Why consolidation favors consumers in industries with horizontal subcontracting

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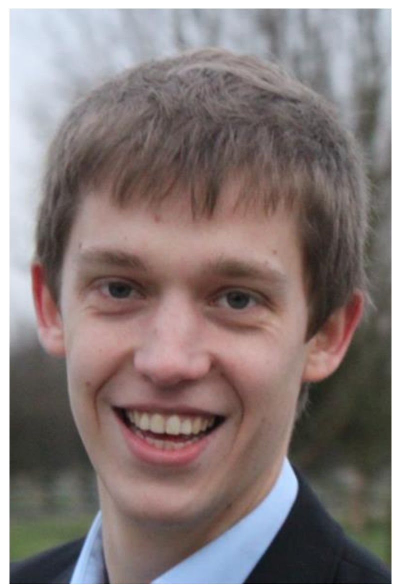

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Horizontal subcontracting—outsourcing activities to competitors—follows from the idea that the firm winning the contract or serving the consumer, is not necessarily the firm that can produce or deliver at the lowest cost. For example in the construction industry, by contracting part of the job from competitors, firms can make better use of the available capacity in the market. Horizontal subcontracting is also common in the financial sector, where banks often share the risk of issuing a large loan among a *group* of lenders. When competing for a large contract, firms would find it difficult to offer a good price if they would have to fulfill the commitment on a stand-alone basis.

Unfortunately, horizontal subcontracting raises competitive concerns. The intuition is that, if a firm wins a contract and makes a sale to a final consumer or procurer, it foregoes the possible profits from subcontracting. Instead, it ends up *paying* subcontractors to perform a part of the workload. So, the possibility for firms to profit from subcontracting acts as an opportunity cost of winning and drives up the price that consumers pay. If a firm can earn a nice profit from selling to competitors, why would it bother to compete fiercely for consumers instead?

Our recent research finds that this competitive concern is more severe for a fragmented industry with many small firms than for a concentrated industry with a few large players.

The argument for consolidation

When there are many small firms, the one that wins the contract would have to exert enormous effort to complete the contract on a stand-alone basis. The winner therefore relies desperately on subcontracting services. Costly subcontracts are a natural result, because the winner has little alternative but to accept what is offered by the subcontractors. The subcontractors, in turn, earn substantial profits. Therefore, with many small players, firms do not *want* to compete fiercely to win the contract because they can earn a nice profit from subcontracting. Moreover, they *cannot* charge a good price because subcontracting is so costly.

The answer is consolidation. By merging or participating in a tender together, firms become larger and have to rely less on subcontracting. That makes merging profitable for two reasons. First, by winning the contract *as a group* of firms, a smaller portion of the workload is outsourced to competitors**;** more can be produced in-house. Second, the merged firm realizes a better deal with its competitors simply because it does not need the subcontractors so badly.

Consumers benefit from consolidation for the same reasons. The winning firm, since it is larger, turns to outsourcing less frequently, and if so, is not willing to pay a lot for it. Firms that do not win the contract therefore do not profit much. So, in a concentrated market, firms *want* to compete fiercely because the alternative results in low profits. Moreover, they *can* offer a good price because they are sufficiently large to complete a large portion of the contract in-house at a reasonable cost.

Mergers and horizontal agreements in industries with horizontal subcontracting

The effects of a merger between horizontally subcontracting firms differ from traditional merger analysis in several respects. First, there is less scope for cost reductions as a result of the merger. By way of illustration, *before* the merger, firms already use subcontracting to allocate the workload cost-efficiently across firms. Cost reductions as a result of the merger, if any, must therefore result from other possible synergies like learning effects or management efficiencies. However, second and importantly, our analysis uncovers that mergers in industries with horizontal subcontracting *do not need* to reduce costs in order to reduce the equilibrium price. Even without cost synergies, consolidation reduces the profits that firms can make from selling to competitors, and thereby gives firms an incentive to compete fiercely for the consumer or procurer instead. This result has important implications for competition authorities that evaluate the effects of mergers. Increased concentration with horizontal subcontracting can be pro-competitive without reference to an efficiency defense. Similarly, this insight is also reflected in agreements falling short of a merger. If bidding consortia are assessed as not restricting competition, article TFEU 101(1) does not apply and there is no need to refer to the efficiency defense exemption provided by TFEU 101(3). Cost reductions are not a necessary condition for a merger or a bidding consortium to reduce the price.

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