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**Working Party No. 2 on Competition and Regulation**

**SUMMARY OF DISCUSSION OF THE HEARING ON THE EVALUATION OF COMPETITIVE  
IMPACTS OF GOVERNMENT INTERVENTIONS**

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*More documents related to this discussion can be found at: <http://www.oecd.org/daf/competition/evaluation-competitive-impacts.htm>*

Please contact Mr. Sean Ennis if you have any questions regarding this document [E-mail: [sean.ennis@oecd.org](mailto:sean.ennis@oecd.org)].

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## HEARING ON THE EVALUATION OF COMPETITIVE IMPACTS OF GOVERNMENT INTERVENTIONS

### *Summary of Discussion*

1. The **Chairman, Alberto Heimler**, opened the hearing on ex post evaluation of competition impacts of government interventions. The focus would be the evaluation of regulatory decisions, not antitrust decisions. He introduced the four experts to give presentations. Professor Christos Genakos from the Athens University of Economics and Business to speak about profit margins associated with regulatory reform; Carmen Suarez from the OFT to deal with the outcome of the reform of the pharmacy sector in the UK; Declan Purcell, the former Chair of the Irish Competition Authority to give an assessment of the developments in the Irish taxi market since the liberalisation; and Professor Kenneth Thomas from the University of Missouri-St Louis to discuss subsidies in the US. This last presentation will lead to the discussion on the ex post evaluation of subsidies that continues with the presentation of the European Commission and Japan.
2. The Chairman gave the floor to Professor Genakos.
3. **Christos Genakos** dealt with the maximum markup regulation on fruits and vegetables, which legislation came to his attention while working on the OECD project in Athens.
4. Instituting maximum markups on a market (i.e. markup regulation) is a tempting governmental intervention. It was proposed as a means to give room to ex-monopolists (like firms in the telecom industry) to adjust to the new situation, but it's common in oligopolistic markets (such as pharmaceuticals or gasoline) with the aim of reducing the average price paid by customers.
5. Professor Genakos summarised the quite ambiguous theory of price effects of such regulations. If a maximum markup regulation was introduced in a market where there are different levels of markups, we would expect (A) that this regulation will bring down the highest markup and the average expected markup as well. (B) But at the same time, small markup firms could potentially raise their markups, so in this case the regulation can actually result in the average markup going up, since the new markup limit might work as a focal point, and through tacit collusion, firms will move towards this focal point. So if the markup regulation was removed on the one hand we would expect (A) prices to go up, but on the other hand (B) by removing the focal point, companies have to find the new level of prices, so by breaking the focal point of collusion, prices can actually go down. The theory is not at all clear concerning the overall effects.
6. In Greece there was a maximum wholesale and retail markup legislation since the 1970's for all imported and locally produced fruits and vegetables (all these form the *treatment group*) – except apples, pears, lemons, mandarins and oranges (these formed the *control group*) – that was repealed in 2011<sup>1</sup>. According to Professor Genakos it is important from a policy perspective to examine the effects (especially the price effects in this case) of any change in regulation, especially in Greece. Since nobody had an

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<sup>1</sup> The cancelling of this legislation was not a Troika condition, it was changed by the Greek government on its own.

answer on the effects of the repeal of this regulation, Prof Genakos wrote a paper on these price effects. In this paper he and his co-authors compared the prices before and after the change of legislation between the control group and the treatment groups. For the analyses on one hand they used the dataset of the Ministry of Development that had a weekly store specific level data (for both specific supermarkets and specific street markets<sup>2</sup>) for all the fruits and vegetables for the period one and a half year before and one and a half year after the legislation was repealed. They also collected monthly wholesale prices from the central wholesale market in Athens, and they got data on 14 others (non-fruit or vegetable) supermarket products that were used as exogenous control to test the robustness of the results. During the analysis a lot of control variables were used (like product fixed effects as well as by-product monthly effects and a yearly trend and its square) and a very restricted framework was set up. Using this framework, results showed that after the elimination of the markup regulation both retail and wholesale prices went down (wholesale information was available for 80% of the products and they also had retail price information). Analysing the products for which retail and wholesale prices were present, there was an overall 6% decrease when maximum markup regulation was repealed. This effect was not only statistically but also economically significant: it represents a 1% decrease on food prices or 0.16% decrease on CPI, which translated into some EUR 256 million total savings. Further examining this result it turned out that this effect mainly stems from reduction in supermarket prices, not the street markets. Controlling for wholesale prices, the effect disappeared, which meant that supermarkets reduced the prices because wholesale prices went down, so the repeal of the law had no further effect on retail prices. It implies that all the action is happening in the wholesale market. Further evidence showed as well – when comparing the different levels (production, wholesale, retail) – that the wholesale level is much more concentrated so it is very much liable for collusion. As the next step, the authors looked only at street markets and split the products in two categories: for *imported goods* that definitely have gone through the wholesale market, and *locally produced goods* in which the competition is much more intense and not all supplies come through wholesale purchases. In line with expectations, the prices of imported goods went down, while there were no price effects on locally produced goods. So as we can see, the results of this analysis were pointing in the direction that maximum markups were used as tacit collusion devices in the wholesale market, so with the removal of the regulation – and the focal point – prices went down as market participants started competing again.

7. According to Professor Genakos this was the first systematic evaluation of markup regulation in an oligopolistic market. In the study they found a very significant negative impact on prices; most of the effects coming from the wholesale market indicating that the removal of such a regulation led to a breakdown of tacit collusion.

8. The **Chairman** thanked Professor Genakos and opened the floor for questions and remarks<sup>3</sup>.

9. A delegate from **Australia** wanted to know how rigorously the regulation was enforced before its repeal.

10. **Christos Genakos** didn't know the exact answer, but he noted that the Ministry of Development had all the relevant data to check the compliance with the rules. However, if the regulation was not binding, the repeal of this law should produce insignificant results, which is not the case.

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<sup>2</sup> The market works like the following: wholesalers buy the products from the producers and bring them to the wholesale market and supermarkets buying from the wholesale market. In the meantime street markets and groceries can buy either from the wholesale market or directly from the producer.

<sup>3</sup> Remark: The comments of the delegates do not necessarily reflect the view of the concerned member countries.

11. The **Chairman** noted that he thought that markup regulation was only for the retail level so he was puzzled to find out that it was applied to both the wholesale and the retail sector. He then gave the floor to the European Union.

12. The delegate of the **European Union** referred to a study made in the 1990's on the cement sector in Denmark. In Denmark the concern of the government was that the cement sector might not be functioning well due to collusion. So the government introduced the publication of prices, but the prices increasing precisely at the moment when the publication took place. According to the delegate of the EU this is perhaps a similar government induced change towards tacit collusion and he wanted to know whether Professor Genakos finds any similarities with the findings of his presented paper and this Danish paper.

13. **Christos Genakos** said he wasn't aware of this paper, but he stated that what they examined was not about announcement of prices, but a direct regulatory measure. He noted as well that perhaps the closest study to theirs is Knittel and Stango (2003) that looked at the interest rates imposed on US banks, which had the same results, namely that once the regulation of interest rates were removed, interest rates fell. Professor Genakos thanked the delegate for the reference and noted that he is interested to read that research as well.

14. A delegate from **Korea** was curious about whether the findings of the study are specific for Greece or they can be generalised to other countries.

15. According to **Christos Genakos** their results, just as any academic research, are bound by the data and the time examined, so in this sense it's not easy to generalize; however it can give specific empirical evidence on firm behaviour and reaction to regulation in an oligopolistic environment and, as such it adds to our cumulative knowledge of what are the real effects of markup regulation.

16. The **Chairman** then gave the floor to Carmen Suarez from the OFT.

17. **Carmen Suarez** introduced the results of the impact evaluation on entry restrictions in the retail pharmacy sector. The OFT's evaluation actually consisted of two studies: in 2003 there was a market study on the impacts of restriction of entry in retail pharmacies on consumer welfare (this was the first market study that the OFT had done in a public sector), based on which the OFT recommended the full liberalisation of entry in the sector. In 2010, after a government intervention to ease the restrictions of entry, an evaluation of the impacts of the policy intervention was released<sup>4</sup>.

18. In 2003 the OFT released a market study on the restrictions of entry in retail pharmacies. In the UK entry was determined at a local level, local authorities had the power to refuse entry and there was a very high threshold, so there were very low level of entries and exits. The market study was based on both economic analysis and empirical analysis (that looked for example at consumer demand and consumer preferences). Based on the results of the market study, the OFT suggested the government liberalise the

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<sup>4</sup> In General Carmen Suarez noted that there are three ways to evaluate the work of the competition authorities in the UK: 1) they try to embed ex ante impact estimation on the design of projects; 2) the overall estimation of the positive impacts of the authority's interventions (e.g. cartel or merger decisions), since there is an agreement with the national treasury to assess the GBP of consumer benefit from the intervention compared to the OFT's budget ; and 3) the in depth ex-post evaluation of a specific policy intervention. This last one is quite challenging, because it's not easy to assess whether the policy has changed because the competition authority had intervened or whether it would have changed anyway. The ex-post evaluations are usually conducted either by independent experts or by the OFT staff, then subject to independent academic review.

entry in the sector. The government basically responded<sup>5</sup> that the OFT was just focusing on competition dimensions and not focusing necessarily on the social benefits provided by pharmacies. But the OFT continued to engage on the issue with the department of health and by the end of 2005 the government decided to partially liberalise the sector. It was limited however geographically (applied only in England) and in scope. There was no need to fulfil the needs of any entry requirements (they could freely enter in the market) in case of pharmacies that:

- are open more than a hundred hours a week;
- open out of town big commercial services; and
- operate by e-mail or internet.

19. A few years later the OFT opened an impact assessment of the former policy intervention (also because in 2009-10 the department of health was thinking again about how to further reform the sector). The evaluation was a combined bottom up approach (looking at a consumer survey and demand data) and top-down approach; they used lot of geographical information system analysis as well<sup>6</sup>. The findings of the study were that the liberalisation (though it was a very partial liberalisation, much smaller than the OFT recommended) had a positive overall benefit on consumers; conservatively estimated the annual savings were between GBP 12 and 20 million, which came from three different sources: 1) there were a 10-15% decrease in the prices for over-the-counter medicines (OTC)<sup>7</sup>; there was a substantial reduction in 2) the travelling times and 3) waiting times for consumers<sup>8</sup>. There were also some non-quantifiable benefits, like the extended opening hours, a greater choice in OTC products and that pharmacies became a provider of health services (like blood-test or advice on minor ailments). The results of the study were published<sup>9</sup> in 2010. It was well received, at least by consumer groups.

20. Concerning the recent developments, Carmen Suarez mentioned that it seems that the department of health has listened to the OFT and in 2012 they decided to further change the existing control of entry regulations by lowering the thresholds of entry and introducing clear rules and conditions for facilitating exit. The less positive development of the 2012 reform is that it changed the rule that facilitated the entry of large number of hundred hours plus pharmacies (the rationale for that was that by lowering the overall bar for entry, there was no need for such exemptions so much). Overall, Carmen Suarez considered this to be a success story of OFT intervention.

21. The **Chairman** thanked Carmen Suarez and noted that the description she gave of the pharmacy sector in the UK is similar to many other jurisdictions as well. Then he opened the floor for questions and remarks.

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<sup>5</sup> When the OFT issues recommendations, there is an obligation for the government to respond within 90 days, however there is no obligation to adopt the recommendations.

<sup>6</sup> Since one of the criticisms about the OFT's market study was, that it hadn't taken into consideration the extent to which the small pharmacies in local communities were playing a different role to the big pharmacies in more urban communities.

<sup>7</sup> The price of prescription medicines are fixed, so there can be no price competition on that dimension.

<sup>8</sup> Those are especially relevant, since convenience and location came on top of what consumers want from retail pharmacies.

<sup>9</sup> According to Carmen Suarez it's important that everything the OFT does on the evaluation front – even the bad news – be published in order not to lose credibility.

22. The delegate of **Peru** had two questions: 1) he wanted to know the administrative and business costs of the reform that the presenter referred to and 2) he was curious how the OFT controlled for quality issues, like for example the requirement (that exists in Peru) of a person with a pharmacy degree being present full time in the pharmacy.

23. Concerning the first question **Carmen Suarez** replied that that the administrative costs were about GBP 2 to 3 million, but the overall benefit of GBP 12 to 20 million already took into consideration those costs. They were mostly related to the fact that people that were operating the system had to familiarize themselves with the new system. Concerning the second question, she told the delegate that the requirement that a pharmacist to be present at all time in retail pharmacies also applies in the UK and it hadn't changed during the reforms. However, the OFT did a lot of research to quantify the benefits of the reform in terms of what consumers consider a quality service. In this respect there is a difference between shopping for goods and for services. On the first front it turned out that consumers are not really price sensitive; locality and shopping convenience are more important factors in the purchase decision. When it came to the provision of services, there are important unquantifiable benefits, like the familiarity with the pharmacist or the level of expertise of the pharmacist.

24. The delegate of **Italy** wanted to know – since the number of pharmacies is usually lower than it should be – why was it necessary to introduce measures to facilitate exit.

25. **Carmen Suarez** stated that before 2012 there was no possibility to revoke the licence given to a pharmacy. So once a pharmacy was open it wasn't studied whether it was delivering a good service or not or whether there is demand at all for the services it provided. But since this provision was introduced in 2012, there is still very little data on its effects yet.

26. The **Chairman** was curious about whether any changes happened in the “distribution” of pharmacies.

27. According to **Carmen Suarez** there were an increase in number of pharmacies 1) opening more than hundred hours a week and 2) in big (over 15.000 m<sup>2</sup>) retail complexes. While most of the impact was felt in urban areas, there were also some small pharmacies in rural areas that opened longer periods of time.

28. The **Chairman** asked whether there were any effects on the size of pharmacies.

29. **Carmen Suarez** explained that there was a 9% increase in the number of pharmacies after the liberalisation, but what actually happened, was that pharmacies reacted to competition by expanding the services they offered (for example picking up the prescription at the doctor for the consumers or offering blood pressure tests and the like). So in fact there was a reduction in the volume of core services, but the overall size of the “business” has expanded.

30. The **Chairman** gave the floor to Declan Purcell, the former Chair of the Irish Competition Authority to speak about the Irish taxi market.

31. **Declan Purcell** introduced the history and results of the ex post and ex ante evaluation of government interventions in the Irish taxi market. His presentation was based on a paper written by his colleague Paul Gorecki in which a classic return to regulatory capture was described. The background of the story was that between 1978 and 2000 there were severe entry restrictions in the Irish taxi market (sometimes resulting in some extremely high waiting times). Then in 2000 a landmark court decision caused the overnight removal of those limits, creating an accidental full liberalisation of the Irish taxi market. The government did not re-impose the entry controls but let the market flow at least until 2010. Entry limits were re-imposed in 2010, further entry restrictions were imposed in 2013 and some more are planned for 2014.

32. The market that is concerned is the small public service vehicles (SPSV) market in Ireland, the vast majority of which are taxis; but there is another category called “hackneys”, which cannot be hired in public streets, but which must be booked by telephone in advance. So to evaluate the effects of the liberalisation, five indicators were picked and analysed:

1. the number of vehicle licences;
2. the degree of substitutability between taxis and other forms of small public hire vehicles;
3. the change in the actual values of taxi licences;
4. the effect of entry restrictions on passenger waiting time; and
5. the change of business models in the sector.

33. The results were mostly consistent with what they expected. 1) There was an explosion in the number of taxi licences (numbers increased from 4.000 to 20.000); the rise continued until the end of 2009 and then the number of licenses has declined at a slow but steady rate since 2010. Mr. Purcell noted that these trends also mirror the change in demand in the national economy generally – referring to the 2008 economic crash. 2) Concerning substitutability, before 2000 there was a strong incentive for other types of SPSVs (like “hackneys” or wheelchair accessible taxis), since the controls were lot less restricted<sup>10</sup>. There was a considerable rise in “hackney” numbers up to the liberalisation and then just as dramatic a drop in the following years, which clearly indicates that “hackney” drivers generally preferred to be taxi drivers, with the right to pick-up clients on the street. There is not much relevant data on the substitutability of wheelchair accessible taxis though. 3) In terms of the value of licences it was noted that before 2000, taxi licences were tradable, and the secondary value of these licences was sometimes enormous. This value was one obvious reason why there would be such a resistance from existing license holders to the abolition of entry controls. 4) Figures show that there were significant improvements in terms of average consumer waiting times<sup>11</sup>. (There is little data available on fare discounting but anecdotal evidence suggests that there was some discounting of maximum fares in 2010). 5) Before the liberalisation, taxi operators were not motivated to innovate or increase efficiency, so from 2000, the large increase in taxi numbers brought a significant change in attitude and innovation. The major structural change was the emergence of part-time operators that better met demand at peak periods<sup>12</sup>.

34. Declan Purcell concluded that the abolition of entry controls in 2000 contributed to a more flexible taxi market, much better equipped to address pronounced peaks and demand. There were many positive results of the liberalisation, examples being the movement away from fixed fares, shorter consumer waiting times and improved quality, significant entry by part time operators and the emergence of intermediary dispatch centres. An independent taxi regulator was established in 2003 for licencing, fare determination and quality standards. By 2010 there was a very significant increase in supply, while after the economic crisis there was a sudden and serious decline in demand. In 2010 the independent taxi

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<sup>10</sup> The number/rate of wheel chair accessible taxis grew form 8% in 1997 to 19%, because only wheel chair accessible taxis could get new licences.

<sup>11</sup> Waiting times less than 10 minutes went from 48% in 1997 to 85% in 2008, while waiting times of more than 20 minutes went down from 12% to 3%.

<sup>12</sup> Before the liberalisation taxi drivers had to be available for work at least 40 hours a week, not work more than 11 hours a day and not engage in any other occupation.

regulator re-introduced a cap on the number of taxi licences<sup>13</sup>. The regulator also introduced new restrictions of other kinds, like the ban on the trading of licences (that is also a kind of exit restriction). Further restrictions were imposed in 2013, such as an obligation that all taxis must have semi-permanent markings on them, not just the familiar roof sign (this rule will definitely discourage part-timers). The new proposed restrictions are that new entrants must drive wheelchair-accessible vehicles that are less than 6 years old, and that advertising both on the outside and inside of the vehicle will be forbidden for new entrants.

35. As a conclusion Declan Purcell noted that the re-imposition of entry controls and measures discouraging part timers will likely result in a less flexible taxi market in terms of meeting customer demand and ultimately this could head back towards longer waiting times and poorer service for customers. So this is an example where the regulatory system simply has not learnt from the experience of the past.

36. The **Chairman** thanked Declan Purcell, noting that there are two kinds of cities: one, where taxis chase consumers and one where consumers chase taxis. In the case of Ireland, he noted that we have seen both. He then asked why the government eliminated the possibility of trading licences.

37. **Declan Purcell** stated that he found this strange, since before 2010 taxi licences were tradable (at least once), but then in 2010 it was banned completely without any explanatory note or speech. But the rationale for that could have been that it was a slow and quiet way to reduce the number of licenses.

38. The **Chairman** opened the floor for discussion on the presentation.

39. The delegate of **Ireland** noted that the Irish Competition Authority has just recently suggested removing the new advertising rules and rules on the cap on taxis except for wheelchair accessible vehicles that are less than 6 years old.

40. **Declan Purcell** noted as well that there are some less regulated countries where there is no restriction on numbers, and there is no trouble for consumers. However in some very developed countries (like US and France) there is a very tight control. Finally, he found it a pity that after 10 years of experiment Ireland had now turned back to stricter regulation and limits on entry.

41. The **Chairman** passed the floor to Kenneth Thomas to introduce the problems with subsidies in the US.

42. **Kenneth Thomas** remarked that there were plenty of problems with subsidies in the US, but most of them are more at the state local level. He introduced a paper on the effect of investment incentives on competition, focusing on how subsidies affect the location of investments with case studies from the retail industry in St Louis, Missouri. He noted that there are lots of case studies on subsidies, however there is not really good data on their effects on competition. In 2006 East West Gateway Council of Government released a study that provided some good information on the topic that will be introduced here.

43. Kenneth Thomas focused on the inefficiency through the harm to competition and competitors<sup>14</sup>. Another thing that discretionary subsidies induce is rent seeking behaviour by firms. US local governments

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<sup>13</sup> Though, the official reason and aim was to encourage the development and proliferation of wheel chair accessible taxis, according to Declan Purcell, it is hard to escape the conclusion that the cap was re-introduced thanks to the increased lobbying of the existing operators.

<sup>14</sup> However the OFT study outlined some examples of how subsidies can affect competition. For example it 1) causes to set output and pricing levels inefficiently, 2) keeps inefficient firms in the market, discourage entry by efficient firms, encourage entry by inefficient firms and encourage exit by efficient firms and 3) distort investment and R&D decisions.

generally have a lot of fiscal autonomy and they want to attract retail development to gain tax sales revenue (that is one of the major funders for local government in addition to property taxes in the US). Cities have an arsenal of subsidies<sup>15</sup> they can use, such as tax increment financing (TIF)<sup>16</sup>.

44. The two case studies he discussed are from the St Louis metropolitan area that is in both Missouri and Illinois. This is an area with 2.7 million population, politically divided into more than a hundred separate towns. Taxable sales of USD 30 billion in 1993 grew to USD 34 billion in 2000 and continued growing until 2007 when there was a notable decline during the recession. The East West Gateway study showed that USD 2 billion went on subsidies to the retail sector (that is about 80% of almost all the subsidies) creating about 5.400 new retail jobs that all disappeared during the recession. 1) In the first case, a St Louis suburb called Des Peres authorized a USD 29.8 million TIF subsidy for West County Center shopping mall in 1998. This was controversial because a nearby mall, Chesterfield had just completed an unsubsidized renovation, and expected that the subsidy given to West County Center would harm it substantially, so it sued the city of Des Peres, however unsuccessfully. Unfortunately there were no reliable data available on Chesterfield mall's sales afterwards, but what happened later was that the owner of West County Center (Westfield America) that already had 5 other malls in the area, bought Chesterfield mall and by 2002 it owned about half of the St Louis mall market. As a result, according to Kenneth Thomas, this subsidy led to a prima facie increase in market power. 2) In the second case Northwest Plaza in St Ann suburbs – which was in the 50s allegedly the largest shopping center of the world – provided around 60% of all the taxable sales of St Ann (Kenneth Thomas used the sales of St Ann as a proxy for Northwest Plaza sales). Then a big competitor that opened nearby, called St Louis Mills, received USD 18.5 million in TIF and USD 34 million subsidies. This caused a decline in total St Ann sales and hence Northwest Plaza sales<sup>17</sup>. Northwest Plaza was entirely closed in 2010, so here there was a clear harm to a competitor, and competition, in the form of market exit. Surprisingly what's going to happen now, it that Northwest Plaza is going to be rebuilt with another TIF subsidy, so it's going to start the merry go round all over again.

45. Kenneth Thomas mentioned a couple of other indicators of concentration in the retail market from the East West Gateway study. In the study it was found that between 1998 and 2007, 2.700 retail jobs were created (thanks to subsidies), but at the same time 598 stores employing ten or fewer employees were closed, which meant a squeezing out of smaller firms. At the same time 52 zip codes (that is the postal code designation in the US) gained establishments and 89 zip codes lost establishments, evidence of a closure of a lot of retail establishment mostly concentrated in the St Ann area. So Kenneth Thomas drew the conclusion that subsidies can:

- squeeze smaller players out;
- cause greater geographical concentration that can cause potential market power for the subsidy recipient;
- cause direct harm to identifiable competitors including market exit;

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<sup>15</sup> These include low cost loans, property tax abatement, special taxing district, free or low cost land or infrastructure and tax increment financing.

<sup>16</sup> Tax increment financing occurs when a locality mortgage its expected future increase in tax revenues. If a headquarters on undeveloped land, for example, the property tax for that property would increase above the baseline rate from the year before the project goes into service. The increased property taxes could be used to pay off bonds that makes it possible to pay the developer as soon as they make the eligible expenditures. These illegible expenditures are quite flexible, and can include infrastructure, land assembly, and relocation costs, so several different sorts of subsidies can all be combined within TIF.

<sup>17</sup> The total decline in sales from 2001 to 2009 was in St Ann case USD 200 million, and in Northwest Plaza case USD 147 million.

- cause oversupply of retail; and
- imply that more capital is going to the retail market that would be justified by the market alone.

46. The **Chairman** thanked Kenneth Thomas noting that he was not aware that the retail sector was subject to such an extensive subsidy scheme in the US. Then he opened the floor for questions and remarks.

47. **Carmen Suarez** asked how much of a difference these subsidies actually meant, taking into account the large investment requirements of these project, since in fact most of the states were involved in such an activity. Perhaps even if there's a huge amount of money, the difference is not crucial between what one state and the other offers. The second question was whether Kenneth Thomas has any data on the impact of these subsidies on consumers, as some negatives highlighted in the presentation can be negative for competitors but not necessarily negative for consumers, and the latter is generally more important from the competition authority point of view.

48. **Kenneth Thomas** emphasised that the fight for retail facilities plays out not at the state level but at the level of local governments and still even though there is no increasing demand for retail services, more and more money gets poured into these malls. Concerning the second question he said that unfortunately at the moment he did not have any data on the consumer effects.

49. The delegate of the **United States** asked whether Kenneth Thomas had any comments on some positive competitive effects of subsidies. As an example he mentioned the totally new, innovative way of entering to the market – like Walmart did, which is also present in the St Louis area. Walmart has a certain reputation and is disliked by many consumers, but – despite the negative effects like the increase in the firm size, the growing geographic concentration and market power and direct harm to identifiable competitors – introduced a completely new way of approaching retail sales and led to huge price cuts in areas into which it moved, which was undoubtedly beneficial for consumers.

50. **Kenneth Thomas** agreed that these kind of effects/results can be induced by innovative approach as well. Concerning Walmart, he noted that certainly it is present in the St Louis retail market for quite a long time, but in this case it hadn't done anything much more innovative than simply moving from an original kind of center to supercenters. Walmart for example was at the border of St Ann and Bridgeton, then Bridgeton gave it a subsidy to move into Bridgeton. So it had a remarkable negative impact to St Ann that was already hit by the fall of Northwest Plaza.

51. **Sean Ennis** encouraged Kenneth Thomas to consider the Schumpeter hypothesis of creative destruction. It's quite natural that some malls are emerging while others disappear, and there is intensive enquiry to determine whether it is a real harm to competition and to consumers from all this. Lump sum subsidies can change market structure, and they can have a potentially negative effect if they create a forum that already existed. But if new investment would occur anyway, to challenge older malls, it is not clear when there is an effect of a subsidy compared to an effect of a new investment that would occur without the subsidy anyway.

52. **Kenneth Thomas** agreed that creative destruction can also cause such changes, but in the St Louis case the oversupply of retail could have not been caused merely by creative destruction. These large levels of subsidies grew far beyond that what we would get just from creative destruction with normal market process.

53. The **Chairman** thanked the presenters for all the presentations so far. He noted that the different examples of regulatory reforms showed the value and importance of doing ex post evaluations of

government policy interventions. He then gave the floor to Vincent Verouden from the Chief economist team of the European Commission, to give a presentation on ex post evaluation of state aid in the EU.

54. **Vincent Verouden** explained that the European Commission puts increased emphasis on the ex post evaluation of subsidies given in the EU. The rationale for this is that subsidies cost around EUR 50 billion per year, which is about half percent of the total EU GDP and little bit less than 1% of all public spending. Subsidies are spent on a range of objectives, most importantly on 1) environmental protection for greening processes and energy savings (that makes quarter of all the subsidies); 2) regional development aid (that is somewhat similar to what Kenneth Thomas was speaking about concerning US retail subsidies) and 3) to foster research and development by firms. (He remarked as well that he is not speaking about crisis related aid like banking support measures.) One of the reasons why the EU pays attention to local, regional and national subsidies – even if they serve a sound public policy objective – is that they can create distortion of competition and trade as it was already recognised in the EC Treaty in 1958. So if one member state gives subsidies systematically and in large amounts, it can have negative spillover effects in other member states in case firms are active in other/neighbouring member states. So the aim of the EU with state aid control is to coordinate and ensure that not too much of these negative spillovers take place. The other reason is that subsidies given to firms selectively by public authorities have a clear risk of undermining the functioning of the internal market, the creation of which is a main goal for the EU.

55. In order to preserve an effective competition between firms active in different member states, Vincent Verouden noted that the EU controls the limit and the amount of subsidies making them subject to certain rules. The European Commission controls subsidies either via rules or on a case by case basis, so it is important to prioritise the Commission's enforcement actions. State aid rules have been in place since the beginning of the European institutions and are subject to periodic revision to make them more up to date. The EU is at present reforming all its rules on state aid (concerning all regional development aids, R&D aids and environmental aids) to enhance the effectiveness of these aids and to further limit distortions.

56. The other important recent development is that the EU opted to increase the emphasis on the ex post evaluation of state aid that requires member states to be able to show that their subsidies were effective and not too distortive. For that purpose, the EU published a draft methodological guidance paper that describes which state aid schemes have to be ex post evaluated and how to do such evaluations procedurally. The draft provides key messages, most importantly on how to evaluate whether a subsidy scheme works or not.

57. The first very important message of the draft is that the EU expects more than just a simple before and after comparison in terms of the impacts of state aid. For example in a case when a public authority gives a subsidy to enhance investment in a certain poor region, to determine the effects of this subsidy in terms of employment requires a more complex analysis. In this example employment was going down before the intervention and it continued to decline afterwards, so at first sight we could think that this subsidy was not effective. But the right question is what would have happened without the subsidy. That reflects on the importance of a well-chosen counterfactual. So examining the case with this counterfactual, we can see that the employment would have declined more steeply without a subsidy so in this case it can be considered after all an effective subsidy.

58. Another important message is that normally a simple comparison of firms that received aid and firms that didn't is not enough, since there can be other external factors that influence the performance of these firms. A good example can be the R&D aid given to the bio tech sector. Most of the difference in performance of these firms has more to do with the characteristics of the sector than the aid itself. So it is important to compare likes with likes. An important problem that often comes up in this context, the

self-selection effect. In the case of R&D subsidies, firms that apply for these aids are often the ones that already have a project/idea in mind. So if they benefit from an aid, the reason they perform better than non-beneficiaries has more to do with the fact that they already had an idea in mind than the aid itself. It is thus important to create a good control group to filter those external effects. It can be tricky though to find sufficiently similar firms to the firm that got the aid. So in order to avoid this kind of self-selection effect, it is important to find something exogenous that determines whether a firm is a beneficiary or not. The EU introduced two examples for this.

1. A rather classical way to do this is *randomisation* (that means that from a group of firms we select some that get the aid and others that did not by chance and then compare the results of the treatment group with the control group. In this case all the differences in outcome will be due to the subsidy). Pilot studies are often engaged with such randomisation, however politically it might be difficult to start randomising subsidies. Here natural experiments can also be referred to, which analyse a situation where an exogenous change altered the environment for one group of firms but not for the other. As an example, he mentioned a study done by the London School of Economics that analyses the effects of a major UK regional aid program to support manufacturing firms. The annual budget of the program was about GBP 200 million, and the study examined the effects of these subsidies on company employment and investment decisions from 1986 to 2004. Instead of comparing beneficiaries and non-beneficiaries, they tried to exploit the eligibility status of firms. The most disadvantaged regions were entitled to get subsidy, most typically the North of Scotland, Wales and Cornwall, however there was a change in the composition of the beneficiary regions in 1993 and 2000. Taking into consideration these circumstances the study found that employment creation indeed grew in areas that became eligible for aid and went down (at least in comparative terms) in areas that used to have the possibility to get support, but then lost that possibility (because they became too rich). So the improvement was largely the effect of the subsidy given that only one factor could be determined to change systematically.
2. Another possibility is to establish a *control group*. This is called *regression discontinuity design* and basically examines the threshold effect. So let's say for budgetary reasons there are EUR 200 million of subsidies that have to be located. So based on a list of different factors firms can reach a maximum of 100 points and the list is cut by 70 points. So firms that have a score above 70 will get the aid, while firms under 70 scores don't. Since firms just over and below 70 points are pretty similar, we get quite an accurate picture on the effects of the aid, as this is the only thing that really distinguishes the firms below and above the threshold.

59. To conclude the EU emphasised that they are in the processes of revising the rules on state aid where more requirements will be put on aid scheme to be ex post evaluated. The goal is, besides giving the EU a better insight into the effectiveness of subsidy schemes, to inform public authorities themselves on whether to modify the scheme if they observe that the aid may not be so effective or could be better arranged. The presenter emphasized as well that sufficient care should be devoted to how the impact of a subsidy scheme can be ex post evaluated, already when setting up the subsidy schemes.

60. The **Chairman** thanked Vincent Verouden for the presentation and as a clarification he explained that a scheme in EU jargon means a general rule, a law or a regulation that provides for state aid or subsidies to be given to a specific group of allegeable firms for a given purpose, so everyone knows what they are getting out of the scheme. He noted that this is not like the retail subsidies mentioned by Kenneth Thomas that were negotiated on a case by case basis. The Chairman gave the floor to Kenneth Thomas for remarks on the presentation.

61. **Kenneth Thomas** welcomed the draft paper of the EU that has the ultimate purpose of improving ex post evaluation to help ameliorate the decisions made on approving proposed aid programs or schemes and individual aid cases. He mentioned some comments on how the analysis can possibly be improved. 1) Concerning the situation where the whole industry was declining, and in which case the analysis suggested that firms getting the aid were losing jobs less rapidly than in the counterfactual, which could certainly be a sign of effectiveness of the aid, he suggested to take into consideration that in such a situation that there can be other competitive effects. It can be a sign as well that the aid is harming unaided competitors by misallocating capital in the industry. 2) In terms of data requirements to make such an ex post evaluation, he mentioned that case studies conducted by the OFT suggested that price data can be important for the evaluation. So in order to ex post evaluate the comparative impacts beneficiary firms can be required to provide price data as a condition of getting the aid. 3) He also asked how many evaluations of this type the EU expects to happen annually and whether there might be some differential effects where some governments need more help related to the capability to conduct such evaluations.

62. **Vincent Verouden** replied, concerning the first comment of Kenneth Thomas, that certainly the employment rates of the beneficiary firms are not the only outcome that would be seen, but we also have to take into consideration the effects of such subsidies on other firms either in that region or even at a larger scale depending on the focus. The study of the London School of Economics did exactly that while analysing the effects of UK regional aid. The idea of the study was to see whether the aid given to certain firms meant more employment at the expense of other firms' employment and whether overall unemployment levels were favourably affected or not. In terms of firms that are not active in the concerned region but elsewhere in the UK or in Europe or even more widely in the world, it needs to bear in mind that the aim of regional development subsidies is to foster the development of certain areas that need further investment. From this perspective the possibly adverse effect of this aid on more urban metropolitan areas (like London or Manchester for example) are secondary. Responding to the second comment on the need of price data, he emphasised that it's one thing to ask firms who get the aid to return something; in this case, data for the analysis. But for a proper evaluation, data is needed from non-beneficiary firms or from some control group as well, but these firms – who don't get anything – would certainly not be interested in providing price figures, so it makes the evaluation a bit difficult. Concerning the third comment, the number of schemes that are/will be affected with the ex-post evaluation annually, he expanded that the EU made a simulation and in its proposal it suggested only the largest subsidy programs to be subjected to a case by case analysis (certain aids on the other hand are subject to so called "block exemption"). There is a double threshold, namely those subsidies will be subject to evaluations that are over EUR 100 million and those for which the budget exceeds 0.01% of GDP. The numbers vary among EU member states, but it implies 3 to 8 evaluation. (Germany might be the one with 8 subsidy evaluation).

63. The **Chairman** asked – as a clarification – whether these 3 to 8 evaluations are in total or per country.

64. **Vincent Verouden** stated it is per country. Finally, continuing to answer the last suggestion of Kenneth Thomas, Vincent Verouden explained that the bodies that are going to do the evaluation need to be functionally independent from the ones who give the subsidy (like the National Audit Office or the Central Planning Bureau in the Netherlands) and even if they are linked to the government they have to have a good reputation. Academics with sufficient economic input and consulting firms would be involved too. It's also an important factor (generally, but in this particular case as well) that the measures of the EU (in this case the implementation of the evaluation) should be applicable and possible to be applied in all member states.

65. The **Chairman** asked Commissioner Odagiri from Japan to present the case of a subsidy given to Japan Airlines. He considered it an important issue, since many countries give subsidies to their domestic airlines.

66. **Commissioner Odagiri** presented the circumstances and the background of the aid that was given to Japan Airlines to revitalise the company in 2010. He noted that many other countries have similar cases to save their failing airlines, but the case of Japan can be interesting because this rescue operation was successful and yet presented an interesting competition issue. Japan Airlines (JAL) was created in 1953 as a government affiliated corporation. At that time there were 2 other private companies, JAS and ANA, but there were strong regulations and the market was basically divided among the three companies (JAL was the only airline operating overseas for example). In 1986 JAL was privatised and competition was introduced into the market (e.g., ANA entered into the international flights), then further deregulations took place from 1998 to 2000 and two new firms entered the market intensifying competition. After that, JAS got into financial difficulty, so a merger took place between JAS and JAL to rescue the failing JAS. The merger was approved with remedies by the JFTC after a careful investigation. As a consequence almost a duopoly situation was created (JAL and ANA had a 95% combined market share). Later in 2010 JAL went almost bankrupt allegedly due to the following factors:

1. cost factors: it had excessive fleet of planes and they could not eliminate unprofitable routes and could not reduce excessive personnel;
3. organisational factors: it was a state owned company by origin with a very bureaucratic and rigid organisation, and lagging decision making process;
4. external factors: decreasing demand due to the financial crisis and the spread of diseases like SARS.

67. So JAL applied for the business revitalisation scheme, which already existed in Japan and was operated by the Enterprise Turnaround Initiative Corporation<sup>18</sup> (ETIC)<sup>19</sup>. In addition to a capital injection and an additional loan<sup>20</sup> to JAL, the government and ETIC appointed an outside manager as a new chairman. The court also approved the plan in 2010 for debt forgiveness and 100% capital reduction. With the financial support and under the new management, JAL started to implement a number of restructuring tactics like the:

- reduction of flights in both international and domestic routes;
- reduction of personnel and labour costs by 20%;
- reduction of corporate pension benefits from 50 to 30% of current and retired employees; and
- divestiture of a number of affiliated companies.

68. The rescue plan was successful and JAL recovered rapidly. The company is now profitable – even more profitable than ANA, which was supposed to be a much more efficient company – and it started to expand into new routes and buy new planes. However this made ANA complain to the government that JAL had received a very unfair advantage distorting the competitive environment. This argument creates an interesting competition dilemma. On one hand the implementation of a revitalisation support to a

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<sup>18</sup> It is a company half supported by the government and half supported by private financial institution. It is a stock corporation set up to revitalise failing companies by purchasing the debts from financial institutions or requesting financial institutions to forgive the debts. It can also invest in the shares and undertake such rescue operations as due diligence, imposition of a business revitalisation plan, and the support in restructuring financial and human resources.

<sup>19</sup> ETIC already had supported around 40 companies, but the majority of them were SMEs. JAL was the biggest rescue operation conducted by ETIC.

<sup>20</sup> Partly given by ETIC and partly given by the government affiliated Development Bank of Japan.

specified company may distort competition by creating different market and financial conditions among competitors, but on the other hand in a concentrated market like this with very high entry barriers, the exit of a major firm like JAL would have created a persistently anticompetitive market structure, that is, almost a monopoly. So the rescue of JAL may have contributed to maintain a more competitive market situation. There are also other policy viewpoints that have to be taken into consideration, such as the maintenance of safe and constant flight services and the availability to consumers of diverse means of transportation, or the maintenance of employment and the prevention of chain reaction on bankruptcy of trade partners. The question is whether this kind of revitalisation measure should be justified or not based on other policy arguments; and what can competition policy do in connection with such situations. The JFTC did not intervene in this case.

69. The **Chairman** thanked the presenter for the interesting presentation and asked whether the restructuring of JAL was voluntary or was it imposed by the state as a trade-off for the state aid.

70. **Commissioner Odagiri** replied that these specific measures were not imposed by the government, but they were considered rational; everyone knew that they had to be done<sup>21</sup> and the new management in fact made them happen. If they had maintained the old management, they would not have achieved this kind of drastic restructuring.

71. The **Chairman** then gave the floor to the European Union for comments.

72. The delegate of the **European Union** noted that it was interesting to see all those types of measures that have been taken in the context of restructuring. However there is another factor that also has to be borne in mind, and that is the effect on pre-existing equity holders. He mentioned that the EU – while revising its rules that apply to firms in difficult situation – puts a greater emphasis on making sure that when a firm is saved, the equity holders or the debt holders of that firm would not remain unaffected. This is a real dilemma and one way to limit distortion of competition is to make sure that equity and debt holders have to pay their price, because if they remain unaffected it means that the company to be saved can borrow at an extremely low rate. One way to limit any distortion of competition is to make sure that there is at least one more firm that faces more or less normal financing conditions even if it has been bailed out once. One question that the delegate of the EU posed was whether there were any other remedies applied to prevent the subsidized company gaining too much market power. He meant (as from a classical merger or antitrust point of view) if there were any expectations from Japanese authorities in exchange for the revitalisation scheme that required JAL for example to release some slots to competitors.

73. **Commissioner Odagiri** answered that in 2002 when JAL and JAS merged, the JFTC approved the merger with remedies, and one of the most important remedies was the release of a number of slots in the very crowded Tokyo Haneda airport. Then the government allocated those slots to new entrants, but that was well before the rescue operation. He stated that he did not think that there was any re-allocation of slots in 2010.

74. Finally the **Chairman** concluded by noting that the last presentations showed that jurisdictions outside the EU are interested in competitive effects of subsidies. He observed that many jurisdictions have similar experiences with the rescue of airlines. He noted that it was good to see that at least JAL became a viable company after the subsidy.

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<sup>21</sup> For example there was an excess of personnel that had to be cut and there were many routes that were losing money but forced to be maintained. The old management could not get rid of them.