Hertie School
Jacques Delors Centre

Policy Brief

The Economics of European Sovereignty:

What role for EU competition policy in industrial policy?

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#Competition
#Digital
#Industry
#Sovereignty

The new Commission aims to develop a new European industrial strategy. Some Member States have called for EU competition policy to support this strategy by allowing the formation of 'European champions' that are better able to compete with US and Chinese corporate giants. Especially in digital technology sectors, where European firms are falling behind, this is increasingly viewed as a question of preserving Europe's economic sovereignty. Should EU competition policy feed into industrial policy and support 'European champions'? What reforms does EU competition policy need, if any?

1 Introduction[1]

The decision by the European Commission to block a planned merger between European railway giants Alstom and Siemens in February 2019 sparked a heated debate about whether EU competition policy is still in line with the realities of the new global economy. Critics of the Commission's decision argued for the need to create 'European champions' capable of competing on a global level, especially in light of increased competition from state-subsidised Chinese corporate giants. More broadly, some Member States (notably France, Germany, and Poland)[2] called for EU competition policy to be 'modernised' and to feed into a modern European industrial policy.

In response, the new Commission has put a review of EU competition rules on its agenda. It has indicated that competition policy will have an important role to play in the Commission's new 'long term strategy for Europe's industrial future'. This planned industrial strategy can in turn be viewed as part of a broader strategic initiative to strengthen Europe's economic sovereignty.

[1] This policy brief follows an expert workshop held on 22 November 2019 as part of a workshop series on the economics of European sovereignty, which is co-organised by the Policy Planning Unit of the German Federal Foreign Office and the Jacques Delors Centre at the Hertie School in Berlin. The argumentation reflects the opinion of the author and not the position of the Federal Foreign Office nor of any individual participant.
[2] German Federal Ministry for Economy and Energy, French Ministry of Economy and Finance, Polish Ministry of Entrepreneurship and Technology (2019), *Modernising EU Competition Policy*

This policy brief outlines the relevance of EU competition policy for economic sovereignty. It argues that competition policy should not be seen as a tool to further industrial policy, but rather as a distinct complement. It shows that the best way for competition policy to support Europe's economic sovereignty is not to loosen merger control in pursuit of 'European champions'. Instead, competition enforcement overall should be strengthened and antitrust, merger control, and state aid rules should be adapted to better handle the unique challenges posed by digital markets.

2 What does EU competition policy have to do with economic sovereignty?

The digital revolution has led to fundamental changes in states and societies. Technology developed and maintained by a small number of private firms increasingly makes up part of critical infrastructure, thereby gaining in strategic importance. This shift is on one hand transformative at the individual level, as digital goods and services collect vast amounts of personal data on users while becoming an indispensable part of their everyday lives; on the other hand, the new technology has significant macro-level government, economic, and military applications. The rapid development of new applications in artificial intelligence (AI), 'big data', and cybersecurity only heightens the importance of digital technology for governments and societies over the coming decades.

At the same time, the digital age has had a significant effect on market structures, allowing for a concentration of market power between a few 'superstar' firms. These 'superstar' firms benefit from advantages unique to the digital environment, namely[3]:

- Extreme returns to scale, as digital products and services can be carried out, replicated, or scaled up at far lower marginal costs than physical products;

- Network externalities, where a product or service becomes more attractive the more users it has (e.g. Facebook), creating positive feedback loops that strongly favour incumbent firms;

- The role of data as an essential input for products, services and production processes, which strongly favours established firms that have already had a chance to collect it.

Together, these factors result in a market environment that strongly favours the formation of a few dominant digital firms that are difficult for newcomers to challenge. This incumbent bias in the market then provides significant incentives for dominant firms to engage in anti-competitive behaviour.

In this market context, there is increasing competition in digital tech between the US and China. American and Chinese firms dominate the top 20 internet companies by market capitalisation, while European firms fail to make the list at all.

[3] Crémer, Jacques, Yves-Alexandre de Montjoye and Heike Schweitzer (2019), *'Competition policy for the digital era'*, European Commission

Table 1: Top 20 internet companies by market capitalisation as of June 2019, with country of headquarters (in billion USD)

1. Microsoft	1.007	US	**11. Salesforce**	125	US
2. Amazon	888	US	**12. Booking**	77	US
3. Apple	875	US	**13. Uber**	75	US
4. Alphabet	741	US	**14. Recruit Holdings**	52	Japan
5. Facebook	495	US	**15. ServiceNow**	51	US
6. Alibaba	402	China	**16. Workday**	48	US
7. Tencent	398	China	**17. Meituan-Dianping**	44	China
8. Netflix	158	US	**18. JD.com**	39	China
9. Adobe	136	US	**19. Baidu**	38	China
10. PayPal	134	US	**20. NetEase**	33	China

Source: Bond (2019), Market capitalisation of the biggest internet companies worldwide as of June 2019 (in billion U.S. dollars), Statista.

China in particular views the rapidly-evolving field of digital technology, and especially the rise of artificial intelligence, as an opportunity to further its own development. In its Made in China 2025 strategy, China targets digital tech as a strategic area for industrial policy and aims to become a global leader in high-tech manufacturing by 2049. Under this strategy, China is channelling significant public and private investment into its industrial giants and aims to reduce its state of current tech interdependence with the US by supporting indigenous tech development. The US, meanwhile, is attempting to disentangle itself from the Chinese tech industry – for example, by implementing stricter controls on foreign investment in the US, blacklisting Chinese tech firms (including Huawei), and considering restrictions on American tech exports to China.[4] This decoupling between the US and Chinese tech industries carries the medium- to long-term risk of splitting the global economy into two distinct 'technospheres', each with its own products and standards. In this respect, the risk for Europe is being caught in between these two spheres and constantly being pulled to one side or the other.

This risk is heightened by the fact that so far, Europe has failed to assert itself as a market leader in digital technology in its own right. There are no European equivalents of American and Chinese tech giants like Alphabet, Facebook or Alibaba. In fact, between 2006 and 2016, European firms dropped entirely off the list of the world's top ten companies in any industry by market capitalisation.[5] As global economic weight shifts from traditional manufacturing and heavy industry towards advanced technology and digital services, European companies risk being left behind if they are unable to innovate or defend their market share. This has potentially far-reaching consequences not only for European consumers, who may be dependent on a few foreign firms with immense market power for their everyday digital necessities, but also for European governments, which may find them-

[4] Rappeport, Alan (2019), *'U.S. Outlines Plans to Scrutinize Chinese and Other Foreign Investment'*, The New York Times, September 17.
[5] The Economist (2016), *'The rise of the superstars'*, September 17.

selves dependent on foreign tech and struggling to manage issues with respect to cybersecurity and privacy.

Concerns such as these have led some Member States, as well as the Commission itself, to call for a new industrial strategy in order to support European competitiveness and improve the standing of European firms in the global economy. Particularly after the failed Alstom/Siemens merger, one specific form of this call has advocated for EU competition policy to relax its rules concerning merger control in order to support the creation of 'European champions'. The hope behind such calls is that these 'champions' would be better placed to compete with US and Chinese megafirms and implicitly strengthen Europe's economic sovereignty.

3 Does EU competition policy need an overhaul?

EU competition policy needs revising, but not in the way that many proponents of European champions suggest. Relaxing competition policy is a crude and generally ineffective tool for industrial policy. Selecting individual firms as 'European champions' for favourable treatment would be a mistake. For one, governments are not necessarily better suited than the market to pick the 'right' champion to bet on; for another, the selection itself can actually reduce the incentives to innovate and increase the incentives for the chosen firm to engage in anti-competitive behaviour. It can also lead to regulatory capture once the state starts to bend the rules for 'its' champion. The end result is often inefficient, and harmful for consumer welfare if the firm abuses its privileged position.
Industrial policy should instead aim to encourage innovation and thereby support economic growth.[6] Rather than selectively relaxing competition rules for individual firms, an effective industrial policy should focus on providing public goods and other inputs to a broad range of sectors (horizontal industrial policy). Where more targeted support is desired, such support should apply sector-wide without firm-level discrimination (vertical industrial policy). In this respect, a strong competition policy can be a highly effective complement to industrial policy: Competition provides incentives for firms to innovate, while effective industrial policy improves their capacity to do so. Indeed, evidence suggests that industrial policy is more effective in highly competitive industries, or when it includes measures to foster competition (e.g. through support for SMEs and start-ups).[7] In other words, if the goal is to support industrial policy, then competition policy should aim to promote more competition, not less.

In fact, there are clear signs that the EU needs more competition enforcement and not less. Market concentration and company markups have increased significantly across the board over the last 20 years in Europe and North America, with the increase in markups (the ratio of sales price to cost) driven largely by a few 'superstar' firms. Together with an observed increase in profitability, these trends indicate a large and growing level of market power.[8]

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[6] See Enderlein, Henrik, Elvire Fabry, Lucas Guttenberg and Nils Redeker (2019), *'Beyond Industrial Policy: Why Europe needs a new growth strategy'*, Jacques Delors Centre.

[7] Aghion, Philippe, Jing Cai, Mathias Dewatripont, Luosha Du, Ann Harrison, and Patrick Legros (2015), *'Industrial Policy and Competition'*, American Economic Journal: Macroeconomics, 7 (4): 1–32.

[8] De Loecker, Jan, Jan Eeckhout, and Gabriel Unger (2019), *'The Rise of Market Power and the Macroeconomic Implications'*, Quarterly Journal of Economics (accepted).

The Commission was heavily criticised in the wake of the blocked Alstom/Siemens merger for being too strict with merger control. However, the numbers show that between 1990 and 2014, the European Commission blocked only 0.5% out of a total 5169 notified mergers, and imposed remedies on another 6.5%.[9] Of particular concern are predatory acquisitions in which large digital firms purchase promising start-ups in order to eliminate them as potential competitors. Many of these acquisitions are either not assessed by the European Commission due to the low turnover of the start-ups involved, or are not immediately identified as anti-competitive because the start-up lies outside the core business of the dominant firm. Facebook's high-profile acquisition of WhatsApp in 2014, for example, was approved by the European Commission in large part because WhatsApp was considered to lie outside Facebook's core business as a social media network and therefore did not represent a significant competitor to Facebook, an assessment that in retrospect appears short-sighted.[10] However, such market evolutions can be difficult for competition authorities to predict.

4 What competition reforms are needed to support economic sovereignty?

The EU needs a competition policy that promotes a level playing field at the European and global levels while encouraging European firms to innovate. EU competition policy must tackle anti-competitive practices by both European and non-European firms; avoid predatory acquisitions while allowing mergers that improve efficiency and deliver benefits to consumers; and effectively deal with EU and third-country state aid. At the same time, EU competition policy must be adapted to acknowledge the realities of the digital era, i.e. that digital markets look and behave differently from traditional markets and appear more prone to winner-take-all market dynamics.

Some competition-related aspects of digital markets are arguably better dealt with through regulation than competition law. In some cases, extreme economies of scale and/or significant network effects may give rise to quasi-natural monopolies of the digital world where there are larger efficiency gains from one dominant firm providing the service rather than multiple smaller firms. In these situations, it may make more sense to regulate the dominant firm(s) rather than trying to encourage greater competition in the market per se. Even where that may be the case, however, competition policy still has an important role to play as a 'background' or framework policy.

The following points outline brief recommendations related to four key areas of EU competition policy: antitrust, merger control, state aid and promotion of international rules.

9 Duso, Tomaso (2019), *'European merger control: More is better'*, DIW Weekly Report 16+17+18/2019, 142–143, DIW Berlin.
10 See e.g. Schechner, Sam, and Parmy Olson (2019), *'Facebook Feared WhatsApp Threat Ahead of 2014 Purchase, Documents Show'*, Wall Street Journal, November 6.

- **Antitrust:** Although the EU has not established itself as a world leader in digital goods and services, it has established itself as a world leader in digital antitrust, with infamously large fines imposed on tech giants like Google (€ 4.2 billion in 2018) and Microsoft (€ 561 million in 2013) for anti-competitive behaviour. The EU should continue to strengthen enforcement against abuses of market dominance in the digital realm and consider supporting measures which take into account the unique characteristics of the digital environment, such as increased transparency requirements for dominant digital platforms or, in certain cases, a reversal of the burden of proof. This would mean placing the burden of proof on the firm to demonstrate that a given practice is pro-competitive rather than on the Commission to demonstrate that a practice is anti-competitive, as is currently the case.

- **Merger control:** It would be unwise to selectively loosen merger control for 'European champions' that are unable to demonstrate sufficient efficiency gains to offset potential harm to consumer welfare. Nevertheless, some revisions to the merger guidelines may be needed in order to bring them in line with the changing nature of the global economy – for example, raising the time horizon for potential market entry of competitors from two years to five or ten. Stricter rules on merger control should be developed to target predatory acquisitions, e.g. by adjusting the notification thresholds, placing more scrutiny on the acquisitions of small start-ups by dominant digital firms, and reversing the burden of proof to require the merging firms to demonstrate the efficiency gains that justify the price paid for a particular acquisition.

- **State aid:** EU state aid rules have already been relaxed in 2017 to exempt more national state aid measures from notification and authorise state aid for small start-up companies. At this stage, more should be done to encourage joint ventures at the European level, especially in R&D. In particular, the Commission should investigate how to encourage greater interest in Important Projects of Common European Interest (IPCEI), as only two IPCEIs have been approved since the policy was introduced in 2014 (microelectronics in 2018 and batteries in 2019). More concentrated policy work also needs to be done on how to tackle the distortive effects of state aid by third countries. Options could include specific bilateral or multilateral agreements on state aid, refining existing tools (e.g. more proactive or ex-ante antitrust investigations into state-supported foreign firms) or developing some form of level-playing-field instrument as currently under consideration by the Commission.

- **International rules:** The EU has already established itself as a global leader in digital regulation, especially with respect to privacy and the handling of personal data. Its sheer size and value as a consumer market gives it considerable soft power as a global standard-setter. The EU should not underestimate this strength, but consciously build on it in order to assert its rules and policy preferences at the international level. Given the current global climate, where the multilateral rules-based economic order is increasingly under strain, robust competition chapters in trade agreements are likely to be a more promising avenue for international cooperation than, for example, WTO negotiations.

Conclusion

EU competition policy has an important role to play in strengthening Europe's economic sovereignty – not as an input to industrial policy, but rather as a complement. Ensuring a high level of competition on the single market will only become more important in the digital era, as digital markets appear uniquely prone to winner-take-all market dynamics that favour the development of a few dominant firms which are difficult for newcomers to challenge. Contributing to this problem is the issue of predatory acquisitions, in which established firms maintain their market dominance by purchasing smaller start-ups with high competitive potential. This is not only a problem for consumer welfare but also a strategic issue for EU Member States: digital tech forms a growing part of critical infrastructure, yet the dominant digital manufacturers and service providers are largely non-European.

The EU needs more competition enforcement, not less, and it needs to adapt competition policy to better reflect the unique challenges of the digital environment. In this respect, the EU should continue to build on its status as a global leader in digital antitrust, adapt its merger control policy to be stricter on predatory acquisitions (rather than looser on 'European champions'), encourage more European joint ventures, and push for stronger competition rules at the international level, especially within the framework of trade policy. The EU has so far succeeded in establishing itself as a leader in digital regulation and competition enforcement; it should make every effort to maintain that status.

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