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Competition Policy in a Small Economy: the Case of Iceland

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Goals of competition policy

- Competition is not an end in itself, but the means to an end
- Main goal: improving efficiency
  - Enhancing "welfare" in the economic sense
- Many other conceivable goals
  - Protecting smaller firms
  - Promoting market integration
  - Economic freedom
  - Fighting inflation
  - Fairness and equity
- For small economies efficiency is the only choice

Goals & tools of competition policy and enforcment in Iceland

- Icelandic Competition Act, Article 1:
  - "The objective of this Act is to promote effective competition and thereby increase the efficiency of the factors of production of society"
  - Premise: competition increases efficiency
- Basic tools:
  - Article 10: Ban on agreements to restrict competition (e.g. price-fixing and market sharing)
  - Article 11: Ban on abuse of dominant position
  - Article 17: Merger control
- "Heart of competition policy": Merger control
  - CA can block or set conditions for merger if it is deemed to "obstruct effective competition"
  - Article 17 does not explicitly mention efficiency considerations

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The small country handicap

- Small countries can often sustain only a few firms in industries where scale is important
- Many firms operate below minimum efficient scale when producing for domestic market only – higher unit costs of production
- Tendency to oligopoly/monopoly
- Adverse effects of lack of competition
  - Allocative inefficiency
    - prices too high
    - supply, quality and variety of goods and services limited
  - Productive inefficiency – badly run businesses ("the quiet life")
  - Dynamic inefficiency – lack of innovation and investment
- Adverse effects on growth and standard of living

Location and integration matter

- In general, oligopoly problems exacerbated by geographic isolation
- Attenuated by proximity to trading partners
- “Gravity” models indicate how close one economy is to other economies, taking both sizes and distances into account
- Describe preconditions – matters can be made better or worse by policies

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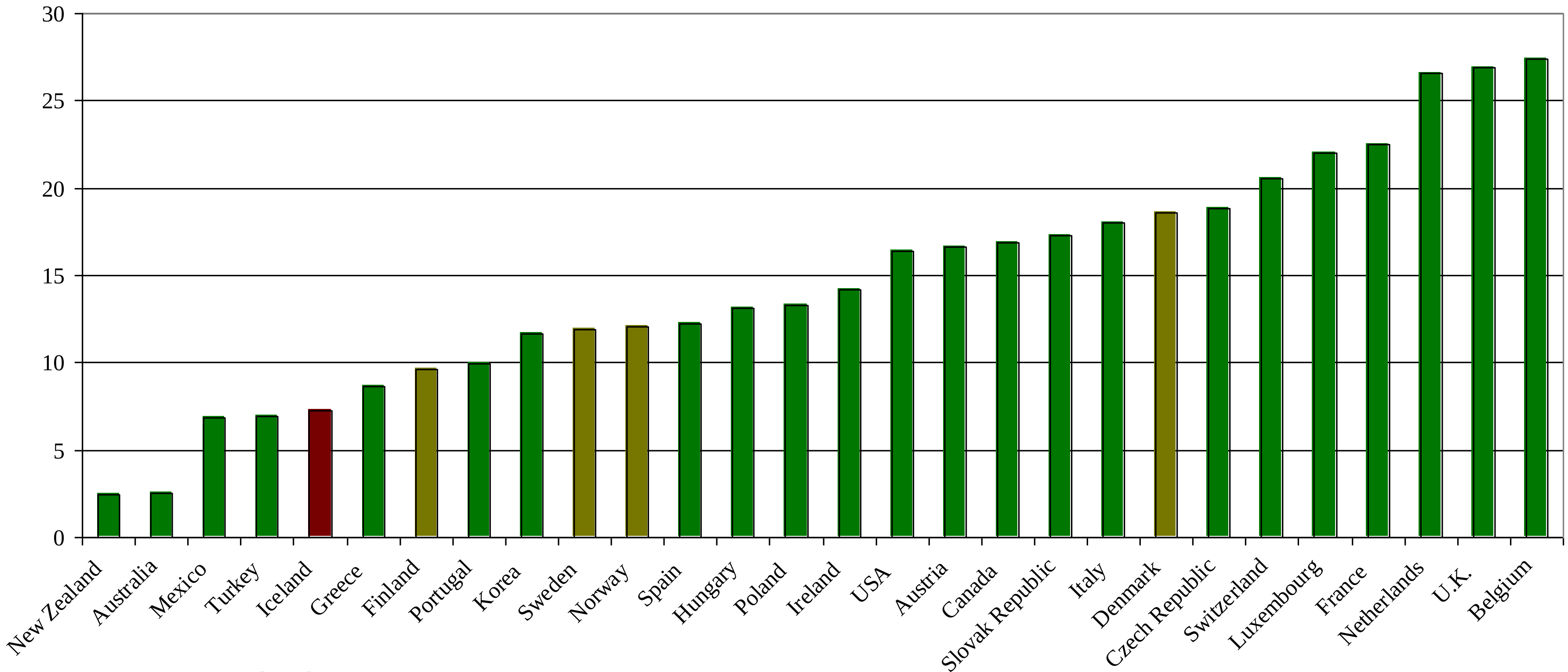
"Gravity" Index for OECD Countries

Indicates "economic pull" between each country and other countries



Source: Evans and Hughes (2003)

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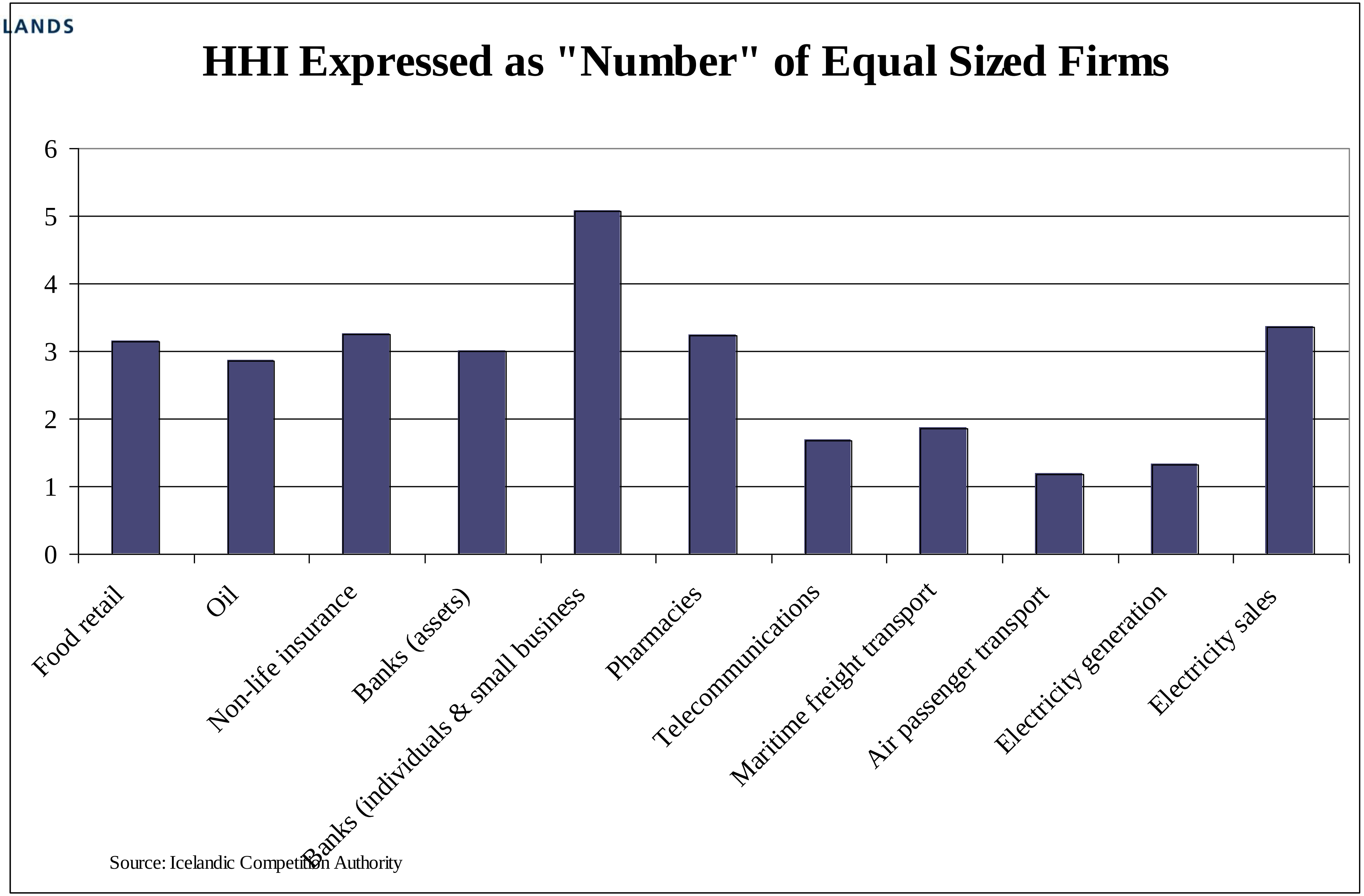

Based on figures from different periods

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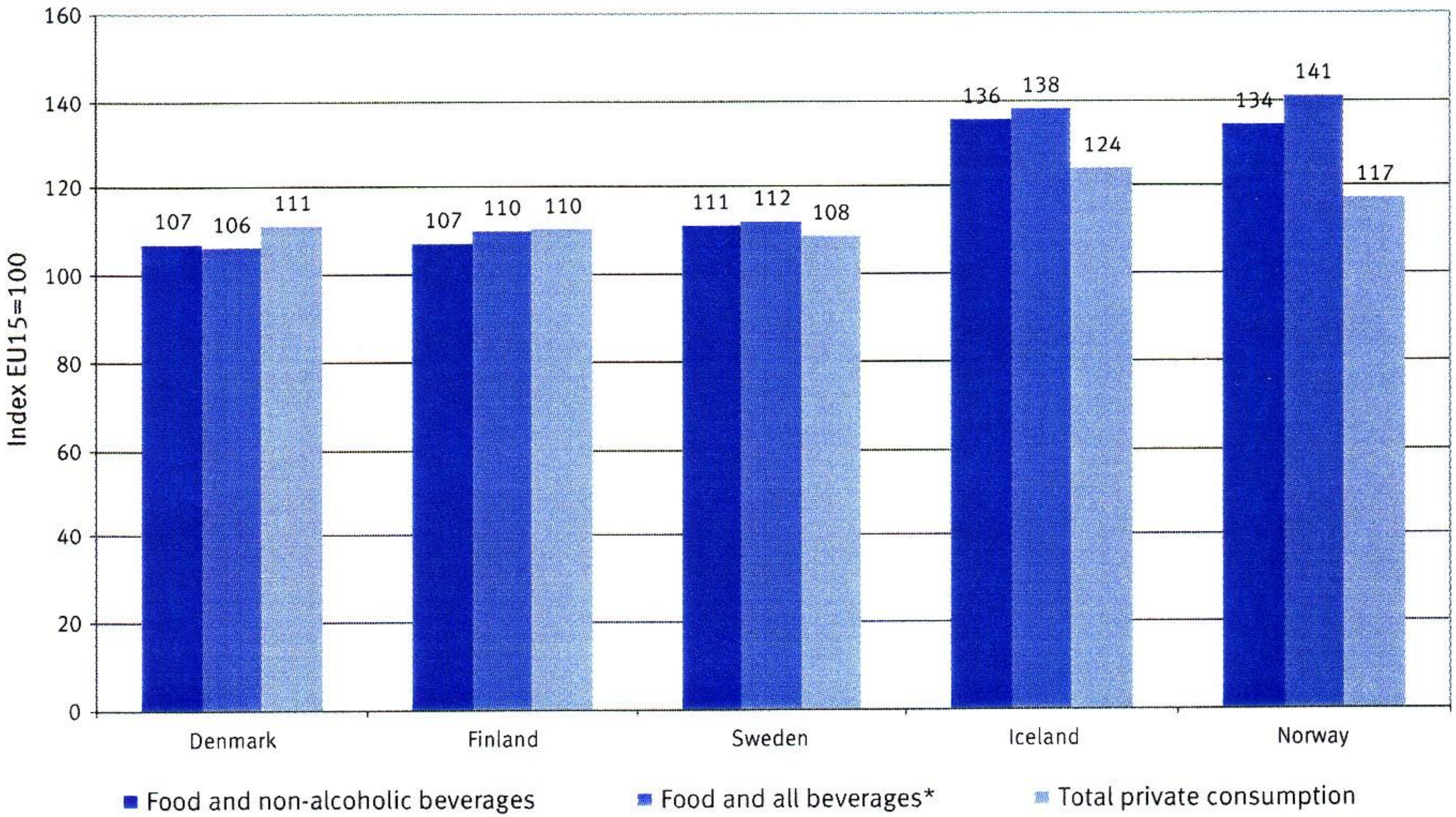
Figure 2. Net food and beverages prices (excl. taxes), 2004



Source: Eurostat and the Working Group's own calculations
Note *: Beverages, i.e. soft drinks and beer

Source: Nordic Competition Authorities, Report no. 1/2005

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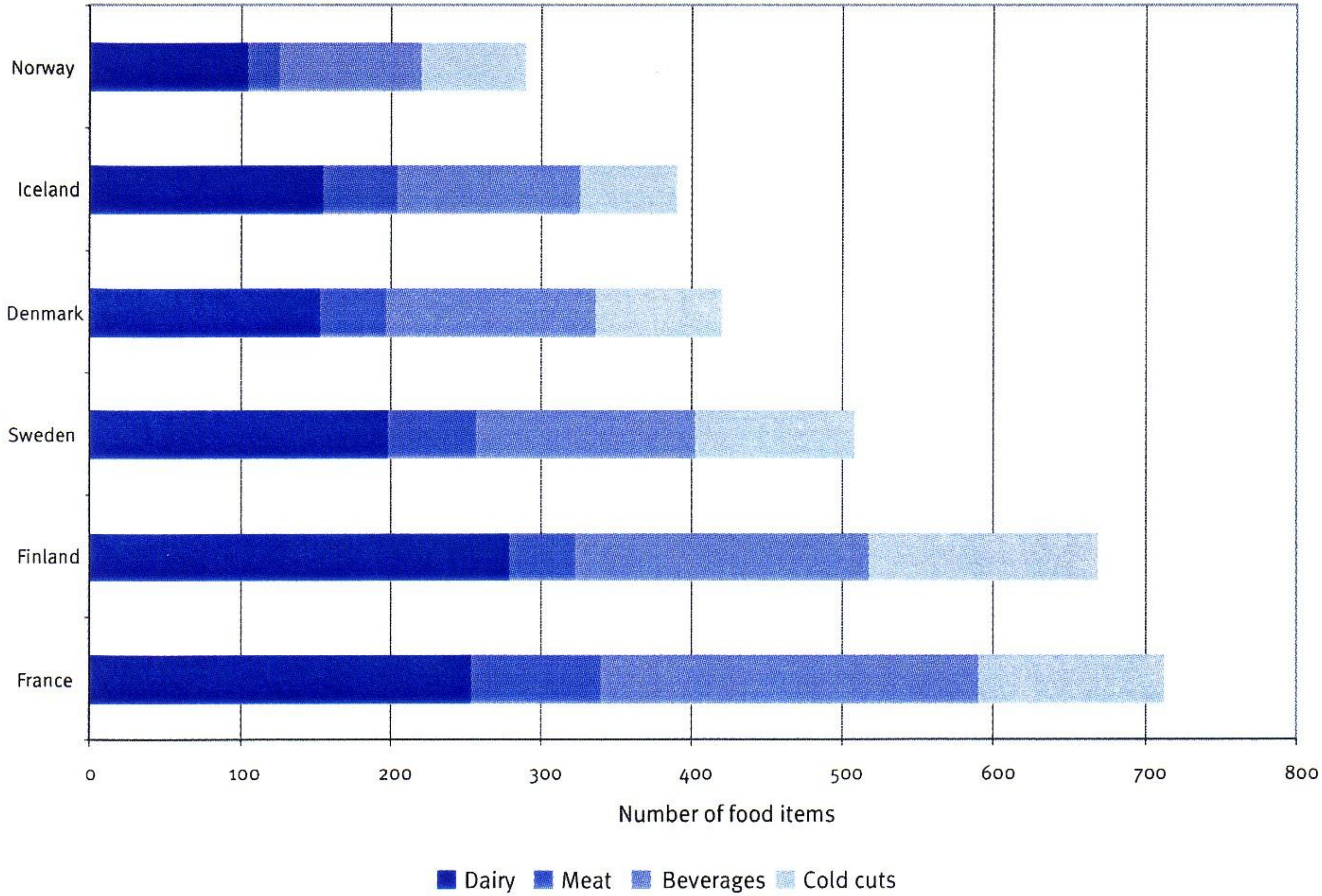
Figure 4. Number of food items in an artificial average supermarket, 2005



Source: Hornstrup and Hornstrup, 2005

Source: Nordic Competition Authorities, Report no. 1/2005

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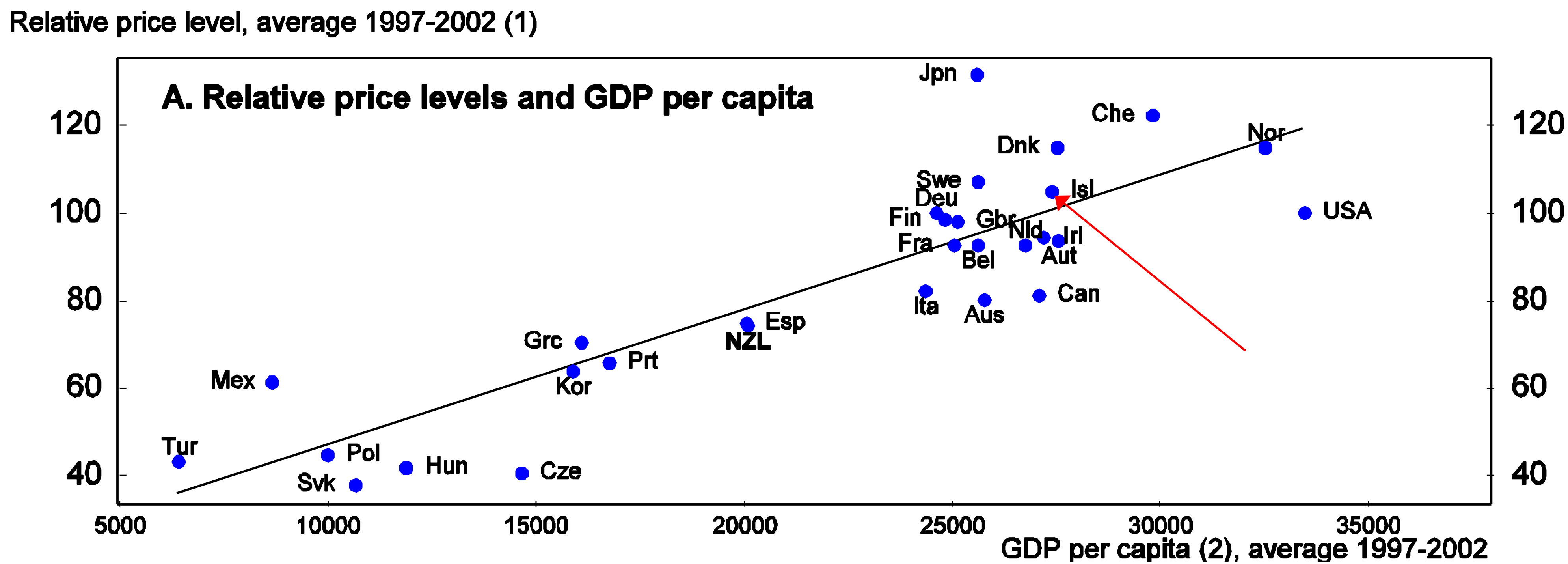
Yet, overall, we don’t do too badly:



Source: OECD

Iceland

- Certainly fits the description of a (very) small market economy
- Location does not help
- Oligopolistic market structure in many sectors
- Examples of collusion, abuse of dominance etc.
- Indications of higher prices, but perhaps less marked than one would expect
- Questions:
  - Should Iceland pursue policies that are more lenient or more stringent than those in neighbouring countries?
  - Should we accept oligopoly as a necessary evil, allowing firms to exploit economies of scale?
  - Should we pursue an aggressive policy on all frontiers?

Policy questions

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Difficult role of Competition Authority

- If too aggressive, may prevent efficient developments taking place
- If too permissive, may cause entrenchment of market power
- Basic tension: market power vs. firm efficiency
- In larger economies CAs may focus on market power without paying too much attention to efficiency aspects
- Problem: Gulliver in Lilliput
  - Locally large
  - Internationally small
- However: we should not underestimate the power of competition for innovation and growth
- Icelandic experience of the last 15-20 years; EEA agreement

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Implications for competition policy

- A vigorous competition policy must be pursued
  - There is no choice, we do not want the quiet life
- However, economies of scale must be taken into account to some extent
  - Benchmarks and rules of thumb used in large economies should not be uncritically applied, e.g. in merger analysis
- Oligopolistic structure is inevitable
- Relatively stronger emphasis on preventing collusive behaviour and abuse of dominance than in larger economies
- Make markets as open, contestable and integrated as possible
  - Stimulate entry into Icelandic markets
  - Set conditions for expansion of Icelandic firms to other markets
- A wide range of policies, laws and regulation play a role

Policy in action: Icelandic banks

- Structure in 2000: 3 commercial banks – 2 state owned, 1 investment bank (Kaupthing), >20 savings banks
- In preparation for privatisation of state banks the state sought to merge the two banks – substantial efficiency gains claimed
- CA was asked for opinion and came out against the merger due to the increased concentration that would follow
- Merger plans were abandoned; both banks privatised; one later merged with Kaupthing to form KBB
- Structure now: 3 "large" commercial banks, >20 savings banks
- Market understood that in order to grow, the banks must grow outside Iceland
- All the commercial banks now have substantial operations abroad
- 70% of the income of KBB comes from outside Iceland

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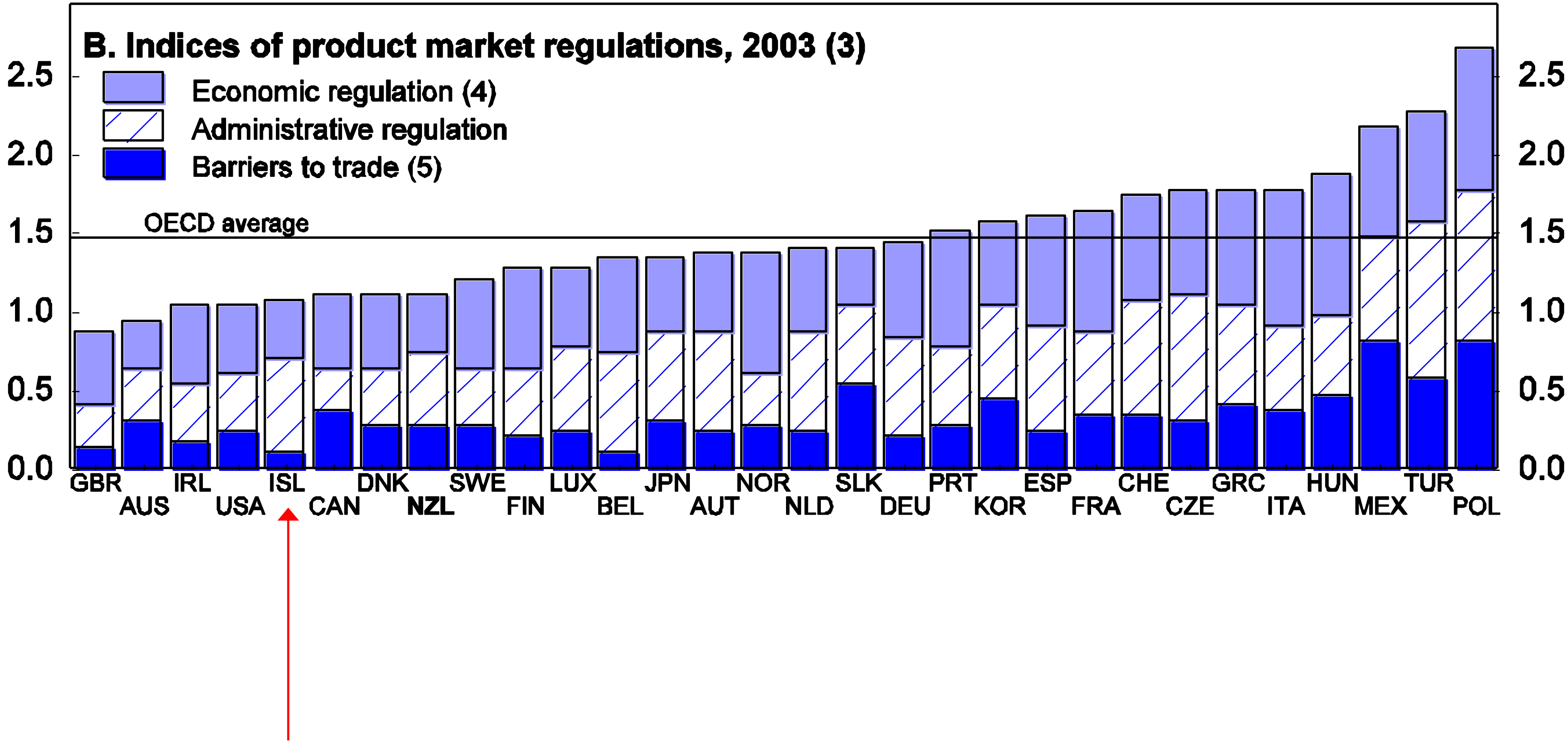
Other important policies

- Market contestability
  - Lowering barriers to trade and investment
  - Clear and transparent rules and legislation
- Encouraging entrepreneurship
- Market integration in a wide sense
- Many policies not thought of as part of competition policy matter
  - Less state control: Privatisation
  - Zoning
  - Currency regime
- Helps not only in attracting entry of foreign and local firms in Icelandic markets, but also helps Icelandic business expand to other markets

Lowering barriers to trade and investment

- A very important complement to traditional competition policy
- Iceland has reduced barriers in many ways in recent years – has one of the least restrictive overall product market regulations in the OECD
- By OECD measures we can still do better in encouraging entrepreneurship – mainly by simplifying administrative procedures
- Iceland has the most restrictive FDI rules in all OECD countries

Product Market Regulation in OECD



Source: OECD

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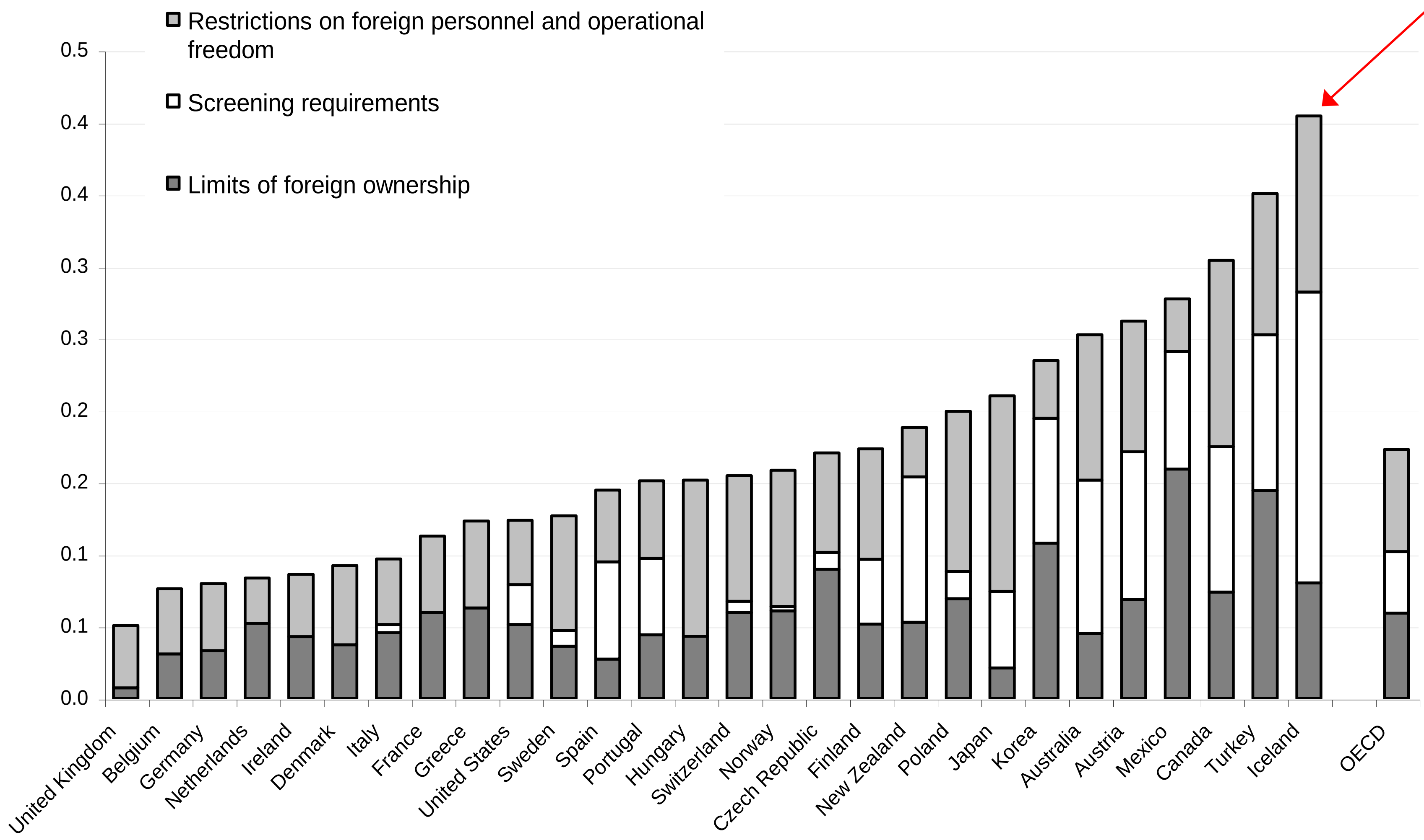
OECD indicators of FDI restrictions, 2001



Should competition be pursued in all sectors?

- Traditionally, the electricity sector was considered the archetypical natural monopoly
- Today, EU countries and many others pursue competition in generation and sales of electricity
- Iceland has followed the same path
- Still remains to be seen whether this is a viable solution
- Alternative: regulated state monopoly
- Which evil is worse?

Should powers of CA be strengthened?

- The new Competition Act gives the CA extensive powers to take measures against infringements of Articles 10, 11 and 12 (e.g. price-fixing and abuse of dominance)
- May impose behavioural and structural remedies
- Same applies for merger cases
- Difficult to see need for more powers in this regard
- However, need a stronger CA: rapid economic growth, intense merger activity etc. call for more resources
- There may also be economies of scale in regulatory and surveillance activities which a small economy should take advantage of to utilise resources better

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Intra-sector-, cross-holdings and market transparency

- Ownership of many firms characterised by intra-sector and cross-holdings
- Natural to a limited extent
- Strategic holdings within same oligopolistic sector are negative from a competition policy point of view
    - Influence and information
    - Market transparency
- Forward contracts in shares with pro-forma ownership (i.e. the “owner” does not retain voting rights) increasingly common
    - Make the market more opaque
    - Negative from an overall market point of view, especially for smaller investors
    - Negative from a competition policy point of view
- To some extent the international market has already sent a clear message regarding the cross-holdings phenomenon
- Is further regulation needed?

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Conclusion

- Preconditions for Iceland are bound to lead to an oligopolistic structure in many sectors
- No sense in trying to maintain or achieve similar structure as in much larger economies
- All the more need for a vigorous competition policy of the proper kind
- Market opening and integration are essential parts of an overall policy…
- …and they are win-win policies
- Have been travelling down this road
- Keep going, in the same direction!