

Does the attitude of France towards national champions have anything to do with economics?

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In October 2006, the SNCF, the French national railway operator, announced that it had chosen the Canadian firm Bombardier to produce some of the motors for its trains, rather than Alstom, the French competitor involved in the same tender offer. This choice has been denounced by a number of political or business leaders as a proof of culpable economic “antipatriotism”. The message was relayed by most medias without much dispute. The fact that Bombardier proposed the best offer, allowing thus to build better quality trains at a lower cost and finally to offer a better service to consumers, was found a second order argument compared to the absence of “national preference” that should have prevailed, at least according to this view. Moreover, most commentators also claimed that the public authorities should have intervened in order to correct what they seem to find a “public bad”, that is, the result of a competitive process involving world operating firms.

This is only the most recent chapter of the long and conflicting relationship that the French public opinion has with the functioning of market economies and with the related idea that competition is a bad, the protection of national champions a good, and that, in any case, the government is a wiser decision-maker than the market in the economic field.

The purpose of this short note is to confront some of the most often expressed views in the French debate on industrial policy with their economic foundations. Beyond the well-known conditions under which public intervention is desirable to improve the functioning of markets (the so-called “market failures”), a large proportion of French political decision makers, right and left, as well as many entrepreneurs, seem to share the following beliefs : (i) big firms are more efficient and should thus be encouraged or even built if they don't emerge by themselves, in particular to be able to intervene on export markets; (ii) markets are unable to promote proper incentives to innovate; (iii) in all cases, public intervention provides better support to economic efficiency than market mechanisms. Therefore, a more important role should be devoted to industrial policy, in particular in order to favour the innovation process. Very few challenge the idea that the selection by the public authority of R&D investment projects and the public design of “competitiveness areas”, where spillovers are supposed to arise more easily than they would spontaneously, are better suited procedures than those that would have been offered by market mechanisms.

A number of practical results of these beliefs can be observed in the French economy : among others, the emergence of national champions like Alcatel-Alstom, Elf, or Aerospatiale, the implementation of rescue plans for failing firms (Alstom again), the intervention of the public authorities in order to prevent a merger between an Italian firm and a French one and to promote another merging scheme instead (Suez / Gaz de France), or last year, the creation of the “Agence de Développement Industriel”, following the recommendations of the Beffa report (2005) are examples of such consequences, for better or for worse. The Beffa report itself takes place in this line of arguments. It recommends that national programs, each of them coordinated by a national champion, should be implemented in order to restore the ability of firms to innovate and export. This recommendation relies implicitly on several assumptions that are very close to the above mentioned ones : first, public authorities would be more efficient in selecting successful R&D projects; second, firms would be unable to generate themselves R&D spillovers; third, these

projects would be better driven by a large firm; fourth, the national champion organising the program should be chosen by an exogenous player, the above mentioned Agence de Développement Industriel.

The idea that the intervention of public authorities in competitive sectors is justified also explains the number of legal procedures against France triggered by the European Commission, rightly or wrongly, in the field of state aids.

On the other hand, the Commission itself, recognizing that the objectives of the Lisbon agenda (3% of the GNP devoted to R&D) would not be met in due time, has launched a re-examination of its own position towards industrial policy and state aid. But there is a number of divergent thinking between the Commission and the French initiatives : whereas state aids are often viewed as the main tool to implement industrial policy in the French environment, the new approach of state aids that begins to prevail at the EU level tends to limit the scope of these aids to the field of market failures, more rigorously defined (public service or general interest objectives for instance). French aids are often directed towards failing firms, whereas the more liberal approach that prevails in other member states or at the European level sees birth and death of firms as the (positive) result of the competitive selection by the market, entry and exit regulating and improving then the efficiency of the surviving firms.

Looking for a theory of industrial policy...

If the economic foundations of competition policy are relatively robust, those of industrial policy are less clear. Of course, economic theory states that public intervention should take place when a precise market failure has been identified and when the public authority has more efficient tools in order to remedy the failure than private actors. These situations include the existence of economies of scale, that of technological spillovers, sectors where the relationships with the state are naturally dominant (arms) or even in some cases the implementation of a strategic commercial policy, even if this last case can be challenged.

Before the emergence of the Chicago school arguments, the dominant view was that market structures have an influence on behaviours and economic performances of firms ; thus correcting market structures through public intervention could be an efficient way of influencing behaviours and performance. The creation of national champions, a clear intervention on market structures, could be accordingly an efficient way of enhancing economic performance.

For the Chicago school, on the opposite, there no scope for public intervention since behaviours determine market structures and performances.

Indeed, regarding more specifically national champions - a part of this broader set of questions - it is worth addressing the question of whether "big firms" are more efficient than small ones (at least if this question is meaningful regardless of the characteristics of the sector). In favour of such a positive link, one finds the fact that globalisation increases the size of markets. Therefore, it would be profitable to allow mergers that reduce domestic competition if in the same time, these mergers increase the size and the efficiency of the merged entity, therefore allowing it to intervene on export markets. Unfortunately, various empirical studies suggest on the contrary that firms whose "environment" (for instance a less concentrated market structure) is more competitive either are more productive (see Nickell 1996), or exhibit a higher productivity growth (Blundell, Griffith and Van Reenen, 1999). Whatever the more convincing type of link between size and productivity, these papers also suggest that being active on a domestic market where competition is intense is a better factor of success on external markets than being "big", the relationship between size and

performance being thus a statement open to dispute. Moreover, reducing domestic competition (and thus domestic consumers' welfare) in order to promote exports may be a valuable choice, but its consequences should at least be clearly explained, a situation seldom observed in practice.

Industrial policy and innovation

Another debate is that of the relationship between the size of a firm and/or the market concentration and the propensity to innovate. Intellectual property is the main policy tool through which incentives are given to firms in order to convince them to engage in long term and costly expenses in innovation. The incentives to innovate clearly depend on three values : the present profit, the expected profit ex post (or the profit differential), and the cost of innovation. Unambiguously, *ceteris paribus*, the higher the cost, the lower the incentive to spend money on investment in innovation; the higher the expected revenue ex post, the higher the incentive to invest in R&D. It is this value that intellectual property rights increase by the guarantee that innovating firms will recover the benefit of their investment through market power on their innovation.

The effect of the present profit (and thus of the market structures that are more favourable to innovation) is less clear cut. The Schumpeterian thesis puts the emphasis on the fact that the present profit is higher for a monopolist, thus increasing the opportunity cost of losing it if entrants take market shares. Monopolies are thus favourable to innovation : they enjoy monopoly profits, which attracts new entrants. Monopolies have therefore an incentive to innovate in order to deter entry and protect their favourable position. In a patent or innovation race, a monopolist has more interest to invest than an entrant, and its higher profits allow him to do so. Other versions of the Schumpeterian argument state that innovation allows a monopolist to diversify risks, or that large scale firms have a better access to financial markets that allow to fund long term projects.

The opposite relationship, according to which competition would favour innovation, relies on other arguments : for instance, Arrow (1962) develops the idea that the "replacement effect" dominates : the cannibalization of its own product by a monopolist that would innovate, thereby ruining its own profits, discourages R&D in monopolistic markets. The reverse of the Schumpeterian argument is also at work on a competitive market : when competition is very intense, profits are low, whereas expected profits, conditional on the success of an innovation, may be higher. There is thus an incentive to escape intense competition through innovation. Another argument relies on the owner-manager conflict : since they have to pay for R&D, owners are more reluctant than managers to engage in R&D expenditures; competition would favour the managers' point of view and would give proper incentives to owners.

Again, empirical studies are useful to validate these various assumptions. Blundell, Griffith and Van Reenen (1999) show that large firms invest more in R&D, but they do not determine the causality between both facts. A more recent paper (Aghion, Bloom, Blundell, Griffith and Howitt, 2005) exhibits the non univocal link between the degree of competition and the intensity of the innovation process : when competition is very intense on the market, firms try to escape the competition process by product differentiation or innovation. Therefore, very competitive markets are favourable to innovation. When considering less competitive one, this mechanism fails to happen and innovation diminishes. But when turning further to almost monopolistic markets, the Schumpeterian mechanism arises and innovation increases again. This gives rise to a U-shaped curve relating the intensity of competition and the ability of a market to innovate : competitive and monopolistic markets favour innovation, whereas oligopolistic ones discourage it.

Therefore, the economic literature does not confirm unambiguously that big size would be more favourable to innovation. Nor does it establish that a dominant firm with a competitive fringe (the structure advocated by the Beffa report) would generate more spillovers than other market structures, despite the fact that most empirical and theoretical papers agree that R&D indeed generates spillovers effects.

Industrial policy and informational asymmetries

Another condition required for the success of the Beffa arguments is that the public authority should hold an informational advantage over “markets”, an assumption somewhat surprising for economists, more prone to admit that private actors are better informed of profit opportunities than public authorities. For instance, the pioneering work of Laffont and Tirole (1993) is entirely devoted to the question of how to bypass the government’s lack of information on the firms they should regulate : which are the efficient firms? how to select the right firm in a procurement process? how to elicit the right investment projects? All these questions are precisely at the very core of the modern economic theory of state and of public intervention. The result of this informational asymmetry is that informational rents have to be abandoned to firms, which is socially costly. Of course, the remedy to this particular market failure is not necessarily to deny any role to public authorities; but it is precisely when selection mechanisms are involved that competition processes seem to be the more efficient, whereas it seems to be the opposite assumption that bases the recent measures of industrial policy in France. The “informational argument” thus rather provides foundations to the opposite view according to which markets are in a better position to select investment project than public decision makers.

The most convincing argument in favour of public support to private investment is that of the short term perspective that prevails on financial markets and prevents some good projects to emerge. Remedies could be more profitably applied to this problem.

Some other arguments should make public authorities cautious with the use of industrial policy : for example, political economy arguments emphasize the irreversibility of decisions when they involve large amounts of money. When these amounts have been invested in these projects, stopping the project becomes difficult, a “too-big-to-fail argument” that would apply to industrial projects.

A number of public decisions involving the functioning of product markets are probably motivated by other goals, more or less explicit, like preservation of jobs for instance. Indeed, more work is needed to better understand the relationship between product markets and employment. Regarding the action of public authorities, two opposite opinions may be discussed : according to the first one, distorting all the markets, that is prices, quantities, and incentives on product markets, in order to act on another one (the job market) amounts to create many welfare reducing distortions ; therefore only employment policies should be used to enhance employment, and industrial policy should not be used for that purpose. According to the second one, in a second best world it is useless to avoid distortions on a given market, and the objective of economic policy as a whole should be to reach a second best equilibrium, irrespective of the distortions it creates on a particular market.

Whatever the wiser point of view, informational asymmetries are probably one of the main obstacles to the implementation of an efficient industrial policy, a major lesson from recent economic theory that does not seem to be taken into account by public authorities.

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