Economic nationalism

1. Introduction

The Treaty of Rome and subsequent EU treaties insist on the principle that national governments should not discriminate against residents of other member states. Economists claim that such a principle buttresses efficiency. It is inefficient, for example, to favour a national firm in public procurement if a foreign firm can supply the same good at a lower cost.

Yet we have observed in recent years a number of incidents where individual countries have pursued nationalistic economic policies despite their pledge. Governments have intervened in financial markets so as to block or modify cross-border mergers involving prominent domestic firms. Attempts to subsidise national champions or to recapitalise and bail out national losers are still common. Economic nationalism is not only frequently observed within the EU, in violation of European or wider treaties. Two recent examples include the failed acquisition of US ports by Dubai-based DP World and the renegotiation of quotas of Chinese imports immediately after their phasing out.

In this chapter we discuss the merits and drawbacks of economic nationalism, its causes and consequences, and whether it should be combated – and with which tools. The criterion we use to evaluate economic nationalism is whether it improves or worsens the welfare of European citizens.

2. Forms of economic nationalism

What is economic nationalism? We define it as any form of interference from governments in private transactions that distorts them on the basis of the nationality of the parties, and that go beyond the normal, non-discriminatory reflection of domestic residents' preferences. Thus, having a national tax system different from other countries, as the result of different preferences and a different economic structure, is not a case of economic nationalism. But launching an anti-trust action against a foreign-owned firm, while being at the same time lenient with domestic monopolies, is a case of economic nationalism. Such policies, while discriminatory, may nevertheless be consistent with benevolent governments trying to maximise the welfare of their citizens, as we shall see, although in many cases the motivation has probably more to do with private rent seeking, which we also discuss below.

These interventions are quite often discretionary in that they consist of a sequence of one-off interventions rather

Box 6.1
Nationalism and the location of the European Parliament

The Wikipedia article on the European Parliament succinctly describes this phenomenon.

"Although Brussels is generally treated as the 'capital' of the European Union, … a protocol attached to the Treaty of Amsterdam requires that the European Parliament have monthly sessions in Strasbourg. However, preparatory legislative work and committee meetings take place in Brussels. Moreover, much of the European Parliament's secretariat, which employs the majority of its staff, is located in Luxembourg, which itself used to host plenary sessions of the parliament.

Parliament only spends four days of each month in Strasbourg in order to take its final, plenary votes. Additional plenary meetings are held in Brussels. On several occasions, the European Parliament has expressed a wish to be granted the right to choose for itself the location of its seat, and eliminate the two-seat system, but in the successive treaties, EU member state governments have continued to reserve this right for themselves. While they did abandon the third seat of Parliament, Luxembourg, two decades ago, the rival demands of Belgium (Brussels) and France (Strasbourg) to base the parliament in their country has prevented a final agreement as to which city would become the sole seat of parliament.

Moving various files and equipment between the two cities takes ten large trucks and the costs for two locations are estimated at 200 million euros a year. A force of 30 people loads the trucks for the 400 km journey between the two locations. Around 5000 people attached to the European Parliament, such as parliamentarians, advisors, clerks and journalists, also move between Brussels and Strasbourg. Most of the parliamentarians are against using Strasbourg, and various initiatives have been taken over the years to have Brussels as the sole location."

Source: http://en.wikipedia.org/wiki/European_Parliament#Location

Box 6.2
The spread of the Airbus workforce over the different corporation locations

Airbus, along with Boeing, is one of the two main aircraft manufacturers in the world. It was created in 1970 as a merger between the French Aérospatiale and the German Deutsche Airbus companies. The Spanish Casa and British Aerospace companies joined later. As of 2005, it is basically on a par with Boeing in terms of market share.

Historically, the French, English, German and Spanish governments have had an important stake in Airbus and still retain a substantial fraction of its capital. As a result, they have been able to influence the location of economic activity on the basis of political criteria. This allocation is shown in Table 6.1. Most of the workforce is spread over the four countries, and the fraction of employment that each country has is in line with its stake in the capital: France and Germany, the two most important partners, have the greater share of employment.[a] Although that seems natural to most non-economists, from the point of view of economic efficiency there is no reason why, more than 25 years after the merger, the distribution of production sites should match the distribution of ownership. In private corporations, the two should typically be unrelated.

The scattering of production sites is partly the legacy of history, as Airbus is the outcome of a merger among several national companies. However, for mergers to enhance efficiency some restructuring has to take place, and one may believe that nationalistic considerations have slowed it and contributed to maintain too many of the initial production sites in operation.

Boeing's production is also scattered across several sites; however, most of these are in the United States. Most importantly, Boeing's dispersion reflects efficiency considerations such as comparative advantage and the international division of labour, rather than political economy considerations. For example, part of the new 787 will be manufactured in Australia and Canada, two countries that have no significant stake in Boeing.

[a] According to our own computations, as of the end of 2004, other than publicly traded shares (i.e. those that are bought and sold by various shareholders on the stock market), the distribution of ownership was as follows: France 33.2, Germany 33.2, the UK 27.5, and Spain 6 percent. As can be seen from Table 6.1, the distribution of ownership closely matches that of employment.

Source: Wikipedia, http://en.wikipedia.org/wiki/Airbus#Workforce_by_sites

than the application of well-defined rules. In the context of the Single Market, that is not surprising: "nationalistic" rules would appear discriminatory and be challenged by the European Commission. Instead of having such rules, governments endorse the EU non-discriminatory rules. Governments commit themselves not to discriminate and in exchange for that they benefit from a similar commitment from other member states. At the margin of those rules, however, governments have an incentive to behave opportunistically and circumvent the rules to pursue their own nationalistic interest, while insisting that the rules be enforced by other countries.

Economic nationalism may take several forms depending on its motivations. It may be proactive (subsidies, nationalisation, political influence etc.) or defensive (blocking a transnational merger). It can affect productive decisions (subsidies for locating a plant in a specific area) as well as control (maintaining a hard core of domestic shareholders). It can be enacted by a national or a local government, and there are also instances of pan-European economic nationalism. We now discuss the various forms of nationalistic interventions in greater detail.

2.1 Influencing the location of firms

Both local and national governments often offer subsidies or other forms of exceptional conditions (such as providing infrastructure) to convince foreign firms to locate in their jurisdiction rather than elsewhere. There are many examples of such behaviour, such as bidding for the Olympic Games, lobbying to attract large international projects, and so on. The nationalist bids for location of large investment projects has often led to costly compromises, like the dispersion of Airbus's production sites across countries and the cyclical motion of the European Parliament between Brussels and Strasbourg, with a staff mostly located in Luxembourg (see Boxes 6.1 and 6.2).

2.2 Influencing control

Governments often try to make sure that the leading firm in a sector is nationally-owned. Thus, they sometimes block acquisitions of domestic firms by foreign firms and sometimes support acquisitions of foreign firms by domestic firms. Recent examples abound:

- The French government recently stepped in to prevent the Italian utility company Enel from taking over a private banking group that had diversified into the sectors of water and utility, Suez. The government instructed the national gas monopoly, Gaz de France, to merge with Suez, thus resulting in the partial privatisation of Gaz de France and the partial nationalisation of Suez.
- Also recently, the Italian government pressured Telecom Italia not to sell its mobile phone subsidiary,[1] on the grounds that it is the only Italian-owned mobile phone operator in the country.

[1] According to Reuters, Sep. 11 2006, "Italian newspapers said (…) that the British buyout firms Apax Partners and Permira, as well as the Texas Pacific Group, an American firm, were considering bids."

Table 6.1
Distribution of Airbus workforce among different locations

	Workforce	Percentage of total workforce
A. FRANCE	**19 400**	**38.9**
Toulouse	14 100	28.4
Saint-Nazaire	2 200	4.5
Nantes	1 900	3.8
Albert	1 100	1.1
B. GERMANY	**18 400**	**37.0**
Hamburg	11 200	22.5
Bremen	3 050	6.1
Nordenham	2 100	4.2
Varel	1 200	2.4
Laupheim	900	1.8
C. UNITED KINGDOM	**8 700**	**17.5**
Bristol	4 400	8.8
Broughton	4 300	8.7
D. SPAIN	**2 700**	**5.5**
Madrid	2 200	4.5
Cadiz	500	1.0
E. OTHER	505	1.0
Washington, DC, USA	165	0.3
Wichita, USA	140	0.3
Miami, USA	100	0.2
Beijing, China	100	0.2

Source: Wikipedia, http://en.wikipedia.org/wiki/Airbus#Workforce_by_sites

- The US Congress blocked the acquisition of US ports by the state-owned Dubai Ports (DP World) on the grounds that it could be a threat to national security.

Other examples are provided at the end of Section 4.

2.3 Political intervention to obtain contracts

In some sectors, such as those involving oil concessions or weapons, politicians often intervene to secure contracts for a national industry. They can pay for these contracts in the form of support for the client government in foreign policy circles. This mechanism can also be a channel of indirect state aid, especially in contexts like that of the Single Market where it has to be authorised by the European Commission: a government can lend money to a foreign government in exchange for a bona fide agreement that the latter will purchase goods and services from domestic firms. There is also a local bias in the allocation of procurement contracts, as politicians typically believe they can increase their votes by picking local companies.

2.4 State aid

Many European countries have a long tradition of subsidising "national champions", be it in the high-tech industry, banking or in declining sectors. Again, these subsidies are discretionary, in that the government picks a number of "winners" and pays for their losses, rather than subsidise an industry, product, activity, or factor of production as a whole. It is usually observed that such state aid is very difficult to remove politically when it appears that the subsidised firm is not successful. An archetypal example is the French computer manufacturer Bull, which in 2002 lost 500 million euros out of a total turnover of 1500 millions and cost the French taxpayer 2 billion euros in just a decade. In many cases, big firms are supported by the government because they are "too big to fail". However, subsidies also seem hard to eliminate for smaller firms like Bull.

2.5 State ownership

State ownership is no longer popular, but has long been an instrument of economic nationalism. Economically, state ownership may be justified in case of market failures, like the existence of a "natural monopoly", due to increasing returns to scale, although many economists tend to believe that such sectors are better regulated, as the lack of incentives of state monopolies tends to generate larger inefficiencies than increasing returns to scale.

2.6 Influencing standards

Nationalism may also arise when setting international standards. A country may boost the value of domestically generated patents by imposing its own standards. Many historical examples abound. For example, in the domain of colour TV, the French standard SECAM competed with the German PAL and the US NTSC. Because the two latter were widely in use, France did not manage to impose SECAM on but a handful of countries. In more recent years the EU has also tried to impose standards developed in Europe rather than elsewhere. It was successful with the GSM mobile phone standard but less so in high definition television (HDTV).

3. Motivations of economic nationalism

In this section we discuss the economic arguments that may explain the rise of economic nationalism, coming

from either benevolent governments trying to maximise the welfare of domestic citizens or politicians driven by private concerns.

3.1 National security

As exemplified by the above-mentioned Dubai Ports case, one argument in favour of nationalistic intervention is that some sectors are "strategic" in the sense that their activity has some impact on national interests beyond the economic sphere. This argument has been used by France to shield a number of sectors from foreign takeovers, by requiring government approval. These sectors are listed in Box 6.3.

It is not clear why national ownership of a sensitive sector should increase national security. If the goal is to prevent some undesirable activities from taking place within that sector – for example, the reason that was invoked for the inclusion of casinos as a strategic sector was money laundering – then one can simply ban or regulate these activities. There is no reason why a foreign private owner would have more incentives to engage in these activities than a national, private owner.

The general economic point here is that money is odourless, and that foreign owners would (and should) maximise profits just like domestic ones, and thus make the same decisions. However, one could conceive of foreign takeovers with undesirable, non-economic effects. What if a hostile, foreign government takes over a weapons manufacturer to buttress a programme of weapons of mass destruction, or accumulates treasury bills in order to massively dump them on the market some day in order to brutally disrupt the economy? Our answer to that question is that "hostile" governments should be clearly defined by a parliamentary bill, in the spirit of the restrictions imposed by the US Congress on some countries. Otherwise, defining strategic sectors and imposing government approval for any takeover in these sectors will favour discretionary behaviour by the government to please domestic lobbies and/or to derive private rents by manipulating the structure of corporate ownership. Furthermore, to the extent that the EU is a club of countries sharing the same values, with some degree of political integration, blocking a takeover from another member state on the grounds that it threatens national security is dubious to say the least.

3.2 Adequacy

Another issue is that domestic firms can be bought by, say, foreign state-owned firms, and be poorly managed because such firms would not maximise shareholder value but pursue other objectives instead. This indeed is a non-trivial issue. In some sense, if it is *known beforehand* that an economic agent is going to perform an inefficient action, it is always valuable for authorities to block that action. This argument holds regardless of the type of agent involved, whether it is a firm or an administration, private or public, domestic or foreign. Thus, it is not a case of nationalism; rather, it is a case of *paternalism* – that is prior government approval of private transactions on the ground that agents may not be qualified to perform them. Although there may be grounds for some degree of paternalism (think of governments certifying the skills of a medical doctor or an architect), in many cases, it is impossible to tell in the first place how well a firm's new owners are going to do. We only know that selection and competition eventually prevail, ensuring that markets eliminate poor strategies. Thus, it is generally best not to interfere with property rights and to let markets punish bad management.

Furthermore, the case for intervention is probably *weaker* when it is a foreign, inefficient entity that is trying to buy a more efficient domestic firm than when it is a domestic, inefficient one. A poorly managed foreign firm has to pay domestic shareholders at least the initial market value of the firm, since that initial value reflects the profit stream generated by the incumbent management. Therefore, the original shareholders cannot be worse off, and all the losses generated by the new, inefficient management are borne by the new

Box 6.3

"Strategic sectors" in France

By decree of March 7 2003, the French government has defined a number of "sensitive sectors" where foreign direct investment is subject to prior approval by the government. These sectors are:

- casinos
- security activity
- biotechnology, antidotes
- communication interception material
- computer systems safety
- "dual technology", i.e. any civilian technology with potential military applications
- cryptology
- defence and weapons

Source: Deloitte Finance, January 2006.

foreign owners. Since their welfare is not taken into account by the domestic government, it should be less worried than if it were a domestic, inefficient firm that tries to purchase a more efficient one. What about the domestic workers? They may indeed suffer from such inefficient management, but only to the extent that domestic labour markets do not work properly. Otherwise, they are paid the equilibrium wage and if, say, mismanagement leads them to inefficiently lose their job at that firm, they can be expected to find another job at the same market wage. As long as the firm's owners pay market prices for all their inputs, they bear the financial consequences of their choices. And, again, the issue is not particularly associated with the entity being foreign.

To conclude: While the issue of whether governments should intervene to correct mistakes by individual agents is complex and beyond the scope of this chapter, there is no presumption that such interventions are more warranted in the case of foreign residents than in the case of domestic ones.

3.3 Preserving employment

Another, oft-invoked reason is the goal of preserving or fostering employment. Here, interventions may take different forms. One may subsidise declining industries to prevent job destruction, for example, or block a foreign takeover on the grounds that foreign owners will be less sensitive to the goal of preserving employment.[2] (That may be especially relevant if the government can pressure domestic owners to take it into account; on the other hand, the argument would not apply if a domestic owner would only maximise profits, just like a foreign owner.)

While this necessity may sound obvious to the layman, it is not necessarily obvious why employment should be an objective. If the labour market is functioning properly, there will be an equilibrium level of unemployment that reflects the frictions involved in the process of matching jobs and workers. A voluntary policy of creating jobs will interfere with that process in an inefficient way. Some workers will be diverted to the new jobs while their social value would have been greater looking for a more productive job elsewhere. At the same time, the new jobs will make the labour market tighter, thus raising wage pressure in other firms, which will inefficiently destroy some socially productive jobs.

In practice, we know that labour markets in Europe are heavily distorted, with persistent unemployment and long unemployment spells. Improving the labour market is then a legitimate goal, which has been discussed in several previous EEAG reports.[3] However, the tools of economic nationalism are likely to be inappropriate, and often ineffective, in addressing labour market issues. For example, if unemployment is too high because of a binding minimum wage, then subsidising firms in declining industries may positively contribute to national welfare. The reason is that firms tend to destroy too many jobs, relative to the social optimum, as the minimum wage creates a wedge between the private cost of labour and its social cost. But it is much more efficient to abolish the minimum wage, while replacing it, if needed, by a less distorting redistributive tool. Barring such an option, to subsidise firms in an efficient way, one would have to subsidise employment uniformly, by giving to each firm an amount equal to the wedge for each of its employed. The cost of such a policy is huge, and since it has to be financed by a tax levied on consumers, which reduces their purchasing power, it is no more than an indirect, burdensome way of reducing the minimum wage.

In many other cases, nationalist policies will fail to create jobs in the medium run. The reason is that unemployment will only be temporarily affected by temporary spurts of job creation (like those generated by the building of a factory) and tend to return to its equilibrium rate, which is determined by the institutional characteristics of the labour market.[4] Furthermore, repeated discretionary interventions may weaken the public's perception that fundamental labour market reform is needed, and therefore the government's incentive to address the roots of the problem.

3.4 Poles and externalities

It has long been recognised that there are agglomeration externalities in the location of economic activity. That is, under certain parameters, a firm is more productive if it locates where economic activity is high.[5] The benefits are numerous: denser markets, access to services that are not available elsewhere, cheaper or better public infrastructures, and so on. Hence, economic activity is concentrated in "poles" like big cities. Within a given economy, there is a substantial degree of arbitrariness and path dependence in the formation of such poles. A region

[2] A notorious example is the closing by Renault, a partially state-owned French automotive manufacturer famous for its social concerns, of its Belgian plant at Vilvoorde. At that time it was pointed out in the press that these concerns did not seem to apply to foreign employees.

[3] See, in particular, EEAG (2002) Chapter 6, EEAG (2004) Chapters 2 and 3, and EEAG (2005) Chapters 2 and 3.

[4] See also Section 4 in Chapter 4 for an analysis of how labour market institutions determine equilibrium unemployment in the context of the Scandinavian economies.

[5] See, for example, Scitovsky (1954), Caballero and Lyons (1990) and Krugman (1991).

may develop into the economic centre (or "core") of an economy for historical reasons and keep that status long after those reasons have disappeared.

Do residents of a region have an interest in living in the economic "core" rather than the periphery? The answer is a qualified yes. To the extent that one is more productive in the "core", this guarantees higher living standards, which creates an interest in attracting economic activity in a given place. Otherwise, workers receive lower wages and they would have to move to the core to get the corresponding wage. Since moving is costly, it is better for a region to evolve into a core rather than a periphery. On the other hand, if agglomeration has costs like pollution, congestion and high land prices, this may induce less skilled people (or people with less big city marketable skills) to stay in the periphery.

Furthermore, the location of headquarters of a firm matters because headquarters create agglomeration effects in terms of the depth of the market for highly qualified labour and business services in general, and are a magnet for the location of more headquarters. Regions are therefore prepared to subsidise the location of new headquarters (see Strauss-Kahn and Vives 2005 for US evidence.) The location of headquarters also matters since proximity is relevant for the protection of the interests of the different stakeholders in a firm, such as workers, suppliers, small shareholders and local communities. An implication is that in a downturn a firm may seek to minimise staff cuts in its country of origin.[6]

When several economies integrate into a single market, one may observe shifts in the regional distribution of economic activity. Some firms may leave a pole for a more efficient location, since they can now freely sell their output within the single market regardless of where they are located. This generates an incentive for nationally elected politicians to stimulate the presence of economic activity in their territory.

Note that this argument only goes so far as to say that there is a value in attracting firms in a given place. This argument holds regardless of who owns these firms, and does not say much about which industries should be favoured – typically, those which generate these "agglomeration externalities", which may be quite different from the "strategic sectors", usually referred to when governments subsidise domestic business.

Another type of effects is learning externalities, which are usually invoked to justify subsidies to infant industries.[7] Here the argument is that the more one produces of a good, the more one accumulates knowledge in the corresponding technology. Therefore, a country is more productive in a given sector, the greater that country's total cumulative output in that sector was in the past. Subsidising an infant industry, which is originally not competitive, may thus help it survive once enough experience has been accumulated. In principle, the industry can then live without the subsidies. This argument is probably valid empirically, and explains why patterns of specialisation tend to be self-reinforcing – that is, there is no particular reason why Switzerland should produce clocks and Germany optical instruments other than the fact that these countries accumulated a lot of experience in these sectors in the past. The question is: Does this justify state intervention to favour a given sector? Typically, one observes subsidies to either declining industries, so as to "preserve jobs", or nascent "high tech industry", to have a national leader in these sectors. The economic value of forcing an economy to channel resources to "high tech" sectors is however unclear. If the learning potential there is high, specialising in such industries may help achieve faster growth. On the other hand, that process is associated with a rapid fall in the relative price of the good, which may harm GDP growth even though growth in "physical terms" is faster. For example, semiconductors are certainly a high tech sector, but their price has fallen so rapidly that it is probably not a good idea to distort specialisation toward that sector, rather than, say, having a strong tourism industry. Indeed, such terms-of-trade effects seem important in the case of Finland and Sweden due to these countries' specialisation on ICT products, the relative price of which have been falling. This is discussed in more detail in Section 3 of Chapter 4 on the Scandinavian model in this report.

Finally, these externalities should not be mixed with pure "pecuniary" externalities, that is the effects of greater demand for goods and services. While these externalities exist and may have to be taken into account, they seldom justify nationalistic interventions. We further discuss their role in Section 4 below.

3.5 Beggar-thy-neighbour policy and exerting monopoly power abroad: the transfer effect

The transfer effect arises from the fact that even a national government trying to maximise the welfare of domestic citizens does not take into account the welfare of foreign residents. Such a government will object to a

[6] See again footnote 2 in this chapter.

[7] See Krugman (1987) and Lucas (1988).

domestic firm charging monopoly prices at home, because monopoly profits are a transfer between domestic residents (from consumers to shareholders), while the excess price charged by the monopoly is a distortion that harms consumers. However, domestic residents benefit from a national firm charging monopoly prices abroad because they are not likely to care about the losses to foreign consumers. Therefore, a national government acting in the interest of national residents may want to promote monopoly for its national firms abroad but competition between them at home. Finally, such a government is likely to perceive it as the worst case if a foreign firm operates at home with monopoly power, as the monopoly profits are transferred abroad.

A social planner acting at a higher level (say the EU level) would take into account the welfare of foreign consumers and try to block nationalistic policies aimed at buttressing national champions' monopoly power abroad. Conversely, a benevolent social planner at the national level is willing to spend more resources on blocking foreigners from extracting monopoly profits from national consumers than an EU-wide social planner. The national residents' losses from monopoly pricing are equal to the full amount of profits transferred abroad, while a higher-level social planner would only take into account the distortions due to the fact that monopoly pricing leads to a suboptimally low consumption of the good.

We can think of a number of examples where this transfer effect leads, under certain circumstances, to nationalistic policies – especially in the context of a pan-European move to deregulate markets that were initially controlled by a handful of often state-owned domestic firms.

- The transfer effect may sometimes induce unilateral deregulation: a country may want to deregulate unilaterally if it leads to perfect competition in its domestic markets. By doing so, it eliminates monopoly rents at home while still being able to reap any monopoly rents from its domestic firms with sales abroad. This is an example where nationalistic policy is also the one which goes in the direction of greater economic efficiency.
- However, if deregulation leads to less than perfect competition, as is usually the case, the conclusion is easily reversed. The reason is that in the initial, regulated situation there are only a few national firms in the market that share oligopoly profits and transfer them to their owners who are national residents. When foreign firms enter the market, some monopoly rents will be transferred abroad, thus harming domestic residents. This effect creates an incentive to block deregulation at home. At the same time, the national government may push for deregulation abroad to the extent that it allows its domestic firms to enter these markets and transfer monopoly rents to the home economy.

When do we expect a government to opt for deregulation? That would be the case if its firms in the relevant sector have some cost advantage compared to their foreign competitors. It is then in the interest of the government to push for deregulation both at home and abroad because domestic firms are likely to conquer foreign markets, while foreign monopolies are unlikely to make it to the national market.[8] Conversely, if the national industry is less efficient than its competitors, the government will be more likely to block deregulation, while still trying its best to enter foreign markets. That incentive may be particularly strong if there is a first mover advantage in conquering market shares, for example, if it is costly for customers to change their suppliers or if those who produce earlier move down their learning curve, thus accumulating a cost advantage over future competitors.

Another potential explanation of economic patriotism can be found in sectors where economies of scale and size are important because of network or learning effects, increased bargaining power in international input markets, or increased financial muscle. In those sectors, if there are asymmetries among countries in terms of their ability to merge their firms to create national champions, countries and firms will have incentives to obtain a first mover advantage by forming a national champion that will consolidate as an European or global champion once the European market integrates. The benefits of such a champion will be enjoyed by the country in terms of the local external effects of headquarters and the reaping of monopoly profits from abroad (the transfer effect). Public ownership introduces another asymmetry because state-owned firms or firms in which a government keeps a golden share are protected from foreign raiders. Still another asymmetry may arise in terms of the differential lobbying capacity in Brussels of firms and countries according to size. Indeed, the weight of large European firms and countries (such as France, Germany or Italy) may make a large difference. In short, regulatory and ownership asymmetries provide incentives to move first

[8] Foreign entrants may in fact limit the ability of a dominant domestic firm to charge monopoly prices by compelling it to charge a "limit price" equal to their cost. In such a case foreign firms get no monopoly profits from operating in the domestic economy but exert price discipline on the dominant firm, which benefits domestic consumers.

to take positions for an enlarged market while keeping barriers at home. The recent turmoil in the energy sector may be related to this potential explanation. Things are more complex when one considers the *acquisition* of a national champion. The transfer effect does not explain per se why one might want to block foreign acquisition of national champions. It is true that these champions' profits would then be exported. But they should be reflected in the market price paid by the buyer, so that there is no transfer abroad in net present value terms. The acquisition is then simply a financial swap, which has a neutral effect on the international distribution of welfare. But the analysis is more complicated if the acquisition leads to a change in prices because consumers are then affected. For example, a well-managed national public monopoly will charge lower prices than a private monopoly, reflecting its concern for the consumers' welfare. If upon deregulation, for example, a national public monopoly is bought by a foreign firm and remains a monopoly, the price will rise. The share prices compensate the domestic taxpayers for the profits transferred abroad but the domestic consumers are not compensated for the higher prices.

The row between France and Italy over the acquisitions of Electricité de France in 2003 illustrates the reluctance of national governments to engage in reciprocal deregulation (Box 6.4).

Another area where the transfer effect may lead to economic nationalism is that of intellectual property. Patents owned by domestic firms increase their ability to obtain monopoly rents from the rest of the world. With respect to patents held by foreign firms, rents are transferred in the opposite direction. The consequences are threefold:

- A national government can lobby to impose its own technological standards upon the rest of the world, thus artificially raising demand for goods with domestic patents. It may keep its own standard instead of a more efficient or more widely used international one. This leads to inefficiencies in the nature and/or number of standards.
- A national government has an incentive not to recognise foreign patents and copyright, while at the same time lobbying aggressively for foreign recognition of its own patents.
- There may be excess investment in R&D, as the outcome of inefficient patent races. These inefficiencies arise because firms fail to internalise the part of their profits that comes from customers poached from their competitors (the business stealing effect). Furthermore, their R&D efforts may be redundant if their competitors work toward the same innovation. This phenomenon may lead to nationalistic interventions to the extent that the patent race is international and the research publicly funded. At the European level, one may indeed cite examples of research projects (such as Galileo or Quaero)[9] that seem inefficient on the grounds that they aim at duplicating innovations that already exist, with the only difference that intellectual property rights would be European.

How can one reduce the incentives to pursue these inefficient policies? An obvious answer may be to coordinate policies across countries. That is indeed what the EU, under the impulse of the Commission, has been trying to do since the inception of the Single Market, in particular by promoting policies such as deregulation and directives that prevent a country from discriminating against other member states in their access to its domestic market. Such policies reduce the level of monopoly rents and therefore the size of the transfers that can be extracted from foreign countries. They also create a level playing field at the European level

Box 6.4

Electricité de France in Italy

The saga of Electricité de France (EDF) investments in Italy illustrates how nationalistic motivations may lead to a war of attrition in the game of opening one's market to foreign competitors.

In May 2001, EDF started acquiring shares in the Italian electricity company Montedison. The move took place in a context where electricity markets were gradually opening to takeovers and foreign competition in Italy, while EDF remained a state monopoly in France. This situation gave EDF an edge in pre-empting market shares for the future liberalised energy market, while Italian firms could not make a symmetrical move by investing in France.

The Italians retaliated by passing a law that limited EDF's voting rights to 2 percent, despite the fact that it had acquired 4 percent of the shares. That provision was subsequently used by the Italians to bargain with the French government over the opening of the French market: The provision limiting EDF's voting rights in Italy would be lifted in exchange for an access of the Italian company Enel to the French energy market. However, the recent counter-move by the French government to block the acquisition of Suez by Enel, by sponsoring a merger between Suez and Gaz de France, suggests that commitment was not very credible.

[9] Galileo is a European competitor to the US-American GPS positioning system, while Quaero is a web search engine project sponsored by the French and German governments. Note that Galileo may be defended on the grounds of national security concerns.

that prevents national governments from preserving their champions' monopoly rents at home while bidding for oligopoly rents abroad. But that strategy is not without shortcomings. Implementation and enforcement of such directives remain in the hands of national governments. Individual countries may want to delay implementation in order to benefit from the transfer effect as long as possible. As a consequence, an inefficient war of attrition arises. Also, countries whose national champions are inefficient and likely to be eliminated may resist such policies, despite coordination, since they will transfer monopoly rents abroad but not receive any in compensation.[10] In some sense, one has to compensate these countries. An obvious suggestion is to synchronise the reform with another one (say deregulation of a sector where these countries have a comparative advantage) from which they can benefit.

3.6 Political economy and private rents

The preceding discussion analysed the extent to which economic nationalism may be beneficial to the welfare of a nation as a whole. In addition to that, nationalistic policies may benefit politicians – and, more generally, the elite – to the extent that private rents can be derived from it. These rents may take several forms:

- Buying a political clientele in order to be re-elected
- Investing in symbolic, visible projects in order to enhance one's own prestige (hosting the Olympic Games, building the largest library or cathedral ever, etc.)
- Distributing rents within networks of friends ("crony capitalism")
- The revolving door (for example, E.On in Germany has on its payroll the former Chancellor, the former Minister for Economics, and the former Secretary of State for Energy)
- Undercover finance of political parties in exchange of favours. To achieve that goal, many techniques are available and some of them – as extracting a bribe from procurement contracts – are not necessarily nationalistic in nature. However, there clearly is scope for an incumbent government to use state-owned firms for political financing, and this option would be much less convenient should these firms be private and/or foreign-owned.[11]

These motivations generate different kinds of biases. The political clientele motivation may induce governments to resist deregulation and openness to foreign competition to the extent that they use public services providers and the like to manipulate the price system in favour of selected groups of voters. Hence, for example, the pricing policy of a public firm may involve an implicit subsidy to these groups. If competitors were allowed to enter, they could soak other groups out of the firms' customer base; the firm would eventually remain only with its subsidised customers, and thus incur losses. In the end, the subsidy would have to be removed, which would be detrimental to the politicians.

The network motivation induces the élite to retain control of a number of firms, which allows them to exchange benefits in the form of board seats or stock options. As argued below, this probably comes at the expense of good governance and competitiveness, which means that a takeover of a firm controlled by the network by an outsider would enhance efficiency. To the extent that such a takeover threatens the rents accruing to the network, and that outsiders are likely to come from abroad, the network has an interest in lobbying for nationalistic policies which would block such a move (see again Box 6.4).[12]

4. The economic costs of nationalism

While the preceding section has analysed the potential causes of nationalistic policies, we now study in greater detail the nature of the economic costs it imposes on society. We study five different aspects of these costs: Sectoral diversion of resources, lack of market discipline and poor corporate governance, productive inefficiency at the firm level, distortions in competition, and coordination failures.

4.1 Sectoral diversion of resources

The most obvious cost of nationalistic policies is that they often divert resources from more to less socially profitable activities. That is especially true of policies that aim at promoting "poles" and taking advantage of externalities in contexts where these externalities are in

[10] Clearly, that is likely to happen if their national producer is not too inefficient. Otherwise, the efficiency gains to domestic consumers from switching to foreign suppliers will exceed the monopoly rent transferred abroad.

[11] The evidence on such activities is scarce, given the incentives to hide evidence and block investigations. However, this possibility has been at least considered in the French "Taiwan fregates" scandal. In this complex case, the French national champion Thomson had sold warships to Taiwan. A number of intermediaries, several of them close to prominent politicians, had received bribes. The suspicion that part of these bribes were transferred to the Socialist Party was voiced. Another characteristic of illegal party financing scandals is that parties opposed on the political spectrum often collude (see e.g. Pujadas and Rhodes 1999).

[12] To be sure, the network can also defend its rents while bypassing the government, for example, by playing on the seniority structure of shares. The point here is that the existence of rents creates incentives to support nationalistic policies.

fact poorly understood. A typical example is the Olympic Games, often presented as being good for the economy in terms of GDP and job creation. Although direct economic "benefits" are documented, substantial controversy remains.[13] The studies usually ignore the alternative use of the resources that are channelled into the production of the Games. If one were to take this into account, the conclusion is that organising the Olympic Games is probably inferior to spending the same amount of money on more useful public goods (health, education, roads, housing projects etc.).[14]

The key point here is that one has to distinguish between any true externality generated by a project (environment, learning etc.), as discussed above, and pure pecuniary externalities that consist in boosting economic activity thanks to sheer spending. The latter is desirable only to the extent that economic activity is believed to be inefficiently low, which may be true because there is insufficient competition in goods markets, rigidities in the labour market, or because the economy is in a temporary slump. Otherwise, people are artificially induced to work too hard or in the wrong sectors. Furthermore, even if stimulating activity is desirable, that does not imply that one should forget about the economic benefits of a project: the socially most profitable projects should still come first.

4.2 Lack of market discipline and poor corporate governance

A number of aspects of economic nationalism are detrimental to an efficient allocation of resources as they weaken market discipline, thus reducing incentives at all levels of a hierarchy. This problem arises not only for firms that are partly or totally owned by the state, but also, more generally, for firms that receive state aid or private firms whose management is controlled by networks of influence rather than shareholder democracy.

A firm that receives state aid has little interest in cutting costs and in improving product quality, as losses are expected to be offset by the government. The firm's managers will have little incentive to rationalise production processes, to recruit workers adequately, to resist pressure for wage increases and to innovate. If managers' political connections are strong enough, they also face little threat of being dismissed for poor performance. Or their perceived cost for being dismissed may be small, as they can rely on their network of influence to find other prestigious and well-rewarded positions. On the other side, regulators have little incentives to enforce rules and issue warnings if they are members of the same networks as the CEOs of the firms they are supposed to supervise. As networks often reward their members by offering them positions in the private sector, civil servants face a conflict of interest between their own career concerns and their monitoring duties. Furthermore, if the state itself is a shareholder, it may assign to the firm goals that are motivated by politics rather than profitability. The government will then naturally be reluctant to retaliate against a CEO who fails to deliver adequate profits (see Box 6.5 on the Crédit Lyonnais scandal). In the case of a publicly listed company, which may potentially end up in the hands of foreigners, the government will be tempted to indirectly condone mistakes made by the management by buying the shares when disgruntled shareholders sell them, in order to preserve national ownership. (This is illustrated by Airbus's recent troubles, which are discussed in Box 6.6.).

Kramarz and Thesmar (2006) have documented and quantified the negative effect of crony capitalism on shareholder value in large French firms. These authors first find that the importance of the network of former civil servants in France is huge: more than 50 percent of the assets on the French stock market are managed by former top civil servants. Furthermore, the network is effective in securing positions for its members. The proportion of former civil servants who are graduates of the Ecole Nationale d'Administration in boards is 16 percent when their CEO graduated from that school, but only 6 percent otherwise. Similarly, the average proportion of former civil servants who graduated from Ecole Polytechnique in boards is 3 percent but goes up to 12 percent whenever the CEO is also a former civil servant who graduated from that school. Finally, and most interestingly, network members shelter themselves from market discipline: While the average CEO's probability of losing his or her job goes up by 4 percent when the return on assets falls by 6 percent, the effect is quantitatively and statistically insignificant for the members of the network. The authors also point out that network CEOs typically hold several directorships on other boards, which has a negative impact on rates of returns, and that stock markets react positively to acquisitions made by non-members but not to acquisitions made by members. This latter effect suggests that the market believes that the network members will not use the acquisition to exploit margins of increased profitability

[13] See Berman et al. (2000), Hotchkiss et al. (2003) and Veraros et al. (2004).
[14] An exception is when the public goods cannot be provided otherwise because of political or institutional constraints and the Olympic Games provide the rallying point to do so.

Box 6.5

The Crédit Lyonnais scandal

The Crédit Lyonnais scandal illustrates a number of pitfalls of economic nationalism:

- The interference of politicians that leads to confusion between partisan goals and the goal of maximising shareholder value.
- The role of networks of influence and the private rents that are derived from them.
- The lack of market discipline, which leads to poor risk management.
- The likely inability of state ownership to prevent illicit activities from taking place.

In 1995, the French, state-owned banking giant Crédit Lyonnais was bailed out by the French government, which transferred all the bank's debt to an ad hoc company, "Consortium de Réalisation". The cost to the French taxpayer, depending on estimates, ranged from 10 to 30 billion euros, up to 2.5 percent of GDP at that time.

What happened? Under the leadership of Jean-Yves Haberer, a member of the French civil service elite, Crédit Lyonnais had pursued a policy of aggressive expansion, buying assets and making loans that turned out to be quite poor. Among the operations made, one example was a "major office block development in the northern French town of Lille that helped local politicians to regenerate the town but then proved difficult to let" [ERisk.com]. Indeed, Haberer's defence was that he was working in close cooperation with the French government "as he expanded the bank and preserved jobs in French industry by extending credit to shaky companies". Thus, political interference blurred any notion of risk/return management and led to an accumulation of projects that eventually threatened the company's solvency.

Another dubious operation involved the purchase of the US insurance company Executive Life, which, according to US authorities, was in violation of regulations. Yet another example is the 1987–1990 purchase of two film production studios – including the MGM studios – with Crédit Lyonnais funds by two Italian businessmen, Giancarlo Parretti and Florio Fiorini, who were both involved in financial scandals at that time. These businessmen managed to convince Crédit Lyonnais to repeatedly lend them large sums which vanished as MGM was forced into bankruptcy by its other creditors, following a liquidy crisis. This episode shows that state ownership did not prevent barely legal transactions from taking place. Quite the contrary, state involvement as the firm main shareholder creates a conflict of interest for those who have to enforce the law.[a]

[a] The criminal charges associated with the Crédit Lyonnais case are summarised at http://www.sgrm.com/art43.htm.

in favour of shareholders but to redistribute private rents in favour of the network itself.

4.3 Productive inefficiency at the firm level

Another aspect of economic nationalism is that it imposes wrong choices on firms. A traditional example is the Concorde, which was a technological marvel valued as such by politicians, but which turned out to be a poor idea in terms of market potential, in part because of its design. In the case of Airbus, much more attention is being paid to the market, but, as Box 6.1 showed, the organisation of production is biased by political influence. The proliferation of production sites reduces productivity for several reasons. First, more resources have to be devoted to transportation and coordination. Second, some plants may be too small and not exploit economies of scale sufficiently. Third, some plants may be located in inadequate places that lack an appropriate supply of skilled workers, and of services and amenities required to attract top managers. This has an adverse impact on the quality and cost of the workforce.

4.4 Distortions in competition

State-supported companies also distort competition. If their creditors know that they will be supported by the state in case of losses, they have a lower risk of bankruptcy, and consequently will benefit from a lower cost of funds. This will give them an edge over their competitors, which may help eliminate them. As an example, the partly state-owned airline Airfrance has reached a 96 percent market share in the French domestic market, after eliminating a number of its rivals, despite the fact that these maintained lower prices.

In that respect, partial privatisation of a publicly owned firm does not bring many economic benefits, as long as the government retains a substantial minority stake. The incentives for public recapitalisation in case of financial troubles remain large, with the associated distortions in competition. The company may be used for other goals than shareholder value (accounting tricks to comply with public finance objectives,[15] overemployment for social purposes,[16] etc.).

Other distortions to competition may arise from the conflicts of interest that the state faces as a regulator, a law enforcer and a provider of public infrastructures, on the

[15] In 1998 the French government "stole" the pension fund of the state-owned France Telecom in order to better meet the Maastricht criteria for monetary union (The Register, 30 Nov. 1998): http://www.theregister.co.uk/1998/11/30/french_prepare_further_france_telecom/.

[16] An example, among many, is the recent French government interference in the decision by SOGERMA, a subsidiary of Airbus/EADS, to close a plant near Bordeaux in France. For details, http://fr.news.yahoo.com/23052006/290/le-gouvernement-veut-une-solution-alternative-pour-la-sogerma.html.

Box 6.6

Nationalism and corporate governance at Airbus

As we have seen in Box 6.1, nationalistic concerns have distorted the production structure of Airbus to a substantial extent. The same is true for its governance structure, which has been repeatedly influenced by nationalism rather than economics. Initially, Airbus was a consortium of aerospace companies. When it was consolidated into a corporation, the French government intervened so as to retain the upper hand in the new parent company that was created, EADS. The trick was to make the French share bigger by forcing Aerospatiale, the French state-owned partner in Airbus, to merge with Matra, a French private defence and media company. This structure allowed for further discretionary interventions and anomalies. For example, the new company EADS had two CEOs: one German, one French. This clearly hampers the consistency and credibility of decisions, by replacing vision with constant bargaining between executives who presumably represent their own countries' governments' interests more than those of the other shareholders. The CEO position was finally unified, but, according to *The Economist* (9 Nov. 2006), crony capitalism again came into play as the French presidency had a big influence on the appointment of the new CEO.

Most worryingly, when, after Airbus's recent troubles, the initial private owner of Matra sold his shares, these were actually bought by a French public savings-and-loans institution, the Caisse des Dépots et Consignations. That is, the French government, which induced the merger between Aérospatiale and Matra to keep French influence at critical levels, is now renationalising EADS in order to maintain that influence. Such discretionary behaviour clearly conveys the wrong signals to the managers, eventually putting them in the same situation as the managers of a pure publicly owned company that expects its losses to be bailed out by the taxpayers. By buying shares in order to preserve national ownership, the government is pushing their price above their true market value, thus damaging both the informational efficiency of financial markets and the incentives faced by managers.

one hand, and as an owner of one of the competitors, on the other hand. In this case it is very difficult to believe that the regulator can maintain its independence.

4.5 Coordination failures

An obvious aspect of economic nationalism is that its potential benefits for an individual country are usually offset by the nationalistic policies of competing countries, while the costs in terms of distortions usually remain. Take, for example, the transfer effect. As argued above, each country has an incentive to delay its own deregulation, so as to benefit as long as possible from the transfer effect; in equilibrium, everybody delays deregulation, and the attempt to extract transfers from neighbouring countries therefore fails. The only effect that remains is that consumers pay a high monopoly price for too long, which harms everybody.

Similarly, consider the infant industry argument. Assume a country subsidises its firms in a given sector. If, at the same time, foreign countries subsidise their own national champions, the home country may end up unable to accumulate enough knowledge so as to compete with the rest of the world. The national champions will never become competitive, and one will never be able to remove the subsidies. Furthermore, the existence of the national champion reallocates market shares away from foreign competitors, which reduces the speed at which they learn, and leads to duplication of R&D costs. Obviously, these two effects are very harmful for the world economy.

The available empirical studies of the effects of Airbus on world welfare highlight these effects, and tend to conclude that, if anything, there is a negative effect on world welfare. As Neven and Seabright (1995) point out, the main positive effect of Airbus on world welfare is that its entry increased competition in the aircraft market, thus reducing prices. However, the estimate is small, essentially because at the time of their study, there was a third participant (the American aircraft manufacturer McDonnel Douglas) in the market. To be sure, Boeing and McDonnel Douglas merged thereafter, but it is unclear that the merger would have taken place if Airbus had been absent from the market. As for European residents, they benefit from the transfer effect: Boeing's monopoly rents are reduced and transferred to Airbus. But European residents are also those who pay for Airbus's subsidies, which benefit consumers in the rest of the world. Finally, duplication of R&D costs and reduced learning effects at Boeing also tend to generate negative effects for world welfare. Neven and Seabright conclude that entry by Airbus has benefited European consumers (because of the transfer effect) but harmed world consumers as a whole (see Box 6.7). Clearly, the US government can be tempted to reverse the transfer effect by subsidising Boeing such that it expands its market share, which would eventually leave both US and European consumers worse off than if Airbus had not entered the market.

5. Will economic nationalism prevail?

Cross-border merger activity is gathering pace in Europe. 2005 and 2006 saw large value mergers or acquisitions such as Italy's Unicredit of Germany's HVB in the banking industry and France's Pernod Ricard of the UK's Allied Domecq in the food and drink sector. The pace of activity in utilities has been especially hectic: France's Suez has acquired Belgium's Electrabel and

Box 6.7

Global effects of Airbus

In an influential study, Neven and Seabright (1995) calibrate a simple model of imperfect competition to estimate the effect of subsidies to Airbus on the welfare of consumers in Europe and elsewhere. They find only a small effect of Airbus's entry on prices: – 3.5 percent. The estimated profit loss for Boeing (in 1995) is 100 billion dollars, while Airbus's profits are around 50 billion dollars. As prices are only moderately lower, the bulk of the lost profits are not appropriated by consumers but dissipated in the form of duplicate fixed costs and lower productivity.

Suez in turn was solicited by Enel in 2006. E.On has launched a bid for Endesa in the energy sector. France Telecom has bought Spain's Amena and Telefónica (Spain) has acquired O_2 (UK). Cross-border mergers are an increasing proportion of the total, and activity within the EU15 is now the most important component of this trend, as stated in last year's EEAG report.

The wave of cross-border movements in Europe has aroused the protectionist instincts of some European governments. However, this does not necessarily mean that governments are succeeding in their attempts. In Italy, BBVA and ABN-Amro attempted to take over, respectively, BNL and Antonveneta, to find the former Governor of the Bank of Italy firmly opposed to the deals. BBVA had already had trouble before when trying to merge with Unicredito. But the Governor of the central bank was forced to resign and in the end BNL was acquired by BNP Paribas (itself an outcome of the triangular battle BNP–SG–Paribas that ended up in the merger BNP–Paribas because of the insistence of the French government on a "French" solution), and the Antonveneta bid eventually succeeded. At the same time, the Italian Unicredito bought the German HVB and Poland was attacked by Brussels when trying to put obstacles to the absorption of a Polish bank by the merged Unicredito and HVB. When E.On launched a bid for Spain's Endesa, solicited by the company to defend itself from Gas Natural of Spain, the Spanish government reacted by enlarging the powers of the energy regulator to potentially put obstacles to the German firm. However, pressure from Brussels has led Spain to backtrack on this route. Another instance where the protectionist reaction failed to deliver is the finally successful bid of the European steel producing champion, Arcelor, by India's Mittal.

Despite all this, protectionist reactions have had, at least, some partial success. When Spain's Abertis proposed a friendly merger with Italy's Autostrade (highway concessions), the Italian government, at the instigation of the Minister Di Pietro put up all kinds of obstacles, and former European leaders, like Prodi (president of the European Commission) or Padoa-Schioppa (member of the Executive Board of the ECB), could not resolve the situation. In essence, the Italian government changed the rules for highway concessions in the middle of the merger move, generating substantial material uncertainty about the future concession terms. At the end of 2006, Abertis and Autostrade postponed the deal until the regulation is clarified. For the moment, European Commission pressure has not been able to remove the obstacles to the deal. When Enel eyed Suez, French Prime Minister Dominique de Villepin reacted by proposing instead to merge Suez with the public GdF. France, in this case, seems to be getting its way: for example, the French government has been allowed by the European Commission to keep a golden share (a controlling stake) in a privatised GdF. A French solution was also found in the merger of Aventis with Sanofis in the pharmaceutical industry, and the French government preferred to take a 20 percent take in the ailing infrastructure provider, Alstom, rather than accept a partial takeover by Siemens. France has also passed a law allowing poison pills as a defence against takeovers.

The UK stands alone as a case of no restrictions to foreign acquisitions. Indeed, the paramount example is the City. The "big bang" opening London's financial market to competition consolidated London as a leading international financial marketplace, but basically no investment banks from the UK were left.

Examples of foreign acquisition abound, like Telefonica and O_2 in telephony, Ferrovial and BAA (British Airport Authority), Banco Santander and Abbey, and the very recent move on Scottish Power by Iberdrola in the energy sector. Santander was able to acquire Abbey because the UK has an active competition policy and the antitrust authority blocked the takeover of Abbey by Lloyds TSB in 2001. In all these cases, as in the acquisitions of the utilities Powergen and Thames Water by the German RWE, the mergers have taken place in regulated sectors where a "public service and security of supply" concern is present. This open attitude should not be surprising. In regulated sectors, the national regulator is in control of the activities of the firm and can protect the interests of the local consumers.

In general, national governments and regulators have considerable leeway in affecting the profitability of reg-

ulated firms. If the industry has natural monopoly segments, like energy or transportation, the regulator will retain power over investment plans, rates and quality in the natural monopoly or bottleneck segment: transmission and distribution of electricity or the road in a highway concession. The impact on consumers or users of the bottleneck segment is therefore basically in the hands of the regulator. The government is responsible for having in place a regulatory framework that induces investment and the supply of quality at reasonable prices for users.

In industries with no natural monopoly segments, like banking, the role of competition policy authorities is more direct in making sure that the merged firm has no excessive market power. In summary, cross border mergers are on the rise despite the obstacles put up by national authorities because of the pressure from Brussels – in the banking sector Brussels now wants to limit the powers of central banks and national regulators to block foreign takeovers, for example – because of the discipline imposed by international capital markets on firms quoted in the stock market, and because of the fact that countries may fear retaliation if they shut their borders to cross border mergers.

6. What to do?

We are now in a position to discuss what can be done to address the challenges of economic nationalism. We essentially offer two prescriptions:

- Improving the effectiveness of competition policy by breeding more coordination and harmonisation of regulation.
- Phasing out the public ownership – whether it be full or partial – of all corporations that operate in a competitive environment

6.1 Coordinating competition policy

As stated in Section 1, our perspective is the welfare of European citizens. We have seen that even if national governments are benevolent in that they maximise the welfare of their own citizens, they can act so as to harm the welfare of the citizens of other EU countries. An example we have given above is how individual countries can attempt to delay deregulation at home, while benefiting from it abroad, which may lead to the deregulation process being stalled for everybody. As far as such discretionary nationalistic interventions are concerned, the existing apparatus of European competition policy partially addresses these issues. Unfortunately, these tools are limited because of the different regulatory and ownership structures in different countries. European competition policy can control state aid and may be effective in checking support to national champions. It may also serve as an external commitment to not keep inefficient institutions in business. But it still cannot overcome regulatory barriers or limit the activities of state-owned firms except under the competition statutes. Regulatory asymmetries have to be overcome by harmonisation of regulation, coordination of regulators, and the establishment of European regulators. National regulators should be integrated, sector by sector, into a European system with common rules. In energy markets, for example, transmission (high-tension grid) and transport (pipelines) should be unbundled, because they are a natural monopoly and the control of this bottleneck by vertically integrated firms has high exclusionary potential. Interconnection capacity across boundaries should be managed at the European level since firms and national regulators may not have the right incentives to provide interconnection capacity across countries. In general, a European system of regulators may be a commitment device to avoid opportunism and resist political pressure. A step in the right direction is the recent move by Brussels to limit the leeway of central banks and national regulators to block foreign takeovers in the banking sector.

There is also a timing issue. Barriers in EU countries should be lifted simultaneously to avoid the strategic gaming and positioning of large firms and countries that follows from asymmetries. Indeed, a country that disarms and liberalises earlier than others puts the consumer first but may forego the opportunity to have some global enterprises, strong enough to compete in an integrated market. Such enterprises may give rise to positive local spillovers in the national economy and capture rents abroad. A piecemeal approach to liberalisation, with it taking place at different speeds in different countries, implies that large firms can use their lobbying capacity to enlarge and consolidate positions in the wake of market integration in regulated sectors. Those positions may entail a first mover advantage in the presence of scale and networks economies.

Still another danger is for Brussels to support pan-European champions that later end up effectively protected from closure. As we argued in our 2006 EEAG report, the political economy of European champions may imply that the powers of European competition policy, with the present institutional structure, are very limited to deal with those cases. This is one instance

where global coordination of competition policies may help.

6.2 Fixing the state ownership issue

Distortions introduced by state-owned firms cannot be addressed exclusively with competition policy. This is so because public firms distort the market for corporate control, and therefore industry restructuring, in a fundamental way. Our discussion suggests that one should seriously consider introducing a European rule which would severely restrict indefinite public ownership or even partial such ownership of corporations. In this chapter, we do not take a stand on the desirability of state monopolies. Although policymakers have been increasingly aware of their costs, there are traditional economic arguments in their favour. For example, a state monopoly can provide a public good that would be underprovided by the market,[17] or set prices efficiently under increasing returns to scale (in this situation, a private monopoly would arise under laissez-faire, and prices would be too high).[18] These arguments are now viewed as weak in light of the poor performance of state monopolies in terms of cost-cutting and innovation – it is indeed that scepticism that has led to the waves of deregulations that Europe has experienced since the 1980s. But these arguments nevertheless have some economic legitimacy. On the other hand, there is no good reason why there should be a grey area where fully or partially publicly owned firms compete on equal grounds with their private counterparts. Such a situation leads to the distortions that we have documented above. But, as we have seen, there are a number of bad reasons why such situations arise. Government support for economic activity should be based on well-identified market failures. These failures are market-specific, not firm-specific. The most appropriate interventions are therefore non-discriminatory taxes and subsidies, not public ownership of a subset of the market participants.

While our proposal to radically restrict public ownership in competitive environments may sound revolutionary, our analysis suggests that its implementation would go a long way toward eliminating the incentives for harmful nationalistic intervention. Indeed, most of the remaining public ownership nowadays is a remnant of the past that persisted for no good economic reason. There is no talk of increasing public ownership anywhere in the developed world. It would be welcome to conclude this disengagement process and to implement an EU regulation restricting governments from owning corporations. Such a rule would not be shockingly intrusive in light of other EU interventions in national policies, for which the economic justifications are not so clear.

[17] In such a case the firm is little different from an administrative service, and the use of the corporate form may be dictated by considerations alien to this chapter's focus, such as the need to bypass the rules of public accounting, etc.
[18] See Dupuit (1849, 1851), Allais (1964), Boiteux (1956), Guesnerie (1975) and Laffont (1988).

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