Make Way for China's Railway
By Robert D. Atkinson

Last month Margarethe Vestager, head of the EU's competition agency, vetoed a merger of two leading European firms: rail companies Alstom and Siemens. Siemens and Alstom had agreed to merge their rail assets in order to create a combined firm with greater ability to compete against world-leading Chinese state-owned rail company, Chinese Railway Construction Corporation (CRCC). But Vestager would have none of this, stating: "We can't build those champions by undermining competition."

If this were 1999, Vestager's veto might have made sense. Back then China had no real high-speed rail industry. But in 2004, China's State Council developed a railway strategy based on requiring, in violation of World Trade Organization (WTO) rules, foreign rail companies to enter into joint ventures and transfer technology as a condition of market access. Given that China was building the world's largest high-speed rail system, no foreign provider could afford to sit out.

The plan, coupled with massive state subsidies, paid off as Chinese producers rapidly gained market share. But the Chinese government understood something that Vestager has not: to gain market share outside of their protected home market, the firms needed scale. So the government merged the two leading Chinese rail companies into a powerful national, state-owned champion. Not only is CRCC virtually guaranteed Chinese rail projects, it is aggressively exporting trains backed by massive government export subsidies. By 2016, CRCC had over two-thirds of global deliveries, taking significant market share away from Alstom and Siemens.

In the face of this distorted competition, the EU had three choices. First, it could close its market to protect domestic companies, while subsidizing Alstom and Siemens. Clearly this was not in the cards, and as the region committed to globalization and open markets, not something Europe should do.

Second it could challenge China's unfair practices in the WTO. One supporter of Vestager's decision writes, "the solution for the EU rail industry will, in part, turn on a coalition of countries forcing China to play by the rules of fair competition." Vestager agrees. But how is the EU supposed to do this? The WTO has no actionable provisions against monopolization. And its provisions against subsidies and forced technology transfer have proven largely unenforceable. Also where was Vestager when China allowed the two firms to merge into CRCC in 2015. That was the time to challenge their merger. Maybe EU leaders believe that if complain loud enough Chinese President Xi Jingping will say he's sorry.

The third choice is to enable mergers so that combined firms get the scale needed to compete against protected foreign champions. Opponents will deny that scale matters, even arguing that scale makes firms less agile. Maybe scale doesn't matter in the dry cleaning business, but as my coauthor Michael Lind and I argue in Big is Beautiful: Debunking the Myth of Small Business, scale is a matter of survival for many firms in advanced technology industries. To start, scale can provide valuable efficiencies. Alstom and Siemens estimated the merger would have provided annual savings of €470 million. Even if that figure is overstated by half, it's still real savings. Moreover, studies show that large firms are also often more innovative than medium-sized firms, in part because they have the scale and scope to invest significant sums in R&D. Finally, advanced industries like high speed rail are characterized by high fixed costs relative to marginal costs: designing and build the first train is vastly more expensive than building the second so additional sales allow more profits to be plowed back into develop the next generation of innovations. That is why with its larger market share CRCC was able to invest €1.25 billion in R&D 2017, compared to just for Alstom €194 million (three times less than CRCC as a share of sales). Over time, that difference will be decisive in determining market share, and even survival.

So when Vestager says that “we want business to have competitors,” she should instead be saying, “we want EU businesses to be in business”, because the risk is that the Chinese champions will put them out of business, leaving an even more concentrated market. Preventing firms from merging in order to retain the ability to compete makes a mockery of the consumer welfare standard. Vestager is saying no EU firms can merge if the combination imposes the slightest possible harm on EU consumers, even if that means massive harm to EU workers in the medium term. Going down this path will mean weakened and shrunken European competitors and a resulting greater pressure on European policy makers to turn to protectionism. The European Commission has announced that it will being a process to reevaluate competition policy in light of competitiveness concerns. That process cannot begin soon enough.