another crucial one is the role played by the highly regulated sectors as inputs into production processes in other sectors in the economy.<sup>11</sup> Furthermore, the analysis above failed to take into account the fact that demand for the now cheaper output of services and utilities will expand, moderating to some extent the job losses in the newly-liberalised sectors.<sup>12</sup> These factors are, however, taken into account in the recently-constructed Computable General Equilibrium (CGE) model of the Irish economy (Denny, Hannan and O'Rourke, 1995, and O'Rourke, 1994). In other respects the structure of the CGE model is similar to that of the very basic model outlined above. In particular, to take account of unemployment as an enduring characteristic of the Irish labour market, the real wage in the CGE model is very inflexible; the only factor which influences it, and then only to a small extent, is the prevailing rate of unemployment.<sup>13</sup> Since the model is perfectly competitive the "competition

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<sup>11</sup> An interesting example of the importance of this mechanism is provided by the boost to tourism arguably given by the 1986 liberalisation of Irish-UK airline routes. Air passenger traffic between Ireland and the UK increased by 18.6 per cent per annum between 1986 and 1990, compared to a rise of only 5.5 per cent in transatlantic traffic (OECD, 1993a).

<sup>12</sup> This factor does not appear in the above model because of the assumption there that the regulated sectors become perfectly tradable, and so demand-conditions no longer play a role in output determination. This assumption does not apply in the CGE model, which instead makes the Armington assumption that domestic and foreign tradable are imperfect substitutes.

"policy" is again modelled as the opening up of some of the sheltered sectors to free trade. These sectors (utilities, distribution, transport and communications) are assumed initially to exhibit prices 10 per cent higher than their foreign counterparts.

As expected, increased imports into one of the newly liberalised sectors reduces domestic output and employment in that sector, but, since these goods serve as intermediate inputs into other sectors, the output of the final goods sectors expands. Particularly large positive effects are found for traded services, traditional manufacturing and high-tech manufacturing, in the case of distribution-sector liberalisation. The heartening result (see O'Rourke, 1994) is that in each case the net effect on employment is positive, although the typical reduction in the unemployment rate is only around two percentage points.<sup>14</sup>

## **IX. Union Responses to Deregulation**

There is a lot of evidence to suggest that the assumption that labour market rigidities are independent of the policy environment is far too strong. Making labour-market rigidities endogenous has important implications for the present analysis. To see this, consider the similarity between, on the one hand, the arguments for maintaining the monopoly power of incumbents in a particular sector (because of labour rigidities) and, on the other, the arguments frequently advanced in the declining industries literature for granting temporary subsidisation.

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<sup>13</sup> The long-run semi-elasticity of the real wage with respect to the unemployment rate in the model is set at -0.035.

<sup>14</sup> The model though has an endogenously determined labour supply, through migration possibilities, so the increase in employment is greater than the reduction in unemployment.

The declining industries literature held that if a sector was struck by an adverse shock that reduced its demand for labour, and if that sector's wage failed to adjust downwards, excessive labour would be released. This labour would then end up either unemployed or, depending on the degree of wage flexibility in the rest of the economy, would be employed elsewhere at (excessively) lower wages. The policy prescription frequently advanced is that the declining industry should be subsidised to some extent so as to replicate as closely as possible the behaviour of the pre-adverse shock economy.<sup>15</sup>

Note that this "traditional" view is exactly that which motivates those worried about the employment implications of deregulation. Deregulation, they suggest, in the context of rigid labour markets, would lead to job losses in the liberalised sectors and could raise overall unemployment. When labour-market rigidities are endogenous, however, this policy can do more harm than good. Several results from diverse areas of economics are supportive of this view.

Calmfors and Horn (1986), for example, show that a government commitment to partially offset the unemployment generated by labour-market inflexibilities actually raises overall unemployment. This occurs because unions have an incentive to exploit their knowledge of government policy - "By reducing the opportunity cost of wage increases in terms of lost employment, the policy rule induces the trade union to raise the wage. Since government employment (protection) makes up for only a fraction of the employment loss in the private sector, the result must be a fall in total employment."

Several other papers endogenise labour-market rigidities in the contexts of sectoral shocks by adopting either the monopoly-union model or the Nash

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<sup>15</sup> Variations on this argument can be found for example in Lapan (1976), Hillman (1977), Ray (1979), Neary (1982) and Fields and Grinols (1991).

bargaining approach to union behaviour.<sup>16</sup> In the monopoly-union model the wage differential between the unionised (protected) sector and the rest of the economy varies inversely with the elasticity of labour demand in the protected sector. Lawrence and Lawrence (1985) confine themselves to cases where sectoral shocks reduce the elasticity of labour demand; this will arise, for example, if investment in the sector is hit so sharply that the possibility of substituting capital for labour is closed off. Wage demands in the sector will rise in this case, though protection would strengthen the hand of unions still further in seeking higher wages and would not revitalise the industry.

This argument clearly will not go through if the elasticity of labour demand in the sector remains constant or actually increases. Barry (1995a, 1995b) shows, however, that under these circumstances the cost-to-benefit ratio of protection increases.<sup>17</sup> If intervention to correct the distortions associated with monopoly-union power was not implemented before the shock, due to the high social cost of taxation, protection is even less appropriate after the shock.

This is also the implication drawn in Barry (1996) who employs the Nash bargaining approach. This paper shows that the union in a regulated sector will release less than the socially efficient amount of labour in the event of a shock (so as to moderate the drop in wages its members must face). Protection of the sector under these circumstances reduces efficiency still further.

This literature, therefore, suggests that when labour-market rigidities are endogenous, the argument for protection or regulation based on labour-market

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<sup>16</sup> See Oswald (1985) for an introduction to these models.

<sup>17</sup> The cost of protection in this case is the marginal social cost of raising taxes to finance the protection. Some of Honohan and Irvine's (1987) estimates of this cost for Ireland range to well in excess of £1 per £1 of additional tax revenue.

rigidities is invalid. Furthermore, a recent analysis of the behaviour of two Irish semi-state companies, TEAM (a business which grew out of the aircraft maintenance function of the state airline) and Irish Steel (a company purchased by the government immediately after the Second World War and finally privatised only in the last few years) revealed many of the dangers recognised in this theoretical literature on public assistance to industry.

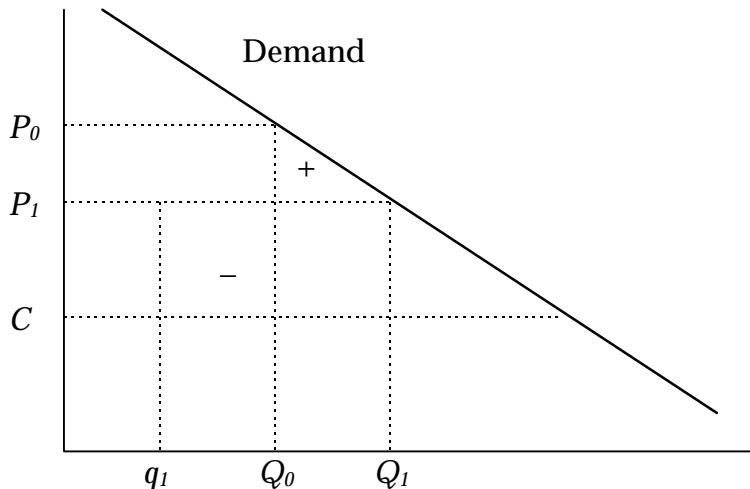
In the case of Irish Steel, Barry and Durkan (1996) concluded that, "...protection, and the knowledge that it would be continued, increased the power of the workforce and pushed up wage demands, inhibiting further the competitiveness of an industry that was in any case unlikely ever to have been able to survive unaided." The situation of TEAM Aer Lingus was recognised to be different in that TEAM is a potentially sustainable company. However, recent intervention by the government led to the return of restrictive work practices. The fact that earnings within the company are well above average for equivalent skill levels is a further indication of "monopoly union" behaviour, suggesting in light of the literature described above that intervention would tend to increase rather than decrease the level of distortions. This literature serves to warn us that it is incorrect to carry out an analysis of competition policy on the assumption of distorted labour markets without taking into account the impact of policy on these distortions.

## **X. Foreign Penetration**

We now wish to turn to the other argument advanced against deregulation, i.e. the capture of profits by newly-entered foreign competitors. Consider a sector in which positive profits can be made because of barriers to entry. Assume also that in the initial situation government regulation prohibits entry of foreign firms into

the domestic market. When these regulations are removed a foreign firm enters the domestic market (either through exporting from abroad or through producing in the home market) but remaining barriers to entry ensure that profits are not bid down to zero. It is possible in this situation that the economy suffers a welfare loss due to rents being shifted from the domestic to the foreign firm (Krugman and Venables, 1990).

In the figure below, this occurs as follows.  $p_0$  is the pre-liberalisation price,  $p_1$  the post-liberalisation price, and  $c$  the constant marginal cost.  $Q_0$  is the initial quantity sold (all by the domestic firm),  $Q_1$  is the post-liberalisation quantity, which consists of  $q_1$  sold by the domestic firm and  $Q_1-q_1$  by the foreign firm.



In this event the rectangle marked “-” is the net rent loss to domestic producers and the triangle marked “+” is the net gain to consumer surplus. It is clear that if price effects are very modest, then the economy can suffer a net loss. The more competition that ensues, however, the more profit levels are driven towards zero, and the greater the likelihood of net gains.<sup>18</sup> This yields the Krugman-Venables

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<sup>18</sup> One adverse consequence about which a considerable literature has arisen concerns the increased risk premium that may be charged to small immobile borrowers as indigenous financial services with local knowledge are crowded-out by international companies; see Branson (1990), Honohan (1995). Their situation may deteriorate through more of the system's overheads being recovered from them, as others can shop around

U-curve: there are net losses associated with very low level foreign entry, but beyond some threshold level net gains expand with further entry.

Another way of generating this U-curve is to note that peripheral economies may lose out from trade liberalisation (and, by analogy, from deregulation) if they "lose" the sectors that are characterised by increasing returns to scale (Krugman and Venables, 1990); as trade costs fall from very high levels this is more likely to occur as the benefits of centralisation close to major markets manifest themselves. As trade costs fall from more moderate levels, however, the labour-cost advantage of a peripheral location comes to dominate, and the periphery is instead likely to gain both in terms of its share of increasing returns to scale industries and in terms of welfare. The U-shaped curve thus depicts the share of high-profit and/or increasing-returns sectors that the periphery captures as deregulation proceeds, and aggregate welfare also follows this pattern.

Are there any general principles which would allow us decide whether liberalisation is more likely to raise or reduce welfare? One principle is immediately clear from the diagram: the more foreign competition (foreign entry) is stimulated, the more likely it is that net benefits result. Another principle is also clear from the diagram, though Barry (1996), rather than Krugman and Venables (1990), draws attention to it in the belief that it is of substantial empirical relevance. This is that if domestic producers are inefficient relative to their foreign counterparts, even if only to the extent of being unable to match them in scale, liberalisation is more likely to be beneficial (because foreign firms set their prices lower than they otherwise would). In the extreme, domestic producers would be driven out of the market completely if the foreign firm's costs were lower and if prices were driven below the level of domestic costs; in this

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in the newly liberalised market. Again, the less efficient the pre-liberalisation system was, the more likely even this group is to gain (in absolute, though not in relative terms).

case benefits to the consumer would outweigh producer losses. The general equilibrium considerations discussed earlier, whereby price reductions in the deregulated sectors reduce wage demands and other input costs elsewhere in the economy, magnify further the gross benefits illustrated in the present diagram.

Two further points, one empirical and one conceptual, tend to further reduce the pessimistic possibilities that show up in the U-curve analysis. Conceptually the Krugman-Venables argument is less potent in the case of functions or sectors which are non-internationally-tradable by nature rather than simply as a consequence of government regulation (these would include retailing and perhaps most transport services, for example). Liberalisation of non-tradable sectors will generally lead to increases rather than reductions in domestic output, offsetting further the adverse possibilities identified above. With distorted labour markets, furthermore, the adverse effects that the diagram illustrates as a possibility are less adverse, since foreign penetration occurs through foreign direct investment (FDI) which generates jobs rather than through imports. The pessimistic results may therefore be taken to be more potent with respect to the location sectors or functions which are by their nature internationally tradable. It warns that deregulation can lead to the disappearance of these sectors from the periphery, with possible adverse consequences for periphery welfare.

To explore whether this is likely to happen or not, it seems worthwhile to look at the experience of the increasing-returns segments of manufacturing in the EU periphery, as these were liberalised rather earlier than is the case with services. Barry (1996) looks at developments in these sectors in the Irish economy. Rather than taking rents from the home market (as in the pessimistic scenario in the above diagram), he suggests, multinational IRS-sector companies used Ireland as

a location from which to capture rents in the European core.<sup>19</sup> Barry also argues that similar developments appear to be taking place in the other EU periphery economies (Greece, Spain and Portugal).<sup>20</sup>

If the analogy with the manufacturing sector experience is valid, it suggests that the periphery, aided by FDI inflows, is unlikely to do badly in the newly-tradable services sectors, and in those services sectors that remain non-tradable after liberalisation, substantial FDI inflows are also likely to be beneficial.<sup>21, 22</sup>

## XI. Conclusions

This paper attempts to deal with arguments about the possible adverse macroeconomic consequences of competition policy. For the most part, it is suggested, these arguments are based on assumed labour-market rigidities that are taken to imply that deregulation will raise unemployment. We presented a series of four separate but increasingly complex models designed to analyse this issue. The first model assumes, in the context of a rigid economy-wide real wage, that the only positive effect of competition policy lies in the knock-on effects to the tradable sector of a reduced CPI (which reduces wage demands). We saw that if this is the case then deregulation is indeed likely to raise unemployment.

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<sup>19</sup> It is very likely that the wage-bill contribution alone of these foreign firms dominates the whole value-added contribution of the increasing returns to scale sectors in the pre-liberalisation period.

<sup>20</sup> These developments furthermore appear to be driven by "absolute" rather than by "comparative" advantage (Barry and Hannan, 1996), so there is little reason to expect that developments in the Market Services sectors should be different.

<sup>21</sup> Buigues and Sapir (1993) have recently shown the crucial role played by FDI in the transformation of the services sector. For the period reported upon in that study (the early 1980s), FDI flows to the service sector accounted for over half of total FDI flows in the EU.

<sup>22</sup> Data for service-sector FDI inflows into Ireland are very poor. For the other three economies, however, the substantial increase in service-sector FDI inflows consequent upon liberalisation indicates that optimism may also be warranted in this sphere. Data are from the OECD (1993b). These show FDI flows into the Portuguese tertiary sector rising from 0.2% of GNP in 1982 to 2.49% in 1991; for Spain the equivalent numbers are 0.27 rising to 2.59%. Greece displays an increase from 0.17% of GNP in 1987 to 0.20% in 1991.

Our second model, however, took into account two extra channels: first, that the price reductions in the liberalised sectors would stimulate demand for their output and so moderate the employment loss in those sectors, and secondly, that these price reductions stimulate the output of other sectors not just through the wage effect but also because the output of the regulated sectors serves as an input into other production processes. We saw that the Irish CGE model, which takes these effects into account, predicts that total employment will rise as a result of deregulation.

The third and fourth models reinforce these more optimistic conclusions. The third simply makes the point that while deregulation will occasionally cause a reduction in sectoral employment levels through the loss of featherbedding opportunities, as is the case in the first two models, it will also frequently induce increased sectoral output and employment through removing monopoly power. The fourth model suggests that the previous analyses, carried out on the assumption of exogenous labour-market rigidities, yield far too much ground to those in favour of continued regulation. Models in which labour-market rigidities are endogenous (i.e. responsive to policy changes) suggest that continued regulation makes the sectors less and less competitive over time, weakening substantially the whole case for regulation.

Finally, we dealt with a number of issues that arise when the sectors to be liberalised are characterised by excess profits and/or increasing returns to scale, and are opened up to foreign competition either through imports or through FDI. In some models peripheral economies can lose out if these sectors are taken over by foreign companies, whether located at home or abroad. We argued that, even if this is found to happen, the consequences are rather less dire than predicted

since the periphery sectors are likely to have been inefficient initially. This has two implications: first, they would not have been earning rents from exporting activity to begin with, and so the rent-shifting argument to justify their protection is weakened, and second, inefficiency on the part of indigenous industry induces foreign firms to enter with lower prices than would otherwise be the case. The latter point makes it more likely that foreign entry is welfare enhancing.

We then went on to argue that in fact the peripheral regions of the EU have been experiencing rapidly increasing FDI inflows into services as well as manufacturing (as a consequence of liberalisation). If entry into periphery markets is strong enough this guarantees that the gains to consumer welfare dominate the losses to periphery producer welfare.

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