“Competition policy and the Covid-19 opportunity”

Foreword  | Concurrences N° 2-2020
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Introduction

Every economic crisis raises the same normative question for competition law. Should decision makers be temporarily more permissive in their application of the law to private and public restraints of competition? Covid-19 is no exception.

While historical evidence from the Great Depression in the US suggests that this is a bad idea, most economic crises since the 1970s led to some softening of competition law. Covid-19, again, is no exception. The European Commission (“EC”) recently signaled that it would let Member States cushion the economic effects of Covid-19 by massive infusions of State aid. In the past month, the EC has cleared all State aid related to Covid-19 in less than 48 hours, undertaking a necessarily summary and tolerant verification of the notified measures under the already lenient conditions set out in the ad hoc Temporary Framework to enable Member States to further support the economy in the COVID-19 outbreak.

The EC competition policy response to Covid-19 deserves praise. It limits panic. Explicit in the EC response is a concern for the protection of European citizens’ jobs. So much for critics of the EU as a neoliberal project designed to disrupt labor market regulation and trade unions.

With the risk of being the bearer of bad news, however, we should not rejoice too quickly about massive infusions of State aid in the economy.

Recessions oftentimes have a “cleansing effect.” They facilitate the exit of zombie firms that crowd out growth opportunities for more efficient competitors, and delay the diffusion of technological innovation. A case might thus be made that the current recession might be a source of opportunities for the EU economy, long trapped in a cycle of weak productivity, low economic dynamism, and a conspicuous absence of superstar firm creation. The challenge for EU competition law is thus to recognize the pro-competitive implications of the cleansing effect, and devise an appropriate policy response on that basis. We submit that an optimal competition policy should reduce barriers to the exit of inefficient firms that prevent industry reorganization. This might justify a more prescriptive approach towards State aid, and a more permissive policy towards mergers.

Cleansing effect of recessions

Schumpeter argued that recessions produce a cleansing effect by substituting inefficient production units with more efficient ones. By contrast to his controversial work on monopoly and innovation, Schumpeter’s idea that recessions are remedial has received broader acceptance in mainstream economic theory.

Several established models describe the mechanics of the cleansing effect. The dominant theory is one of natural selection. According to the theory, less productive firms are the first to turn out to be unprofitable and scrapped in a recession. Of course, inefficient firms may be “insulated” from competition due to the fall in demand, because entry of more efficient firms might be lower during recessions. And yet, even in the absence of entry, the fall in demand will raise the returns of the most efficient incumbents relative to the industry laggards, precipitate the latter’s exit, and end up increasing productivity and growth.
A second influential theory finds that the cleansing effect of recessions is due to changes in opportunity costs. In times of recession, the returns generated by investments that raise short-term output decrease as a result of falling demand. Simply put, there is no demand for that output. Firms thus find it relatively less costly to invest time and divert resources towards organizational efforts that improve long-term productivity. Firms do less advertisement, and more labor force training. Those firms with a superior stock of human capital prosper and grow, whereas those which did not build the right skills in the good days perish when the recession arrives.

The cleansing effect of recessions is just another manifestation of Darwinian dynamics that results from the functioning of unfettered competition: efficient firms survive, while inefficient ones go under. However, an economy can only grow effectively out of recession, regenerating like a Phoenix, if inefficient incumbents are not unduly protected by exit barriers. What counts from a social welfare perspective is not the number of firms that remain in the market, but the number of efficient firms that compete effectively to meet demand. This important fact cannot be stressed enough. Though modern competition economics no longer make industry concentration the central focus of market power evaluation, many areas of legal doctrine and practice remain based on rivalry-spirited theories of competition in which a reduction in the number of firms raises a preliminary suspicion of market failure.

This reification of rivalry biases competition law against exit by agreement or merger. And it may bias enforcement towards State aid that prevent further increases in industry concentration. However, facilitating the speedy exit of inefficient firms should become a priority of competition policy, particularly in times of crisis. Efficient firms’ incentives to compete will be reduced if competition law prevents them to force weaker rivals to exit, especially when demand is tight. And inefficient firms have no incentives to change— including by moving to other markets— if competition law protects them from stronger rivals, whether actual or potential.

**Why the cleansing effect matters for the EU economy**

The cleansing effect of Covid-19 is an opportunity for the EU. There is no discussion that the EU has a productivity problem. Since the mid-1990s, total factor productivity performance has been “lackluster” in the euro area compared to other advanced economies. The euro area is also one of the regions with the “slowest” labor productivity growth.

The mechanisms that underlie Europe’s weak productivity performance are well-known. To start, business churning, i.e., the entry and exit of firms, is low, preventing the reallocation of labor and capital towards productive activities. Recent analysis shows in particular a secular decline in the churning rates of large companies since the early 2000 (see Figure 1 below). The business “churn”— or firm turnover—is generally calculated as the sum of the birth and death rates. Stringent product market regulations arguably play a key role in explaining the low exit rates of large European firms.

Besides, the EU has not witnessed a growth of the high-tech sector comparable to the US in the 2000s. In particular, the euro area has missed out on “superstar firms” (ibid.), which raise general and sectoral productivity, as well as provide incentives to other firms to invest and to innovate through a variety of channels, e.g., corporate venture capital, knowledge spillovers, and platform leadership.

Additionally, Europe has a well-documented problem of technology diffusion. While innovation levels are comparable to other advanced economies, the EU is slower to incorporate state-of-the-art innovation into the production processes of businesses. The distance between the productivity of “frontier” firms that invent, and “laggard” firms that do not has increased in the euro area, in particular in services.

Last, as if this was not enough, the fallout of the 2008 financial crisis has seen a cross-sectoral rise in “zombie firms” in Europe. In a recent study, Andrews and Petroulakis show that banks weakened by the financial crisis have extended evergreen loans—i.e., loans in which only interests are due—to failed firms so as to avoid capitalizing losses on their balance sheets. The very low interest rates resulting from the ECB’s expansive monetary policy have also facilitated the survival of dramatically inefficient firms. The result is that zombie firms crowd out growth opportunities for more productive firms. In fact, the evidence shows that the rate of large firm creation in Europe has been falling over time and is a more persistent driver of the decline in business dynamism than the decline in exit rates (see Figure 1 below).

With this background, the cleansing effect potential of Covid-19 might provide a unique opportunity to address part of the EU productivity problem in the short term, compared to costly initiatives like labor, product market or bankruptcy reform. But a more tempting political response consists—we fear—in protecting inefficient firms subject to a flexible application of State aid control rules, especially if they are too big to fail. This will limit the growth potential of the EU economy for years to come. What may
seem like a success in the short term will be the seed of unemployment and low wages for a long period of time.

Figure 1

Unfortunately, this does not seem to be the road that the EC is taking. As noted above, the EC has promptly cleared State aid under the Temporary Framework. True, the recent consultation on the recapitalization of companies in need signals a commitment to apply conditionality to distortive aids to zombie companies. And yet, the process of State aid control in a context of uncertainty, rush and political pressure leaves doubts that this will be the case.

In sharp contrast, and for unrelated reasons, the EC has also asked firms to suspend merger filings. This may have the unintended consequence of depriving inefficient firms of restructuring opportunities on the M&A market.

This is problematic on several grounds. Firstly, a horizontal State aid policy may be too lenient, by entrenching zombie companies with problems that predate the Covid-19 crisis and that had nothing to do with it. Furthermore, it may work against the objective of convergence within the EU, since the survival of firms will not be determined by...
their relative efficiency, but rather by the fiscal power and munificence of the Member State where they are headquartered. This could give rise to a “rich get richer” vicious cycle that could undermine the single market and the economic viability of the eurozone and the Union itself19.

Secondly, the increasing skepticism of the EC, and the competition authorities of the Member States, about the pro-competitive effects of mergers may deter the restructuring of sectors of the economy20. Firms in distress may be lucky and receive government support—more likely if they belong to rich Member States—or face the prospect of liquidation. A grim prospect indeed since many assets will be liquidated in the dire days that lay ahead of us and the demand for those assets may be low, especially if efficient industry leaders are excluded as potential purchasers.

Economics can help allay these concerns in two concrete ways. First, the European economy would be well served by a buyer-specific merger policy, in which the competitive assessment would discriminate between acquisitions by frontier firms and of technology laggards. As a rule, inefficient buyers would be subject to stricter merger scrutiny, unless evidence is given that the purpose and effect of the acquisition is exit by mobility or efficiency by cross-fertilization. As ever, strong empirics must be mobilized to distinguish between inefficient and efficient buyers. Most importantly, inefficient buyers should be required to bring cogent evidence that they have the long-term human capital and assets required to launch new products and services at low costs, and demonstrate a recent track record of product and process innovation. By contrast, past or ongoing benefit of subsidies, as well as state-owned enterprise (SOE) status, should be adversely accounted for in the competitive assessment.

Second, merger and State aid approval should be conditional on demonstrable reorganizational and managerial efficiencies, including reskilling plans and innovation incentives for the workforce at all levels. European firms suffer from a long-standing management gap, first documented in the 1960s in Jean-Jacques Servan-Schreiber’s *The American Challenge* (Scribner, 1968), and more recently in the works of economists Nicholas Bloom, Raffaella Sadun and John van Reenen21. And if, as Bloom and Van Reenen note, “Competition (…) policies probably have benefits that are more modest for innovation” than R&D tax cuts, “they are cheap in financial terms”22. This is an important point, in times of Covid-19 where all available public expenditure is channeled to short-term health and economic relief policies. Every opportunity should thus be taken by competition agencies to use their relatively uncostly decisional powers under the merger and State aid rules to promote allocation of resources towards firms’ policies that raise productivity, quality and innovation.

**Conclusion**

President Obama’s chief of staff Rahm Emanuel once said, “You never let a serious crisis go to waste. And what I mean by that is an opportunity to do things you think you could not do before”23. Every crisis is an opportunity. Covid-19 is not an exception. The EU has the opportunity to restructure its industrial and service sectors, getting rid of many zombie firms that have dragged its productivity and constrained its growth. Protecting those firms may appear necessary to protect employment and avert a social crisis, to maintain labor income and rein in the danger of populism. But it is not. On the contrary, policies which allow zombie firms to survive cause long-term unemployment and set a brake to productivity and thus wage growth.

Policymakers’ decisions are most often driven by the same loss aversion bias that distorts so many other human choices. They need to overcome such a bias and this time, unlike in previous occasions, unleash the cleansing effect of economic recessions. They need to trust that increases in industry concentration resulting from the exit of inefficient firms are a blessing, even if that means a reduction in the rivalry metric. Of course, because each firm’s story is different, this recommendation is only valid on a case-by-case basis, which is just what the temporary framework does not do. What is generally true, however, is that horizontal rules that allow unselective subsidies regardless of firm type or structural presumptions and other inefficiency possibility theorems against mergers are bound to be socially costly24.

We reckon it is far from simple to determine when financial distress reflects firm-level inefficiency and when it is driven by external factors and bad luck. But as a rule of thumb we are willing to bet that inefficiency explains the difficulties of many large firms now queuing to receive support from their governments, whereas promising startups which would have done well absent the Covid-19 shock will leave the market almost unnoticed. Our position is simple, we need to show hostility for the former and all our sympathy for the latter so that at very least they can sell their distressed businesses to others with the necessary capabilities and resources to scale them up. Do not be misled. The point is not to refuse aid to firms that face financial difficulties owing to the Covid-19 conjuncture. The point is to deny aid to firms encumbered by organizational, managerial and structural inefficiencies manifest in mediocre productivity.
Upshot for competition lawyers? State aid and merger policy in times of Covid-19 require a “rule of reason” approach, away from rigid “per se” rules.

Take away for competition economists?

Consumer welfare analysis in times of Covid-19 requires a departure from the rivalry obsession, and an unequivocal embrace of efficiency.


3 J. A. Schumpeter (1934), *Deeplining*, How can we learn from past experiences? *The Economics of the Recovery Program, 4* [“Recessions are but temporary. They are the means to reconstruct each time the economic system on a more efficient plan.”] This quote is taken from J. E. Stiglitz (1993), Endogenous growth and cycles, *NERB Working Papers* No. 4256.


8 A good example of the central place of rivalry in modern competition cases can be found in Commission Decision of 27.3.2017 declaring a concentration to be compatible with the internal market and the EEA Agreement [2017/C(2017) 1946 final (Case M. 7932 – Dow/DuPont). See also G. Federico (2017), Horizontal Mergers, Innovation and the Competitive Process, *Journal of European Competition Law & Practice* 8(10), 680–677.

9 In coordinated conduct cases, judicial dicta have occasionally recognized that competition might efficiently lead to reduced rivalry through concentration, especially in a context of crisis. See *Competition Authority v. Barry Brothers* [2000] ECLI:EU:C:2000:643, para. 35. To declare an agreement anticompetitive, the Court considered that absent the coordination, the firms “would have […] no means of improving their profitability other than by intensifying their commercial rivalry or resorting to concentrations,” that is reducing rivalry.


12 M. Chiara Cavalletti et al., Concentration, market power and dynamism in the euro area, *ECB Discussion Papers* No. 2253 / March 2019.


16 See “Vestager will struggle to police the industrial zombies”, *Politico Pro*, Thibault Larger, 13 April 2020.


18 Note that we are talking here about weak firms that were already “undertakings in difficulty” under State aid rules and the temporary framework, for the latter are excluded of new aid by the temporary framework. See Temporary Framework, §22 c.


20 For an overview of that skepticism in relation to the adverse impact of mergers on rivalry, and proposals for structural presumptions against mergers, see J. Padilla (2019), Revisiting the Horizontal Mergers and Innovation Policy Debate, *Journal of European Competition Law & Practice* 10(7), 463–471.


23 B. Vande, Rahm’s Rule of Crisis Management: A Footnote to the Theory of Regulation.

24 For example, the EC has signaled flexibility by declaring that the “one time, last time” rule that prevents a firm to benefit from restructuring aid more than once in a period of ten years is not applicable to aid given under Article 107(2)(b) TFEU. The Temporary Framework says that “Member States may compensate under Article 107(2)(b) TFEU the damages directly caused by the COVID-19 outbreak to undertakings that have received aid under the Rescue and Restructuring Guidelines.” Even if new aid will not be unconditional, and assessed under the relatively stricter conditions of Article 107(2)(b), the general policy message is one of leniency (See Temporary Framework, supra, at para. 15).

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