A Response to the Consultation Document: 'A new pro-competition regime for digital markets'

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September 2021

I. My Background

I am writing to submit my views on the government's consultation document 'A new pro-competition regime for digital markets'. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1003913/Digital_Competition_Consultation_v2.pdf

I have worked on competition and innovation for 30 years as an academic, consultant, entrepreneur and policy advisor. My bio and CV are here. I am the Ronald Coase School Professor at the London School of Economics.

II. Summary of my views

It is clear that competition in digital markets is not working as it should, with some firms holding very strong positions and showing signs of entrenched market power. This is leading to a worse deal for consumers, workers and businesses than could be the case. In my view, innovation and growth are lower than they would be under a modernised competition regime. The set of reforms proposed by the government provides a start in addressing the harms that are materialising and should help promote competition and innovation in digital markets.

I support a strong emphasis on an evidence-based and targeted regime. This will help focus the regime and minimise the risk of unintended consequences. Locating the proposed Digital Markets Unit (DMU) within the CMA should help generate rigorous analysis and high quality assessments. It uses the CMA's existing comparative advantages: knowledge of competition law and practice as well as a growing understanding of digital matters through its past and

ongoing case work. This should help give stakeholders confidence that the regime will be run with evidence at its heart.

III. Introduction: Competition and Innovation

There is evidence that indicators of product market power have been on the rise around the world over the past few decades, including in the UK. Industrial concentration and markups appear to have risen, particularly (although not limited to) digital markets (Autor et al, 2020). There are different interpretations over the exact causes of these trends which are linked to network effects, the growth of fixed costs associated with intangible capital, globalisation and possibly institutional changes (see Van Reenen, 2018). There is broad consensus, however, that digital markets are characterised by having some very powerful leading firms and even if they arrived at their dominance by competing solely on the merits of their products and services, there are ways in which these "tech titans" have the ability and incentive to harm to welfare and innovation. Hence, policymakers have a duty to create an environment which reduces the risks of harmful actions and maximises the chances of benefits.

There is a longstanding economic debate over what is the impact of product market competition on innovation. In Griffith and Van Reenen (2021) we summarise the current state of the literature. Although the theoretical literature is ambiguous, in my view the empirical literature has produced somewhat clearer results.[1] For the type of firms typically analysed by competition authorities, including the ones the DMU will regard as having Strategic Market Status as have (SMS), I believe there should be a general presumption that competition *enhances* innovation. The particulars always need to be investigated, of course. But just as there is a presumption that reductions of competition produce upwards pricing pressure, my view is that limitations on competition will also produce downwards innovation pressure. Indeed, I have argued that competition can be one of the most powerful innovation policies we have (Bloom, Van Reenen and Williams, 2019).

The notion of competition is not simply the number of firms or market share. What is critically important is to create a level playing field to enable competition *for* the market (rather than just *in* the market). We must guard carefully that powerful incumbents do not put up artificial barriers that reduce the ability and incentive of actual and potential rivals to innovate and

[1] For example: Blundell, Griffith and Van Reenen (1999), Bloom, Draca and Van Reenen (2016) and Aghion et al (2015).

compete in the future. Dominant firms in industries characterized by network effects may well be able to do this. My work on the Microsoft case, found that innovation incentives were at the heart of the (justified) competition concerns (e.g. Kuhn and Van Reenen, 2009).

IV. Specific Responses to Consultation Questions

IV.1 Duties of the DMU ("Part 2")

I would support an explicit reference to innovation in the duties of the DMU. Foregone innovation is a particular risk in digital markets when competition is not working effectively. By requiring the DMU to consider innovation, the risk of being unable to consider those more difficult to quantify benefits is reduced. I agree, however, that the overall duty should be focussed on the interests of consumers rather than competition itself.

IV.2 Strategic Market Status ("Part 3")

The Strategic Market Status test is a key part of the proposals and will ensure the regime is focussed on the most problematic firms. I support the use of market power as an existing economic concept to underpin this assessment and agree that avoiding strict market definitions is desirable. Requiring a finding of both substantial and entrenched market power is a solid basis for the definition and will help to keep the regime targeted. There is also some merit in the proposed criteria for 'strategic' to help further focus the regime. Again, they capture the key indicators for firms having the ability to stifle competition and innovation and therefore that should be the focus of this regime.

An alternative approach that specify the products or services that would be captured by the proposals has two risks. On the one hand, they risk over-regulating by imposing unnecessary requirements on some firms. On the other, such an approach can omit from the scope of the regime *future* products and services that need to be subject of new provisions. Since there is often rapid changes in digital markets and technologies this is a key factor to keep in mind when determining what firms are 'in scope'. Consequently, I think the proposed approach with its flexibility and ability for the DMU to make an 'in the round' assessment is appropriate.

IV.3 Code of conduct ("Part 4")

It is essential that a new regime actively shapes the behaviour of the firms subject to it. The proposal for an enforceable code of conduct is very useful in this regard and it is also important that the DMU is able to refine the requirements placed on SMS firms. The proposed objectives

for the code look broadly right. I am worried, however, that the DMU is limited to an enforcement role under "Option 2" (in Figure 3 on p. 29, "Principles"). This would not enable the proactive, targeted shaping of requirements for firms. This is different to the participative role envisioned in the Furman report. It would inevitably be a backward-looking approach that would potentially not address harms quickly enough.

Further, the precise drafting of the legislative principles would need to set out clearly what was permissible, or not, for firms. For the types of conduct that are problematic in many of these digital markets, it would be extremely challenging to draft such principles in a way that would provide sufficient clarity for firms to know how to act. In turn, this risks lengthy litigation and delay.

The DMU should be given the ability to impose legally binding requirements on firms with SMS. This will enable the DMU to provide clarity to firms as to what is expected of them and, allow problematic conduct to be well targeted, reducing the risk of unintended consequences. Option 1 would more closely resemble other UK regulatory regimes where the regulator is empowered to set provisions within the scope of high level legislative parameters. Giving an expert regulator this discretion, subject to appropriate checks and balances, seems preferable to the other two options in my view.

A problem with Option 3 is that the proposed legislative principles prevent the DMU from tackling a particular harm by exclusion. It is also not entirely clear that it would provide much additional clarity to firms over Option 1 as to how they must behave. As drafted, the principles are at such a level that the DMU would need to further specify requirements on individual firms.

IV.4 Pro-competitive interventions, PCI ("Part 5")

This tool could be hugely significant for promoting competition and encouraging innovation. For example, interoperability is very important in many high tech markets (e.g. Genakos et al), so mandating it may be necessary and the DMU should have the power to do this. More broadly, the range of remedies set out in the consultation would enable the DMU, where there was sufficient evidence of harm, to take action to remove barriers to entry and address the underlying sources of firms' power. I agree there should be an in-depth process before introducing such measures and that this category of intervention is complementary to the code.

IV5. Regulatory Framework ("Part 6")

In line with my comments on the code, I support the DMU having wide discretion for these interventions. I also think that the ability to trial and test remedies would be a particularly useful feature of the DMU's toolkit.

IV.5 Mergers ("Part 7")

Overview

Mergers are used by some of the largest tech firms as part of a strategy to build and strengthen their ecosystems, insulating them from competitive pressure. The level of M&A undertaken by these firms is very high and in many cases they are acquiring targets at an early stage of their development, which would pass underneath notice of most authorities. However, this M&A activity can significantly limit innovation – particularly if targets are acquired just to be shut down (the so-called 'killer acquisitions' in Cunningham et al, 2021). The result is that there is less innovation and lower productivity growth.

There is now general consensus that there has been historic under-enforcement of mergers in digital markets, both in the UK and around the world. For the CMA to block a merger or impose remedies, the current regime requires it to find that it is more likely than not that the merger would lead to a substantial lessening of competition. In mergers involving digital companies, any harm to competition often relates to the loss of *potential* competition that the target company could have provided in future as its services developed. As noted in the Furman Review, given the forward-looking nature of this assessment, and the inherent uncertainty, it is difficult for the CMA (And similar competition authorities around the world) to demonstrate that a substantial lessening of competition is more likely than not, even if that loss of competition could result in significant harm.

The proposed changes are sensible and proportionate

The SMS merger proposals are a sensible and proportionate set of measures to address the issues with the current regime that present a barrier to effective enforcement. In particular:

a. The proposal to apply a more cautious standard of proof to SMS mergers would strike an appropriate balance between allowing benign mergers to proceed, while enabling the CMA to intervene where there is a risk of significant harm to

consumers and businesses. This test would be better suited to the particular issues that arise from M&A activity in dynamic digital markets.

b. The 'in advance' reporting requirement would not be particularly onerous and would likely assist the CMA in identifying mergers of interest.

c. The imposition of a mandatory and suspensory regime for a subset of the largest transactions also appears to be a sensible mechanism to ensure that the CMA can intervene before any harm arises from these mergers.

In my view, the SMS merger proposals are aligned with the broader global movement to increase scrutiny of acquisitions by powerful digital firms. For example, in the US, Senator Klobuchar has introduced a wide-ranging bill to strengthen the US Government's ability to block anti-competitive mergers. The bill goes further than the merger recommendations in the consultation in many respects. For example, it proposes to shift the burden of proof from the US Government to the merging parties to prove that a merger is not anti-competitive in certain situations (including where a nascent competitor is bought by a dominant firm). Viewed in this light, the SMS merger proposals to lower the standard of proof are relatively modest. Indeed, they and perhaps too modest and there is an argument to toughen them more towards the US proposals (as in Figure 6 on p.55). They would not be expected to result in over-enforcement by the CMA. They will have to be reviewed after a period of time in case they still lead to under-enforcement.

The proposed changes would support competition and innovation

Will the SMS merger proposals risk damp innovation and/or harm investment in UK start-ups? I seriously doubt it. I have argued that they should strengthen competition which should help improve innovation. It is true that many start-ups may aspire to be acquired (or receive large amounts of funding in return for minority interests) by large digital firms. In many cases, such mergers are likely to be benign and I do not consider that the proposals would close off this form of investment. Rather, they would ensure the CMA is able to prevent the minority of acquisitions that are anti-competitive and harmful to consumer welfare and the wider economy. Indeed, if more entrepreneurs saw "exit to an IPO" as more attractive now that "exit to be taken over", I actually see some attractions of the changed incentives.

V. Conclusions

As noted at the beginning of this submission, I am broadly supportive of the reforms which are necessary to deal with the threats to innovation from market power in many digital markets.

VI. References

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