Interview with Prof. Thomas Philippon, New York University Stern School of Business

Competition Should Be Highly Valued for Achieving Superb Economic Performance Under Capitalism

By *Japan SPOTLIGHT*

There has been increasing doubt about the functioning of market mechanisms under competition in developed nations. But it is too much to say that economic efficiency must be sacrificed for some other values such as security or equality. Such cases must be strictly limited, as market competition still helps to achieve excellent economic performance promoting human welfare. This issue is discussed in the interview below with distinguished economist Prof. Thomas Philippon of New York University Stern School of Business.

(Online Interview on Sept. 6, 2022)

Competition in US Industries Today

JS: In the United States today there seems to be much less competition than previously in many industrial sectors. What do you attribute this to?

Prof. Thomas Philippon

Philippon: I think broadly there are two main reasons: some changes in technologies, and complacency in regulation and market design. In some cases you have industries where network effects have become relatively important, and very quick to play out. Network effects are not new, and we have had many industries with network effects in the past, but if you look at the time it takes for a firm to become dominant in some industries, it used to be years. In today's world, on the Internet it could just be a few months. This leaves less time for regulators to react and so that is one explanation and part of the reason we saw this happening for companies such as Google and Facebook. But I don't think it's the main reason, just one reason. A lot of the issues in the US have nothing to do with technological changes or network effects; they are to do with regulation and too many mergers that should not have been approved. In some industries there was not enough of an effort made to keep them competitive. A good example is broadband Internet where the US used to be a leader in high-speed Internet access and now it is far behind other countries both in terms of price and quality. Why? Because there is no competition. To remain competitive, that market needs some proactive regulations. All the countries that managed to keep the market for broadband cheap and high-quality for households have regulators that have intervened in the market to keep it competitive. In the US, they let the market become monopolized and then they get the monopoly price.

JS: Do the regulations in the US tend to protect vested interests?

Philippon: Yes, that is exactly right. To some extent you could say that is true in every country; but the US used to be a place where there was not too much protection of vested interests. And there is a lot more now as opposed to the tradition of free markets dating back to Teddy Roosevelt 100 years ago. There was a strong tradition in the US of not helping the incumbent and not protecting the vested interests, but this has declined.

JS: To what do you attribute this decline?

Philippon: Some of it is down to overconfidence. If you live in a country and everything works fine, you start thinking that things work fine by themselves. You don't realize that the reason why they are working fine is because there has been a lot of work in the background to keep them like that. And you start to think it is natural and would happen without any effort, which is not true. So there is this complacency there. I think that in many industries there is active lobbying to a greater extent than happened in the past. I don't think that it is by chance that the rise of market power by incumbents in the US happened at the same time as the bid increase in most political campaigns and the size of the contribution by firms to political campaigns. I think that these things happen at the same time, and it is not by accident. We have seen more and more companies paying a lot of money to finance political campaigns, and of course they get something in exchange.

Merits of Competition & Demerits of Restricted Competition

JS: Restricted competition would lead to inflation because the big enterprises that dominate the market could maintain their shares and even raise prices in response to higher costs, such as for energy or commodities. Could inflation be caused by such monopolistic or oligopolistic markets today?

Philippon: Yes, it is possible. While in theory it is something that you might be worried about, in practice it's not obvious. If you look at current inflation – whether it be the US, Japan or Europe – I don't think we will see more inflation in sectors that have more monopoly power. The reason is basic: if a firm has monopoly power, its prices are already high. They don't wait for inflation in the rest of the economy, they raise the prices immediately. If you look at the prices that Comcast charges for Internet access in places where they have a monopoly, they have been high for 10 years. That is the most important thing to understand. Monopoly is bad when the prices are already high. That is the main problem. The separate question is that if we have an economy where there is not enough competition and the prices are too high, then here comes another shock such as the war in Ukraine, disruption in food and energy markets, so that there is a global increase in inflation in the market, which changes the environment.

In this new environment, is it the case that firms losing monopoly power where prices are already high are going to take advantage to increase them even more than the other ones? It's possible but in practice when you look at the data, it doesn't seem to be striking. In other words there is plenty of inflation in sectors that are very competitive. In economic theory it doesn't really help much here because it could go either way. Although we do have a lot of models where monopolies tend to have very high prices, they don't move a lot, so there are theories where inflation could be a bit smaller in industries with monopolies because their prices are already high, and they can insulate the price from inflation. So it could go either way but in the data we see a lot of inflation in sectors that are very competitive, and in sectors that are not very competitive, so I don't think that the connection is very strong for the change in price – the price is already too high.

JS: Declining competition would seem to have other negative impacts on the economy such as stagnant innovation, for example. Would you agree that with declining competition, so-called "zombie companies" could survive, which would be quite detrimental to economic efficiency?

Philippon: This is correct. The main virtue of competition is that consumers get lower prices; firms have to compete on the market side but also the labor market side as if you are going to lower the price and try to sell more you will have to hire more workers. So competition is also good for workers because it increases the demand for labor and there are more employers to choose from. The third big benefit is innovation. If you are a firm in a very competitive industry and you want to gain market share, you can cut your price – which many firms do. But at that point there is only so much you can cut as you do have costs to cover. So if you still want to be able to compete you must innovate. And that is going to motivate you to innovate – we do see that in the data, direct evidence that more competitive industries have more innovative firms. That is the main benefit. We also see the cleaning-up effect eventually, which is where in a highly competitive industry, firms that are not very efficient do not survive. The zombies do not have enough breathing space to exist. Therefore, competition is good for growth.

JS: On the question of innovation, some would argue that large enterprises could create scale economies and certain technologies could be developed well under such large-scale economies. In that sense, would you concur that large enterprises could have benefits in terms of innovation?

Philippon: Yes. It is correct that when we say competition is good for innovation, we don't mean that we go all the way to perfect competition with millions of small producers. What we mean is that if we have the choice between one firm or two, or having three, four or five, you are going to be better with the latter. And these three to five firms are still very big. Many industries are never going to have 200,000 small firms; it is never going to happen. This is because of the scale effect. You do want to have large firms but three, four or five rather than just one big firm. You could have many industries that work very well with competition among a few large firms. One example would be Airbus versus Boeing – industries where the scale effects are enormous. When Europe decided to have Airbus to compete with Boeing, who have been the biggest beneficiaries of that? It is probably everyone else in the world. Because with Americans and Europeans competing, everybody has a better airplane at a lower price. Now, these are still two very big firms and very far from perfect competition because they get government subsidies. But I think it is very clear that many industries and many companies are better off with two competitors rather than one. It doesn't mean that government subsidies aren't warranted sometimes; they can be. And it doesn't mean that firms should be small. But it does mean that once you have too few, it is bad, and usually for the wrong reason. You can try to quantify the degree of scale economy, and there is an empirical question: is it the case that scale economies have increased so much today that many industries have a natural monopoly? And I don't think that is true, you don't see that in the data. Estimates of scale economies may have increased a little but have not exploded to the extent that there are monopolies everywhere. Oftentimes it is used in political economy by people who want to have their monopoly rights, so they use the scale story as an excuse. We don't have to believe them, though.

Negative Impact of GAFA & How to Deal with It

JS: On the question of giant platform companies like GAFA, you mentioned the networking effect. Their industry is a sort of scope economy. Could a scope economy be justified to restrict competition or is the current situation of giant monopolies disastrous for the economy?

Philippon: If you look at GAFA, it is clear that two things are true at the same time. There is a very strong technological change, and that change explains in part why we have more concentrated industries and monopolies. So technology change is a big factor, but it is not the only one. It's also bad regulation at the same time. One reason why we have bad regulation in this industry is because regulators have not done their job properly in part, but to be fair it's harder for them because these scope economies go much faster than before. There have been scope economies in many industries, such as pharma. It's all fixed cost – once you have discovered the drug and you know how to manufacture it, the cost per unit is very low. This is a perfect example of a strong scale economy which we have had for centuries, and we know how to regulate it. If you look at the industry, they are big firms but there is more than one. With GAFA we didn't do that, partly because the speed at which they get the scope economy is way faster than in the past. Their technology happens to be multi-purpose so once they have the platform set up and the software they can use it cross-platform and branch out relatively quickly. The scope economy is there, so it can play out extremely fast before the regulators can even think about it. This was the case with Facebook, WhatsApp and Instagram. At the time when Facebook made the decision to make these acquisitions, the regulator was way behind, it was just too quick. I think this was part of the reason but still not an excuse to do nothing.

JS: What should regulators do to catch up to the speed of innovation in this area?

Philippon: The first thing that played out was the acquisitions. So it turns out that these firms can do acquisitions very quickly and they can do acquisition of companies at a very young age before the companies are big enough to call for investigation. Now we understand that, and the regulators will pay more attention to these mergers. To be honest – perhaps it was not so obvious in real time but at least now we know – in these industries we should be more careful of mergers, even in cases where the target of the merger is small. Big lesson number two is that it is not realistic to expect to regulate these industries entirely via antitrust, or entirely via regulation. It is by telling them in advance what they are supposed to do. The consensus seems to be that we will need a hybrid model where there is regulation and antitrust and a balance between the two. This will be a challenge in the future – the European Union has moved a bit faster on the regulatory side, but the Americans prefer to stick to the more classic antitrust approach. They are suing the companies over various practices and conditions. What we don't know yet is the right balance between these two approaches. We know we need both, but I don't think we know exactly what the balance is.

JS: The key would seem to be the market price. How can public policy restore public confidence in the market price?

Philippon: There are two aspects – the competition aspect, which is true for many industries, and then there is the specific aspect with some platforms to do with social media. For the price, ensuring competition goes a long way to ensuring that people have a choice – they have the basic right to change providers if they don't like it. It is shocking in the US that some people don't have a choice in some communities – they get a company charging them a hefty price for a lousy service and there is nothing they can do. They don't have a choice, and that is shameful and should change. Once people have a choice and they can switch providers, it would be progress.

Secondly, for big global firms we still have the issue of tax evasion. We have made some progress but making sure that big international firms pay their taxes is a challenge and evasion is perceived by many people as being unfair. That takes care of the classic part of the equation. The second half is the social media aspect which is much more difficult. This is not an issue for many companies except Facebook, Google and Twitter, but involves the regulation of news and social media. That is an old problem also linked to how you regulate newspapers. Every country in the world has its own specific regime for news. News is social good, and has to be done to scale; it's very hard to have a pure simple competitive model. Countries found a balance before social media, and this balance was disrupted by social media. They needed to find a way to have Twitter and newspapers at the same time. That is a bigger issue than just economics.

JS: Perhaps it would be difficult to reach a consensus among regulators on this issue. Complacency could be bad for the economy, and the regulators need to continue stimulating enterprise behaviors.

Philippon: It's possible for regulators to do too much to a point that it becomes inefficient. But there is a difference between something being plausible and being likely. There are more reasons to be worried that regulators don't do enough than there are reasons to worry that they do too much. On balance, I would always push for them to do more rather than less because there are a lot of lobbying interests on the other side to prevent them from doing something.

In most industries it's clear-cut. In the social media space it's tricky. Nobody has a magical solution, and all you can hope for is that countries act independently. Australia recently did something to have a deal between social media and news outlets; every country is trying something different, so I don't see any magic solution. It is a matter of a balance of power between the big Internet firms and the outlets. It's not healthy for a company like Google or Facebook to capture all the added-value in that market – they don't produce the news. So we need to find some balance in that market.

Industrial Policy & the Overall Economy

JS: Many countries today seem to be keen on industrial policy, due to concerns about national security in general. Will this trend pose a danger to capitalism, which is inherently competition-oriented?

Philippon: In many cases, not much will happen. It is easy to go on TV and say that you want to bring back production of X, Y, Z in Japan or in Europe instead of importing from other countries. But when it comes down to the cost, these promises go away quickly. It doesn't make sense to build things at home when you can import them much cheaper. And the reason you can import them cheaper is because people are better than you at making them, and you should focus on the things you are good at. There are some exceptions related to trade disruptions during the pandemic, and we learned that there are a few sectors where we want to be more strategic in how we diversify; but if you look at the number it is very small.

For the health sector, it is true that some countries want to have more control, but the number of industries where it is critical is very small. The energy part is different and covers a wide range of stuff. It is also more political because it is part of the strategy in the US – there are big links with China and the issue of decoupling.

In many cases, monopolies will use this as an excuse to keep their monopoly powers. If you look at the AT&T case in the US, when AT&T was dismantled and broken up, one of the arguments against it was that we would lose the Cold War against the Russians because we wouldn't have secure communications. So they were playing out the threat of Russia to justify the monopoly at home. That made no sense, but we hear these arguments all the time. Or that we need to be bigger to compete with China – which may be true in one or two cases but is mostly completely bogus.

In Europe also the proposed merger of train producers Alstom and Siemens – they used all kinds of arguments to justify their merger, saying it was because of China or Brazil. Ultimately it was nothing to do with that, it was just two firms trying to get political leverage to get monopoly power, and thankfully they got shut down and didn't get their merger. So I would be most worried about firms using it as a bad excuse for bad policy.

Income Equality vs. Economic Efficiency

JS: Finally, regarding the direction of "new capitalism". The Japanese government is now pursuing a new capitalism policy focusing on income equality rather than economic efficiency. In many parts of the Japanese economy, there are still many areas that require new competition, such as digital transformation. This cannot be expanded without competition and is currently hampered by regulations. So deregulation might be a good way to nurture a good economy in Japan. However, the trend of discussion in Japan is leaning towards reducing income inequality which could potentially increase zombie companies and economic inefficiency. How do you feel about this?

Philippon: Similar to my opinion on industrial policy. First, in many cases competition is good, including for inequality. In the US, the data suggests that in labor markets where there are too few firms the workers suffer. In fact, for workers who are low-skilled – if there is only one employer in town, it is going to pay a low wage and these workers have no choice and can't move. So there are in fact many places where competition is good for efficiency but is also good for equality.

It's not always the case – I think the prime example is with foreign trade. Anything that can increase domestic competition you should do. It's good for efficiency, and it's good for equality.

With respect to trade policy, I agree that the naïve view of global trade has gone for everyone and it's not coming back. We are looking more seriously at where we want free trade and where we want some protection. That's a fair discussion but my only concern there is that it is quantitative; I am sure that there are some cases where you could justify protection. The problem is that out of 10 cases, probably one is going to be like that while nine are going to be local monopolies using that as an excuse to protect themselves. They are going to use inequality as an excuse to protect themselves. If the current buzzword is "fear of China", they are going to use this to protect their monopoly. If the buzzword is "inequality", they are going to use that. They don't care, and that is what I am worried about. JS

Written with the cooperation of Joel Challender who is a translator, interpreter, researcher and writer specializing in Japanese disaster preparedness.