Article

Activity & growth

Navigating in an ocean of big companies, or on the art of regulating a world undergoing disruptive change

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Àlex Ruiz

Economist

We live in a world of large companies, there is little doubt about it. If you, dear reader, have had the kindness to pause in our first article of this Dossier, you will probably be convinced by now. Should we be concerned about this? If, again, you have read the second of our articles, you will have concluded that the phenomenon can have major consequences in terms of efficiency and equality. But beyond what the economic analysis indicates, what is certain is that the ordinary citizen perceives this change as being far from minor and, in fact, is concerned. According to Gallup, in 1965, 17% of respondents believed that large companies posed a risk for the future of the US. In 2017, the figure rose to 26%.

The public assessment is not wrong: there is a significant change taking place in the business structure. First of all, we must remember that today's world of large companies marks a notable change from the past. Not only is there greater global concentration, but there are also many new aspects that characterise the phenomenon. As we have seen in the first two articles, new large companies concentrate much of their investment in intangible assets, in contrast to the dominance of investment in physical capital in the giants of the past. In addition, their markets, which are experiencing ever-faster technological change, are much more fluid than in the past and, at least potentially, have more frequent business entry and departure rates. Finally, together with the presence of significant economies of scale in production (something that was also characteristic of large companies of the past), the new big players have economies of scale in consumption, often in the form of network effects. In this new context, what role should regulation play in a world of large companies?

Setting a new course for regulation

First of all, we must ask a preliminary but fundamental question. One of the principles that every party of the competition should have engraved on the façade of their offices is the Hippocratic Primum non nocere, «First, do no harm». After all, regulation, and more specifically bad regulation, can end up making the situation it seeks to rectify worse. Let us explain the paradox. Generally speaking, and as has been explored in the first article of this Dossier, the increase in business concentration and the acceleration of the process of large companies being created may be due to technological change, to globalisation or – and this is surprising – to regulation itself. In particular, regulation can reduce competition for large companies due to the high costs involved in complying with it, particularly fixed costs, and the fact that large companies are better placed to assume such costs.[1] In addition, regulation can introduce barriers to entry, sometimes arising from lobbying practices, something which large companies are more likely to be able to finance.

While the above condition is a necessary one, but may not be enough to ensure good regulation, the next key element for setting the new course of regulation is precisely to know what North should be – in other words, what the goal of the regulation is. The natural starting point to answer this question focuses on the main balance that regulation seeks when faced with large companies, placing consumer welfare on one side of the scales and economic efficiency on the other. In basic terms, the regulator seeks to ensure that the consumer surplus is as high as possible. This generally means ensuring that excessive profit margins do not arise or, if they do, that they result from market situations and not from anti-competitive practices. These undesirable situations are more likely to occur if companies are large and possess market power. In addition, the existence of high returns at scale and network externalities, previously listed as characteristics of the new large companies, tend to lead to winner-takes-all situations in which the market leader gets used to holding a highly dominant position. This, in turn, can end up affecting consumer welfare to a greater degree than in the past. But the regulator is also well aware that large companies tend to be more innovative, which affects the creation of prosperity in the long run.[2]

As a result, the regulator is aware of the benefits that regulation must preserve. Since these, let's say, traditional objectives are difficult to reconcile, to make the situation more complex they have been expanded with other, more recent requirements. The regulator must now not only find a balance to guarantee the consumer's welfare without restricting innovation, but they are also prompted to provide assurance over matters relating to consumer protection (in particular, public health and safety), to address extra-economic considerations such as national security, to safeguard labour and social standards (avoiding social dumping, for instance) and to offset the undesirable effects of other sectoral policies.

Given the growing demands faced by the regulator, when reviewing the operation of the main classic regulatory tool that affects large companies, namely competition policy, it is noted that the safeguarding of consumer welfare is given de facto priority over other goals. Therefore, the key is determining whether company mark-ups are suitable or excessive. This is the case in US competition policy, which tends to undervalue other considerations besides price for consumers. It is also central to EU policy, although in Europe more attention is also paid to different aspects, such as protecting the proper functioning of the internal market in general and consumer protection. The way to modernise competition policy is to explicitly redefine its objectives, such that the regulator should recognise at the outset that its task is to balance competition and innovation. In other words, it has to preserve consumer welfare, but also give equal weight to innovation.

But the challenges for the regulator do not end there. Large companies can not only potentially tilt the competition stakes in their favour. They also have the possibility to take advantage of their size to reduce their taxation and to place it at levels that are not consistent with their economic activity. For starters, one mechanism that large companies sometimes use, particularly multinationals, is the use of subsidiaries to shift their profits to jurisdictions with lower tax rates, even if this practice does not reflect the value added that is generated in these jurisdictions. In addition, these large companies have a strong capacity for negotiating with governments and regulators, since they are negotiating from a position of strength, armed with the threat – often credible – of relocating their business to other countries or regions.[3] We should repeat and reiterate that these are only possibilities, since many large companies – in fact the vast majority – are likely conduct their business in a way that is far removed from such practices.

What is being done in the field of taxation of large companies? The key to mitigating the mechanisms outlined above lies in strong international coordination that limits the shifting of profits between jurisdictions and reduces the threat of relocation.[4] For the time being, an emerging international consensus is being built, albeit slowly. Led by the OECD, this consensus is taking the shape of the so-called BEPS (Base Erosion and Profit Shifting) strategies. BEPS is a plan consisting of 15 measures that acts on various specific aspects affecting the problems outlined above. This is an example of somewhat lax international coordination, the effects of which are not expected to be observed for some time to come. Nevertheless, the EU has already endorsed it by means of a proposal for an anti-tax avoidance directive.

With everything mentioned thus far being of fundamental importance, the reader may wonder, do the difficulties of regulating in a world of large companies end here? The answer, as you might have guessed, is no. Not only is it a question of changing course, but we must also develop new regulatory practices. In other words, to evoke an equivalent in the maritime simile that inspires us, we must equip ourselves with new arts of navigation.

The new arts of regulatory navigation

It is time to roll up our sleeves and take a detailed look at the challenges that the regulator faces, specifically in the area of defending competition. To do this, let us first recall the ancient arts of navigation, that is, the traditional approach to regulation. The logical phases involved in regulation do not change at their core: first, it is necessary to establish what is the market in question; next, it must be determined whether there is a situation of dominance in that market that could lead to anti-competitive behaviour. In its traditional version, the relevant market is generally evident, the situation of dominance is established through relatively simple and widespread methods that measure the degree of concentration of the market in question,[5] and the anti-competitive behaviour, if any, is usually apparent in profit margin calculations or in the identification of cases of collusion, such as cartels. Now let us examine what happens when trying to analyse this new world of large companies that are different to those of the past.[6]

As mentioned earlier, the new large companies often operate in what are known as fluid markets, that is, without clear boundaries or, sometimes, in more than one relevant market. To further complicate the matter, many of these new large companies operate in so-called non-monetary markets, such as platforms in which the transaction with the public does not involve prices, but rather the transfer of data. But this is not just a problem of large tech, since difficulties also arise in more conventional sectors. For example, if a television channel buys a free daily newspaper, what is the relevant market? Is it the television market, the newspaper market, or that of the advertisers, since they are the ones that finance both businesses? Perhaps the domain is relative to the latter and not to the traditional consumer (viewer or reader). Of course, the utmost degree of complexity arises when the limits of these ambiguous markets occur not within a particular country or region but at a global level.

There is no perfect solution, but a promising avenue is to analyse the business models, and then to try to identify whether they clearly affect the capacity for competitors to enter the market. In other words, does the business model in question alter the minimum conditions that allow innovation to be developed through the capacity for fluid entry and departure in the market?

Once the relevant market has been defined, it is time to assess market dominance – i.e. anti-competitive practices. Although, in theory, a company could be dominant in a market and not employ anti-competitive practices of any kind, in practice the risk of this not being the case is significant. Here, the main difficulty arises from the combination of large companies and a context of technological disruption. Let us suppose that a company has developed a totally disruptive innovation that enables it to acquire a position of dominance through the development of a new business model. How do we judge this dominance in the market? It might be temporary and later be diluted as new competitors enter the market, in which case perhaps regulation would not make much sense. Alternatively, it could be permanent, because the company continues to constantly innovate, because the innovation cannot be replicated or because the company takes advantage of its position to buy potential competitors in order to eliminate future competition. While in the first two cases of this second scenario the persistence of the position of dominance is not due to anti-competitive practices, in the third case it is. Even in this case, however, it is not easy for the regulator to justify ex-ante that an acquisition should not be permitted.

Again, as was the case in the question of defining the relevant market, the approach with the greatest potential is to take the business model as a starting point and to try to determine whether we are in the presence of «normal» strategies or, on the contrary, strategies that aim to stifle the competition. The best approach is to broaden the focus in order to integrate indicators that detect situations involving possible barriers to entry, to consider whether there are alternative ways to provide a quality product to the end users/customers and to assess the extent to which the innovation in question is groundbreaking.

In short, the new course of regulation should prevent it from facilitating an increase in business concentration, even if unintentionally, and it should enrich the objectives of regulation by finding a balance between consumer welfare and promoting innovation, which is the key source of future prosperity. Finally, it should ensure a level playing field that discourages the shifting of profits, and even of activities, for tax reasons that run contrary to criteria of productive efficiency and resource allocation. Competition policy should also shift its focus towards gaining a deeper understanding of new business models, in order to determine when we are in the presence of anti-competitive practices and when we are not. No one expects it to be easy or fast, but it is clear that the benefits of this new approach make it the most promising path towards having a more modern and comprehensive form of regulation.

Àlex Ruiz

CaixaBank Research

1. On this topic, see J. Van Reenen (2018), «Increasing Differences Between Firms: Market Power and the Macro-Economy», CEP Discussion Paper n° 1576.

2. This topic has been extensively debated in the economic literature, given that, although a greater capacity for innovation is usually associated with a very small scale, it is also true that excessive size can end up discouraging innovation. See, for example, D. Shefer and A. Frenkel (2005), «R&D, Firm Size and Innovation: An Empirical Analysis», Technovation, 25(1): 25-32.

3. See P.H. Egger, N.M. Strecker and B. Zoller-Rydzek (2018), «Estimating Bargaining-related Tax Advantages of Multinational Firms», CESifo Group Munich, Working Paper Series n°

6979.

4. Ideally, the costs of these actions would be higher than the benefits, i.e. the threat of abandoning certain markets would have little credibility, since it would mean giving up on profitable markets.

5. For example, market shares are used to calculate concentration ratios in a particular sector.

6. On this topic, see, for example, N. Vap Gorp and O. Batura (2015), «Challenges for Competition Policy in a Digitalised Economy, Study for the European Parliament». IP/A/ECON/2014-12.

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