



**From Antitrust to Disaster:
An Overview of European Union Competition Policy**

**Dr. Tim Evans
Dr. Sean Gabb
Alberto Mingardi**

Contents

Authors	3
Introduction	4
An Overview of European Union Competition Policy	4
The Reality of European Competitiveness	7
The Analysis of Market Failure	9
The Austrian Theory of Competition	12
Further Comments on ‘Imperfect Competition’	14
Why European Union Competition Policy is Destroying European Competitiveness	16
The Public Choice Trap	18
The Full Costs are Dynamic Rather than Static	19
Further Dynamic Costs of Regulating Competition	20
An Attempted Quantification of European Competition Rules	21
Concluding Remark	22

The Authors

Dr. Tim Evans is the president and director general of the Centre for the New Europe (CNE) Europe's leading, Brussels based, free market think tank. A former executive director of public affairs at the Independent Healthcare Association in London, he has also been an assistant director of the Foundation for Defence Studies and a senior policy consultant at the Adam Smith Institute. In 1991 he was the chief economic and political adviser to the Slovak prime minister in the former Czechoslovakia and was head of the prime minister's policy unit. In that year, he was the highest-ranking political adviser in the former Soviet bloc.

The author of numerous books, monographs and articles, he has been published by the Adam Smith Institute, the Fabian Society, the Institute of Economic Affairs, the Fraser Institute, the Libertarian Alliance, the Heritage Foundation and the Independent Healthcare Association. A regular commentator on television and radio, his articles have appeared in *The Guardian*, *The Economist*, *Financial Times* and *Wall Street Journal Europe*. In 1993 he was awarded his PhD from the London School of Economics. Today, he lives in Brussels with his wife Helen – and two cats Basil and Freddie.

Dr Sean Gabb's career has spanned the worlds of business, government service, academia, journalism, the media, politics and public affairs. A former political and economic adviser to the Slovak Prime Minister, he is also an experienced broadcaster on both radio and television, and has appeared on programmes in Britain, the USA, Canada, Argentina, Sudan and various world-wide networks. He has notched up over 250 appearances on major new programmes, documentaries, debate programmes and chat shows, including *Newsnight*, *The Midnight Hour*, *Scottish Question Time*, and *The World Tonight*. He is consulted as an expert on civil liberties issues, economic freedom and the open society. A prolific writer, his essays and monographs have been published by a wide range of institutions, including the Social Affairs Unit, the Independent Healthcare Association, the Adam Smith Institute, and the Libertarian Alliance, on such topics as constitutional law, health policy, religious freedom, civil liberties, history and economics and economic policy.

Alberto Mingardi is a Visiting Fellow at the CNE and an Executive Director of the Italian award-winning free market think tank Istituto Bruno Leoni (IBL) - www.brunoleoni.it - for which he covers issues related with globalization, competition and welfare reform. A prolific scholar and journalist, Mr. Mingardi is a columnist with a number of Italian newspapers - including "Il Riformista", "Libero", "Il Foglio", "L'Indipendente". His English-language writing has appeared in different publications, including the *Wall Street Journal*, *Markets and Morality*, *National Review*, *Religion and Liberty*. He lectures regularly in Italy and abroad.

From Antitrust to Disaster: An Overview of European Union Competition Policy

Introduction

Almost uniquely among trading blocs, the European Union's founding documents sound explicitly friendly to business. They insist on the need for competitive markets, and seek to deny any company or market any protection from competitive forces.

Yet paradoxically, the European Union is also one of the least competitive environments on earth. Its tax levels are far above the international average. Its regulatory burden is much heavier. Companies are openly reluctant to locate there, and are often actively seeking to relocate from there. Economic growth is far below the international average, and unemployment is far above.

The ambition of the European Union is to be an open, dynamic economy - an alternative to and competitor with the United States. Its reality looks increasingly to be as a sideshow in a world still economically dominated by the United States - and soon perhaps also by China and even by India.

Because of the competition policy actually adopted by the European Union, around 780,000 may presently be unemployed who would otherwise have jobs. Put differently, competition policy may be costing the European Union nearly a million jobs.

As such, this paper attempts is to what has gone wrong with competition policy in the European Union.

An Overview of European Union Competition Policy

The source of laws governing competition for the EU is contained in the Treaty on European Union, as amended by the Treaty of Amsterdam, signed on Oct. 2, 1997. Article 81 of the treaty governs agreements between, or practices of, two or more parties acting together that have as their object or effect the restriction of competition in the EU. Article 82 governs abusive business conduct of a single party in a dominant market position.¹

¹ For wording, see Articles 81 and 82 of the Consolidated Version of the Treaty Establishing the European Community, signed at Amsterdam in 1997, Official Journal C 32 , 24 December 2002 - available on line at: http://europa.eu.int/eur-lex/en/treaties/dat/EC_consol.html (checked September 2004):

(81) 1. The following shall be prohibited as incompatible with the common market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market, and in particular those which:

- (a) directly or indirectly fix purchase or selling prices or any other trading conditions;
- (b) limit or control production, markets, technical development, or investment;
- (c) share markets or sources of supply;
- (d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
- (e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

2. Any agreements or decisions prohibited pursuant to this article shall be automatically void.

3. The provisions of paragraph 1 may, however, be declared inapplicable in the case of:

- any agreement or category of agreements between undertakings,
- any decision or category of decisions by associations of undertakings,
- any concerted practice or category of concerted practices, which contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not:

(a) impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives;

(b) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.

(82) Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States.

Such abuse may, in particular, consist in:

- (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;
- (b) limiting production, markets or technical development to the prejudice of consumers;
- (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
- (d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

Interpretation - subject to the European Court of Justice - and enforcement of these articles are in the hands of the relevant European Commissioner. This is presently Neelie Kroes, whose full official title is Member of the European Commission responsible for competition. Until November 2004, the relevant Commissioner was Mario Monti. In 2000, Mr Monti described his functions as follows:

The competition policy implemented by the Commission and by the Member States' authorities and law courts aims to preserve and develop a state of effective competition in the common market by impacting on the structure of markets and the conduct of market players. Requiring firms to compete with each other fosters innovation, reduces production costs, increases economic efficiency and, consequently, enhances the competitiveness of the European economy, particularly *vis-à-vis* its main trading partners. Firms stimulated by competition thus offer products and services which are competitive in terms of price and quality.²

The main areas of competition policy are:

- The control of trusts and cartels
- The control of mergers
- The liberalisation of markets
- The prevention of state assistance

Antitrust and Cartels

It is illegal for businesses, including the professions, to collude with each other to fix prices or to share markets. If a single company has a dominant position in a particular market, it may not abuse its market power to drive out competitors. Nor may a large company exploit the weaker negotiating position of its smaller customers and suppliers. This makes it illegal for a big firm to impose conditions on its suppliers which make it difficult for them to do business with other companies. The Commission can and does fine companies for these practices.

Mergers

The Commission can ban mergers between two large companies or takeovers of one firm by another if the enlarged company would “dominate the market” (exercising by so doing “market power”) and therefore too easily be able to squeeze out its competitors or if a merger would leave so few players in the market that innovation would be stifled, or price competition or consumer choice significantly reduced.

Liberalisation

The Commission encourages and often requires that markets throughout the European Union

² *Competition Policy in Europe and the Citizen*, The European Commission, Luxembourg, 2000, p.4 - available on line at: http://europa.eu.int/comm/competition/publications/competition_policy_and_the_citizen/en.pdf (checked September 2004)

should be opened, so that firms in all other member states may compete on a level playing ground, and so that European firms should be enabled to benefit from economies of scale. Exceptions and subsidies are allowed for inherently uneconomic services, which are seen as a basic right, such as postal deliveries in rural areas. However, a monopoly supplier cannot use revenue from its monopoly activities to cross-subsidise commercial operations in which it competes with other firms.

State Assistance

The Commission closely monitors how much aid member state governments make available to business. It looks not just at obvious forms of aid, such as loans and grants, but at tax breaks, goods and services made available at preferential rates and at loan guarantees which make the borrower a better credit risk.

Future Ambitions

At its meeting in Lisbon in March 2000, the European Council launched a strategic goal - to make the European Union by 2010 “the most competitive and dynamic knowledge-based economy in the world, capable of sustainable growth with more and better jobs and greater social cohesion”. The various leaders of the member states also agreed a detailed strategy for achieving this goal:

- To prepare the transition to the knowledge-based economy;
- To promote economic reforms for competitiveness and innovation;
- To renew the European social model by investing in people and combating social exclusion;
- To set in place the right macro-economic policy mix for sustainable growth.³

The Reality of European Competitiveness

In February 2004, the European Commission published its fourth interim report on how the Lisbon Strategy had been implemented. The conclusions were disturbing:

Apart from the advances made in certain domains, the report clearly highlights that measures taken at the European level are only part of the formula for putting the Lisbon strategy on the right track; numerous reforms and investments, which are the responsibility of the Member States, have yet to be achieved.

³ Source: the Lisbon Strategy Policy Co-ordination Cycle, Factsheet F068, Infobase Europe, Huddersfield, January 2004 - Available on line at: <http://www.ibeuropa.com/Database/Factsheets/F068policy.htm> (Checked September 2004)

Indeed, in certain domains there are significant problems which hold back the entire strategy and which hinder the return of strong growth. What is more, the most important delays have been identified in three strategic domains which are crucial for growth: knowledge and networks, industrial and service sector competitiveness, and active ageing.⁴

So much for the words. Let us now look at the economic data:

**Cumulative Real GDP Growth,
fourth quarter 2001 to fourth quarter 2003**

European Union	2.2 per cent
United States	7.8 per cent
Japan	5.9 per cent ⁵

**Economic Growth,
2002-03**

European Union	0.8 per cent
United States	3.1 per cent
Japan	2.7 per cent ⁶

**Unemployment Rate Changes and Comparisons,
2000 - 2004**

	EU	USA	Jpn
Unemployment Rate At Peak of previous cycle	7.3 (3/00)	3.8 (4/00)	2.0 (2/92)
Highest Unemployment Rate in Present Cycle	8.0 (12/03)	6.4 (4/03)	5.5 (1/03)
2002, Percentage Finding work within 3 Months	23.6	65.3	33.7
2002, Percentage Still Unemployed after 6 Months	59.0	18.3	49.0 ⁷

What we can see from these figures is substantially lower economic growth in the European Union than in the two other main world economies, and much higher unemployment. Indeed, the raw unemployment figures do not tell the whole story. If we look at the figures for long-term unemployment, we can see that the European figure is three times that of the United States. In America, unemployment is a largely cyclical phenomenon. In mainland Europe, it is chronic. And these figures are biased by the fact that they include the United Kingdom, which has an approach to economic policy largely different than the other member states, and corresponding better performance. This means personal disaster for millions of families living in what is

⁴ Report From the Commission To the Spring European Council Delivering Lisbon Reforms for the Enlarged Union, Commission of the European Communities, Brussels, 20th February 2004, p.2 - available on line at: http://europa.eu.int/comm/lisbon_strategy/pdf/COM2004_029_en.pdf (checked September 2004)

⁵ Source: *International Economic Performance Since the Stock Market Bubble: A Joint Economic Committee Study*, prepared by Vice Chairman Jim Saxton (R-nj), Joint Economic Committee, United States Congress, March 2004, p.8 - available on line at: <http://www.house.gov/jec/growth/03-18-04.pdf> (checked September 2004)

⁶ Source: *More Facts and Figures on the European Union and the United States*, European Commission, 2004 - available at: <http://www.eurunion.org/profile/EUUSStats.htm> (checked September 2004)

⁷ Source: Saxton, op.cit., pp.7-8

supposed to be “the most competitive and dynamic knowledge-based economy in the world, capable of sustainable growth with more and better jobs and greater social cohesion”. It means low income and loss of skills for the workers concerned. It means higher taxes for everyone else, to support the burden of welfare payments. And it means considerable foregone growth throughout the European economy as a whole.

We can take a more sophisticated measure of economic performance. We can look at labour productivity growth. This shows how effectively workers are being organised - or how effectively labour is being combined with capital investment - to satisfy the wants of those who buy their products.

Labour Productivity Growth, 1995-2002
annual average percentage

European Union	1.3
United States	1.9
Japan	1.8 ⁸

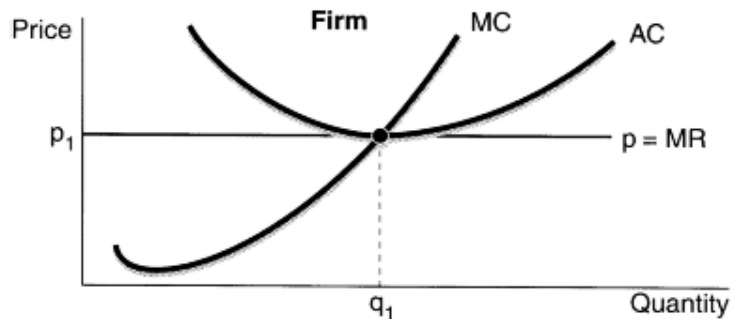
This again shows a substantial lag in performance. It could be that the emphasis placed on “competitive” and “dynamic” economies during the past generation has been in fact misplaced, and that the critics of market liberalisation have been shown right by events. Or it could be that the European Union has been going about the business of liberalisation in largely the wrong way.

The Analysis of Market Failure

The mainstream defence of the free market rests on the claim that it allocates resources more efficiently than any other system. To speak formally, it tends to bring about both productive and allocative efficiency. This first means that goods and services are produced at the lowest currently known cost. The second means that production satisfies the known wants of consumers in the fullest way currently possible.

We can best see this argument in the analysis of firms under perfect competition. Let it be granted: that there are many buyers and sellers in a market; that all the goods produced in this market are of the same quality; that there are no barriers to entry or exit for any player in the market; that there is perfect knowledge among all players in the market regarding prices and production methods. Granting these assumptions, it is possible to express the outcome in a diagram:

⁸ Source: Robert H. McGuckin and Bart Van Ark, *Despite Cyclical Downturn, Structural Trends in Productivity Remain in Place into 2003*, Conference Board/Groningen Growth and Development Centre, New York, 2003 - available at: http://www.ggdc.net/pub/performance_2003.pdf (checked September 2004)



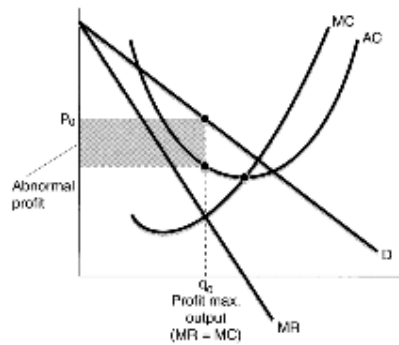
Because each firm is too small for its production decisions to affect price, each faces a perfectly elastic demand curve for its output: it can sell as much or as little as it chooses to produce at exactly the same price. Because there is free entry for other firms, competition will bid price down to the lowest point in each firm's average cost curve, which will also be the point of intersection between average and marginal cost. Because knowledge is perfect, any firm that is able to lower its average cost of production will earn a supernormal profit only in the short term: in the longer term, other firms will copy its new production method, and will bid price down to the new lowest point in the average cost curve. All producers will then earn only "normal profit" - that is, they will make enough to cover all their costs, plus the imputed cost of paying the owner an income equal to what could be earned by doing the same job elsewhere as a salaried employee.

The long-term equilibrium is productively efficient, because firms produce in the most economical manner currently known. It is also allocatively efficient, because no consumer will be deterred from buying something that he values above its cost of production.

This model conforms to the ideal of market competition that the European Union wants to implement upside down. The most obvious objection to this model is that the output of the free market very seldom complies with the model's requirements. Those who are not familiar with economic literature may instinctively believe that competition should be perfect - because, after all, we have a number of competing firms, prices are almost homogeneous, and there are very few signs of market power. However, each author of a specific book is in reality a monopolist. Despite the evidence of a large number of competitors, and the fact that each of the products they are selling looks like a substitute to the others, the book market itself doesn't resemble perfect competition. As with the market for novels whose copyright have expired - and which can therefore be freely available for re-print by an infinite number of publishers - reality dictates that the products will still differ in terms of their cover design, quality of paper and illustration.

So, there are really few markets in which the product is of the same quality, very few in which no firm is able to influence price, almost none in which there is perfect freedom of entry and exit, and none at all in which knowledge is perfectly available to all players.

All this is admitted by the mainstream economists, and further diagrams can be produced to show the effects of the "imperfect" competition that exists in the real world. Take this to show monopoly or oligopoly:



Here, we can see that a firm that wants to maximise short-term profit will set output short of the lowest point in its average cost curve. Because the firm is able to influence price by its output decisions, there is a divergence between average and marginal revenue, and the profit maximising point is where marginal cost intersects with marginal revenue. The result is higher prices than would emerge under perfect competition, and a supernormal profit in the long run. This profit is a pure surplus, serving no economically efficient purpose. Such a situation is neither productively nor allocatively efficient.

Based on this sort of diagram, and on the analysis of asymmetric knowledge, we have the great superstructure of welfare economics. Markets are assumed in which all players have perfect knowledge of purchase and production and selling possibilities; and the overall success of the model is appraised on how well it approaches to a known or knowable state of equilibrium. When equilibrium does not come about, the economists cry “market failure”, and start devising methods by which the government can step in and bring about equilibrium by the forced coordination of interests.

This is the intellectual justification for the whole of European Union competition policy - for control of monopolies and mergers, for the regulation of advertising, and for the general level of interference in business decisions in which we now live. The purpose is to bring about a state of affairs in which no firm is big enough to have a significant effect on price, and in which consumers are as fully informed as they can be on a whole range of issues considered relevant.

That is why so much of what the European Union publishes on the benefits of competition include statements such as:

In order to be effective, competition assumes that the market is made up of suppliers who are independent of each other, each subject to the competitive pressure exerted by the others. In order to preserve the ability of suppliers to exert such pressure on the market, competition law sets out to prohibit agreements or practices which might reduce it.⁹

Few mainstream economists are socialists. However, the subject - as they have developed it and as they normally teach it - has made many of their students into something like socialists. They are told at first that free markets are efficient in ways they manifestly are not. Reality then breaks in with the realisation that ideal and actual markets resemble each other vastly less than the models of classical mechanics do the real world of friction and variable gravity. They then

⁹ *Competition Policy in Europe and the Citizen, op. cit.*, p.7

accept levels of regulation that come close to abolishing market freedom.

Given these assumptions about the meaning and value of competition, some might argue for instance that it was inevitable that Microsoft would be investigated in recent years. Microsoft has a 90% share of the market for the operating systems of Intel-compatible PCs, and for this it seemed like an obvious candidate for investigation by antitrust authorities on both the sides of the Atlantic. Still, here comes the essential trick of legislators: “market-definition”. Saying that Microsoft has a 90% market share over OS for Intel-compatible PCs means, basically, that Microsoft has a monopoly over an operating system, Windows, which it invented. It is like saying that Ken Follett is the monopolist in a particular market: the one for Ken Follett’s books.

In addition to this, one point should be made clear: market share does not define monopoly. The definition of the market is essential. By speaking of Intel-compatible PCs, we rule out by default all those not based on Intel processors.

The Austrian Theory of Competition

A better approach to understanding markets is provided by the economists of the “Austrian” tradition. Starting with Carl Menger and Eugen von Böhm-Bawerk in the 19th century, and continuing in the 20th with Ludwig von Mises, F.A. von Hayek, and in our own day with Murray N. Rothbard, Israel Kirzner and many others, this tradition is flatly opposed to the mainstream theory of the firm. Mainstream theory is obsessed with situations to the exclusion of process. It concentrates on the analysis of static situations in which all the necessary information regarding consumer preferences and production techniques and resources is already available, and the only function of the entrepreneur is to use this information to bring about equilibrium within a market. The economic problem, under these circumstances, is a simple matter of using the right means to obtain a known end.¹⁰ If so, within a few years, this coordinating job could probably be managed by a computer. It can certainly be managed now by any bright economist working for a government regulatory body. Free market economists working within this framework of assumptions may praise private enterprise as doing the job of allocating resources better than the authorities. But their view of the entrepreneur is usually rather flat - he is a “profit maximiser”, someone who organises production and takes risks, and makes the curves on the graph get into the right equilibrium.¹¹

The Problem of Knowledge

One problem, as said, is that the knowledge assumed by mainstream theory is not available. Consumer tastes change from moment to moment, and usually in manners that are beyond prediction. Who, for example, could have predicted the sudden emergence in the early 1990s of

¹⁰ See, for example, James Buchanan, *What Should Economists Do?*, Liberty Press, Indianapolis, 1979, pp.17-37.

¹¹ Takes this definition from one of the standard A Level textbooks:

Entrepreneurs are individuals who:

- organise production - organise land, labour and capital in the production of goods and services;
- take risks - with their own money and the financial capital of others, they buy factors of production to produce goods and services in the hope that they will make a profit but in the knowledge that at worst they could lose all their money and go bankrupt

(Alain Anderton, *Economics*, Causeway Press, Lancashire, third edition, 2000.

a taste for tattooing and body piercing, and the consequent demand for magazines and other publications about this? Who knows when this taste will end? Who can predict whether people in England will want to buy mobile telephones with cameras built in? The fact that they may have some popularity in Japan is no indication that they will be popular here. We are already seeing that the third generation mobile telephones actually introduced here are not recovering their costs of introduction: not enough people, it seems, are interested in being able to access the Internet via the small keyboards and monitors now available. Equally, production techniques are not static, but in a state of continuous flux, as new techniques are discovered, and new uses found for old techniques.

From this, we can see that the demand and supply functions assumed in mainstream theory are radically indefinite, and indeed largely unknown in advance. Even when it seems possible to draw revenue curves, these are conjectural and based on information that may be wholly out of date. Suppose, for example, that a decrease in price for some commodity is accompanied by an increase in quantity bought. Does this show a movement along an unchanged demand curve? Or does it show an independent shift to the right of the demand curve? In the real world, we can never know the answer to this rather basic question. And so, in the real world, any attempt at measuring demand elasticities must always be a matter of guesswork rather than the precise analysis that we see explained in the standard texts.

In any market, there may be a tendency towards equilibrium - that is, the price of any commodity will tend towards a point at which demand and supply are exactly equal. But this point of equilibrium is so unstable that it is hardly ever reached, and then is not reached for more than a few seconds at a time.

On this view of markets, information is not something like a dead body that can be laid out on a slab for careful dissection, but is more like the endlessly shifting colours of a million different kaleidoscopes. No one person can see perfectly what is happening as it happens. Even if the information can eventually be gathered by diligent data gathering, it will by then be useless as a guide to the current equilibrium.

Competition as Process

The second, and equally fundamental problem with mainstream economics is that it is worthless to try analysing markets in terms of a static equilibrium in which the competitive process has already done its work. And this criticism does not apply only to the perfectly competitive model developed by Marshall, but also to the imperfect competition models developed by Chamberlin and Robinson.¹² These models are more realistic, so far as they get away from the unlikely assumptions of perfect competition. But they fail because they are still concerned with the analysis of equilibrium states rather than the process by which they emerge.¹³ They fail because they also assume away something that it is the main task of the analysis of competition to explain.

¹² For the clearest exposition, see E.H. Chamberlin, *The Theory of Monopolistic Competition*, Harvard University Press, Massachusetts, 1956 (7th edition). See also Joan Robinson, *The Economics of Imperfect Competition*, Cambridge University Press, Cambridge, 1933. For a penetrating critique of this work, see Bruno Leoni "Mito e realta dei monopoli" in Alberto Mingardi (ed), *Antitrust mito e realta dei monopoli*, Istituto Bruno Leoni, Soveria Mannelli, 2004.

¹³ For a good critique of equilibrium analyses of all kinds, see Israel Kirzner, *Competition and Entrepreneurship*, The University of Chicago Press, Chicago and London, 1973, pp.118-19 *et passim*.

The real problem of economics is not to know what equilibrium looks like once it has emerged, but to understand the process by which it is continually approached. This is clearly stated by Hayek:

The peculiar character of the problem of a rational economic order is determined precisely by the fact that the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess. The economic problem of society is thus not merely a problem of how to allocate “given” resources.... It is rather a problem of how to secure the best use of resources known to any of the members of society for whose relative importance only these individuals know. Often, to put it briefly, it is a problem of the utilization of knowledge which is not given to anyone in its totality.¹⁴

Bearing in mind, he argued, that the “omniscience yardstick” assumed by mainstream theory is not available, we need to judge institutional and market arrangements by how well they contribute to a process whereby the knowledge that exists scattered almost at random through countless millions of individuals can be somehow mobilised to contribute to the coordination of economic activity.

In this alternative view of markets – with competition seen as a process rather than a situation – the role of the entrepreneur comes into better focus. Indeed, enterprise moves to the centre of the picture. It is no longer a matter of taking advantage of information that is already generally known, and shifting markets to their equilibrium. It is rather a matter of discovering information and then coordinating it. An entrepreneur is not so much someone who makes fastest use of knowledge, as someone who is alert to opportunities that no one else has yet discovered.

Israel Kirzner observes:

The successful businessman-entrepreneur “sees” what other market participants have not yet seen; the entrepreneur sees opportunities to buy at one price and to sell at a higher price. To see such opportunities will typically call for (a) superior imagination and vision (since the perceived opportunity to sell at the higher price is likely to exist only in the future) and (b) creativity (since such a profit opportunity is likely to take the form of selling what one buys in an innovatively different form, and/or different place, than was relevant at the time of purchase).¹⁵

Profit, therefore, is found where opportunities exist for a more complete coordination of economic activity. It is made where an entrepreneur discovers and exploits an opportunity that no one previously knew to exist. It shows a previous disequilibrium caused by the systemic ignorance that exists in the real world.

Further Comments on “Imperfect Competition”

While we dealt with the abstract reasoning that underlies much European competition policy, there is also faulty understanding of matters of fact. This is especially the case in modern high

¹⁴ F.A. von Hayek, “The Use of Knowledge in Society”, reprinted in *Individualism and Economic Order*, Routledge and Kegan Paul, London, 1949. See also his 1945 paper, “The Meaning of Competition”, published in the same book

¹⁵ Israel Kirzner, “The Role of the Entrepreneur in the Economic System”, *The Freeman*, a publication of The Foundation for Economic Education, Inc., New York, February 2000, Vol. 50, No. 2.

technology markets.

Increasing Speed of Market Turnover

One of the basic assumptions of present policy is that market domination is associated with a disinclination to introduce new products or to find new and more effective ways to distribute existing products. However, the Austrian analysis helps us to see that the opposite may just as often be true - that market domination is the effect of innovation.

While for instance Microsoft excels at the moment, its products are only as good as their consumers think them at the moment. This sounds like an obvious point. But it applies with unprecedented force in the information technology market. Until recently, products changed slowly. The product lifecycle - introduction, growth, maturity, decline - was often spread over years or even decades. A car made in 1980 was not that different from one made in 1985. A music centre made in 1988 could still be sold as new in 1993 and find buyers. Market share could be built up over a longish period, and companies could then expect their position to erode slowly if they then decided not to invest in new products. Or they could keep their position by making cumulative changes to existing products. Once the point of market domination had been reached, it could persist for generations; and the analysis of imperfect competition did seem to correspond with the reality - even if the policy prescriptions were still in error.

But product lifecycles in the high technology markets have been drastically shortened in recent years. A cycle is completed not in decades or even years, but very often in a few months. For example, there is hardly any Microsoft product that can be sold more than two years after its introduction to the market - not, at least, without modifications that make it essentially a new product.

As such it is usually a mistake to believe that any company's market share so solid and stable over time. In reality market share is far from being a monolithic entity.

This is particularly true throughout the electronics sector. Nokia, for example, is the leading mobile telephone producer in the European Union, and one of the leading producers in the world. It is a rare example of a European company that has a leading position in world information technology markets. But it maintains its dominant share of the European market only because it has a regular stream of new products for the market. If it were to continue selling the kind of telephones that made it dominant in - say - 2000, it would by now have disappeared.

We can see this also in the portable music technologies. At present, Apple dominates this market with its iPod - by far the most innovative and trendiest tool of the kind. This has a 70 per cent share of the downloaded music market throughout the world.¹⁶ But this share is already under attack. Sony is entering the field. But experts are already saying that even these latest portable digital music players could be obsolete within three years. Manufacturers of mobile phones are already devising models that can also store thousands of songs, making a separate music player unnecessary.

¹⁶ Source: Nic Hopkins, "Crunch time for Apple as iPod faces new crop of rivals competing for shelf space", *The Times*, London, 20th July 2004.

Therefore, the presumption made by European competition policy that dominant market share is a sign of market abuse is unfounded. As said, dominant position in a market so dynamic as information technology is much rather a sign of giving customers what they want.

The Need for Market Domination

Moreover, because the turnover of new products in information technology is so rapid, success for any one product must often be defined in terms of market domination. Only if a product drives all its competitors from the market can it be expected to pay back its development costs during its short lifetime.

Take, for example, portable data storage. By the middle of the 1990s, the 3.5" floppy disk was reaching the end of its product lifecycle. The race was on among manufacturers to replace it. An early contender was the Zip disk format. This product sold in large numbers, and seemed set to become the market standard for portable data storage. Then, for some reason that does not need discussing, the compact disk overtook it and achieved complete market domination. Within a few months, the Zip format was effectively dead. In this case, it had sold in sufficient numbers for the manufacturer to recover its costs. But that was only because it had *nearly* won the market race to become the standard. The CD rom became the market standard, and then the manufacturers of the mastering hardware were able to make large profits. But these in turn were transitory. One of the first companies into that market was Hewlett Packard. By 2002, it was out of the market, and already gambling its winnings there in the new market for DVD mastering hardware. This has become less dominant than was hoped, and may soon fade away in the face of competition from external drives that allow hard disks to be switched.

Speaking generally, we can say that in many cases, market domination is the natural state for the information technology sector. Though each new product may have a lifecycle of just a few years or even months, it will, if successful, drive out all its competitors while it is in fashion. Therefore, a model of competitive behaviour that, while fundamentally wrong, could be defended into the late 20th century, cannot be applied in the 21st century.

Why European Union Competition Policy is Destroying European Competitiveness

We cannot place all the blame for economic under performance in Europe on the competition policy of the European Union. There are other forces at work. Some of these are the fault of governments in the individual member states - for example, very high levels of tax and policies that encourage welfare dependency. Some are beyond the control of any political authority - for example, the demographic stagnation that will, for the next few decades at least, inevitably depress the growth of labour productivity. But competition policy does have a significant part in this economic under performance. As said, it is based on a defective understanding of what competition is and what it can achieve. Bad reasoning in the social sciences generally leads to bad results in the real world. Let us see how this happens.

Driving Business Away

According to Thomas Andersson:

The economic performance of the EU, especially compared with that of the United States, worsened in the 1990s. ICT [information and computer technology], the major hallmark of the

“new economy”, played an important role in the prolonged, non-inflationary boom of the United States, and also served as a driving force for investment and growth in several EU-countries. However, whereas some of the small EU-states improved their economic performance markedly, seemingly with ICT-related factors making favourable contributions, the major continental European countries struggled.¹⁷

As said, we do not know what share in this under performance was played by competition policy. Nevertheless, there is no doubt that economic performance in the near future will be overwhelmingly determined by the health of the information technology sector. And there is reason to believe that a strict enforcement of the present competition policies will continue to damage the information technology sector in Europe as a whole.

Drive out Research and Development

As said, a successful company in the high technology sectors must almost by definition become dominant in its market. If there is a strong chance that success will be misconstrued as market abuse and therefore punished, European companies - of which there are already very few - will be inclined to move out of the European Union. They will for the moment keep their research and development in Europe, assuming that is where the necessary skills are to be found. But their product launches and main marketing will be in more liberal markets; and products will be introduced to the European markets only when they are established elsewhere.

In similar fashion, multinational companies may decide to lower their exposure to European competition laws by withdrawing from the market, and selling their products in Europe via intermediary retailers. As such, they could move beyond the reach of European law.

Therefore a strict enforcement of European competition policy will not achieve even the formally more perfect competition that it is intended to achieve. Instead, it will make the European Union into a place where gigantic foreign corporations simply market the products that they have designed and made elsewhere.

This is more than a theoretical danger. Business has never been so mobile as it is today. Much of this mobility is driven by labour costs. Companies are already relocating within the European Union and also away from it. In October 2000, for example, Panasonic announced it would move production from Wales to the Czech Republic, where labour costs are only one sixth as high.¹⁸ In October 2000, OKI threatened to move production from Scotland, to Thailand. At the same time, Sony announced a move from Wales to Slovakia - though also to Spain.¹⁹ Again, early in 2000, Philips announced plans to move its picture tube production from Holland to the Czech Republic.²⁰ In 1999, Volkswagen invested heavily in the Czech and Slovak Republics.²¹ And, according to a recent study, one in five German companies has plans to relocate - with Britain being their favourite location.²² The reasons for these relocations were

¹⁷ Thomas Andersson, *The European Union in the New Economy: FDI, Technology Flows and Economic Growth*, IKED (International Organisation for Knowledge Economy and Enterprise Development), June 2003, p.26 - available on line at: <http://www.iked.org/pdf/ikedworkingpaper.pdf> (checked September 2004)

¹⁸ Jim Pickard, “Panasonic job cuts add to fears for Wales”, *The Financial Times*, London, 25th October 2000.

¹⁹ Alf Young, “There will be a high price to pay for staying outside the euro”, *The Sunday Herald*, Glasgow, 22nd October 2000.

²⁰ Robert Anderson, “Foreign investors eye ventures in the Czech Republic”, *The Financial Times*, London, 19th April 2000.

²¹ Robert Anderson, “Skoda drives VW’s success story”, *The Financial Times*, London, 1st March 1999.

²² Feature article, “Why we attract investment - and the Eurozone is losing it”, *The Derby Evening Telegraph*, Derby, 13th

given as labour costs, tax, and regulatory burdens. But there is no reason why relocations in future should not be to avoid the attentions of the European competition regulators.

The Public Choice Trap

A further consequence of regulated competition is that it provides businesses with an irresistible temptation to compete other than on price and quality of products.

According to James Buchanan and Gordon Tullock²³ there are forces at work in politics analogous to those at work in economics. Among the most common desires of individuals are wealth and status, usually in some combination. Businessmen in a free market are driven, by the promptings of self-interest, to offer new products to their customers, and to cut costs and prices. They do this not because they love their customers, but because this is only way in which they can struggle through to fortune and perhaps a place in the history books. In politics these things are achieved by gaining and keeping office. This is most easily done in a democracy by promising the electors benefits for which others must bear the costs. These others may be later generations or a minority of the present generation. In either event, the benefits will be offered; and politics becomes a competitive auction for votes with other people's money.

At the same time, the personal interest of most administrators will lie in welcoming and even proposing such schemes, because they must be put in charge of delivering the benefits. This will mean an increase in their budgets, in the number of their subordinates, and in the status that they possess in the public mind.

The public choice trinity is completed by pressure groups. Typically, though not always, these will have a personal motive. Political and administrative reformers nearly always stand to benefit from the adoption of their "reforms". And for all they may celebrate private enterprise in their public utterances, few businessmen really like having to operate in a free market. It means competition in which they might lose, but in which they must always be acting against their own convenience. Even if they are not complete cynics, it takes little persuasion to make themselves believe in "market rationalisation" or "safeguarding the national interest", or "protecting consumers", or whatever. Other things being equal, these groups and their demands will be taken up by the politicians and administrators in proportion to how well their schemes require a bigger and more active state.

Quite often, opposition will fail even when what is proposed is not remotely in the public interest as conceived in the wider sense. The reasons for this have been most rigorously explained by Mancur Olson in his writings on collective action.²⁴ All voluntary associations involve their members in costs and benefits. When the actual or potential benefits to each member are large, the members will be happy to incur heavy costs. When the benefits to each are small, there will not be the same incentive to incur costs. Typically, producer groups in

June 2000. See also News article, "Inward investors scorn euro scare", *The Times*, London, 25th January 2000.

²³ See James Buchanan and Gordon Tullock, *The Calculus of Consent*, University of Michigan Press, Michigan, 1962. See also: Gordon Tullock, *The Vote Motive*, Institute of Economic Affairs, London, 1976; and James Buchanan, *The Economics of Politics*, Institute of Economic Affairs, London, 1978. For a good primer, see Gordon Tullock, Arthur Seldon & Gordon Brady, *A Primer in public Choice*, Washington: Cato Institute, 2002. For a brief but precious guide to public choice, see Pierre Lemieux, "The Public Choice Revolution", in *Regulation*, Vol. 27, N. 3, fall 2004.

²⁴ Mancur Olson, *The Logic of Collective Action*, Yale University Press, Connecticut, 1964, and *The Rise and Decline of Nations*, Yale University Press, Connecticut, 1982.

search of market privilege fall into the first category, and consumer groups into the second. The first will have the money to buy the best and most intensive publicity in favour of their desired privilege. They can hire economists to draw up the relevant graphs or tables of statistics, and to make the worse appear the better case. The second are compelled by lack of finance to reply with general arguments that do not seem actually to address the main points at issue. The first will be helped by politicians and civil servants who see their own interests served thereby. The second can rely, at best, on the support of political outsiders who have no interest in the present state of affairs, but who also have little popular or party support.

The Full Costs are Dynamic Rather than Static

As said, the real function of competition is not that it produces a static equilibrium in markets that already exists, but that it enables entrepreneurs to discover and satisfy wants that no one else has yet perceived. There are still many unsatisfied wants, because no one has yet perceived them, or realised any way of satisfying them. But opportunities for beneficial exchange have been created where none existed before. This is a simple point, but it is a point that cannot be explained in the mainstream theory of static equilibrium. Writers in this tradition can use an Edgeworth box diagram to explain how, when the indifference curves of two parties intersect, there is an opportunity for mutually beneficial exchange. But they are much less interested in discussing the means by which these parties become aware of the opportunity. In this sense, explaining exchange by simply taking enterprise for granted is rather like explaining a house fire by showing how a lighted candle near wooden furniture can enable combustion - and by assuming without further examination that someone has knocked the candle over.²⁵

Or let us take a real and more elaborate example. Take the development of sound recording. By 1877, all the technology needed to record sound had been around for centuries - the sufficiently accurate clockwork mechanisms, the steel of sufficient hardness, the means of coating smooth wax onto a cylinder, the speaking trumpet needed to collect and focus sound, and so forth. At the same time, there was a demand - though no one had previously articulated it - for sound recording in both the commercial and entertainment sectors. And there was sufficient wealth in at least America and Western Europe to create an effectual demand for a sound recording machine. There was no reason, given the perfect knowledge assumed in equilibrium models, for the phonograph not to have been invented in 1800, or even in 1700 or 1600. But it was Thomas Edison who put everything together in 1877 and thereby started the modern entertainment industry. He did this not because he was purely interested in the advancement of technology or the welfare of the masses - though these things did interest him - but because he was looking for new ways of making a profit for his research and development company.

Of course, once profits have been made - or once an opportunity for profit is announced - others come into the market and compete away the profits of the discovering entrepreneur. The final position, assuming no further change in preferences, is the equilibrium with which mainstream economics is most concerned. But it is the process of coordination that is really

²⁵ Israel Kirzner makes this point:

[F]or an exchange transaction to be completed, it is not sufficient merely that the conditions for exchange which prospectively will be mutually beneficial be present; it is necessary also that each participant *be aware* of his opportunity to gain through the exchange.... [E]xchange may fail to occur because knowledge is imperfect, in spite of the presence of the conditions for mutually profitable exchange. (*Competition and Entrepreneurship*, pp215-16)

important, as it is the engine that drives towards a more satisfactory allocation of resources.

Profit and dominant market share here are the incentive - but it is not an incentive to work harder at allocating known resources to known ends. It is an incentive to stimulate the alertness of the entrepreneur to look out for previously unknown resources and apply them to previously unknown ends. It is also, as in the case both of the phonograph and of the cleaner, an incentive to create new resources. And what must be clearly understood is that, assuming markets are open to entry from outside high profits and dominant market share are evidence of great previous uncoordination. The higher the profit and greater the market dominance, the greater the previous uncoordination.

As with Edison, it is entrepreneurs seeking profit who have done most in the past few hundred years to raise the living standards of western societies. They have achieved this by doing things that no one had done before because no one had previously imagined that doing them was possible. The process has not been smooth and continuous - after all, entrepreneurs are only human beings who see a little further than others; and they frequently see the wrong object. But, while there have been many failures to set against each success, there have been more successes since around 1600 than in any other period of history.

If we want this progress to continue, we must learn to respect enterprise and not be frightened of it, or concerned to restrict it because certain consequences of letting it alone may be found to be unfortunate. According to the Austrian analysis, markets do not need to be “perfect” in the sense of the mainstream equilibrium models. They simply need to be open to entry for new competitors.²⁶

Further Dynamic Costs of Regulating Competition

Attempts to regulate enterprise by government officials must be counterproductive to the progress of humanity. This will be so for two reasons:

First, let us take the usual “market failure” case for regulation. Perhaps some firms are making “excessive” profits - that is, their revenues are considerably higher than their total actual and imputed costs. Or perhaps there is an “under supply” of goods relative to their “social marginal benefit” as asserted by those in authority. Or perhaps there is an “over supply” of certain goods, like cigarettes or flammable nightclothes or chain letter companies, relative to their asserted social marginal benefit. Even assuming those in authority are motivated purely by desire to promote social welfare - a dubious assumption, bearing in mind the insights of public choice analysis - they lack the knowledge to respond better than the market to the actual preferences of consumers. These preferences are known in advance only to consumers themselves - and then not always very well. And then there is the conceptual problem of how to know and rank the scales of preference of all consumers, and then to aggregate them into a social welfare schedule. Regulators cannot know in advance what is the correct price of any product or the correct amount to be supplied. At best, they will impose their own preferences on the pattern of economic activity - and though tyrannical, this is at least honest and satisfactory to someone. At worst, they will introduce chaos into what would otherwise be an increasingly ordered state of affairs.

²⁶ For what may be the best treatment of this subject currently available, let us direct the reader to Pascal Salin, *La concurrence*, PUF, Paris, 1995.

Second, and perhaps more serious, there is the fact that direct controls on prices, quantities, or qualities of output production, or profits, may discourage or block future activities that have not yet been imagined. Suppose, for example, that Edison had made fantastic profits from his invention of the phonograph, and that he tried to prolong these by very restrictive management of his patent - neither of these is true, by the way. Suppose then that the authorities in every country where he operated had stepped in and forced him to lower prices, or had forced him to give up his dominance of the market. Berliner then might not have been stimulated in 1888 to invent the gramophone. Later, others might have been deterred from investing in the hugely expensive business of developing electrical and then stereophonic and then digital recording. Intervening to correct what may even be real “market failures” in the present may block or distort the discovery process that entrepreneurs in unconstrained markets provide.

Is this a defence of mergers that create giant companies that dominate markets? Of companies like that tie products into bundles and offer these in a way that crowds out other companies? Yes. Mergers and other kinds of market dominance are part of the discovery process. Until one has been tried, it is not possible to know the optimum scale of output in any given market.²⁷ As for fraud, breach of contract should always be a matter for the courts of a just society - but never for government officials making judgments of what is or is not a fair price. Sooner or later, someone may discover a way of bundling products in a way that does give perfect computers to people. A society in which this sort of progress is welcomed should not be putting barriers in its way.

An Attempted Quantification of European Competition Rules

As repeatedly said, there is much more wrong about European economic management than the competition rules of the European Union. Even if the European Commission were to give up entirely on trying to make competition in the real world conform to what the university text books say it ought to be, Europe would remain in deepening economic troubles. Tax and general regulatory burdens are probably far greater causes of European under performance. However, there can be no reasonable doubt that strict enforcement of the existing competition rules is a significant part of the overall problem.

We can see that cumulative economic growth in the European Union was 5.5 percentage points below that of the United States in the first two years of the present century. We can also see that long term unemployment in 2003 was 3.51 percentage points above that in the United States. Let us make the very conservative assumption that the present costs of competition policy in the European Union had contributed 10 per cent to this lagging in economic growth. On a combined European Union GDP in 2001 of \$10.522 trillion, this represents foregone economic growth to the value of \$36.932 billion.²⁸

Of course, as a fraction of the overall wealth of the European Union - and we are discussing here only the 15 member states from before the 1st May 2004 enlargement - this is not very

²⁷ See, on cartels and mergers, Peter Klein, "Mergers and the Market for Corporate Control", in Elgar Companion to Austrian Economics, Peter J. Boettke, ed., Aldershot, U.K.: Edward Elgar, 1994. See also Pascal Salin, "Cartels as Efficient Productive Structures", Review of Austrian Economics, 1996 9(2), pp. 29-42.

²⁸ Source: *More Facts and Figures on the European Union and the United States*, European Commission, 2004 - available at: <http://www.eurunion.org/profile/EUUSStats.htm> (checked September 2004)

much. In itself, however, it is a large amount of money. It would not go very far divided among millions of citizens of the European Union member states. But in terms of investment, it would go far to creating the conditions in which that unemployment level could be significantly reduced.

If we take the average GDP per capita throughout the 15 old member states of the European Union, which was \$23,700 in 2000²⁹, and divide this into the foregone growth per year during the two following years, we get enough additional GDP to finance around 780,000 additional jobs. With European Union unemployment of around 14 million, that is a greater than 5.5 per cent fall in overall unemployment.

Of course, these figures are all questionable. We cannot know if the additional wealth created would have been used to create more employment opportunities, or if it would have turned into the more general “jobless” growth seen in the European Union - where economic growth leads to wage rises among those already employed. We also must bear in mind that the average GDP per capita figures are just an average - between the various member states, they vary greatly.

Even so, on the very conservative figures assumed above, it seems to be the case that competition policy is to some degree holding back a considerable and perhaps sustained fall in the presently very high levels of unemployment throughout the European Union.

Moreover, these are the costs assumed on a static basis. They take only the foregone growth in the previous year. If we consider the dynamic costs - the compounded loss in future years because of foregone growth in previous years - the overall costs might be heavier still.

Concluding Remark

The Lisbon Agenda is about creating a culture of enterprise within the European Union. If only the policy makers within the European Union could understand that this enterprise more than the regulatory equivalent of growing ivy on a garden trellis - allowing growth in one direction, positively encouraging it in another, and ruthlessly forbidding it in others. Real enterprise is a natural growth, and flourishes best when left to its own directions. This is an insight of the Austrian school of economists. But it has been eloquently stated by other economists over and over again. We find it in the works of the great economic journalist Henry Hazlitt, in the essays of the great 19th century French economist Frederic Bastiat, and of course in the writings of Adam Smith.³⁰ But let us end with this chapter with the words of the free trader Richard Cobden, speaking in the British Parliament back in 1846:

²⁹ Source: *2000 Country Reports on Economic Policy and Trade Practices*, Released by the Bureau of Economic and Business Affairs, U.S. Department of State, March 2001 - available on line at: <http://www.state.gov/documents/organization/1618.pdf> (Checked September 2004)

³⁰ See: Henry Hazlitt, *Economics in One Lesson*, Harper and Brothers, New York, 1946; Frederic Bastiat, “What is Seen and What is Not Seen”, published in *Selected Essays on Political Economy* (translated by Seymour Cain), the Foundation for Economic Education Inc, New York, 1964; Adam Smith, *An Inquiry Into the Nature And Causes of The Wealth of Nations*, 1776 - see especially:

Whoever offers to another a bargain of any kind, proposes to do this. Give me that which I want, and you shall have this which you want, is the meaning of every such offer; and it is in this manner that we obtain from one another the far greater part of those good offices which we stand in need of. It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages. (Chapter II, “Of the Principle which gives occasion to the Division of Labour”)

You may, by legislation, in one evening, destroy the fruits and accumulations of a century of labour; but I defy you to show me how, by the legislation of this House, you can add one farthing to the wealth of the country. That springs from the industry and intelligence of the people of this country. You cannot guide that intelligence; you cannot do better than leave it to its own instincts. If you attempt by legislation to give any direction to trade or industry, it is a thousand to one that you are doing wrong; and if you happen to be right, it is a work of supererogation, for the parties for whom you legislate would go right without you, and better than with you.³¹

Centre for the New Europe AISBL
Rue du Luxembourg 23
Brussels 1000
BELGIUM

³¹ Richard Cobden, speech in the House of Commons on the Corn Laws, 27th February 1846 - in *Speeches on Questions of Public Policy by Richard Cobden, MP*, edited by John Bright and J.E. Thorold Rogers. T. Fisher Unwin, London, 1870, vol. i, p.197.