

Nicolaides, Phedon

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itself, but the process of European integration as a whole might also be seriously damaged. The idea of monetary union ought therefore to be abandoned. Instead the national currencies should be retained and their exchange rates should be determined solely by market forces. In this way all the problems associated with European Monetary Union would be avoided:

□ The national currencies would continue to be part of each member state's national identity and to be a symbol of prosperity and secure savings. Citizens would not have to become accustomed to a new currency regarded as artificial.

□ In the case of flexible exchange rates the risk of inflation would be checked by the disciplinary effect of currency competition. Nowadays the international financial markets, which are becoming steadily more efficient, react to any policies inimical to monetary stability in a particular country by withdrawing capital on a massive scale. Individual countries therefore

have an incentive to align themselves with the most stable currency, which in Europe's case means with the deutschmark.

□ Exchange rates and national monetary policies would continue to serve as mechanisms of adjustment to asymmetrical shocks and to divergent economic trends in the long term. The demands placed upon the labour markets of the EU as an adjustment mechanism would not be excessive.

Under these circumstances, with the completion of the single market and the admission of Central and Eastern European countries as member states, the economies of Europe would gradually be able to deepen their integration. At the same time a political order could be developed which would reflect the national identities of the peoples and would act as a lasting guarantor of peace in Europe. A common currency is neither a prerequisite for this process, nor is it beneficial to it.

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PUBLIC SERVICES

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Phedon Nicolaides\*

## Competition versus Social Responsibility in the European Union

*Recently, in the European Union there has been extensive public debate on the nature of public services, the means of delivering them and the role of public companies. The Commission is pushing for greater liberalisation, more extensive common rules and increased transparency in the application of national regulations. Prof. Nicolaides argues that the state should function as the regulator of the providers of such services rather than as a provider itself. Moreover, in the Community's single market, national regulatory systems should be neutral and should rely more on price-based instruments rather than statutory and administrative measures.*

The Commission's XXV Report on Competition Policy, published in mid 1996, states that "... the development phase of Community competition policy is completed. Policy and law are now well established through the Commission's administrative practice and the principles developed by the European Courts."<sup>1</sup>

This is a fairly sweeping and surprising statement, especially when one considers the obstacles that the Commission has encountered in its attempts to subject undertakings with special or exclusive legal rights to the Community's rules of competition. That statement may be correct as far as private undertakings and Articles 85 and 86 are concerned, but it is doubtful whether it provides an accurate description of the state of play as far as public

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\* European Institute of Public Administration, Maastricht, The Netherlands. The author is indebted to the following colleagues for their comments and suggestions on previous drafts of this article: Robert Polet, Arild Saether, Aad van Mourik, Sylvia Raja Boean and Koen Nornden. Sole responsibility for the views expressed in the article lies with the author.

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<sup>1</sup> European Commission: European Community Competition Policy, 1995: XXV Report, Brussels: 1996, p. 14.

undertakings and Article 90 are concerned. For example, during the last two years and despite continuous effort by the Commission, little progress has been achieved in the liberalisation of the electricity and postal services markets.

The purpose of this article is to explain why the Community's task vis-a-vis public undertakings providing services of general economic interest is unfinished.<sup>2</sup> We argue that to finish that task it is necessary to develop new principles and probably to assign an additional role to the Commission. The assignment of any new role to the Commission is always a complex and deeply political issue. Hence, completion of the Community's competition policy cannot be achieved by the rulings of the Court alone. It will require agreement within the Council.

This issue is further complicated by the fact that recently there have been calls for the establishment of an independent competition agency. But as will be suggested later on, the assignment of a politically sensitive role to the Commission reinforces the argument for an independent agency.

The article examines the reasons which have been advanced in favour of the view that the provision of services of general economic interest is a fundamental social obligation of the state that, if necessary, should take precedence over the maintenance of free competition in the internal market. It then explains why a new policy principle for the Community's competition rules and a new enforcement role for Community institutions should be developed in order to deal effectively with the apparent conflict between social obligations and competition. The article concludes with a number of observations on the institutional nature of the enforcement of that new principle.

Concern about services of general interest is high. The European Parliament has proposed amendments to the Treaty to safeguard public services while other bodies have put forth more extensive revisions and the text of a charter on services of general economic interest.<sup>3</sup> By and large, the provision of services of general economic interest on affordable terms to consumers has been thought to "justify" restrictions

to competition (i.e. deviations from the Community's competition rules) for primarily three reasons:

□ First, the markets for services such as rail transport and supply of water may be natural monopolies. These monopolies, therefore, need to be regulated and entry into those markets controlled.

□ Second, services of general interest such as energy generation and distribution, telecommunications, mail delivery and transport are believed to be socially very important. Governments are assumed to have a special responsibility to ensure the delivery of these services on a "universal" basis, meaning that all consumers should have access to them at the same price and on equal terms.

□ Third, the dispensing of universal service obligations requires cross-subsidisation between different markets segments, so that it may be necessary to close off the market to competition.

We shall examine these arguments in turn and explain that they are fallacious in the sense that provision of services considered to be socially or politically important does not necessarily require complete exclusion of competition (i.e. complete exclusion of private service suppliers). We begin by examining the extent of the apparent contradiction between natural monopolies and competition.

### Natural Monopolies

The production of a good or service is a natural monopoly when the long-run average costs decline as output increases. It follows that in an industry which is a natural monopoly the operation of a single company minimises production costs. The problem is that a single company which would maximize productive efficiency could at the same time lead to allocative inefficiency because it could charge monopoly prices.

Like any other economic activity, natural monopolies are also affected by technological change. What is a natural monopoly is a function of available technology. The advent of the car and the aeroplane broke the monopoly position of the railway. Computer-based technology has eroded the dominance of the traditional broadcasters as the basic providers of information and entertainment. Satellite communications are challenging terrestrial communications. Networks which are beginning to be operated by water and electricity utilities are offering in certain cases cheaper alternatives to the networks of the telecommunications authorities. So natural monopolies are never permanent and often wither

<sup>2</sup> For detailed definition of this and other related terms see European Commission: Services of General Interest in Europe, COM(96) 443 final, 11 September 1996.

<sup>3</sup> See European Parliament: Briefing on Public Services, No 12, Task-Force on the IGC, PE 165.902, 15 March 1996; European Centre of Enterprises with Public Participation: Europe, Competition and Public Service, Brussels, June 1995.

away. The same cannot always be said for regulations which linger on long after they cease to be useful.

If a company is legally protected from potential rivals so that it can expand its operations to the level where average cost is minimised, it will naturally tend to charge a monopoly price. Hence, the problem with natural monopoly is how to prevent incumbent firms from charging excessively high prices, while at the same time maintaining a system of incentives for continuous investment and improvement of the goods or services they provide. There are several alternative solutions to this problem.

A typical approach to monopoly regulation is to specify a price that allows the monopolist to cover its full costs and earn a reasonable rate of return. When average costs are declining the objective of covering costs presents certain difficulties. By definition, marginal cost must be less than average cost when average cost declines. Efficient pricing requires that the price is set at the level where marginal cost equals average revenue or market price. But then the price will be less than the average cost so the monopolist will be making losses. So the efficient solution would require a direct subsidy from the government. Alternatively, the price must be set at the level of average cost or a little above so that the monopolist can cover its costs and make a satisfactory return on its long-term investment. "Satisfactory" in this context means the same return as that earned on other similar investments of equivalent risk.

The solution of setting prices or, more precisely, ceilings on prices has at least four drawbacks. First, it assumes that the government or regulator knows the real costs of the monopolist. Second, the optimum price is more difficult to calculate and the informational costs are commensurately higher when the monopolist produces multiple products or services. Third, a price ceiling would still allow the monopolist to reap any profits it would make from gains in productivity, use of new technology or anything else that would result in lower production costs. Fourth, if prices are set too low to mop up excess profits or if they are reviewed too frequently, the monopolist may have no incentive to make long-term investments.

A way to deal with the problem of lack of information about the true costs of the monopolist is to specify the permissible rate of return (or the profit rate) rather than price. The monopolist would not be able to make excessive profits by overstating its costs. The weakness of this method is that it creates

the opposite problem from that of price controls. Even though the monopolist may now reveal its true costs, under certain circumstances the regulation of the rate of return gives no incentive to the monopolist to contain costs and improve efficiency. As long as the specified rate of return is generated by a price which is below the profit maximising level, the monopolist will allow both costs and prices to drift upwards. More importantly, the unions will try very hard to capture some of the monopoly profits themselves by continually asking for higher wages. In these cases, somewhat surprisingly, the interests of the workers, managers and owners would coincide, but only for as long as the price is below the profit maximising level. Indeed, there is ample evidence that wages are higher in industries where competition is weak. There is also evidence that wages decline in industries which are deregulated or liberalised.<sup>4</sup>

This brief exposition of the difficulties associated with the control of prices and rate of return suggests that in essence the problem of regulation concerns the acquisition of correct information and the setting of appropriate incentives.<sup>5</sup> This problem is compounded further whenever regulators seek to control not only a single price but also to define complicated price structures, quality levels, special service obligations to particular groups of consumers, etc. As will be seen later on, these issues may be linked to the regulation of entry into the market whenever the entry process (i.e. injection of competition) can generate information which is useful to the regulator.

A pricing formula that has been developed in the UK to get around the problem of disincentives is " $p = rpi - x$ ". The price, " $p$ ", which is allowed to rise with inflation (at the rate of the retail price index or " $rpi$ ") must be reduced by a specified amount " $x$ " per year which signifies efficiency gains obtained from technological improvements and increased productivity. In this way the monopolist can keep any extra profits which are generated from cost reductions that exceed the pre-specified amount " $x$ ", but cannot charge a monopoly price. With this formula, regulation does not take away the incentive to be efficient, and does not require too much information in determining

<sup>4</sup> See D. Pilat: From Competition to Growth, in: OECD Observer, No. 202, 1996, pp. 41-44.

<sup>5</sup> The classic references to the economics of regulation are G. Stigler: The Theory of Economic Regulation, in: Bell Journal of Economics, Vol. 2, 1971, pp. 3-21, and R. Posner: Theories of Economic Regulation, in: Bell Journal of Economics, Vol. 5, 1974, pp. 335-358.

the right price level each year. Nonetheless, it still requires a lot of information to set the initial price level and the magnitude of "x". If the regulator gets it wrong the first time, it can correct it later on, as it has actually happened in Britain. But too frequent reviews distort long-term investment plans.

A different method of dealing with both incentives and informational problems is to award the right or the franchise to operate the monopoly to those who make the best bid in terms of the lowest price for a given level of quality. The bidders have a strong incentive to know as much as possible about the monopoly they are seeking to operate and to operate it as efficiently as possible. Although franchising has obvious advantages it also has disadvantages in the sense that it shifts the problem faced by the regulator to a definition of the required quality and required investments for maintaining continuous improvement in existing goods/services and the introduction of new goods/services. Also the bidding process itself may be subverted if the bidders collude or if the franchise is not well defined. But those who win the franchise can also make mistakes and lock themselves in such low prices that prevent them from introducing new services later on (because they may not cover their costs), even if consumers are willing to pay a higher price for them. Regulators do not necessarily have sufficient information to know consumer preferences and willingness to pay, nor are they always in a position to monitor subsequent compliance with the terms of the franchise contract. Franchising is an attractive alternative to price regulation, but it is more complex because bidding takes place over more dimensions than just price.

In an ideal world with perfect information, regulation of behaviour in the market, say by setting prices, would be equivalent to regulation of entry into that market, say by auctioning the rights to operate in the market. Since, however, informational imperfections abound, the two methods of regulation may lead to different results. The important thing to note is that even where in principle a market can accommodate most efficiently only a single firm, it is still possible to introduce competition at the point of entry into the market by auctioning the franchise or the right to operate in the market.

It was stated above that natural monopolies are determined by available production and delivery technology. Technological advances undermine monopolies not only by enabling the supply of competing services through alternative modes of delivery (e.g. terrestrial versus satellite tele-

communications), but also by enabling the "unbundling" of the monopoly service itself. That is, new technology may make possible the supply of competing services even if they share the same mode of delivery. For example, the same telecommunications network may now be used by two or more companies to provide competing or different services to the same customers.

For this reason, regulation of network services such as telecommunications, electricity distribution and rail transport is increasingly concerned with issues such as access to established networks, the construction of rival new networks, the relationship between the network owner, network operator and network users and the sharing of costs for the maintenance of the shared network. Again, the tasks of the regulators have become more complex because, as a result of technological progress and unbundling, there is no fixed or immutable relationship between the provision of services, the operation/maintenance of networks and the ultimate ownership of such assets. This, of course, rejects the traditional view that certain services can only be provided by a monopoly and raises the question why it is necessary at all for the state to own any assets used for commercial transactions.

### **Public Ownership**

Given that the regulation of private operators is a difficult task, a government may decide instead to supply the regulated goods or services by itself. That is, it may nationalise or acquire the shares of the private operators or may establish its own company to compete with the private companies or may otherwise exercise control over the decisions of private companies. Indeed the avowed aim of state or public ownership is that public companies can be made to produce the socially desired good or service. In theory, there would be no divergence in incentives and information such as that which exists between the regulator and the private operator. So again in theory, there is no reason why a public company cannot be as efficient as a private company.

Public ownership of factors of production is a politically charged issue. To some, public ownership serves broader political and social objectives such as safekeeping of important national assets. To others, the state has no business in competing with private companies because it stifles private initiative. To economists, ownership is neutral. Contrary to popular belief, at least in mainstream economics there is no theoretical presumption against public ownership.

Economics attributes no special significance to ownership as such. Whatever economics may say about public or private ownership, it is the result of its analysis of the system of incentives established by the two different forms of ownership. So the manager of a public company may behave differently from the manager of an equivalent private company not because the former is incapable or uninterested in maximising the profit of the company but because he is subject to different constraints and incentives.

In most west European countries the employees of public companies, especially those of utilities or companies with legal monopoly rights, have a status similar to civil servants or a status which is more favourable than that of private sector employees (e.g. they enjoy job security, generous pension and private health-care arrangements, early retirement and other privileges). These companies do not go bankrupt and even if they make losses their employees and managers do not lose their jobs. In many cases their job performance is measured against their job description rather than the results of their section, division or company. For those companies which do not or are not supposed to make profits, it is also conceptually difficult to measure performance. Absence of the threat of failure and the difficulty of measuring performance blunt the incentives of public companies to be efficient. Also if the management cannot be easily replaced or if salary increases are linked to those obtained by the civil service unions, there is little incentive to contain wage costs. The end result is lower efficiency than in comparable private companies. It is necessary to acknowledge, however, that recently qualitative performance criteria have been introduced in the public sectors of several countries. Moreover, in the European Union, compliance with the Maastricht convergence criteria and the resultant budget austerity measures have put added pressure on the public sector to reduce costs and increase productivity.

On the whole the evidence supports the expectation of lower efficiency in state-owned companies. Viscusi et al who review a large number of empirical studies conclude that "... the evidence concerning the relative efficiency of the regulated privately owned utilities and publicly owned utilities is mixed. Nevertheless, a survey of comparative studies provides general support for the hypothesis that there is greater productive efficiency with private enterprise ... perhaps the major advantage of a privately owned firm is that it is subject to the disciplining force of the capital market."<sup>6</sup>

While the capital market is a source of discipline because shareholders or prospective new managers who launch hostile takeovers can sack ineffective managers, the capital market also provides an advantage not normally available to public companies. Private companies can obtain capital in the form of equity financing. At best, public companies can obtain funds from private investors through debt financing which may not be the cheapest source or the most flexible form of capital for long-term investment purposes. At worst, they are dependent on the government's budget and all their investment plans may need to be approved by the responsible ministry. If the government cuts its expenditure, so will the companies it controls.

The control exercised by the government over the companies it owns extends to issues other than investment. During the 1960s and 1970s when Britain still had a large number of nationalised companies, the most bitter complaint of their managers (and surprisingly an argument they often used to defend their performance) was that Whitehall interference prevented them from competing effectively with their American, German and Japanese rivals. They argued that they were given neither sufficient resources to invest in new technologies, nor were they allowed to shed excess labour because the government did not want to be seen to be contributing to increased unemployment.

In a recent article summarising the experience in Britain with the gradual withdrawal of the government from management of industries and companies, Prof. John Kay finds that "almost every success of public sector management reform results from increases in decentralisation, pluralism and contestability – handing down responsibility, allowing new ways of doing things, opening up activities that were previously public sector monopolies." And he continues, "privatisation has been successful ... when directly associated with the introduction of competition ... most of the failures have to do with the substitution of formal contractual relationships for previous structures of informal cooperation."<sup>7</sup>

In conclusion, theory suggests that state ownership weakens incentives for efficient production. Clearly there is no considerable evidence that public

<sup>6</sup> K. Viscusi et al: *The Economics of Regulation and Antitrust*, Cambridge, MA (MIT Press) 1995, p.468.

<sup>7</sup> John Kay: *Now Mind the Gap: The Public Sector Seems to be Suffering from Confusion about where Responsibilities for Functions and Results Lie*, in: *Financial Times*, 8 November 1996, p. 6.

companies outperform their private counterparts. Public companies are also disadvantaged both by restricted access to the capital markets and by excessive political interference. But the transformation of public monopolies to private monopolies does not necessarily improve either efficiency or service quality. As Prof. Kay notes, privatisation works when accompanied by sufficient structural change that allows competition to flourish. This is also the assessment of Bishop et al<sup>8</sup> who review the UK privatisation experience. So again, we need to question critically the view that the state through the companies it owns or controls is better placed or equipped to provide socially desirable goods and services. Neither statutory monopoly, nor state ownership is a panacea to the problem of regulating natural monopolies and providing services to the public. We need to consider alternative arrangements. Does, however, the provision of certain "important" services justify restrictions to competition?

### Services of General Economic Interest

Mainstream economics suggests that the intervention of the state should not be pervasive and where it is necessary it should not obstruct competition either between sectors or within sectors of the economy.<sup>9</sup> It follows that the agents of the state should likewise refrain from obstructing competition. Indeed, in a number of recent rulings on public companies providing services of general economic interest, the European Court of Justice has confirmed that according to Article 90 of the EC Treaty these companies are not exempt from the normal rules of competition that apply in the European Union. They may not act in any way that infringes Articles 85 and 86 of the Treaty. More specifically, exclusion of private companies that can or want to offer services which the public companies are not capable of providing constitutes an abuse of dominant market position, contrary to Article 86.<sup>10</sup>

However, the Court has also said that there may be an exemption to the extent that exclusion of competing private companies is necessary for the public companies to perform their tasks of general interest and in particular to achieve a position of "economic equilibrium", meaning in this case

breaking even. Notwithstanding the exception which is available through Article 90(2) and leaving aside any legal arguments whether the need to break even falls within the provision of Article 90(2), this view of the Court lacks economic foundation.

The Court has in fact allowed companies operating legal monopolies to maintain their monopoly positions primarily in order to cross-subsidise the loss-making activities or services with their profit-making activities or services. The Court has implicitly accepted the prevailing institutional arrangements for bringing those services to the consumers. The problem with this position is that although the prevailing institutional arrangements may be perfectly legal, they are not necessarily the most efficient. Economics recognizes that the only case in which restrictions on entry may be justified as a means of raising productive efficiency is that of natural monopoly. There are also other cases where entry is restricted through authorization and licensing, but by and large the purpose of such restrictions is to protect consumers and guarantee a minimum level of service quality (e.g. professional licences, banking licences). Even in the case of natural monopolies, however, competition may be introduced via auctions of the monopoly rights and by unbundling the ownership of networks (and essential facilities) from the services provided through them. The Court's concept of economic equilibrium in fact enables the spill-over of monopoly from one market segment to another; something that it is *prima facie* evidence of abuse of dominance.

There are two general cases in which subsidisation or cross-subsidisation becomes necessary. Either a company operates in two or more distinct market segments, each with its own cost structure, or the cost structure is identical for all market segments, but demand in some of the segments varies. Note, however, that even if there are cost or demand variations, it does not necessarily follow that there is an economic problem, as long as, of course, prices are allowed to vary. Economic theory shows that allocative efficiency improves if the monopolist who is faced with distinct market segments is allowed to price discriminate. So part of the problem we are examining is caused not only by the variation in costs or demand, but also by the requirement usually

<sup>8</sup> See M. Bishop et al: *Privatisation and Economic Performance*, Oxford (Oxford University Press) 1994.

<sup>9</sup> For a recent quantitative analysis of the relationship between regulation and economic performance see K. Koedijk and J. Kremers: *Market Opening, Regulation and Growth in Europe*, in: *Economic Policy*, Vol. 23, 1996, pp. 445-467.

<sup>10</sup> For a legal review of recent Article 90 cases see H. Rundgren: *Developments in the Case Law Concerning Article 90 of the EC Treaty*, paper presented at a conference on "Managing Universal Service Obligations in Public Utilities in the European Union", 28-29 November, European Institute of Public Administration, Maastricht 1996.

imposed by the government on public companies to supply certain socially "important" services on a universal basis, i.e. at uniform and affordable prices and uniform terms of delivery to customers.<sup>11</sup>

### **Subsidisation and Cross-subsidisation**

Consider first the case of a monopoly operating in two distinct market segments and which can serve both segments with the same costs. We know from economic theory that the profit-maximising strategy for this monopolist is to charge two different prices and to supply each segment the quantity at which the marginal cost of production, MC, and the marginal revenue, MR, are equalised; i.e.

$$(1) \quad MR_1 = MR_2 = MC$$

where "1" and "2" stand for segment 1 and segment 2, respectively.

Government regulation which imposes universal service conditions, however, prevents price discrimination. Under this constraint, the profit-maximising output is given by the formulae

$$(2a) \quad SMR = MC, \text{ and}$$

$$(2b) \quad AR_1 = AR_2 = P$$

where SMR is the sum of marginal revenues of the combined demand of both segments and AR is the average revenue or price, P, which is the same in each segment.

The prohibition of price discrimination means that the price in the segment with the relatively inelastic demand will decrease, while the price in the segment with the relatively elastic demand will increase. Government regulation also aims to prevent monopoly profits, so the conditions given by (2a) and (2b) change into

$$(3) \quad MC = AR_1 = AR_2 = P.$$

Note that where average cost, AC, is declining, i.e. there are economies of scale, MC will always be below AC. For this reason, if the price to consumers or users, P, is set to equal MC, the monopolist will not cover completely its full costs. So either P must be set at the level of AC or the monopolist must receive some form of subsidy from the government.

Equations (1) to (3) have meaningful solutions only when there are output levels for which AR<sub>1</sub> and AR<sub>2</sub> are different from zero. Assume now that MC (and AC) > AR<sub>2</sub> at all levels of output. This means that the

company in question has no incentive to supply the second market segment because it cannot make any profits.

Assume now that the government wants "poor" consumers in segment 2 to be able to purchase services which are considered to be socially important. If the government requires the company to supply that segment, it may either subsidise the consumers in that segment to induce them to purchase the regulated service (so that AR<sub>2</sub> rises as demand expands to the right), or it may subsidise the overall costs of the company so that it can supply both segments at a lower price. The former option is more efficient because it causes a smaller distortion. The latter option introduces a distortion to segment 1 as well. Note that cross-subsidisation within the company would not be an acceptable solution because it would require the setting of different prices in two segments.

Consider now the case of a monopolist that operates again two distinct market segments, but this time costs in each segment differ. Profit maximisation occurs when

$$(4a) \quad MR_1 = MC_1, \text{ and}$$

$$(4b) \quad MR_2 = MC_2.$$

Social optimality would be achieved and economic efficiency maximised by regulation which forces the monopolist to generate output and set prices so that

$$(5a) \quad MC_1 = AR_1, \text{ and}$$

$$(5b) \quad MC_2 = AR_2.$$

Since MC<sub>1</sub> and MC<sub>2</sub> are by definition different, AR<sub>1</sub> and AR<sub>2</sub> will also vary. It follows, therefore, that a universal service requirement with price uniformity implies some kind of subsidy. Such subsidy can come from the government or from a legal requirement imposed on the monopolist to cross-subsidise its operations. If MC<sub>1</sub> < MC<sub>2</sub>, if the monopolist is not allowed to make excess profits in segment 1 and if the universal price is set at the socially optimum level of segment 1, then the subsidy must necessarily come from the government. If the monopolist is allowed to make excess profits in segment 1 (which means that AR<sub>1</sub> > MC<sub>1</sub> and AR<sub>1</sub> > AC<sub>1</sub>), then it may be possible to force the monopolist to subsidise loss-making operations in segment 2 at some price P = AR<sub>1</sub> = AR<sub>2</sub>, (while AR<sub>2</sub> < AC<sub>2</sub>).

Note immediately two fundamental problems with the second option of forcing the monopolist to cross-subsidise. First, it introduces a distortion into market

<sup>11</sup> For definitions of these terms see the reference in footnote 2.



segment 1, by allowing the monopolist to charge a price that deviates from the level that maximises allocative efficiency. Second, even if cross-subsidisation is politically unavoidable and socially desirable, it is still not easy to determine in practice the appropriate level of the universal price. In principle, the right price under these circumstances is that at which the allocative deadweight loss caused from higher pricing in segment 1 equals the productive deadweight loss from excess production in segment 2. In view of the above discussion, it should be appreciated how difficult it is to obtain reliable information to carry out such calculations. It is not surprising, therefore, that regulators set prices in relation to costs and perceived social need rather than at the level where social welfare loss is minimised.

Cross-subsidisation is feasible only when the profits made in the profitable segment are larger than the losses made in the unprofitable segment. These profits and losses are in turn determined by the level at which the universal price is set. The lower the price, the lower the profits in one segment and the higher the losses in the other segment, and vice versa. This adds a further complication in the sense that the socially desirable price may differ from the price that equalises the efficiency losses in each segment resulting from the misallocation of resources.

What should also be appreciated is the predicament of the service provider who has to cross-subsidise operations in the face of threat of entry into the profitable market segment. Competitors will eat into the profits of the incumbent who will be left with the loss-making market segment. The problems caused by this "cream-skimming" have long been recognized in the literature of regulation. In this context, the European Court of Justice was correct in limiting the application of Article 90 for the purpose of enabling universal service providers to attain "economic equilibrium".

But that context with its pre-determined set of property/operating rights is not the only possible one in which to analyze the problem of providing a universal service to different market segments. The reason why it has been thought necessary to exclude competitors is to enable the incumbent to cross-subsidise its operations. But the creation of a monopoly causes other problems. It may retard technological innovation, delay the introduction of new services and above all blunt the incentives for efficiency. The need for cross-subsidisation within a single company can be removed by various other means. There could be a direct grant from the central

budget of the government so that the profitable segment is left open to competition. Or, competitors into the profitable market segment pay an entry fee or licence fee to the regulator who uses it to finance the grant. Or, the profitable segment is defined as a separate franchise the rights for which are auctioned and the proceeds are again used to offset operating costs in the unprofitable segment. Finally, even if none of the above options is feasible and cross-subsidisation is inevitable, there need not be complete exclusion of competition. Both segments can be included in the same franchise whose rights may be auctioned through a competitive process.

All of the options outlined above introduce competition which is preferable to the alternative of a market-wide statutory monopoly. The provision of services through a statutory monopoly does not avoid the problem of how to allocate resources between the different market segments. It only makes it less transparent and probably less efficient. To the extent that the competition process is also a discovery process (generating information), it assists the regulator in its task. The problem with regulating the provision of a universal service is in essence a problem of allocating resources at a certain price and quality between different market segments. Hence, the task of the state is to induce resources to remain in a certain segment while allowing competition in the market as a whole. More significantly, once some kind of transfer mechanism is put in place, it becomes possible to introduce competition for the right to operate in the otherwise commercially non-viable segment. Such competition is necessary because otherwise the operator of the commercially non-viable segment would have no incentive to reduce costs and improve productivity and service quality. If a transfer mechanism is introduced, competition must also be introduced in all market segments. This conclusion is important and casts doubt on the wisdom of allowing EU member states to retain certain market segments as statutory monopolies. As long as some part of the market is closed off to rival firms, there is always the danger that the monopoly could spill over into the more competitive segments.

The heart of the issue concerning services of general economic interest is the introduction of competition into different market segments and creation and regulation of a financial and institutional link between the various segments. This is the reason why it is unfortunate that the European Court of Justice refrained from examining that link more critically and in greater detail.

### **The Case of the Single Market**

We have argued that market-wide statutory monopolies are the least efficient means of delivering services or goods on a universal basis to different market segments. Alternatives that allow some form of competition are more efficient. In the context of the EU's internal market, these alternatives are also preferred for several other reasons. They are more transparent, more objective and more accessible to potential competing providers of services from other member states.

The literature of economic integration and the experience of actual integrationist schemes, like GATT, support price-based instruments over quantitative and administrative regulations. The reason is fairly simple. Although in theory there can be static equivalence between price and quantitative or administrative regulation, in practice the latter is opaque and, therefore, can be more discriminatory and distortive. Moreover, even in theory this equivalence breaks down when the underlying economic conditions change. Administrative regulation distorts price signals because it does not normally allow gains in efficiency or productivity to be translated into actual competitive advantage leading to improvement in market share.

At present, member states are obliged to use objective criteria when they regulate a sector through licensing procedures. In addition they have to declare which are the "reserved" market segments, which are open to competition and what are the universal service requirements. They also have to notify to the Commission their criteria and requirements imposed on companies operating in reserved segments. The Commission is understandably very reluctant to challenge the right of member states to reserve market segments by excluding competitors. Moreover, the Court has accepted that the reserved segments may extend into other segments which could otherwise be open to competition if the operators supply services of general economic interest and if that is necessary for them to carry out the tasks assigned to them by the state.

We have argued that, irrespective of one's views on the social/political need to provide certain services on a universal basis, the boundaries of reserved segments are in principle defined by cost considerations which are in turn determined by available technology. These are the segments where either companies have to be subsidised to maintain their operations or where companies operate more

efficiently if they function as monopolists. The nature and characteristics of the universal service are also a function of available technology. For example, the concept of basic telephony twenty years ago is very much different from the concept today, which includes things such as access to emergency and public information services, itemised billing, barring of certain pay services, etc. If the incumbent provider of a universal service is not exposed to competition, what incentive will it have to modernise its own services? Even worse, there is a danger that statutory definitions of universal service obligations in some kind of universal service charter which will be difficult to adjust afterwards, may introduce rigidity in the market that can harm consumers' interests in the longer term.

Furthermore, the provision of universal services to commercially non-viable segments may be financed by charges and access or licensing fees levied on operators in commercially viable (or non-reserved) segments. These are price instruments. In addition to being transparent, such instruments are preferable to other regulatory instruments because they also give a strong incentive to member states not to discriminate in favour of incumbent national operators. Provided that licensing procedures are objective, if the regulated price is set too high, it will attract many candidates which may be more efficient than the incumbent. If it is set too low, it will reduce the profits of the incumbents. In either case, governments will be less inclined to use that regulatory instrument to favour the incumbent because they cannot, from their point of view, discriminate effectively against other companies. They will have a stronger incentive, therefore, to use it to raise efficiency.

It was explained earlier that regulation has to address the issues of incentives and information. Instruments that encourage cross-border competition in the EU have the advantage that they provide the right incentives to governments as well. The EU has little hope to create a single market also in services of general economic interest if it goes on accepting member states' own delineations of reserved segments and their own definitions of the boundaries of the required monopolies to achieve economic equilibrium. There should be increased use of objective criteria based on the cost of providing such services.

We have not questioned the prerogative of member states to define universal service obligations. We have, however, challenged the view that the delivery of universal services requires market arrangements

that exclude competition. Universal services should be de-linked from statutory monopolies. Member states should have the right to define universal service obligations, but they should also have the obligation to justify to the Commission any law or regulation which prevents entry into any market segment.

Several proposals have been put forth recently on how the Treaty should be amended to protect the right to deliver certain services of general economic interest on a universal basis. If the Treaty is amended, then it is important that member states are also required to adopt measures that are neutral in their treatment of incumbents and potential rival service providers. Neutral measures are those that do not make it easier for the incumbent to supply the services in question by conferring on it an advantage not available to other companies or by ignoring the advantages that may already be enjoyed by the incumbent. This concept of neutrality is wider than the principle of non-discrimination, because it also takes into account that the incumbent and the potential rivals do not start from the same position. For example, it is unfair to require a small company that seeks to supply only a small market segment to take on extensive universal service obligations that may be beyond its capacity. But it would be neutral and fair to allow this company to enter the segment it wants to supply and charge it its share of the cost of the universal service provision. Exclusion of potential rivals is by definition non-neutral because it prevents companies from supplying a service they are capable of supplying. The Community's policy on Article 90 should be developed by refining and applying this concept of neutrality.

This means that there should be fair competition at the point of entry into the market, within the market and between market segments. Member states should be able to set the rules, not stack the rules. As Grout<sup>12</sup> explains, it is conceivable that in some circumstances the charges and terms of market access may justifiably discriminate against new entrants (e.g. because the incumbent is required to construct a new national network). In these cases member states should be obliged to explain their discriminatory policies to the Commission and obtain its authorization. An apparently discriminatory policy may in the end prove to be neutral if it imposes heavier requirements on the incumbent. Neutrality would require equivalence between the obligations

and the privileges of each company seeking to provide services of general economic interest. Since this cannot be guaranteed *ex ante* through equal legal treatment, the Commission should function as a referee. This is a role that has traditionally been assumed by the Commission in other fields as well but in this case there are likely to emerge certain difficult problems.

### **A Role for a New Agency?**

The development and application of the principle of neutrality will require extensive involvement by the Community into the design and implementation of national regulatory systems. The Community will in essence have to ask whether there are market segments (geographic or product) which can be opened up to competition and whether member states have put in place the necessary administrative machinery to make the entry and operations of new service suppliers possible under fair terms.

This is an intensely political task because member states consider any moves to open up sectors such as electricity and post as encroaching on their sovereignty and also because the Community will most likely have to instruct member states on what system they should put in place. Competition policy is based on largely "prohibitive" criteria. It declares certain practices and policies as incompatible with the common market, but it does not dictate to member states how they should manage particular national markets. The envisaged Community involvement in national regulation will be quantitatively and qualitatively different. It will steer member states in particular directions rather than steer them away from particular directions while leaving to them the choice of the alternative destinations.

Since it is the Commission that administers the Community's competition policy, it will inevitably come under severe political pressure from member states, if it assumes that new role. Although the Commission is well aware of its mission, legal rights and power and it is also well seasoned in disputes with member states, it knows the futility of trying to push member states to adopt policies they consider unacceptable. It is no coincidence that the Commission has used the power vested in it by Article 90(3) only on 15 occasions in the last 38 years (8 directives and 7 decisions). Article 90(3) is very unusual in the sense that it confers to the Commission extensive powers which are hardly found in other parts of the Treaty. They have been likened to a

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<sup>12</sup> See P. Grout: Promoting the Superhighway: Telecommunications Regulation in Europe, in: *Economic Policy*, Vol. 22, 1996, pp. 109-154.

“nuclear weapon”, but like nuclear weapons they can be used only very rarely.

The Commission, therefore, will come under political pressure because member states will feel threatened and also because it will have to apply competition policy in conjunction with the Treaty's other principles (e.g. social cohesion) and in relation to the Community's other policies. Those other principles and policies may justify dilution of competition principles and policy compromises. By contrast, an agency that is entrusted only with the application of competition rules will presumably face less pressure exactly because it will not have a choice in the principles on which it will base its decisions. The Commissioner for competition, Mr Karel van Miert, has argued against the creation of an independent agency on the grounds that the Commission has to take into account in its decisions the other Treaty obligations as well.<sup>13</sup> But this is precisely the reason why the Commission is vulnerable to the pressure and arguments of member states which always find some provision in the Treaty to justify their need to keep supporting certain industries.

Immediately the question arises as to whether it would be wise for the EU to establish an agency that will have a narrow mandate and no regard for other social or economic concerns. One cannot give a definite a priori answer to this question. Even narrowly focused power can be abused. But one can safeguard against abuse of this kind of power by separating responsibilities. For example, the new agency may be responsible only for fact finding while the Commission retains ultimate responsibility for issuing directives and decisions to member states.

This division of responsibility has a number of advantages. First, it will be clear that the basic case analysis is done on transparent competition policy criteria. Second, the agency will be a natural advocate of the adoption of the findings of the case investigation. Third, the Commission will have a pretty strong excuse to the member states that it cannot be always seen to reject the findings of another agency. Fourth, the debate will come out in the open, instead of being confined within the Commission (in arguments among Commissioners).

Like most other policy reforms, the problem is not so much the final destination or objective, but how to get there. Will the member states concede to the

establishment of a new agency that will be beyond their influence and will have as its sole purpose the application of competition criteria to their own policies? Irrespective of the answer to this question, the Commission needs to think of how to refine the instruments for the application of competition policy in services of general economic interest.

### Conclusion

The role of the state in market economies is both a complex and controversial issue. The primary regulatory role assigned to the state by economic theory is that of correcting market failure. In particular, where it is necessary to channel resources to certain socially desired activities, it should be done through measures that do not discriminate among companies and do not distort competition. Where there exist natural monopolies, they should be regulated through instruments that also permit competition. The least preferred instrument is that of statutory monopoly accompanied with state ownership. In this way competition is completely stifled.

The role of the state is to set objective rules and let companies compete unhindered. Where entry, rather than behaviour, in a market needs to be regulated, the state should set objective selection rules. So if competition within a market is not possible, at least there can be competition for entering that market.

Recently, in the European Union there has been extensive public debate on the nature of public services, the means of delivering them and the role of public companies. The Commission is pushing for greater liberalisation, more extensive common rules and increased transparency in the application of national regulations. We have argued that irrespective of the definition of what is a socially desirable service, the state should function as the regulator of the providers of such services rather than as a provider itself. Moreover, in the Community's single market, national regulatory systems should be neutral and should rely more on price-based instruments instead of statutory and administrative measures.

Complete removal of obstacles to trade and competition requires the development of new policy principles and more active supervision of national regulatory systems by the Community. This is a politically sensitive role which, if assigned to the Commission, will make the task of the Commission more difficult. It will probably be advantageous to the Commission if the new role is assigned instead to an independent competition agency.

<sup>13</sup> See European Commission (DG IV): The Proposal for a European Competition Agency, Competition Policy Newsletter, Vol. 2(2), summer 1996, p.1.