United Nations Conference on Trade and Development

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COMPETITION, COMPETITIVENESS AND DEVELOPMENT:

LESSONS FROM DEVELOPING COUNTRIES

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Foreword

For nearly four decades, UNCTAD has been dealing with the issue of anti-competitive or restrictive business practices. As evidenced by the rapidly growing number of countries involved in the preparation, adoption and implementation of competition laws and policies, there is growing awareness among developing countries, including the least developed countries (LDCs), of their special needs in this area. This publication thus focuses on the policy options available to these countries and on the role of competition policy in the overall design of a coherent development strategy.

The volume highlights the prerequisites for successful implementation of a development-oriented competition policy. It also elucidates the mechanisms through which competition policy can contribute to improved economic performance by fostering enterprise development, investment, productivity and export performance.

The key arguments of the book build on specific lessons from developing countries on the adoption and implementation of competition laws and policies. The selection of countries for case studies was motivated by an interest in shedding light on the experience of a wide range of developing economies, including such relatively advanced developing countries as South Korea, Brazil, Peru, Thailand and South Africa, and such small least developed country economies as Nepal, United Republic of Tanzania and Zambia.

The fundamental message to be derived from the empirical findings and policy experiences presented in the publication is that merely adopting a competition law is no panacea. As the contributors show in their analyses, significant efforts are needed to ensure that competition policies are implemented well and have the desired developmental effects.

The book makes a series of recommendations for policy changes and institutional reforms needed to promote domestic competition, international competitiveness and development. It is my hope that this publication, which is being launched on the occasion of UNCTAD XI, will raise awareness and enhance expertise among public policy officials, private sector stakeholders, consumer organizations and civil society in general about the crucial importance of competition law and policy for creating competitive enterprises in developing countries.

I would like to take this opportunity to thank the International Development Research Centre (IDRC) for its invaluable support in carrying out this research project.

Rubens Ricupero
Secretary-General of UNCTAD

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Acronyms

ACCC	Australian Competition and Consumer Commission
ALAFACE	Asociación Latinoamericana de Fabricantes de Cerveza (Latin American Association of Beer Manufacturers)
AMBEV	American Beverage Corporation (Brazil)
ANA	Brazilian Water Regulatory Agency
ANATEL	Brazilian Telecommunication Regulatory Agency
ANC	African National Congress
ANNEEL	Brazilian Electricity Regulatory Agency
ANP	Brazilian Petroleum Regulatory Agency
ANTQ	Brazilian Waterways Transportation Regulatory Agency
ANTT	Brazilian Overland Transportation Regulatory Agency
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
CADE	Competition Defence Administrative Council
CAN	Comunidad Andina de Naciones (Andean Nations Community)
CCU	Compañía Cervecerías Unidas (United Breweries Company), Chile
CLICAC	Comisión de Libre Competencia y Asuntos del Consumidor, Panamá (Commission for Free Competition and Consumer Affairs)
CMQ	Cervecería y Maltería Quilmes (Argentina)
CNDC	Comisión Nacional de Defensa de la Competencia, Argentina (National Commission for the Defence of Competition)
COMESA	Common Market for Eastern and Southern Africa
DTI	Department of Trade and Industry
EU	European Union
FDI	Foreign direct investment
FTC	Fair Trading Commission
GDP	Gross Domestic Product
ICN	International Competition Network
IMF	International Monetary Fund

INDECOPI	Instituto Nacional de Defensa de la Competencia y de la Protección de la Propiedad Intelectual, Perú (National Institute for the Defence of Competition and the Protection of Intellectual Property)
KFTC	Korea Fair Trade Commission
LDC	Least Developed Countries
M&A	Mergers and Acquisitions
MRFTA	Monopoly Regulation and Fair Trade Act
OECD	Organisation for Economic Co-operation and Development
OSINERG	Organismo Supervisor de la Inversión en Energía
PROCOMPETENCIA	Superintendencia para la Promoción y la Protección de la Libre Competencia, Venezuela (Superintendence for the Promotion and Protection of Free Competition)
QUINSA	Quilmes Industrial S.A. (Argentina)
R & D	Research and Development
RBP	Restrictive Business Practices
SACU	Southern African Customs Union
SADC	Southern Africa Development Community
SAWTEE	South Asia Watch on Trade, Economics & Environment
SME	Small and Medium Enterprises
SMME	Small, Medium and Micro Enterprises
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization
ZCC	Zambian Competition Commission

INTRODUCTION

Lucian Cernat and Peter Holmes

1. The need for competition policy: pros and cons

Standard economic theory tells us that competitive forces work best and deliver the expected outcomes when there exists a market that is not overridden by distortions. The model of free market economies is a theoretical construct with great historical power. It is the model that is introduced at the beginning of every economics textbook and has been canonized with the authority of Adam Smith, the founder of modern economics. Free competition is a fundamental assumption in any market economy and has even been seen as one of the foundations for democratic societies. However, few standard economic texts refer to Adam Smith's *caveat* about the need to "cultivate" free competition. He understood only too well that "people of the same trade seldom meet together even for merriment and diversion, but the conversation ends in a conspiracy against the public or in some contrivance to raise prices" (Smith, 1776). Smith in fact went further than this and devoted many pages to discussing the specific damage done by the monopolistic buying and selling activities of the East India Company in impoverishing both Indian producers and English consumers.

Smith and other earlier writers, such as Alfred Marshall, were realistic in the kind of competition they thought feasible and desirable in a developing economy, such as that of the UK as it first industrialized. Above all, they emphasized the benefits of free entry and exit to and from industries. This insight has been rediscovered in the theory of "contestable" markets and is distinct from the static notion of perfect competition. For there to be dynamic benefits of competition, it must be relatively easy for new and more efficient firms to enter a market and for older less efficient ones to be forced to upgrade or leave. In fact, modern economics has also rediscovered the idea that competition is a trial and error process, not always perfect, as firms enter and leave. The gains from competition are thus not simply that prices will be kept as low as possible for consumers, important as that is in developing countries; they also include the creation of opportunities for new firms, including small businesses, to enter markets and to grow, and the pressure on existing firms to innovate, by which we have to think of introducing new products and services, new ways to manage the business better, and not simply expensive R&D.

Critics of this view sometime argue that safe secure markets for monopolistic firms will provide them with a guarantee of profit for investment and innovation. There are circumstances when this might occur, but there is little evidence that such policies work systematically (see below on the Korean case). In most developing countries, the conditions for perfect competition are far from being met and the possible benefits of competition do not necessarily always translate into additional growth. At the same time, efforts to deregulate markets that are intended to benefit consumers

do not always work. For example, the consumer welfare and developmental benefits resulting from trade and investment liberalization and privatization, in the absence of the appropriate competition rules and supporting institutional infrastructure, have been questioned in the light of the experiences of many developing countries.

For many developing countries, competition law is a recent innovation. This upsurge in interest in competition law in developing and transition economies reflects the substantial changes that have been taking place in the political and economic environment. During the past two decades, many developing countries have instituted a programme of microeconomic reform, involving greater reliance on markets and less emphasis on state intervention. Among the more important changes have been a lowering of tariff barriers, the removal of many quantitative import restrictions, the reduction of subsidies to domestic producers, the privatization of government business enterprises as well as utilities, the easing of foreign exchange controls and the encouragement of foreign direct investment.

Underlying these reforms is a renewed confidence that market forces and the individual decisions of consumers and privately owned businesses, can make a greater contribution to economic and social development than an inward-looking centralized economic system. However, the potential benefits of a shift towards a more market-oriented economy will not be realized unless business firms are prevented from imposing restrictions on competition. Deregulation of previously regulated sectors, including state-controlled monopolies such as utilities and "network industries", for a long time considered for the most part to be "natural monopolies," need to be subject to competition review by competition authorities or sectoral watchdogs to ensure that these firms do not abuse their dominant position in the market. It is now considered likely that competition is possible in markets once thought of as naturally monopolistic, especially telecommunications, but experience worldwide shows us that incumbent monopolists often have tricks up their sleeves to inhibit this.

All these economic reforms have one important feature in common: the need for competition policy if market-oriented policies are to be given the best possible chance of success. For example, price liberalization, if not accompanied by competition laws and policy aimed at controlling economic behaviour and structures, can result in substantial price increases and reduced benefits for the overall economy. If monopolistic structures are allowed to continue unchecked, price liberalization will not proceed satisfactorily. The same can be said of privatization of state monopolies into private monopolies. Finally, opening of markets through import competition and FDI liberalization might bring enhanced competition, but if no safeguards exist, foreign firms might also engage in anti-competitive practices and abuse dominant market positions (UNCTAD, 2002a). This may take the form of predatory behaviour to eliminate local competition,[1] or perhaps more likely cartels and market-sharing agreements possibly in cooperation with local firms, which deny consumers the benefits of trade liberalization. Hence the need for a strong and effective competition law which

will only permit anti-competitive agreements or conduct where there are demonstrable net public benefits.

Although a new arrival among traditional policy instruments applied by developing countries, competition policy as a public policy has developed its own field and criteria in the economies that have only recently begun to open up. A major focus of competition law and policy is the avoidance of market-dominating behaviour of businesses through, *inter alia*, price fixing or market-sharing cartels, abuses by leading firms and undue concentration. Entry and exit are key to this. High concentration and excess profits should be allowed to attract new firms. There is evidence that developing country markets do exhibit the same kind of ecology of entry and exit as developed economies, though the process is far more complex than simply good firms entering and knocking out bad ones. In fact the process is not well understood (Tybout, 1998). The main objective of policy should thus be to promote competition as a means of assisting in the creation of markets responsive to consumer signals, and ensuring the efficient allocation of resources in the economy and efficient production with incentives for innovation. This is expected to lead to the best possible choice of quality, the lowest prices and adequate supplies to consumers, leading to increased consumer welfare. However, there is no contradiction between this "static" efficiency and "dynamic" efficiency, which is sometimes referred to as "competitiveness".[2] Efficient allocation and utilization of resources also lead to increased competitiveness, resulting in substantial growth and development. There is a growing consensus that competition is an essential ingredient for enhancement and maintenance of competitiveness in the economy.

In almost all countries that have a competition law, the stated objective of the legislation is to improve economic efficiency and thus contribute to economic development. It is also widely accepted that the law should aim to increase consumer welfare. While there is a broad consensus among developed and developing countries about the principal objectives of competition law and policy, there are also some differences between countries in the statement of secondary objectives. Some developing economies emphasize that competition law has a role in limiting further increases in the concentration of economic power in the hands of a few large corporations. Other countries see the need to have provisions in the legislation to protect the interests of small and medium-sized enterprises and, in the case of South Africa, for example, the promotion of other social goals for diffusing economic power more widely (UNCTAD, 2002b). It is worth adding that competition policy is a broader concept than competition law. The general promotion of competition in the economy requires a broad spectrum of action, for example in the fields of trade policy and public procurement. The agency in charge of promoting competition may have to engage in trying to persuade the government and business not to do certain things, as well as applying a law against practices that have been identified as actually occurring (see below).

From this short account it becomes clear that competition policy is directly relevant to the main policies of market-oriented economic reforms undertaken in most countries of the world during the last 10–20 years, in particular trade liberalization, foreign direct investment policies, privatization and deregulation. An examination of the relationships between competition, competition policy and the related policies will further clarify this point.

It must be stressed that the argument has many steps to it. It is necessary to establish that competition is, overall, a positive force for economic development. It is then necessary to show that firms left to themselves will resist pressures for markets to operate competitively: they will form cartels, create entry barriers and lobby governments. Once we see this, we further need to show that government policies to promote competition (including having a competition law) can actually remedy this in a cost-effective way. It would be just as naive to suppose that competition policy always works perfectly as to suppose that markets work perfectly when left alone. One of the aims of this publication is to establish what the pre-conditions are to get the maximum benefits of competition and of competition policy.

2. Trade liberalization and competition policy: overlapping or complementary tools?

The liberalization of international trade, including the reduction of tariff barriers and the elimination of most quantitative restrictions on imports and exports, allows producers to expand their horizons to world markets, rather than relying exclusively on small domestic markets. By taking up the new export opportunities, they are able to increase output and lower costs through economies of scale. Moreover, because strong competition is usually encountered in export markets, these firms are generally under pressure to devise more efficient methods of production, better marketing techniques and quality improvements in their products. This often results in lower prices and better-quality goods, not only for foreign customers, but also for domestic consumers. The lowering of trade barriers also increases competition from imports for those local producers of tradable goods and services mainly dependent on the domestic market.[3] The additional competitive pressure obliges these firms also to improve their productivity and keep down prices to consumers.

Based on such arguments, for small open economies, trade liberalization is frequently assumed to provide the required market structure for competitive industries so as to prevent monopolistic behaviour. There are many issues that call for competition policy in the broadest sense, including restrictive distribution arrangements for imports, and the need to control abuses of intellectual property rights[4] (Hoekman and Holmes, 1999).

Trade liberalization alone is often not enough to maintain an optimal level of competition in all economic sectors. A number of trade barriers still exist and new ones are often introduced to compensate for the reductions in tariffs and abolition of quantitative restrictions on trade. For instance, contingent protection and in particu-

lar anti-dumping, has become a major bone of contention in international trade relations. Many economists are of the view that to the extent that dumping is potentially an economic problem for an importing nation, it can and should be dealt with through enforcement of national competition law; it has to be recognized that most anti-dumping actions do not in fact involve "predation" by dominant firms against importing country competitors. On the contrary, it is often observed that, when domestic firms file anti-dumping complaints, this increases the potential for anti-competitive practices to occur at home. Several studies have found evidence that anti-dumping is closely related or leads to different forms of anti-competitive practices. For example, Prusa (1992) and Zanardi (2000) studied the incentives for collusion between domestic and foreign firms involved in anti-dumping investigations. Prusa presented a bargaining model to explain why so many anti-dumping petitions were withdrawn during 1980–1985, when duties had been imposed in only 27 per cent of the investigations initiated by the USITC, while 38 per cent of the petitions were withdrawn and 35 per cent rejected. His model shows that anti-dumping petitions serve as a vehicle to achieve cooperative levels of profits among competitors. Zanardi examined the period 1980–1992 and reached the same conclusion. Using an extended version of Prusa's model, he shows that incentives to collude depend on two basic parameters: coordination costs and the relative bargaining power of participating firms.

Furthermore, trade liberalization may not by itself eliminate the propensity of firms to engage in anti-competitive practices. Firms may simply widen the basis of the cartels they operate. Moreover, when collusion is based on prices, reduced trade barriers may increase cartel stability, by making retaliation for price cutting easier, promoting a more collusive understanding between domestic and foreign competitors about not exporting into each other's domestic markets (something similar to voluntary export restraints, but privately enforced).[5] This argument suggests that, as in other instances, anti-competitive private barriers can easily replace governmental barriers to trade.

Thus, even if one believes that trade liberalization is of vital importance countries may not be able to rely on this delivering its full benefits without a complementary competition policy.

Therefore, even in the presence of more liberal trade policies, an effective competition policy is a highly desirable ingredient since private actors, fearful of the consequences of trade liberalization and stronger competition, may be inclined to protect their interests and market shares by introducing cross-border anti-competitive practices, such as international cartels, abuse of dominance, and abuse of intellectual property rights (IPRs). In some circumstances, such practices can limit international trade even more severely than the former high tariffs and just as severely as the non-tariff barriers. Domestic suppliers may enter into exclusive arrangements with their local distributors, which effectively deny importers access to some markets. Large retail chains may refuse to distribute traded goods. An international cartel may be established to fix prices, so that traded goods cannot be sold more cheaply

than the equivalent domestically produced items. If an effective competition law is in place, such anti-competitive practices can be challenged. However, in countries where there is no competition law, the benefits of trade liberalization could be lost through such anti-competitive conduct in the domestic market.

It is increasingly clear that anti-competitive practices, both domestic and transnational, impair the process of development in developing countries more significantly than has previously been thought. This is true for at least three reasons. Firstly, given their narrow domestic industrial base, developing countries have to rely on imports of intermediate goods. To the extent that such imports are subject to anti-competitive practices either by domestic firms (for example an import cartel) or by foreign suppliers of these imports (for example an export or international cartel), the importing country will be penalized by higher than necessary import prices. The first practice clearly falls within the objectives of a national competition authority.

In a number of papers, Evenett and colleagues[6] have documented the extent to which international cartels still operate in markets where developing countries import a lot and there are increasing concerns that agricultural exports and imports of LDCs are dominated by the small number of traders concerned.[7] Prosecuting cartels among foreign suppliers is a more daunting task for developing countries, which in many cases will need international cooperation.

Secondly, to achieve their developmental goals, developing countries need to rely on export-oriented strategies. However, the gains expected to arise from recently eased market-access conditions at a multilateral level or through preferential schemes will be severely limited if private anti-competitive practices are still in place.

Thirdly, foreign firms feel freer to engage in across-the-border anti-competitive behaviour when the countries to which they export do not have a domestic competition law and can neither individually nor through cooperation with foreign competition authorities challenge the firms' market behaviour. Thus, countries that do not have a domestic competition law will be the prime victims of international anti-competitive practices. Ensuring that measures are in place to deal appropriately with such arrangements should be one of the major objectives of any national competition framework.

3. FDI attraction and competition policy: is there a need for both?

The need for competition law is also evident when foreign direct investment is being liberalized, as the impact of FDI is not always pro-competitive. It is often the case, in fact, that foreign direct investment takes the form of a foreign corporation acquiring a domestic enterprise or establishing a joint venture with one. By making such an acquisition, the foreign investor may gain a dominant position in the relevant market, enabling it to enjoy a high profit margin, and charge prices well above a competitive level. Another scenario often encountered in developing and transition economies, is where the affiliates of two separate multinational companies (MNCs) have been es-

tablished in competition with one another in a particular market, following the liberalization of foreign direct investment in that country. Subsequently, the parent companies overseas decide to merge. With the affiliates no longer independent of one another, competition in a host country may be virtually eliminated and the prices of the product increased, even if the market in the MNC home country may have more competition so that the authorities there need not worry.

These adverse consequences of mergers and acquisitions by MNCs can be avoided if an effective competition law is in place in the host country. As UNCTAD (1997) points out, competition law enforcement signals to firms that inward investment that is motivated by the pursuit and eventual abuse of a dominant position will be dealt with by competition law. As mentioned earlier, one element typically found in competition law is a prohibition of any merger, acquisition or takeover likely to substantially lessen competition or prevent access to a market. Being realistic, we know that even developed country competition agencies have limited scope to ban more than a few mergers outright. However, they can often impose conditions on such mergers – and what is striking is that we find that developing countries, notably South Africa, have also been able to impose conditions, for example brand divestiture on foreign MNCs, provided they act in time (CUTS, 2003).

It is also argued that an economy that has implemented an effective competition law is in a better position to attract foreign direct investment than one that has not. This is because most multinational corporations are accustomed to the operation of such a law in their home countries and know how to deal with any concerns that the competition authority may raise. Moreover, multinational corporations expect competition authorities to ensure a level playing field between domestic and foreign firms, including among MNCs.

However, when considering the prospect of investing abroad in a developing economy without a well-established competition law, foreign investors face the uncertainty of not knowing if, and when, competition legislation will be introduced and, perhaps more importantly, how it will be implemented. There are, of course, other areas of uncertainty that may tend to discourage foreign direct investment, notably political uncertainties, the slow pace of economic development, exchange rate movements, obstacles to international trade and government regulations and, of course, any discriminatory application of competition laws. Nevertheless, when a foreign investor has to make a choice between two or three alternative locations for a particular investment and these are of approximately equal merit, the country that has an effective competition law may be favoured.

In order to ensure that a developing country gains the full benefit of foreign direct investment, government policy in that area must be consistent with the objectives of competition law. Sometimes, in order to attract a large-scale foreign investment by an MNC, a national or local government may offer that corporation exclusive rights to supply its goods and services to the public authorities. It may even agree

that no other firm will be given approval to enter the market in question. Such inducements are evidently anti-competitive, and the crucial question is whether competition policy objectives should be outweighed in certain circumstances by the economic benefits that the foreign direct investment can bring.

4. Competition, regulation and deregulation: conflicting objectives?

Competition law and policy are intended to regulate anti-competitive behaviour by firms, whereas deregulation is aimed at minimizing market-distorting government intervention. Regulation is meant to control the behaviour of firms in sectors where market failures are widespread and where we cannot rely on competition alone. Regulation can pursue different types of objectives. Economic regulation, social regulation, environmental, health and safety regulation are among the main categories of government intervention that may have a bearing on the market and may interfere with competition objectives.

Regulatory policies can become a barrier to competition when measures taken by state administrations (e.g. central or federal government, local government) or by bodies enjoying a governmental delegation prevent or hamper effective competition, e.g. by licensing restrictions on investment for new entry, and lead to a loss in welfare. Such measures are to be found in as diverse activities as telecommunications, financial services (banking and insurance), professional business services (accounting, lawyers, architects, etc.), and the energy sector (electricity, gas), as evidenced by an abundant literature. These measures, which can negatively affect market entry, market exit and market operation, take a wide variety of forms, such as:

- Restraints on competition, i.e. by introducing uncommon norms and standards amounting to barriers to market entry or by preventing foreign firms from competing in a national market;
- Elimination or exclusion from competition laws through exemption of certain activities from the scope and coverage of the competition laws;
- Creation of distortions to competition, such as artificial executive interventions changing the competitive positions of certain firms (through arbitrary public procurement policy decisions, for instance).

Regulatory barriers to competition not only relate to market entry but also can prevent market exiting from happening, for instance through public subsidization or the granting or prolongation of monopoly rights. In addition, they can make it harder for resources to be allocated from one sector or market segment to another. They can be considered barriers to mobility, which prevent resources from being transferred into more-efficient sectors or segments, and which in the end will reduce allocative efficiency (UNCTAD, 2001a).

Aware of this potential conflict of objectives between regulation and competition, a large number of developing countries have undertaken regulatory reforms aimed at ensuring that regulations serve public interests better and reinforce competition in the market place. These reforms have been introduced in industries such as commu-

nications, transportation, water/sewage, agriculture, and financial and professional services. They have included privatization and the liberalization of restrictions on market entry, and have also related to prices and business practices as well as universal service obligations, although there are important differences across countries and industries. One of the principal objectives of these reforms has been to broaden the scope for markets to allocate resources, and improve general consumer welfare and economic efficiency. Given these considerations, there is a clear interface between competition law and policy, deregulation and consumer welfare. Often a public choice would need to be made between the extension of economic regulation and consumer protection under the competition laws in order to avoid potential conflict between these two policies and to promote consumer welfare.

Competition agencies are equally affected by and interested in the regulatory reforms and many have played, and continue to perform, important advocacy and consumer protection roles in the regulatory reform process. Competition agencies have also been instrumental in drawing attention to how regulation has unnecessarily restricted competition and how part of the solution to this problem may lie in the universal application of general competition law. The experiences of many countries show success in removing some of the severe restrictions on competition in regulated sectors. However, despite significant progress through competition advocacy and competition law enforcement reported by many countries, changes in the affected sectors occur relatively slowly (UNCTAD, 2001b).

From a market structure point of view, the competition authorities should be consulted when a process of regulatory reform is being undertaken as part of a privatization programme. They should be given legal powers to impose divestiture measures on existing monopolies or to control or prohibit mergers that undermine competitive market structures. If they are not given such powers, for instance because of a lack of human resources, it should be made possible for them to suggest divestiture measures or merger controls to an executive authority that has those powers. Nevertheless, it is clear that the dominant pattern of distribution of roles between competition agencies and regulatory agencies is rarely one whereby competition authorities simply replace regulatory agencies. Even in the UK, where it was once hoped that free competition would replace all regulation in the telecoms sector, we still see a powerful sectoral regulator. The division of responsibility between competition authorities and regulators has proven difficult to agree in developing countries. Experience suggests that there is a real danger of capture where a regulator has just one or a few major firms as its “clients” (CUTS, 2003; Tirole, 1999).

Studies of these relationships show that the competitive process can be appropriately stimulated by the intervention of competition authorities when firms in a regulated sector abuse their privileges to the detriment of consumer interests and the efficiency of firms that use their regulated services. The experiences so far suggest that there are specific regulatory regimes in many sectors and there is no unique model for the relationship between sector-specific regulators and competition au-

thorities either across countries or sometimes even within a country. However, one particular model – the mandate-driven division of labour approach – appears to be somewhat more common than others. It is clear, at least, that sectoral regulators should be separated from regulated firms or entities and should assume obligations regarding accountability and independence from the executive branch of government. Also, institutional changes should be effected in order to guarantee their independence (UNCTAD, 2001a).

5. Competition policy and broader development objectives: friends or foes?

Competition is unambiguously a good thing in neoclassical economic theory. This stems from a belief that competitive markets give consumers wider choice and lower prices and give sellers stronger incentives to minimize their costs and eliminate waste. In addition, in competitive markets, firms need to innovate and adapt quickly to changing circumstances, thus creating dynamic efficiency. Competition also induces firms to pass on cost reductions to consumers and better satisfy their specific preferences. Ample empirical evidence supports these theoretical arguments. For instance, Nickell (1996) in a study of 670 British companies found that market power (estimated by high market shares) led to reduced levels of productivity, and that more competition (as measured by increased numbers of competitors or lower profit margins) was associated with higher rates of total factor productivity growth. Moreover, in a cross-country study (100 countries over the period 1986-1995), using the presence of an antitrust policy as the main proxy for intensity of competition, Dutz and Hayri (1999) show that competition has a positive impact on growth, both in developed and developing countries. Kee and Hoekman (2003) examined the impact of competition policy on profit margins and concluded that government policies to facilitate entry and exit of firms can have important effects on industry.[8] Tybout (1998) shows that a naïve view suggesting that developing country economies display much less entry and exit by firms than developed countries would be wrong: nevertheless, the evidence he cites suggests for example that in Taiwan half the productivity growth in a 1-year period can be accounted for by more efficient firms replacing less efficient ones.

The benefits of competition may be assessed on the basis of data relating to the effects of collusion or concentration and, conversely, the effects of competition policy enforcement or of deregulation upon productivity, prices, profit margins, the persistence of profits, the flexibility or adjustment speed of prices or profits, incentives for technological innovation, consumer and producer welfare, economic growth and competitiveness in international trade. Some of the effects of competition are not easily measurable, since there are shortages of data and much of the evidence is inconclusive, ambiguous or over-aggregated. There are also sometimes trade-offs to some extent between competition, static efficiency, and dynamic efficiency. Nevertheless, the data available still broadly confirm the benefits of competition. There is also a shortage of data as to the effects of competition policy enforcement and competition advocacy efforts. However, there is still evidence that the application of competition

policy has had an impact, both in individual cases and by having a deterrent effect, helping to create a climate favourable for competition. To maintain such a climate, however, continuing efforts have to be made to enhance the effectiveness of enforcement. Also, deregulation has been more effective when backed up by competition policy enforcement.

Because of these difficulties, there is a paucity of *ex post* studies quantifying the effects of competition law enforcement. Yet, surveys in the United States have found that price cuts tend to occur at the outset of an investigation, before the actual bringing of a case. Even where firms investigated for price fixing are not charged, there may be price reductions, and trend-adjusted prices may remain lower than their pre-investigation levels for a considerable time after the termination of a price-fixing case (Feinberg, 1984). Similar responses to competition cases were found in a time-series study of producer price indexes for 10 products from the mid-1950s to the mid-1980s involved in cases where the European Commission and/or the German Federal Cartel Office (FCO) had found that anti-competitive practices had occurred (Feinberg, 1986). In many developing countries, however, the benefits of competition policy have yet to emerge visibly, because enforcement has been hampered by lack of resources, reliable data, or sufficient information about production costs, market shares and consumer behaviour. However, in many cases, the competition authorities have played an important role in the formulation of liberalization, privatization and deregulation policies, ensuring that their objectives are growth inducing.

Despite such growing evidence of the benefits of adopting a competition law and policy, the gap between the assumptions of theories and the realities in many developing and even developed countries still remains. Several objections about competition policy objectives have been raised. Concerns have been expressed about the emphasis placed on competition in reform programmes on three main grounds. Firstly, it has been argued that competition policy does not allow state authorities adequate discretion in relation to other development policies, in particular industrial policies or strategic trade policies. However, in principle, industrial policy does not necessarily conflict with competition policy. In fact, some economists consider industrial policy to be one of the main elements of broad competition policy, as distinct from competition law, and indeed *vice versa*. Singh (2002) argues that a sound industrial policy should include the promotion of competition, even though he argues that developing countries may also need policies to promote cooperation between firms in some areas. Inadequate institutional infrastructure, low levels of research and development, limited access to capital, inefficient distribution networks, all need policies that will put in place a “competitive” infrastructure which cannot be provided by the market alone. In such circumstances, a non-intrusive industrial policy with clearly defined economic criteria may complement the broad competition policy framework and promote growth and development. Competition policies everywhere contain exceptions and special provisions. Within the EU, for example, competition policy is under an obligation to favour the promotion of small and medium enterprises. It is in fact arguable that this

is an inherent element in the promotion of competition and diversity. Secondly, it has been argued that its effective contribution to economic efficiency is relatively small. Thirdly, opponents of competition policy argue that it gives too much weight to efficiency relative to other societal goals, such as environment protection, income distribution, etc. We see, however, that South African competition law is able to take social objectives into account. Interestingly, it appears that the authorities have rarely, if ever, found that the promotion of competition conflicted with the need to promote the welfare of historically disadvantaged people.

In particular, concerns have been voiced about the constraining effects of competition policy on other development strategies and major debates have addressed the potential conflict between competition policy, on the one hand, and strategic trade and industrial policies, on the other. Strategic trade policy makes a compelling argument in favour of temporary protection suggesting that development requires modern technology, which must be acquired and cultivated, and that learning by doing must occur within national borders and sheltered from import competition. Examples of successful industrial policies are found in past and recent history, particularly in East Asia. For such policies to succeed, governments must be able to identify strategically important industries and some firms that can act as "national champions" once the learning-by-doing phase has been carried out under appropriate funding and protection. However, despite a number a success stories, no systematic positive relationship has been found between firm size and profit, export activity, or research and development, and an equally large number of notorious failures of industrial policy can be cited. Indeed, even if we could show that governments had in the past been able to pick winners by ignoring the, admittedly highly imperfect, natural selection process of the market to help them, we could not be sure that such a process would work today, even in Korea (see chapter by Hur) let alone in other countries with less capability.

It is therefore not surprising that different schools of economic thought have strongly conflicting views on the relevance and the content of competition policy in developing countries. Developing economies, in particular, are even further away than developed countries from this ideal, theoretical world, with respect to how well both governments and markets work. Paul Krugman has written of "a sadder but wiser case for free trade in a world whose politics are as imperfect as its markets" (Krugman, 1987). We can substitute "competition" for "trade". The current discussions on these issues point to the fact that the main policy question that needs to be addressed is not "Competition policy: to have or not to have?" but rather "How to maximize the expected benefits arising from competition, given the existing policy and economic constraints?".

The discussions conducted in various *fora* have already identified a number of cases where a too-narrow definition of competition policy objectives may be detrimental for developing countries. An important paradox is that promoting transparency in market transactions can harm competition by enabling companies to sell at

high prices through tacit collusion. Likewise, aiming at very high quality standards for products to ensure consumers get good-quality products may run the risk that such standards will limit dynamic competition. Excessive competition may also negatively affect the stability of small and medium enterprises. Deregulation of interest rates and rapid entry by new banks in small markets may lead to “excessive” competition, which forces banks to make risky investments to boost their margins, sometimes with destabilizing effects for the entire financial system. Excessive competition was also mentioned as one factor contributing to the downward trend in commodity prices.

Notwithstanding these arguments, “excesses” of competition could hardly be thought to exceed the negative aspects arising from the absence of competition. In fact, there is growing empirical evidence that, in general, more competition leads to more innovation and accelerates productivity growth and that there is a strong correlation between the effectiveness of competition policy and growth. Such analyses suggest that the effect of competition on growth goes beyond that of trade liberalization, overall domestic institutional quality, and a generally favourable policy environment. Yet, this link is not equally strong across all economies. This observation cautions us against being overly simplistic in promoting the importance of competition policy as a major and independent determinant of long-term growth. Competition policy is a complex, cross-cutting policy instrument that is affected by a number of related factors. Failures in the overall infrastructure that effective competition policies need for their enforcement will obviously reduce the expected benefits stemming from the adoption of competition policy and laws at national level. As a number of developing countries still struggle with deficiencies in their overall institutional infrastructure, an appropriate balance should be found between the objectives and reasonable achievements of competition policy in developing countries.

However, these very specific implementation difficulties make the case for competition policy in developing countries actually stronger. This argument becomes clearer when realizing that factors that facilitate collusion, predatory strategies, market concentration (such as weak credit markets, high entry barriers and existence of capacity constraints) are likely to be more important in developing countries. Therefore, the design of a body of simple and transparent competition policy rules for developing countries, in particular for horizontal collusion and abuse of dominant position remains a worthy task. The optimization of the use of scarce human and material resources for regulatory purposes is also crucial. Furthermore, a competition agency will be valuable for its educational role in advocating the social benefits of fair competition.

6. Justification of the project

There is a relative knowledge gap in developing countries on the specific impact of competition law and policy on their development prospects. Recurrent calls have been made at the WTO and UNCTAD for further studies on the topic. Key concerns that have been raised by developing countries considering adopting a competition law or strengthening competition in their economies, referred to whether such a law is necessary given trade liberalization, whether it would damage international competitiveness,

and whether increased competition would raise unemployment or cause other social problems. To address these concerns, UNCTAD has received a special mandate to look at competition policy and competitiveness issues.[9]

A key factor contributing to the effectiveness of competition laws and policies has been the possession of enough information by competition authorities. Conversely, lack of reliable or disaggregated economic or product data, together with lack of information about production costs, profits, market shares and consumer behaviour, has been a problem, particularly in developing countries and countries in transition, and has affected the enforcement capacity of competition authorities.

Hence, this publication is a timely re-examination of the role of competition policy in the overall development strategies available to developing and least developed countries. In this context, it should shed some light on, and test the viability of, existing conflicting hypotheses on competition policy at the domestic and international levels and contribute to consensus building.

7. Methodology

As any work on the topic must be, ours is deeply indebted to prior scholarship in the field. At the same time, however, the objective of this book is to elaborate a new framework for understanding the importance of competition policy for competitiveness and development, one that offers a convincing set of answers to a number of key questions. We outline the basic approach in this introduction. Subsequent chapters extend and apply it to a wide range of issues. In many respects, this approach is based on a well-established theoretical ground. In others, the contributors to this publication provide a fresh perspective and bring in new empirical evidence from a diverse set of developing and least developed countries. Such issues range from prerequisites for development-oriented competition policy implementation, competition policy as a stimulus for enterprise development, exemptions and exceptions from competition and their implications for economic performance, as well as the relationship between competition, supply capacity and export competitiveness.

The role of competition policy in development strategies and the specific features of institutional design that are most conducive to development have been constant areas of enquiry in development economics. This book explores these issues and places the current debate surrounding the role of competition policy in the wider context of pursuing effective development strategies in an increasingly globalized economy. In this attempt, the chapters contained in this publication seek to pull together the prerequisites for development-oriented competition policy implementation (such as institutional design, implementation issues) and the mechanisms through which competition policy can contribute to improved economic performance (enterprise development, improved corporate governance, investment, productivity and export performance).

The selection of countries as case studies was motivated by an interest in shedding light on the experience of a wide range of countries such as successful East-Asian countries (Republic of Korea), small least developed countries (Nepal), or larger more advanced developing countries such as Brazil or South Africa. The basic message stemming from the empirical findings and country experiences included in this publication is that the adoption of policy reforms in the presence of well-implemented competition policies is more likely to enhance the competitiveness of developing and least developed countries than a passive government attitude towards anti-competitive practices.

Michal Gal's chapter gives a general overview of the issue. Gal argues that competition policy needs a series of political social and institutional pre-conditions to be effective. A credible independent competition agency, which is willing to resist attempts to capture it, is vital. Singh (2002) argues that developing countries can provide a fertile soil for competition policy. Research (e.g. CUTS, 2003) supports this, though success is not guaranteed. The competition authority must have reasonable autonomy and be protected from capture. CUTS (2003) shows a number of cases where competition agencies in developing countries have been willing to stand up to political pressures. Issues to address include the personalities of the officials involved in the system, and the amount of discretion they have. Tirole (1999) argues that developing countries have an interest in simpler *per se* rules, which make certain types of conduct illegal, irrespective of what elaborate economic justifications may be put forward by firms; exceptions to the rules should therefore be laid down in advance in law not at the discretion of officials. Adequate finance is necessary though, as Clarke and Evenett (2003) point out, the economic benefits of a well-functioning agency can be many times its costs and, if fines can be collected, the financial costs can be recovered.[10]

In order to ensure that pro-competition policies meet their desired objectives, they should be anchored on the development dimension. Since development is the priority for most LDCs, it is essential for them to prepare development-oriented competition policy and legislation. However, implementation of these policies has not been as effective as was originally thought. The prevalence of anti-competitive practices has hindered the process of creating a competitive environment in the marketplace. In addition, lack of political will coupled with apathy of the implementing agencies to put these policies into practice is considered one of the reasons for policy failure in the LDCs (see in particular the chapter by R. Adhikari).

Another lesson that can be drawn from the experiences of various developing countries is that just having a competition law is no panacea. In fact, as the case of Thailand shows, a badly designed law and faulty implementations can have adverse consequences, in particular when the law is used discriminatorily. In some case, anti-competitive practices are allowed to continue unchallenged, while in other cases, what appears to be a competitive process is subject to investigation and undue intervention (see chapter by Deunden Nkikomborirak). Bullard offers an interesting analysis of the beer industry in seven Latin American countries. He shows that very high levels of concentration exist in all the cases studied (Venezuela, Panama, Argentina, Peru, Ecua-

dor, Guatemala and Bolivia), even though their competition laws are quite different, varying from no law at all through having rules on conduct but not structure to rules on both. He argues that there is scope for a more active competition policy to promote new entry into this sector.

Oliveira and colleagues take this argument a step further and analyze the role of the Brazilian regulatory agencies in influencing decisively the development prospects of the Brazilian economy. The chapter investigates the relationships between sector performance and regulatory design by constructing an independence index and an index of the regulatory effectiveness. The analysis suggests that the degree of independence of regulatory agencies has a positive impact on the sectoral competitiveness. In sectors with a high independence level of the agencies, that is, with a high independence index, positive impact upon competitiveness is expected.

Three other chapters review and assess the focus on enterprise development, specifically SME development in selected countries. In the case of South Africa, for instance, the chapter by Hartzenberg shows how active support for SME development is found in the South African Competition Act and in the context of South Africa's broader industrial policy. Both Hartzenberg (in the case of South Africa) and Lipimile (in the case of Zambia) review a selection of key merger transactions where decisions by the competition authorities have specifically addressed SME development within the context of the public interest test. Drawing on these cases, the chapters conclude with a discussion of the contribution that competition policy and law could provide for developing countries in the sphere of enterprise development. The experience of South Africa and Zambia is contrasted with a discussion of the benefits stemming from the adoption and implementation of competition law and policy in the Republic of Korea over the few last decades (see chapter by Hur). Hur's analysis demonstrates how the principles of competition have been instilled over the years into the Korean economy by monopoly regulation, cartel repeal and competition advocacy built into the regulatory reform.

Thus, Hur's chapter add a number of qualifications to the widely held belief that the "Korean miracle" in terms of economic competitiveness was solely based on nurturing national champions by suppressing competition at the firm level and protecting the domestic market. A similar conclusion is reached by Yun, in her empirical analysis of firm-level data in Korea. Yun tests whether the "national champion" theory holds up to empirical evidence, or whether in the Korean case also, competition has been an important factor for improving corporate performance. The result suggests that, at least in the 1990s, competition was conducive to improving productivity levels as well as the rate of productivity growth. This leads to the conclusion that, in general, competition is important for both current and future growth, contrary to the claim that competition is inimical to economic growth and development.

A similar approach is used by Kahyarara in the case of Tanzania. This study assesses the role of competition policy in influencing productivity, investment and export

performance of Tanzania manufacturing enterprises. The major study objective is to investigate the extent to which firm-level performance, measured by investment, productivity and export, is influenced by government measures aiming to stimulate competition and protect consumers against monopoly. To analyze this influence, the study assesses the effect of control of dominant firms through institutions, the effect of mergers to prevent industries becoming monopolized and finally the effect of control of anti-competitive behaviour such as full-line forcing and predatory commission. In particular, the study assesses the existing government efforts to regulate business activity in order to ensure that it operates in the public interest. The study provides direct evidence based on microeconomic data of how the existing government policy and institutions charged with overseeing fair competition have succeeded in ensuring competitive production that is fair and in line with public interests. The study further identifies gaps and need for policy changes and/or institutional build up to cater for the new production environment in which the Tanzanian manufacturing sector has been operating. The data used are the employer-employee matched firm-level data, Tanzania Manufacturing/RPED surveys that contains detailed information on company-level performance and other firm characteristics.

Lastly, the lack of competition in markets of non-tradable goods is a factor that may limit substantially the competitiveness of industries intensive in the use of non-tradable inputs. This hypothesis is tested by Ruiz in his examination of the recent experience of privatization, deregulation and competition promotion applied to the electric power sector in Peru. His study provides an interesting example of how a combination of these policies can be reflected in a better performance of the industry, more competition in the electricity generation market (of non-tradable inputs), reduced prices of energy, and improved quality conditions for intermediate and final consumers (including industries of tradable goods and services). Ruiz measured the actual and potential benefits associated with the promotion of competition in the electric power sector, through the impact on price competitiveness of other industries. His results suggest that, between 1994 and 2002, real prices of energy sold to final users showed a cumulative price reduction of 17.6 per cent. This reduction in prices of electricity (broken in direct and indirect price effects) contributed to an increased competitiveness of the overall Peruvian economy, and in particular in the mining, manufacturing and chemical sectors.

8. A way forward

Each of the chapters included in this book captures important ways in which competition and competition policy, broadly defined, affect economic behaviour and the overall performance at national-, sectoral- or firm-level in several developing and least developed countries. The chapters have tried to separate the differences between the notions of competition, competitiveness and competition policy. Competition policy is designed to promote both competition and competitiveness, but we also need to be clear that there are a number of pre-conditions needed for an effective competition policy. These essentially boil down to the existence of a credible competition agency that cannot easily be captured. Gal's contribution explores the "ecology" of this. Singh (2002) argues that

despite the pessimism of some writers (such as Tirole, 1999) the preconditions can be met in many developing countries (see CUTS, 2003; Holmes, 2003). A good competition policy is not free of cost, but there is evidence (albeit limited at this stage) that if its effects are indeed positive the social benefits can be many times the costs. Further research is needed to assess in detail the impact of competition regimes in developing countries.

Competition policy should have as a major priority the creation of pre-conditions likely to assure the effective functioning of *competition*. This role involves not only seeking to enforce competition regulations but also a more general "advocacy" role within government, for example trying to ensure that other legislation and government regulations (including protectionist trade measures, privatization, IPR protection, licensing, etc.) are consistent and pro-competitive (Boner and Krueger, 1991; Boner, 1995; Khemani and Dutz, 1995). We can only hope that, as a result of such compelling evidence, the number of those who embrace the very idea that competition policy is a major ingredient in any successful development strategy will increase even further.

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Notes

1. Many economists think this is rare and caution against allowing too free access by "losers" to use competition laws and trade laws to curb competition. Tirole (1999) argues that this is more likely in developing countries, but hard to deal with.
2. Krugman (1994) has criticized the use of this term as synonymous with productivity. The European Commission (e.g. European Commission, 2003) argues that the term can usefully be used to characterize the ability of an economy to adapt and grow sustainably without involuntary unemployment.
3. Several studies have found that trade barriers lead to inefficiency or higher profits, but high seller concentration does not do so as long as import competition is vigorous and may have led to economies of scale. See, for instance, Scherer and Ross (1990) and Macdonald (1994).
4. The WTO TRIPS agreement, Article 31, specifically gives greater autonomy to countries to address abuses of IPRs when they have a competition law in place.
5. See for instance Lommerud and Sørgard (2001) for a formal proof of this argument. Schröder (2003) further qualifies this argument and suggests that, when different types of trade costs (e.g. transport costs, tariffs, currency risks, administrative red tape, etc.) are disentangled and accounted for in the formal modelling of trade liberalization, the pro-competitive effect tends to outweigh the incentives for collusion. For instance, incomplete trade liberalization measures that tackle only unit cost trade barriers are potentially anti-competitive (Schröder, 2003: 12).
6. See Evenett, Levenstein and Suslow (2001) and Clarke and Evenett (2003).
7. The well-known banana dispute between the EU and the US at the WTO was really about the division of excess profits (rents) between the big banana trading firms (Holmes and Read, 2001).
8. They argue that the adoption of a competition *law* is just one factor, alongside import liberalization and the abolition of regulations that actually prevent entry and exit.
9. See "Preparations For UNCTAD XI (São Paulo, 14 June 2004): Submission by the Secretary-General of UNCTAD", Document no. TD(XI)/PC/1, 6 August 2003.
10. An internal audit study of the Peruvian competition agency INDECOPI argued that the agency generated in 1993–1996 benefits of US$ 120m against costs of US$ 20m (Caceres, 2000).

I

Prerequisites for development-oriented competition policy implementation

I.1. THE ECOLOGY OF ANTITRUST: PRECONDITIONS FOR COMPETITION LAW ENFORCEMENT IN DEVELOPING COUNTRIES[**]

Michal Gal[*]

1. Introduction

The number of developing countries that have adopted a competition law has grown exponentially over the past two decades.[1] Often the passing of a competition law has been treated as one of the cornerstones of the liberalization and pro-market reforms that have swept through many developing countries. Yet the mere adoption of a competition law is a necessary but not sufficient condition for it to be part of market reform. Just as ecological conditions determine the ability of a flower to bloom, so do some preconditions affect the ability to apply a competition law effectively.

This study seeks to identify the ecology of antitrust in developing countries: the soil, sun, water and pesticides of competition law adoption and enforcement. In particular, it analyses the socio-economic ideology (soil), the institutional and organizational conditions (sun and water), and the political economy conditions (pesticides) that are necessary for competition law to bloom. It does so based on a theoretical framework as well as by analysing the experiences of developing countries in applying competition laws. Of course, other conditions may also affect the efficiency of competition law enforcement. These may include, for example, the size of the market (Gal, 2003), its openness to trade, or the extent of its privatization process. These conditions are, however, country specific and will only be dealt with in this paper inasmuch as they shed light on the above preconditions.

The first section sets the stage by elaborating on the special characteristics of developing countries. The second section analyses the inevitable connection between a country's socio-economic ideology and the enforcement of its competition laws. It delineates the experiences of several jurisdictions in adopting a competition law at different stages of development and with differing socio-economic ideologies. As will be shown, the ideology of policy makers must strongly support a pro-market reform for competition law to have a significant impact on markets. The section also highlights the two-way interaction between competition law enforcement and competition policy in developing countries. As will be argued, the competition authority

has an important role to play in creating a competition culture. It can do so, *inter alia*, by advocating the creation of pro-competitive conditions to regulators and the general public and by enforcing the law to limit private barriers to trade, thereby exemplifying the benefits of antitrust.

The third section focuses on the political economy of antitrust. It delineates possible challenges to the adoption of a competition law in developing countries. As will be argued, competition law is susceptible to political influences given its non-sector-specific and long-term nature. It is thus necessary to adopt pesticides, either internal or external, to overcome such obstacles. Such pesticides will also be analysed.

The fourth section focuses on the organizational and institutional preconditions for antitrust enforcement. As Richardson observed, firms will commit their investments and productive resources into production activities, as long as they have a reasonable expectation of obtaining a return for their investments (Richardson, 1960). Such assurance depends not only on one's competitive advantage but also on the existing institutional setting, which determines the actual enforcement of laws, including those limiting the creation of private barriers to trade (De Leon, 2000: 14). To ensure credible and impartial enforcement, the institutional landscape should provide the enforcing bodies with efficient and effective tools for enforcing the law and for educating market players in its provisions and its benefits. It should also reduce the motivations of the enforcing bodies to make decisions that favour specific interest groups. The section will analyse the necessary institutional preconditions to achieving such goals, with a special focus on developing countries.

Clearly, the themes of this paper are interrelated. The political economy of antitrust affects the existing socio-economic ideology, and the institutional features of the enforcing agencies will affect their ability to educate the public in the benefits of competition law in order to create a competitive culture. Yet, the somewhat sterile differentiation between the preconditions for antitrust enforcement serves an important function by enabling us to place a spotlight on each of the components of the ecology of antitrust.

It should be emphasized from the outset that this paper does not seek to answer the question of whether competition policy is an optimal tool for promoting the economic and social objectives of developing countries. It is based on the assumption that the answer to this question is positive, at least to a considerable degree. Yet, it does seek to answer the question of what preconditions must be present for a competition law to apply in practice.

2. Why focus on developing countries? Identifying the challenge

Developing countries pose unique and interesting issues for competitiveness and competition law enforcement. Their low level of economic development, which is often accompanied by institutional design problems and complex government regulation and bureaucracy, creates real-world challenges that have to be recognized

before the successful implementation of an antitrust regime. The experience of many emerging competition authorities underlines the importance of identifying the specific challenges developing countries face in adopting and enforcing competition law as part of an overall public policy mix in pursuit of economic development.

The role of competition law has arisen in response to the privatization and liberalization movements that have swept many developing economies in the past two decades, which have been spawned by technological, economic, political and ideological forces. To enjoy the benefits of liberalization, however, an appropriate regulatory framework must be put in place. Otherwise, private barriers may simply replace governmental barriers to trade, an outcome which might prevent improvements in social welfare. Trade liberalization alone does not necessarily lead to more competitive markets. An important share of economic activity in developing countries relates to non-tradable goods and services (e.g. electricity, financial and legal services), which are only marginally exposed to international competition (Correa, 1999: 368–369). Moreover, trade liberalization may sometimes exacerbate the need for competition law, as the liberalization process in many developing economies has entailed the displacement and closing down of many small and medium local enterprises, and has led to market dominance of a few firms through unilateral or coordinated conduct (Khemani, 1996: 107). If such markets are not subject to constraints on private limitations to competition, companies might not be able to take advantage of competitive opportunities and social welfare might even be harmed (UNCTAD, 2000: 12).

Moreover, the need for competition laws has increased due to globalization and the changes it has brought about at the international level, including the gigantic cross-border merger movement of the 1990s (Singh, 2002: 9; UNCTAD, 2002a: 17). Developing countries might be significantly affected by the monopoly power of large international firms, exercised either unilaterally or collusively, if such power is not properly regulated (UNCTAD, 2002a: 11). Competition law is thus an important part of market reform, to ensure that social welfare is increased and that developing countries can enjoy at least some of the benefits of world markets.

A study on the effective implementation of competition laws estimated that competition authorities in advanced countries are 40 per cent more effective than their counterparts in developing countries (World Bank, 2002). What, then, are the obstacles to the effective implementation of a competition law in developing countries and what can be done to overcome such obstacles and create a strategy that supports reduction of private barriers to trade? This will be the focus of the remainder of the paper.

3. Soil: socio-economic ideology and competition law

Competition law is a regulatory tool that limits the conduct of economic actors to ensure that the benefits of competition are not frustrated by the erection of private barriers to trade. It does so, *inter alia*, by limiting abuses of monopoly power by

dominant firms, by prohibiting cartelistic activity and by preventing mergers and other types of cooperative conduct that would harm social welfare. Yet competition law is not a stand-alone regulatory tool. Rather, it is generally part-and-parcel of a wider set of public policies in pursuit of social welfare. As such, it is shaped and transformed by the existing socio-economic ideology and by the other policy tools that are implemented.

As the experience of many jurisdictions clearly indicates, socio-economic ideology, sometimes termed the competition culture, determines to a large extent the success or failure of a competition law. Several developing countries have had antitrust laws for many decades, but until recently none appears to have been regularly enforced to further the aims generally associated with competition law. This was because competition law clashed with the existing socio-economic ideology, which shaped public policy and, thus, it did not enjoy full and consistent support by the enforcing government. This section analyses the experiences of developing jurisdictions in adopting a competition law in different public policy settings. It points to non-market ideology underlying public policy as a major obstacle for applying competition law, and proposes some methods to limit this obstacle.

The Israeli experience serves as a good example of the effects of socio-economic ideology on competition law enforcement (Gal, 2004). Israel adopted a competition law in an early stage of its economic development, as a response to a public outcry against private cartels. The Israeli Competition Act dates back to 1959, only 11 years after the country was established, at a time when it was trying to create an economic infrastructure to serve a small, developing, immigrant country, while combating formidable monetary problems. To do so, the government adopted a highly interventionist and paternalistic industrial policy that regulated almost all aspects of economic activity. The market was likened to an infant, who cannot walk on his own and who has to be directed so that he would eventually learn to walk. Since the belief in the market's invisible hand was very limited, the government held the reigns of the market, *inter alia*, by controlling import certificates, by providing monetary funding to economic activity that it deemed beneficial, by granting exclusivity rights to some producers and suppliers, and by directly controlling prices and trade conditions of many goods and services. As a result, competitive conditions in the Israeli market were very limited. Free competition, it was believed, would have prevented the establishment of efficient domestic firms and would have destabilized the market.

This raises the question of what role a competition law has to play in such an environment: How does a competition law apply when prices are controlled by direct price control rather than by market forces, where investment decisions are indirectly subject to approval by government officials, or where joint ventures between potential competitions are supported by the government in order to achieve economies of scale and prevent market destabilization? The answer is that the application of the competition law reflected this socio-economic ideology. The Antitrust Tribunal, which was charged with determining the legality of business conduct, gave little weight to

competitive considerations in its decisions. Rather, its decisions mirrored the controlling ideology by broadly interpreting the public interest exception that was included in the law.

The Tribunal's decisions in the 1960s and 1970s are characterized by an emphasis on nationwide goals, such as the encouragement of export, the realization of economies of scale, and the improvement of the country's balance of payments while placing little emphasis on the establishment of competitive conditions. Accordingly, the Tribunal ordinarily approved agreements among competitors, which had the potential to increase productive efficiency by designating the production of different types of products to different firms. It also approved many agreements which were geared towards an increase in exports, even if the effect was increased dominance in the Israeli market. This is exemplified by the Plywood decision,[2] in which the Tribunal approved an agreement among plywood producers that fixed prices and designated quotas, although the agreement clearly increased prices in the Israeli market. It reasoned that the agreement was necessary to increase exports of plywood and to increase productive efficiency. This application of the law fit well with the prevailing ideology. The first Director of the Antitrust Authority, who adopted a more pro-competitive approach, was not well accepted by the government and most of his recommendations were not applied in practice.

It was only in the mid-1980s, when the socio-economic ideology of the Israeli government changed significantly towards a pro-market orientation, that the Competition Act began to have a significant effect on the Israeli economy. The government's pro-competitive approach resulted in the lowering of governmental barriers to the free operation of markets, the implementation of privatization plans and the liberalization of trade to ensure that competition was the main driving force of most of the Israeli markets. Similarly, the Tribunal and the Antitrust Authority began to give more weight to competitive considerations and applied long-term, dynamic economic analysis. In the span of only a few years, a large corpus of decisions based on economic analysis was created and enforcement rates rose significantly. The Israeli Supreme Court likened the Competition Act to the Magna Carta of consumer rights and free competition.[3]

This change can be exemplified by the decision in the case of Poligar.[4] There, the Antitrust Authority was requested to approve a joint marketing venture between the only two Israeli producers of polyethylene covers. In analysing the effects of the proposed venture, the Director stressed the disciplining effects of potential and existing imports on the market power of the domestic firms. He approved the venture since it would enable the domestic firms to reduce their costs and thus compete more effectively with foreign importers, without harming the Israeli consumer. This reasoning differs significantly from that on which past decisions to approve joint ventures were based. Whereas in the past, emphasis was placed on the ability of the parties to the venture to reduce their costs without a real analysis of total welfare effects, the decision in Poligar approves the venture based on the need of the parties

to act more efficiently in order to meet foreign competition. The analysis promises that the Israeli consumer, as well as the Israeli firms, will enjoy the benefits of the venture. This sort of analysis, which gives much weight to competitive considerations based on market conditions and evaluates the effects of the conduct on all market players, characterizes most of the decisions from the 1990s on.

What are the lessons to be learned from the Israeli experience? Most importantly, that competition law does not stand alone. The prevailing socio-economic ideology and public policy are determinant factors in the application of a competition policy. Without the elimination of governmental barriers to competition and a real change in public policy it is not possible to create a level playing field in which firms will invest and compete effectively. It is thus imperative that the government truly and consistently accepts the principles of competition in all of its spheres – the judiciary, the government and the legislature – for competition law to be effectively implemented. Competition law, of the kind known and accepted in most developed economies, could only bloom in a society which is based on a belief in the benefits of the market's invisible hand over direct regulation, at least in most of its markets.

A similar conclusion can also be discerned from the experience of other jurisdictions, which have adopted a competition law without a real conviction and belief in a competitive system. Several Latin American countries have had competition laws for long periods. Yet, competition policy enforcement clashed with the industrial development policies prevailing in the region. Even when economic liberalization was under way, governmental barriers still existed in the form of capacity licensing, investment and procurement policies and price controls (Frischtak, Hadjimichael and Zachau, 1989: 2). This conflict delayed the successful implementation of competition laws, as the setting within which Latin American competition law grew was not receptive towards the ideas and values ingrained in competition policy. Unsurprisingly, in this context competition could not emerge as a worthy social value. It was only when the paradigms of public policy in some Latin American countries changed profoundly to endorse market functioning, rather than government action, as the cornerstone of economic development that competition law could begin to blossom (De Leon, 2000).

Owen has also observed that comparative success in market reforms and the application of a competition law appears to be due in significant part to a policy consensus within the government. Competition law enforcement has been successful in some Latin American countries, such as Chile and Mexico, in which there is a substantial national commitment to market reforms. In countries where the political and social commitment to market reforms is more ambivalent, or where other priorities prevail, such as in Argentina, competition agencies appear to have been less successful (Owen, 2003: ii).[5] The following statement of the Brazilian Agency is indicative:

"Although Brazil has had an antitrust system for more than 30 years, it was only after all the necessary structural reforms had been implemented that it did in fact

become operational. The reforms included trade liberalization, privatization and the creation of sectoral regulatory agencies, which made it possible to enforce competition rules. These reflected the change in understanding over who should be responsible for the promotion of economic growth: before, there was the government leading the investment and indicating the relevant sectors for the private businesses, and then free market allocation of resources."[6]

The importance of a strong and unambiguous pro-market policy as a key factor underpinning the enforcement of a competition law is also emphasized by the experiences of Korea, Jamaica, Zambia, Poland (ICN, 2003: 28), Pakistan and India (CUTS, 2003a).

One can legitimately ask why would a country adopt a competition law without a sound competition policy and a market-oriented ideology to support it? Several reasons may explain this puzzle. It may well be that the law was adopted in response to pressures from certain groups or institutions. These can be internal, such as in the case of Israel, or external, as in many Latin American and Eastern European countries which have adopted competition laws for the purpose of ensuring the successful negotiation of trade agreements, or in response to demands of international lending agencies who viewed the introduction of a competition law as a fundamental component of institutional reform. In other countries the adoption of the law was sometimes guided by rather superficial concerns, such as a potential antidote to spiralling price inflations, without the parallel creation of a competitive environment.

To sum, the experiences of many jurisdictions indicate that the socio-economic ideology of a country has an important role to play in shaping the antitrust landscape. Without a supporting belief in pro-market reforms, competition law alone has a very limited effect on changing market conditions. Such support should be not only theoretical, but must also be manifested in other policy tools that serve to create a competitive environment, to induce and increase private players' efforts to attain and maintain competitiveness. Thus, if competition law is to be an effective deterrent to private anti-competitive behaviour, a real change in the socio-economic ideology underlying public policy is required.

To be sure, this does not mandate the adoption of competitiveness or economic efficiency as a stand-alone goal. It does, however, require the government to limit competition only where such limitations are necessary in order to accomplish more important social objectives, after weighing the costs of reduced competitiveness against the benefits of such policies. This point is worth elaborating upon, given the resistance of many developing countries to the adoption and the implementation of a competition law, which is often based on the argument that it may harm the furtherance of goals, which are crucial to the country's economic development or to its social values. In particular, it is argued that application of a competition law can harm the creation of a technological infrastructure that would enable firms in developing

countries to achieve dynamic efficiency and compete in the future in global markets, and that it would strengthen distributive justice concerns.

These concerns about the goals of antitrust are not necessarily valid. If correctly applied, a competition law should take account of dynamic efficiency considerations rather than be based on a static appraisal of business conduct. It may, thus, sometimes promote competition and in other cases allow for its limitation. Moreover, although the main goal of competition law is the enhancement of economic efficiency (OECD, 2003), there is no inherent limitation in the law to the furtherance of broad industrial policy and socio-economic goals. In fact, developing countries may, and often do,[7] give weight to other public policy concerns, such as distributive justice or employment concerns. South Africa is an often-cited example. There, the competition law is applied in a manner that balances between competitive considerations and broader policy initiatives, such as the protection of low-income inhabitants from price rises. A mixed approach to antitrust, while creating costs in loss of efficiency, especially for small economies (Gal, 2003), may be justified in those developing economies in which a purist approach might prevent societal acceptance and disintegrate the social fabric. This is particularly important where economic efficiency considerations alone would strengthen or maintain existing wealth disparities, especially where it parallels a racial divide. As Chua has argued, the overlapping of class and ethnicity characteristics, which characterize many developing economies, mandate that the distributional effects of a market economy be taken into account. Otherwise, this may create instability in democracy, which could convert into an engine of potentially catastrophic ethno-nationalism (Chua, 1998, 2000). Thus, the goals of competition law may, in some cases, need to be broadened to include distributional effects, which may be an important factor in the social-welfare function. Such social policies may be especially important in the first years of transition to a more competitive economy (APEC, 1999: 37) and may then be changed to be more efficiency-oriented. Thus, in some settings, competition law enforcement should not be blind to societal failures which might be even more important than market failures.

As argued above, a pro-competitive socio-economic ideology, whether or not intertwined with other social goals, is the soil of competition law. But the picture is more complicated than that, as the interaction between the competition law and socio-economic ideology is a two-way stream. While a competition law might be flexible enough to accommodate industrial policy or distributive objectives through the valve of a public benefit test, competition authorities, where they exist, have an important role to play in influencing public acceptance and awareness of competition law and policy. Competition advocacy, i.e. those activities conducted by the competition authority that are related to the promotion of a competitive environment for economic activities by means of non-enforcement mechanisms (ICN, 2002), is, perhaps, the most significant task of competition authorities in developing countries.

Two advocacy roles can be identified: the first is the advocacy of the benefits of competition to governmental institutions (governmental advocacy). The second is

the advocacy of competition to the general public, and especially to consumers and other market players (public advocacy). There exists a complex interaction between these two roles. Public advocacy can serve as an indirect form of government advocacy in two ways. First, it serves to increase the acceptance of pro-market policies, and thus the willingness of the government to adopt such policies in the first place. Second, public advocacy of the benefits from competition law enforcement can create public pressure on the government to change its policies. Therefore, strategies aimed at gaining public support for competition law enforcement are highly important. Public advocacy should be approached, however, carefully, as the competition agency is an integral part of the government and should not operate too strongly against the government's stated policy objectives.

Let us first focus on governmental advocacy. For it to exist, some degree of support for pro-competitive market reforms within the government must be present, as the authority is part of the government whose views and ideology it wishes to change. Yet the competition authority has a central role in assisting governmental and other regulatory agencies to realize and analyse the competitive effects of their decisions. The Venezuelan competition authority's proactive efforts to air the arguments on market dynamics and the impact of different economic measures on market conditions, for example, assisted the process of opening up and liberalizing its economy. The awareness of public authorities of the long-term benefits of competition to the society, even when the adoption of competitive conditions may create difficulties and may clash with other social policies, is an important ingredient in building a competitive environment. By changing decision-makers' perceptions and understanding, it may change the range of options perceived by them to be rational and acceptable. Such awareness can be raised by a theoretical analysis of the social effects of market conditions. It might be best to build a convincing case for competition by focusing on examples and success stories derived from the experiences of developing countries. Taking examples from environments that are seen to resemble the local context more closely may help to make policy makers in developing countries aware both of the seriousness of the competition problems in their countries and of the benefits they could derive from adopting a competition law (ICN, 2003: 25). The enforcement of a competition law can also serve as a governmental advocacy tool, if such implementation changes the decision parameters of decision makers, either by convincing them of the benefits of increased competition or by creating societal pressure to adopt competitive measures. While it may be difficult to engage in governmental advocacy where the government is hostile to competition law issues, the Zambian and Zimbabwean experiences show that if the government is merely indifferent to competition a strong-willed competition authority can be effective (Holmes, 2003: 7). The institutional conditions for governmental advocacy are elaborated in the fourth section.

Public advocacy is no less important. Without popular support, the regime will not afford the benefits that competition law may bring about. This is especially impor-

tant in democratic regimes, in which a change in policy must have visible short-term or understandable long-term positive effects that consumers and other market players can appreciate. Accordingly, it is vital to create a competition culture among consumer organizations, the private sector, the media and other stakeholders that might otherwise be ignorant of the law and its virtues. Such awareness-raising activities also enhance the credibility and the convincing power of competition authorities. The institutional and organizational tools for public advocacy are elaborated in the fourth section.

To conclude, a pro-market socio-economic ideology dictates to a large extent the effectiveness of a competition law in reducing private barriers to trade. Simply adopting a competition law is not sufficient when such adoption is not part of a broader pro-competitive microeconomic policy to which the government is strongly committed. The competition authority has an important role in advocating competition, should it exist at such stages.

4. Pesticides: political economy obstacles to antitrust

Assume that the adoption and enforcement of a competition law is socially desirable for a developing country and that such policy fits well with the country's socio-economic ideology. Will it inevitably be adopted and implemented? The answer is not necessarily positive. As the field of political science has taught us, those who make the choices underlying public policies do not always have the motivations to adopt socially desirable policies. Accordingly, this section seeks to identify the forces that may lead decision makers to deviate from optimal social policy in the context of competition law. As will be argued, there may exist strong political forces that affect the incentives of decision makers to adopt a competition law. It is thus vital to recognize such forces and to devise ways to effectively limit their effects. The latter are the pesticides of the ecology of antitrust.

Let us first identify the problem. The adoption of a competition law may encounter resistance from many groups in society. Generally, such adoption involves a significant change in the "rules of the game". As noted above, it limits the ability of an incumbent monopolist to create artificial barriers to the entry or expansion of its rivals; it limits the ability of firms to raise their prices or profits collectively; and it limits the ability of firms to achieve market power by changing the market structure by way of merger or joint venture. As a result, it may change the legal status of deep-rooted types of business conduct. For example, in many developing countries, trade associations have served an important function under the previous economic order by setting prices and quotas for all market participants (Stewart, 2004). This form of conduct may well be prohibited under a competition law. Altering the legal status of entrenched conduct might encounter resistance from those who fear change, especially when they do not fully understand the benefits it brings about.

But more importantly, altering the rules of the game may change the existing economic equilibrium by impairing the economic status of some market participants

that were sheltered from competition by governmental-made or private barriers to entry. This change often involves high personal stakes of the existing dominant firms, entrepreneurial associations and employees of state-controlled enterprises who are likely to be adversely affected by the reduction in the intervention role of the government in the market. The prospect of reform may thus motivate such firms to engage in rent-seeking behaviour, aimed at limiting change in the existing regime. The higher the stakes of private groups in the policy at hand, the stronger their motivations to influence the policy makers. According to some scholars, such groups would invest in securing or maintaining a policy that favours them up to the total expected profits they stand to gain from it (Posner, 1976: 8–18). They may do so directly, by appealing to decision makers to take into account their interests, or indirectly, by creating social resistance to the adoption of a policy, by building upon fears about change and misconceptions about the effects of competition law enforcement. Such conduct, even if it harms social welfare, is generally perfectly legal, and therefore cannot be limited by legal means.

Why should such interests affect decision makers, if they believe that the adoption of a competition law is socially desirable? The problem is simply that, in the absence of constraints, both legislatures and government officials may have motivations to abuse their decision-making power by singling out particular individuals or groups and bestowing government largesse upon them in return for political support (Kaplow, 2003). This problem is known as regulatory capture. Such capture arises when small groups with large *per-capita* stakes in a policy organize and cause the government to regulate in ways that are against the public interest and usually against consumers, who are poorly organized and have small *per-capita* stakes in the specific regulation. Regulatory capture is exacerbated in democratic societies, especially where the ultimate policy decision lies in the hands of one politician or a small group of politicians (e.g. the relevant minister or a legislative committee) rather than the government as a whole, as specific, well-organized sectors can ensure the politicians' re-election (Wiley, 1986). Social logic may thus not always coincide with the logic of politics.

As noted elsewhere (Gal, 2002), the problem of political influence might be aggravated with regard to competition law. This is because the benefits of competition law enforcement are inherently non-sector-specific and look at the long-term horizon. The law applies similar rules to all industries, which are based on total welfare considerations, rather than on the welfare of specific market players. It also usually spells out a long-term vision for society, beyond the immediate pain of the adjustment or change in specific industries and beyond the profitability considerations of specific firms. For example, a merger that would create significant market power would generally be prevented even if it results in financial loss for the firms wishing to merge. Yet, these two traits of competition law – non-sector-specific principles and its long-term horizon – create inherent political pressures to limit its adoption and its applicability.

The law's non-sector-specific nature increases the influence of politically influential groups, as its beneficiaries – consumers and small businesses – are generally dispersed. Moreover, its focus on long-term goals usually requires political fortitude that is typically in short supply among political figures. Most professional politicians who rely on regular and frequent popular elections are mainly concerned with their personal survival and advancement. This implies that they have an inherent tendency to discount heavily all events occurring beyond their personal time line. Instead, they tilt towards the achievement of short-term goals (Shepsle, 1999).

In addition, the adoption of a competition law is usually an integral part of a change from a centrally controlled market to a decentralized market regime. It involves significant decentralization of decision making, a shrinking of the size of the public sector, and a significant reduction in the interventionist role of the state in the economy. This often means the loss for politicians of some of the power that they used to survive politically, and some of their political allies.[8] The outcome often is that decision makers, even those convinced of the need for economic policy changes, could not escape considering the political wisdom of adopting and pursuing them.

The effects of political pressures on decision makers can take many forms. In the most extreme case, such pressures may be sufficiently strong to virtually inhibit the willingness of decision makers to adopt a competition law at all. But the effects may be subtler, by limiting the width or strength of the legal provisions adopted. Such effect might be articulated, *inter alia*, in limits placed upon the discretion granted to independent enforcement bodies, in the height of the sanctions for non-compliance with the legal prohibitions, in the weight given to the furtherance of economic welfare and freedom in the constitutional hierarchy, in the inclusion of wide social goals in the law, or in the adoption of sector-specific exemptions from the application of the law. In Israel, for example, the agricultural lobby has succeeded in including a specific exemption in the law for agreements for the marketing of agricultural produce (Gal, 2004). Alternatively, the effects of political pressures may be less visible by affecting the institutional and organizational conditions for antitrust enforcement which are, as elaborated below, the sun and soil of the ecology of competition law. To give but a few examples, decision makers may not properly fund and structure the competition agency in order to reduce its ability to enforce the law in practice, or they may not provide it with the political support necessary for a strong agency to strive. This, for example, was the case in Argentina (Owen, 2003: ii). Of course, members of the competition law enforcement bodies are also susceptible to regulatory capture, an issue that will be dealt with separately in the next section.

These concerns are especially significant for developing countries. The reason is that economic power in developing economies tends to be more concentrated in the hands of a few rather than dispersed amongst many small competitors. Moreover, often the economic and governmental elites are intertwined. This reality increases the probability of lobbying, rent-seeking behaviour, and political influences aimed at the pursuit of private objectives. The problem is also exacerbated by the fact that in

developing economies many consumers – who are the main beneficiaries of competition law enforcement – cannot be easily educated in the benefits of competition law enforcement, and will rarely join forces to vie for it.

Given these political motivations, we should wisely recognize that the effect of politics on the adoption and the implementation of competition law cannot be simply ignored. Instead, it requires a modicum of responsiveness, away from Adam Smith's absolute economic liberalism, by devising ways to reduce political pressures that might reduce government officials' willingness to adopt and implement a socially desirable competition law. While such mechanisms may sometimes need to be tailored to the particular circumstances of each country, some general pesticides may well be applicable to most cases.

One possible method to reduce opposition to desirable reforms, which is sometimes suggested, is the adoption of a limited reform that does not fully apply the whole arsenal of competition law to incumbent firms but instead allows them to continue to engage in some types of business conduct that benefit them and would have otherwise been prohibited by the law. Such limited reform could definitely reduce political obstacles to the adoption of the rest of the legal provisions, especially if the law is a result of negotiation with pressure groups. At the same time, such limited reforms come with a large price tag attached. Obviously, limited applicability means limited competition and limited ability to achieve the benefits of a competitive system. In addition, as Kaplow rightly observes, such concessions may create higher costs for the implementation of socially desirable policies in the future. Special interest groups already have strong incentives to lobby for favourable treatment. If the norm is that if and when a change in the legal regime is implemented the special interests will be compensated or otherwise protected, then their initial incentive to lobby for such policies will be increased. It is thus not obvious that the net effect of buying-off opposition, when one includes the effects of future undesirable policies and wasteful rent-seeking expenditures, would be positive (Kaplow, 2003).

Another method to reduce the pressures of power groups on politicians is to balance these pressures out by creating opposite, pro-law pressures. This requires a political anchor or godfather for competition law, which can be a politically strong body, such as the Prime Minister's office (CUTS, 2003b: 18), or decision makers that are less affected by pressure groups and narrow considerations, whether because they do not need the support of interest groups for their political survival, or because their motivation to adopt a competition law is stronger than their will to give in to pressure groups. Decision makers are often best placed to think strategically about managing opposition, taking advantage of opportune moments and putting together supportive coalitions for reform. Politicians often have a detailed knowledge of power relationships that could help hinder efforts to reform, and can carefully craft the content, timing, and sequence of reform in order to mobilize support and manage opposition. For example, a crisis situation can be utilized to reduce political obstacles, as decision makers are likely to give more weight to societal concerns in such situa-

tions, and change is likely to be more dramatic and comprehensive (Grindle and Thomas, 1991: 5).

An extremely powerful and important method for combating political influences on decision makers is the creation of a strong and educated public opinion in favour of antitrust. Such public opinion may refocus the political interests of politicians on long-term and general goals and lead to the channelling of their private aspirations in more constructive and overall efficient ways. Even if politicians may not look beyond the next election, the interests of those who chose them may be long-term and non-sector specific. Education thus has the effects of lengthening the time horizon of politicians.

For public pressure to exist, however, two conditions must be met. First, the beneficiaries of the competition law, consumers and market participants who have so far been excluded from the market, as well as opinion formers, should be educated in the benefits of competition law enforcement. Second, the collective action faced by many individuals with a mutual interest should be overcome. A competition authority, where it already exists and is non-political, may play an important role in this process by educating consumer groups, businessmen and academia alike on the merits of antitrust enforcement to ensure that the public is well aware of the consequences of the decision made and by solving the collective action problem.

There exists, however, a chicken-and-egg problem, as the same law that pressure groups would like to limit its adoption in the first place often leads to the creation of a competition agency, which is the natural vehicle to solve the collective action problem by advocating consumer benefits in competition. Consumer groups, academics and concerned public figures can instead play an important role in taking the reigns of public support by forming consumer interest groups that would encourage lobbying aimed at establishing more efficient forms of regulation.

As internal forces to constrain problematic political motivations are likely to be limited, external sources, such as global institutions (e.g. the World Bank, UNCTAD or the WTO) or trading parties, may sometimes serve to overcome internal political economy issues. In this light, one can view the pressure of international bodies that developing countries adopt a competition law as a positive phenomenon, as it limits the discretion of policy makers and adds another factor to their political logic equation. In fact, many developing countries have adopted a competition law in response to external pressures, and external advisors that are generally devoid of internal political pressures have drafted their laws. One positive outcome of such laws is that they create a competition authority that, as elaborated above, if structured and funded properly (sun and water), may serve an important function in reducing internal political pressures to limit the law's applicability. Such external pressure is only positive, however, when it echoes the desired socio-economic policy of the country to which it is applied.

5. Sun and water: institutional and organizational preconditions

The actual enforcement of a competition law is no less important than its adoption. Enforcement is determined, to a large extent, by the organizational and institutional conditions in which the enforcing bodies operate. Such conditions determine whether antitrust is workable and its enforcement is credible and reputable: whether there exist efficient and effective tools for antitrust enforcement, and whether appropriate measures are implemented to ensure that the motivations of the enforcers to apply the law in specific cases are not limited by political pressures. The institutional and organizational conditions in which the enforcing bodies operate are, thus, the sun and water of competition law, as they allow it to develop and take root.

The competence and credibility of competition law enforcement are necessary in order to limit anti-competitive conduct. The more effective the enforcement bodies are in detecting and sanctioning legal violations, the more instances of anti-competitive conduct will be prohibited *ex post*. But, more importantly, the institutional conditions of the enforcing bodies affect the expectations of economic actors and their incentives to engage in such conduct in the first place. The higher the possibility of detection and sanctioning, the stronger the deterrence effects on market participants. In the face of uncertain enforcement, firms will reduce the possibility that they will be caught and charged with anti-competitive conduct and will have stronger motivations to engage in such conduct. If, on the other hand, enforcement levels are high, firms' motivations to commit their resources into anti-competitive activities will be lower. Regulation by deterrence should be the main course of antitrust enforcement, as it is much more efficient than direct regulation of conduct in limiting anti-competitive conduct.

The competence and credibility of the enforcing bodies are, in turn, highly dependent on the institutional and organizational conditions in which the enforcing bodies operate. The level of deterrence depends on market players' awareness of the objectives and scope of antitrust law. Thus, it is important to design and implement efficient mechanisms for disseminating information about competition law and its enforcement. Deterrence also depends on the existence of adequate human and financial resources for monitoring, detection, proof of violation and sanctioning, and on the enforcing body's ability to make impartial decisions. It also depends on the stature of the authority within the public at large, as enforcement is influenced by the general perception that the decision-making process is predictable, impartial, and equitable.

Accordingly, this section seeks to shed light on the organizational and institutional conditions that are necessary to ensure the successful enforcement of competition laws in developing countries. It builds upon the vast literature of the past decade on the institutional economics of antitrust enforcement. William Kovacic (Kovacic, 1995, 1997, 2001), among others, has emphasized the great importance of institutional competence, credibility and independence to the effectiveness of competition

policy. Several international institutions have also generated detailed and interesting reports on the institutional conditions for antitrust enforcement (e.g. APEC, 1999; UNCTAD, 2002; CUTS, 2003a, 2003b; ICN, 2003).

It is regularly recognized that developing countries often face institutional difficulties in enforcing competition laws. These involve, *inter alia*, inadequate judicial systems, excessive bureaucracy, corruption and a lack of transparency, a lack of resources and professional expertise within the competition authority, extensive capture by regulatory groups and weak professional and consumer groups. These problems can and should be addressed by developing the ability and institutional strength of the competition enforcement bodies. No unique model exists for all developing economies. The mix of institutions and organizational features has to be tailored to the particular economy in which it is applied. Yet several general principles can be discerned for competition law to be workable.

Of course, competition law enforcement is only part of a broader legal enforcement environment. Thus, it is vital that reforms be undertaken on several fronts to increase institutional competence and credibility (e.g. by creating a competent judiciary) and to build an environment that will support the efficient decisions of market participants (e.g. enforcement of contract law). Where there is no law and order, where corruption is rampant and where the informal sector is large, competition law enforcement might be extremely difficult. Yet some institutional measures that focus on the antitrust enforcement bodies can still improve the conditions for antitrust enforcement. This section focuses on such conditions.

The organizational and institutional conditions for competition law enforcement are for the most part cumulative: efficient enforcement depends on their parallel existence. For example, empowering the competition agency with investigative powers is not effective without sufficient human and financial resources to carry out investigations. Some conditions are mutually reinforcing. For example, educating consumers in the law and its benefits may significantly reduce enforcement costs and thus budgetary needs of a competition authority, by creating motivations for consumers to inform the authority of possible anti-competitive conduct. Interestingly, in some cases the organizational and institutional conditions necessary to perform certain functions conflict. This is the case, for example, with the double function of a competition authority: enforcement of competition law and creating support for competition policy, *inter alia*, by advocating the reduction of non-governmental barriers to competition. The institutional conditions for achieving both goals are, however, different. If enforcement is the goal pursued, then the institutional structure should favour independence, predictability and fairness of decision making. On the other hand, if competition-oriented reforms are the most important policy objectives, then the institutional structure must allow for the greatest possible influence with the policy makers. Leaving antitrust decision making to a judge, for example, favours independence while downplaying advocacy, especially when antitrust is completely left to pri-

vate initiative (ICN, 2003: 30). Each jurisdiction should thus find a balance between the achievements of these two goals that would fit its special setting.

It is useful to differentiate between two different types of institutional obstacles that must be tackled for enforcement to be effective: the practical ability to enforce the law and the motivations of the enforcing bodies to enforce it in practice. The two following sub-sections fit this divide.

5.1. Tools for effective enforcement of competition laws

Simply having a competition law on the books is not sufficient for its enforcement. The enforcing agencies must have a tool-kit that would enable them to apply the law effectively and efficiently. This requires financial and human resources, but it also requires legal mechanisms that would support such enforcement. This sub-section analyses such tools, based on a theoretical framework as well as on the experience of antitrust authorities, especially in developing countries.

1. *Human resources:* the best of laws cannot be applied without adequate human resources, i.e. a staff of sufficient size with adequate technical competence. The last condition is especially important in the area of competition law, which often involves a high-level economic analysis that complements a legal one in order to detect and to analyse the effects of business conduct. Lack of such human resources may lead to under-enforcement of the laws. It may also undermine the standing and reputation of the competition authority, especially where it results in incompetent enforcement efforts such as the loss of many cases brought by the authority.

Competition authorities thus need to employ lawyers, economists and investigators familiar with competition law and policy. In addition, several attorneys with litigation experience and a sound knowledge of administrative law and civil procedure should be hired. Particularly in its early years, the competition agency might be required to convince the courts that its cases are procedurally sound and substantively meritorious. It is vital that the agency be ready to prevail on such issues, as this will determine the breadth and scope of the legal basis for its future actions (Kovacic, 1997: 431).

Yet the attraction of professional staff that can deal effectively with antitrust issues is a major obstacle to competition law enforcement in developing countries (Stewart, 2004: 184). Developing countries must therefore devise ways to overcome such obstacles. In the long run, low levels of professionalism can be countered by building links with universities and ensuring that they teach the appropriate relevant courses (APEC, 1999: 9.3.14). In the short run, staff training programmes in procedural, methodological and substantive matters are key mechanisms for overcoming human resource constraints. Such training can be provided internally, but often there is an important role for external training. Internships, or seconded staff from more mature authorities, should be arranged to guide staff while gaining practical experience. Technical cooperation agreements and exchanges with other competition agen-

cies are crucial in this respect, as long as they match the learning curve and annual operational targets of the authority (UNCTAD, 2000: 38). It might also be advisable to retain outside counsel in important cases. To combat the problem of high staff turnover rates that is plaguing competition authorities in developing countries, it was recommended that training of staff should be offered on the condition of being bonded for several years (Stewart, 2004).

The inevitable disparities between private- and public-sector salaries also create problems of professional staff retention. The ability of the authority to overcome this problem will be determined, *inter alia*, by its standing and reputation within society. The independence, transparency and regard for due process all serve to create an attractive working environment for the high-quality economists and lawyers. Poland's successful antitrust authority, for example, took early action and created a good reputation that set off a virtuous circle. Its advocacy role reinforced its success and it has continued to attract good staff and political support. Yet there is here a kind of a chicken-and-egg problem, because in order to achieve a positive reputation, the authority will need skilled staff. Just as a competent, reputable agency generates a virtuous circle which attracts appropriately skilled and competent staff, so too does a poorly performing agency create a vicious circle that might repel those who may be able to turn it around (ICN, 2003). It is thus most important to invest in institutional conditions for antitrust enforcement from its start. Barbados has overcome this problem by setting up the agency and training its staff before its competition law was adopted. In that period, staff were recruited and trained in competition law and investigation procedures. By the time the law was passed, the Commission was ready to start operating (Stewart, 2004). Yet the Barbados experience has its costs, as it requires hindsight regarding the passage of a law or the postponement of the adoption of a competition law. An alternative method to tackle the problem of financial compensation disparities is by emphasizing to possible skilled employees the impact of their work on increasing social welfare. The personality of the authority's director will play an important part in such motivation-building efforts.

To reduce human resource problems it is also important that professional knowledge be accumulated in the agency, and is not totally dependent on specific people. Guidance manuals may provide new staff with access to the approach to be adopted. These should be supported by case histories so that the collective memory of the authority is easily and continually available (APEC, 1999: 2.9.17).

2. *Financial resources:* financial resources are a necessary complement to human resources. These expenses encompass the salaries of professional and administrative staff and the creation of an infrastructure to support the work of such staff. The Chilean agency was considered, for many years, a "second-tier" agency, due to insufficient resources, despite the fact that most of the Prosecutors were highly respected and influential individuals (OECD, 2004). Similarly, the Israeli authority did not have, for many years, a budget that could support engagement in investigations of the conduct of market players (Gal, 2004). This condition, among others, pre-

vented it from effectively enforcing the law. Conversely, the Zambian authority was well resourced, a fact that contributed to its ability to apply its laws (Holmes, 2003: 5). Since competition law cases often consume large sums in investigation and trial costs, it is also vital that enforcement decisions be taken on a rational basis and cases should only be tried where enforcement costs are lower than the harm prevented in the specific case or by the possible deterrence effects that would prevent similar cases. This is especially true for small economies, which naturally have lower enforcement budgets.

3. *Legal enforcement tools:* while this paper does not deal directly with the content of competition laws, there are several legal provisions and conditions that affect the institutional competence of the competition authorities. Three such conditions are elaborated below. The first condition is ensuring that the law is compatible with general legal principles and constitutional values. Jamaica has had the very unfortunate experience of having a fundamental error in its competition law, in that the investigative and adjudicative arms of the Fair Trading Commission were not separated. The competition authority was taken to court for breach of natural justice, lost the case and the appeal, and is now in the process of revising the law. This has had significant negative effects on the reputation of the competition agency and on its ability to operate, since it cannot pursue any cases until the law constituting the institution is amended. The lesson to be learnt here is that it is essential to have the draft law vetted by several experts of general legal principles (Stewart, 2004).

The second condition is that the authority be granted broad investigative powers. Competition agencies need to be able to monitor markets and obtain information on the conduct of market participants if they are to be effective. To perform such tasks, the competition authority must be equipped with investigative tools that enable it to obtain the relevant information (CUTS, 2003a: 67). For example, the authority should be empowered to enter into business premises to collect information, to investigate managers and employees of firms and to demand information from business entities, where there is suspicion of a violation. There should also be a high penalty for failing to comply with investigative efforts. The importance of such tools can be illustrated by the Zambian experience. The Zambian Competition Authority had much trouble getting information from Coca Cola on possible anti-competitive violations. It was only when the government passed a law making it punishable by incarceration if a firm fails to cooperate with the authority, that the authority got immediate cooperation. While this is an extreme example, there are less draconian means by which firms could be persuaded to cooperate (Stewart, 2004).

The third legal institutional condition is that the enforcing bodies be able to impose high penalties for anti-competitive conduct. Economics has long taught us that the level of deterrence of a law is largely determined by the probability of detection of a violation and the level of sanction imposed upon the violator. If sanctions were not sufficiently high, then it would still be rational for market players to engage in anti-competitive conduct. Accordingly, the law should provide the enforcing bodies with

sanctions that are high enough to act as a disincentive to engage in anti-competitive conduct, when taking into account enforcement levels. The Peruvian experience is a case in point. At first, the fine for engaging in anti-competitive conduct was set at US$ 40,000, but this was found to be too low to create disincentives for large multinational companies, and the fine was raised (Stewart, 2004). However, it might be better to base fines on the potential and actual profits from the anti-competitive conduct or on the yearly turnover rates of the firms instead of on predetermined sums. Sanctions should also depend on the law's level of clarity. Where the legal principle is clear, the sanction can be higher than when there is some uncertainty in the legal provisions. This is because imposing high sanctions in instances in which laws do not clearly define legal conduct can prevent pro-competitive conduct. It is also suggested that where courts lack institutional competence, it might be better to leave sanctions in the hands of an independent competition agency and to avoid private remedies and treble damages.

4. *Institutional tools for building credibility and stature of enforcing bodies:* to increase social acceptance and compliance with competition law, the enforcing bodies should be regarded by consumers and producers as credible and should be respected. The authority's stature, in turn, increases its ability to enforce its laws on both domestic and international firms. Accordingly, technical compatibility for enforcing the law must be accompanied by reputation-building procedures and tools. Here we shall focus on several tools. Others will be elaborated in the next sub-section, which analyses the tools for limiting political influences on the enforcement of antitrust laws.

An important tool for building credibility involves taking-on large incumbent players at the early stages of enforcement. Beyond educational and immediate social-welfare purposes, this will signal to market participants that the enforcing authority is determined to follow a resilient agenda of enforcement. It is also important to choose the first cases very carefully in order to build credibility. Jamaica's experience exemplifies how important it is to exercise prosecutorial discretion. The Jamaican antitrust authority chose as one of its first cases to challenge the Bar Association, claiming that its Canons of Professional Ethics, including restrictions on advertising and fixing of fees, were inconsistent with its competition law. The Commission lost the case and its credibility, as the court decided that the Bar is exempted from the application of the competition law. It is thus important to choose cases that are easy to investigate and to win, in which the issues are easily understood by the public (Stewart, 2004). Follow-up on compliance with the authority's orders is also a valuable method for establishing credibility as a strong enforcement institution. Moreover, to enhance credibility, the law should apply to all sectors of the economy and exemptions should be limited. Otherwise, consumers might perceive enforcement to be discriminatory or marginal. The personality of the director of the competition authority is also important to build credibility and respect. The impact of the competition agency in South

Africa, Peru, and other developing economies was clearly derived from the respect for senior figures (Holmes, 2003: 8).

Transparency is also an important mechanism for enhancing credibility. This includes transparency in administrative procedures and regulations, the right to appear before the enforcing bodies unless strong reasons mandate otherwise, the publication of fully reasoned decisions and, where feasible, the maintenance of a web site on which the authority publishes its decision as well as guidelines and speeches and other public statements. In Chile, for example, the Prosecutor's Office has prepared a database containing summaries of many of the enforcing bodies' rulings that is reachable through its web site (http://www.fne.cl/).

A strong emphasis on consistency and due process are also central in developing the credibility of the authority. This could be achieved, in part, by adopting guidelines and notices setting out the manner in which the authority will apply substantive and procedural elements of the law, and by following such guidelines to the extent possible. It is also useful to set pre-determined time periods for the treatment of cases. Choosing and pursuing articulated priorities with a reasonable and well-explained rationale may also enhance credibility as a non-discriminatory agency (De Leon, 2000). All these methods serve to demonstrate that the authority is acting impartially and efficiently within its legal mandate.

5. *Judicial competence:* the judiciary plays an important role in the institutional apparatus of antitrust enforcement. In most countries, decisions by the competition agency are subject to judicial review and in some cases the judiciary has also the initial decision-making power. It is thus crucial that the judiciary support sound and credible antitrust enforcement for limiting anti-competitive conduct and for creating deterrence effects.

A serious problem with the judiciary, encountered by many countries, is the low level of expertise of judges in antitrust issues (e.g. Rodriguez and Williams, 1994; Cook, 2002). This stems from the judiciary's possible lack of experience in competition cases and from their difficulty in dealing with cases that require economic analysis, as is often necessary in defining and proving anti-competitive conduct. The judiciary may, then, issue decisions that are incompatible with the principles of competition law or resort to purely technical reviews instead of determining the merits of the case. The problem of judicial competence is so significant that Jamaica identified the main constraint it encountered in the implementation of competition law as the fact that the judiciary is not conversant with competition principles. Similarly, the Russians experienced competition law enforcement problems due to the lack of experience and understanding of the judges of the necessary economic concepts (APEC, 1999).

This is why the training of judges in competition matters is crucial to competition law enforcement. Another solution is to set up a specialized tribunal, as has been done in South Africa and in Israel, that is exclusively empowered to hear competition

cases. This allows for a small body of judges to develop experience in the application of the competition law. Judges will, over time, learn the guiding principles of competition law and will be less inclined to uphold purely technical reviews in preference to determining the merits of the case. It may also be wise to structure the court of first instance as an administrative tribunal, which is headed by a judge, but composed also of competition experts, both lawyers and economists, to assist the courts in reaching their decisions. To ensure that the benefits of specialization are not lost, however, the appeals court should be limited in its review of the decisions of the tribunal to significant errors of law or fact.

It might also be useful to allow the competition agency to submit written comments to the courts in order to draw the court's attention to issues that are important for the consistent and effective application of the law. Belgium and Finland, for example, empower the competition authority to submit its comments to the court. The issuance of the opinion of the authority to the courts, in the name of the public interest (as "*amicus curiae*"), is an important tool for creating consistent and credible antitrust enforcement (ICN, 2003).

Where problems of corruption or lack of expertise in the court system cannot be easily overcome, it might be wiser to place decision making in the hands of an administrative body rather than a court. This circumvents the problem of generalist or corrupt judges taking decisions on competition matters. It also provides for swifter access to the decision maker and it frees the adjudicative bodies from the extreme formalism that frequently characterizes judicial processes. Yet, administrative enforcement lacks the diffused onus of responsibility, and increases the possibility of political considerations, as elaborated below. The institutional structure should thus be determined by the special characteristics of each country.

6. *Role of competition authority in regulatory reform:* competition may not only be hindered by private anti-competitive conduct, but also by public regulatory intervention and rule making. Some examples include licensing, standards, import and export quotas, privatization decisions, and policies for access of competitors to bottleneck segments (Tirole, 1999: 3). Such government-made obstacles may be warranted where they are necessary to correct market failures or for the achievement of more important social goals. However, regulatory intervention may go beyond the strictly necessary. This might be due to the influence of interest groups, or to the insufficient weight given to competitive considerations (ICN, 2002: ii–iii). The competition authority may provide important tools for minimizing both problems. While the next sub-section will deal with the institutional tools to reduce political economy issues of antitrust enforcement, below we elaborate on the institutional mechanisms available to tackle the lack of competition culture problem.

Increasingly, it is recognized that competition authorities play an important role in the promotion of a competitive environment by pro-actively influencing regulatory activities to ensure the rejection of unnecessarily anti-competitive regulatory meas-

ures. This government advocacy role may, in some cases, be more important in promoting competition than the repression of anti-competitive behaviour through antitrust enforcement. A study undertaken by the OECD showed that the competitive process can be appropriately stimulated by the intervention of competition authorities when firms in a regulated sector abuse their privileges to the detriment of consumer interests. In fact, some of the greatest successes of competition authorities identified by developing countries are in the prevention or reduction of anti-competitive legislation and other interventions by government in the competitive process (ICN, 2003). For such a scenario, a proper institutional framework must be put in place. Creating an institutional framework for competition advocacy is especially important for developing countries. In such countries, many functions are still subject to direct regulation. This gives rise to an intensive rule-making process in which competition advocacy has an important role to play (ICN, 2003: iii). The competition authority can assist in the adoption of socially desired policies.

The interaction between the competition authority and other regulatory frameworks takes place at two stages. First, the competition authority may seek to influence the rules that govern the sector, by ensuring that the concerns of competition are taken into account at the time the regulatory system is set up or reformed. Second, advocacy may take place at the implementation stage, by convincing other public authorities to abstain from adopting unnecessarily anti-competitive measures, and helping regulatory agencies to clearly delineate the boundaries of economic regulation (ICN, 2003: iii). Both require some institutional preconditions for their existence.

An important prerequisite for effective government advocacy is that competition authorities be informed about regulatory initiatives in a timely manner, to ensure that the competition agency is consulted at a time when there is still opportunity for considerable feedback. This task is best placed upon the legislative or regulatory body, by mandating it to inform the competition authorities of any act that may reduce competition. In the US, for example, some provisions ensure that the Department of Justice gets timely notice of proceedings.

A second institutional issue is whether the consultation of the competition authority is mandated by law or discretionary. The OECD's Regulatory Reform Report recommended providing competition authorities with the authority and the capacity to advocate reform throughout the government (OECD, 1997). Some authorities can only conduct studies or make recommendations when requested by the Ministry they belong to and they cannot decide on their own to make the contents of their reports public or to pressure for their recommendations to be taken into account (ICN, 2002). In other jurisdictions, the authority may participate in meetings of the Government on an occasional basis, e.g. upon invitation to pronounce its view on a specific project. It is much preferable that competition authorities be granted the power to act on their own initiative. Some procedural safeguard or formalization of the consultation process is also desirable.

A third institutional issue involves the formal power of the competition agencies to influence governmental regulations: does the competition authority issue opinions that are binding on the policy maker? There is a wide range of answers to this question. At one extreme, the competition authority has a decisive role in regulatory and reform processes. This can be achieved by a participatory role, as in Chile, where the competition institutions are included in the process of regulating infrastructure monopolies. Alternatively, the authority may have an influential supervisory role. In Uzbekistan, for example, the Anti-monopoly Committee may require state administrative bodies to terminate or modify legislative acts and orders which are found to contradict antimonopoly legislation. Similarly, in Hungary, if the Hungarian competition authority finds that any public administrative decision violates the freedom of economic competition, it may request the public administrative institution to amend or revoke the decision in question. If the public administrative institution fails to do so, the authority may seek a court review of the decision.

Yet in most jurisdictions, the law places upon the agencies the smaller but important role of commenting from a competition policy perspective on issues that that will be decided by other sectors of the government. The UNCTAD Model Law on Competition requires that regulatory barriers to competition incorporated in economic and administrative regulation should be assessed by competition authorities from an economic perspective (UNCTAD, 2002b). This recognizes the authority's expertise in determining market power and the conditions that must exist for effective competition, yet leaves the ultimate decision to the specific regulator, who may have expertise in the industry at hand.

In politics as in politics: another means of practising to create government advocacy is to join forces with other governmental bodies with similar goals. This can be illustrated by the battle against the Israeli monopoly in public transportation. For years, one firm dominated the Israeli public transportation market. The Ministry of Transportation was reluctant to open up the market to competition. The Antitrust Agency joined forces with the Ministry of Treasury to create public opinion for the introduction of competition into the market, which eventually led to the creation of more competitive conditions.

7. *Public advocacy as an enforcement tool:* the importance of educating market participants in the rules of competition law as a tool for reducing political economy obstacles and for creating a socio-economic ideology has already been emphasized. Here, we focus on its importance as an enforcement tool, to increase compliance and deterrence effects, and on the institutional tools necessary for it to be effective.

It is possible to identify several ways in which public advocacy assists competition law enforcement. Competition advocacy serves to change the mindset and *raise the awareness* of market participants to the legal framework. It can thus act as a preventive measure, as it adds to the economic calculation of market participants the perceived costs of anti-competitive conduct. In many developing countries, a signifi-

cant problem with antitrust enforcement results from the fact that firms are simply not aware of the antitrust implications of their conduct and there is no sense of wrongdoing, especially where conduct has been legal for many years. To give but one example, the five largest poultry producers in Trinidad indulged in collusive increases of price, without being aware of the anti-competitive nature of their acts (Stewart, 2004: 184). Accordingly, there should be an intensive educative programme that will focus on trade associations and dominant incumbents prior to and during the implementation stage of a competition law. A successful case against a particular form of behaviour can also have significant educative effects. A highly publicized UK test case in early 1959 resulted in the voluntary abandonment of over 2000 cartels (APEC, 1999: 9.3.10).

Also, education of the general public may increase enforcement levels. Competition authorities are always straddled for funding. They are also in constant search of proof of anti-competitive market conduct. Market participants can play an important role in increasing enforcement levels and reducing resources needed to detect anti-competitive effects by informing *the agency* of anti-competitive conduct. To create incentives for private players to collect the relevant information and to file complaints with the authority, however, three conditions must exist. First, there must be an open channel to the antitrust authority. Second, the potential enforcers – most importantly consumers and small and medium-sized competitors who are the authority's natural allies – must be educated with the legal provisions and the benefits they bring about. Third, they should have motivations to supply the information, which are influenced by their belief that the agency will indeed investigate their claims and, if justified, take action against the violator. Public advocacy is thus a crucial ingredient in disseminating enforcement efforts.

Finally, and of no less importance, the strength and compliance with the law result, *inter alia*, from *the recognition and acceptance* of competition mechanisms within society. Where there is no acceptance, there is a stronger reluctance to comply. Such acceptance is especially important in those developing economies in which the levels of compliance with the legal system are relatively low. Thus, educative efforts, where society can fully grasp the benefits and content of competition law, may be decisive in ensuring the successful implementation of the law in the long term. Education also serves to reduce the danger that expectations of consumers for competition law enforcement be too high. Understanding the limitations of competition law enforcement, or the kind of evidence necessary for it to apply, is sometimes no less important than understanding its benefits. To increase social acceptance, advocacy should not only focus on informing society about the benefits of competition law, but also on the authority applying the law correctly and impartially (APEC, 1999: 2.9.9).

How is such public advocacy to be brought about? In the past few years, there have been several extensive studies on competition advocacy that analyse the tools at a competition authority's disposal to strengthen the competitive culture (see, e.g.,

ICN, 2002, 2003). I would like to focus on some that are especially relevant to developing economies. In the specific context of developing countries, consideration must be given to potentially low income levels and high illiteracy rates, both of which may impact on the ability of consumers to understand the benefits of the law. Accordingly, the objectives, principles and tools of competition law should be explained in simple, "lay" rather than legal terms. The costs of monopoly, cartels and competition distorting regulations should be explained, while also reassuring the business community of legitimate forms of competition. Also, where other social goals may receive primacy over consumer welfare, the advocacy programme should include emphasis on the goals of competition law and how it interrelates with other policy tools. Such information should be disseminated through multiple channels, including giving public lectures to professional and trade associations, academic institutions, organizing conferences, writing articles for publication in specialized or general reading publications, holding press conferences and otherwise publicly explaining the importance and implications of competition and market principles. Another way of public advocacy is to select cases that resonate loudly with consumer concerns and relevant to the family budget. Some competition authorities have consciously selected cases that make a difference to the ordinary lives of low-income consumers. Peru, for example, took early action against cartels in the bakery and chicken industries, which resulted in a reduction in the price of such products. Even an uneducated consumer can easily grasp the effects of competition in this everyday context (ICN, 2003). Indeed, the recipe for success might well be said to choose the initial cases with a view to strong impact on the general public and the publicity benefit that might be obtained. Thus, the application of the law should initially be focused upon cases with little chance of loss and with a high and direct consumer benefit (APEC, 1999: 2.9.8).

Another interesting idea to make the introduction of a competition law more acceptable in developing countries could be the adoption of a consumer protection law at the same time as a competition law, and to have both sets of laws administered by the same agency. Thereby, competition policy would become more visibly associated with consumer protection. It should, however, be ensured that the two policies work in a complementary way by focusing jointly on consumer welfare (ICN, 2003) and that consumer protection does not take up too much resources.

5.2. Institutional solutions to political obstacles to competition law enforcement

The previous section focused on strategies available to developing economies to counter political pressures on legislatures to refrain from adopting a competition law or to limit its breadth or scope. This sub-section deals with the institutional tools available to reduce political pressures *on the enforcing bodies* to limit competition law *enforcement* in favour of specific interest groups. As noted above, the enforcement of a competition law involves high personal stakes, both to incumbent market players and to politicians. Such high stakes are often translated into lobbying, rent-seeking behaviour, aimed at limiting enforcement efforts in specific sectors or cases.

As the competition authority is an integral part of the government, no such authority is completely independent from political pressures (Pittman, 1992).

Yet careful institutional design and social planning can significantly improve upon the influence of political motivations on competition law. The key is the creation of an autonomous and non-partial agency. This sub-section will analyse the tools available for limiting political pressure, based on a theoretical framework as well as on the experience of antitrust authorities, especially in developing countries. It is based, in large part, on the author's previous work (Gal, 2002). The tools suggested are often intertwined. To give but one example, in a cyclical manner, the less political the authority's decisions are perceived to be, the stronger the public support, and the more powerful the public opinion to reduce political pressures in the first place (Gal, 2002).

1. *Autonomous agency:* probably the most important condition for combating political pressures on enforcement is ensuring that the antitrust authority is independent, to the extent possible, from political figures. This requires that the authority be a separate body and not an integral part of a ministry and that its decisions could not be overturned by a political figure. The possible consequences from lack of independence are exemplified by a Pakistani case, in which the decision of the competition authority was overturned due to the intervention of a minister who was on the board of the company in question (Holmes, 2003: 4) .

In some circumstances, however, the politicization of the antitrust authority need not be rejected. Russia provides a fascinating example (Yuzhanov, 2002). Russia has adopted an Antimonopoly Law as an integral part of wide-scale economic reforms to move from a centralized, communist government to a market-oriented economy. A minister, who is an active member of government, heads the Russian Antimonopoly Ministry. This proved to be beneficial: the antitrust principles were so different from the embedded ones, that to be effective, the head of the antitrust authority had to be a strong political figure that took part in the ministerial discussions on the adoption of economic policy. Although some decisions were based on political considerations, others could not have been reached or implemented without strong political power. Once the new economic order matures, however, it might be wise to change the institutional organization and create a more autonomous agency.

2. *Non-political nomination of the Director:* in reality, the head of the agency largely determines the authority's priorities and the outcomes of its decisions. Even if he is not legally empowered to authorize certain types of conduct, he may nonetheless decide whether or not to conduct an inquiry of certain markets. It is thus crucial that he not be politically oriented towards any specific group of interests. Although political pressures on the nomination process cannot be totally eliminated, it is important to minimize such pressures. In Chile, independence is sought by nomination by the President of Chile. In Hungary, the leading officials of the competition authority are appointed by the President of the Republic on nomination of the Prime Minister, and their appointment is for 6 years, 2 years longer than the mandate of the govern-

ment. In Israel, the Director of the Antitrust Authority is chosen by a special committee headed by a judge, which selects amongst the contenders to a public tender in accordance with their personal qualifications. The Minister appoints only one of the three committee members. The chosen director must meet the criteria necessary for a justice of the peace. Another often-used method involves prohibiting the Director from working in the private sector on antitrust-related issues for a predetermined period after his/her term is over, as is done in Israel. This reduces, at least to some extent, his/her inclination to weigh the considerations of possible future employees or clients. Such institutional tools may reduce political pressures on an important decision.

3. *Independent budget:* yet even the most impartial person will have limited ability to disregard political considerations if he does not have the fiscal resources to carry out his actions. It is thus extremely important that determining the agency's budget be free of political considerations. Although this cannot be accomplished in full, the agency being part of the government, there are several methods to reduce political pressures through budget setting. One method is to base at least part of the budget upon some income that is generated by the agency, such as on fees charged by them for merger decisions and on fines imposed for anti-competitive conduct.[9] Another important method is to separate the agency's budget from that of other governmental functions and make it transparent to the public. The stronger the public scrutiny, the more difficult it will be for the political system to cut back the agency's budget. Here the competition agency has an advocative role, which it can carry out by publishing its expected enforcement costs relative to the proposed budget, the relative budgets of successful competition agencies in relatively similar countries, the estimations of international bodies of the expected costs of competition law enforcement, and the expected savings to society that will result from such enforcement. A third method is to establish a minimum budget as part of the law, to ensure that the agency has funding to carry out at least some of its tasks.

4. *Juridical scrutiny:* juridical scrutiny of the antitrust authority's decisions, where there exists a strong, independent and objective judiciary, may also be used to reduce political pressures. For such scrutiny to be meaningful, the scrutinizing court should be an expert one that is empowered to hear cases *de novo*, rather than determine whether the decision was reasonable. In South Africa, the court was even granted special inquisitorial powers. Yet, for several reasons, juridical scrutiny is a limited tool. First, it is very difficult to question cases in which the authority has decided not to take any operational step. Second, there may exist informational asymmetry problems between the agency and the court. Third, for such scrutiny to be operational, there needs be a plaintiff who is willing to invest resources in questioning the authority's decision. Fourth, juridical scrutiny is often not timely. Yet juridical scrutiny may still reduce political pressures if politicians know that the agency's decision might be subject to investigation and might be overruled by an objective body.

5. *Transparency of decisions:* an important method for minimizing political influences is by ensuring the transparency of antitrust decisions to public scrutiny. This requires the adoption of several complementary methods. Most importantly, the decision maker, whether the Director of the authority, the court or any other body, should be mandated to issue reasoned decisions. Technical tools to disseminate decisions in a timely manner, such as via an Internet site or via a newsletter should complement this. In addition, hearings before a competition court should be public, except to the extent necessary to protect confidential information.

6. *Empowerment of consumer groups:* another method to reduce political pressures is to grant consumer groups standing in the decision process. In South Africa, for example, some third parties with a material interest (such as the parties entitled to notice about mergers) may participate in hearings before the Competition Tribunal, with the right to put questions and examine evidence presented.

7. *Criminalization of antitrust proceedings:* the criminalization of antitrust proceeding may serve to limit political pressures on the antitrust authority. Where interference with an ongoing criminal investigation is an offence, politicians might be more cautious before intervening in an antitrust investigation, unless they enjoy legal immunity for the consequences of such interference.

Therefore, institutions play an important role in providing the tools necessary for a workable competition law. The law is similar to a fort, which must be correctly built and protected in order to protect its inhabitants (Popper and Kegan, 1957: 66). Accordingly, the success of competition law enforcement depends on the adoption of institutional and organizational tools to ensure social acceptance of the law, to enable the enforcing bodies to enforce the law in practice and to limit political pressures.

6. Conclusion

A competition law is an important tool for creating competitive conditions, yet the creation of a workable competition law is not an easy endeavour. As this article has shown, the adoption of a competition law is only one precondition for the enforcement of the law. For the law to take root and bloom, other conditions must also exist, which are the soil, sun, water and pesticides of competition law.

As has been argued, the socio-economic ideology of the government is an important determinant of the adoption and the enforcement of a competition law. A competition law is generally broad enough to incorporate divergent ideologies – from total rejection of power and large size, to the acceptance of monopolistic positions as necessary for creating incentives for firms to compete in markets. Its enforcement, thus, depends to a large degree on the view of the enforcer regarding the role of market forces and the role of the government in its regulation. Accordingly, its efficiency as a pro-market tool depends on the government's competition culture and its public policies based on it. Changing the socio-economic ideology of a country is one

of the most important and difficult challenges for a developing country, in which a market ideology is not deeply ingrained and protective policies are often used to solve economic problems.

In addition, it is vital to recognize the obstacles created by political pressures to limit the adoption and implementation of a competition law. Such influences should be combated by both internal and external counter-tools that are crafted to meet the specific concerns of each jurisdiction. Otherwise, political logic might triumph over social logic.

The legal tools must also be accompanied by institutional and organizational conditions that are conducive to the enforcement of competition rules. As such, they should provide the regulatory bodies with the necessary resources – human, financial, and legal – that are needed in order to apply the law effectively.

The implementation of a pro-market regulatory framework thus requires more than simply liberalizing trade or supporting privatization processes or adopting a competition law. It also requires strategic thinking about the ecological conditions for effective competition law enforcement, of the kind suggested in this chapter.

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Notes

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* Senior Lecturer and Director of Law and MBA Program, Haifa University. Academic Fellow, NYU Centre for Law and Business.

1 Until 1990 only 16 developing countries had a formal competition policy. With encouragement and technical assistance from international institutions, 50 countries have completed legislation for competition laws in the 1990s, and another 27 are in the process of doing so (Singh, 2002: 6).

2 Antitrust file 202/240/5 Plywood producers *vs*. Director of Israeli Competition Authority, 48 District Court Decisions, 158.

3 Civil Appeal 2247/95 Director of Competition Authority *vs*. Tnuva Inc., 52 Supreme Court Decisions, 213.

4 Request for Exemption from Court Approval for Agreement to Establish Poligar, in Antitrust (Bar Association, Tel Aviv, 1994), vol. A, 108.

5 For a similar conclusion in the case of Venezuela see UNCTAD (2000: 24).

6 Brazilian response to ICN capacity working group (ICN, 2003: 28).

7 Virtually all developing countries that have adopted a competition law include public interest objectives in their laws. These countries include, *inter alia*, Cameroon, Gabon, Jamaica, Kenya, Macedonia, Morocco, Pakistan, Sri Lanka, Chinese Taipei, Tunisia and Zambia.

8 Unless, of course, the politicians' political allies are the beneficiaries of such policies.

9 This method might, however, have some negative effects, as it might create incentives for the competition authority to use broader merger notification standards, to bring more cases and to impose higher penalties than is socially optimal.

I.2. PREREQUISITE FOR DEVELOPMENT-ORIENTED COMPETITION POLICY IMPLEMENTATION: A CASE STUDY OF NEPAL

Ratnakar Adhikari

1. Introduction

Competition policy was not a priority for most least-developed countries (LDCs) in the era of widespread state intervention in economic activity, which was underpinned by the concept of import substitution industrialization (ISI). However, subsequent developments, both internal and external to these economies, demonstrated the need for specific pro-competitive initiatives. Internally, the adoption of liberalization policies, the rise in privatizations, and the fact that most privatized entities in the utilities sector are natural monopolies underscore the importance of a solid competition regime to elicit the most favourable efficiency and welfare effects of liberalization and privatization. Externally, the massive international merger wave and the existence of international cartels (WTO, 2001) and their potentially negative impact on market contestability posit a case for competition policy to equip developing countries with the tools to deal with the increased market power of multinational companies and their anti-competitive practices (Adhikari and Knight-John, 2003).

Most LDCs have, explicitly or implicitly, adopted some kind of competition policy measures during the past decade. The majority of them have virtually done away with a licensing regime, accelerated the process of privatization, deregulated or delisted many industries from the earlier "reservation" system, and opened themselves up to international trade and foreign investment (Adhikari and Regmi, 2001; Musonda, Mbowe and Sampson, 2001).

Theoretically speaking, these measures have the potential to significantly contribute towards increasing market contestability in the domestic markets of the LDCs. However, implementation of these policies has not been as effective as was originally thought. The prevalence of a host of anti-competitive practices has hindered the process of creating a competitive environment in the marketplace. A lack of political will, coupled with apathy within the concerned agencies to implement these policies, is considered one of the reasons for policy failure in the LDCs.

In order to ensure that pro-competition policies meet their desired objectives, they should be anchored on the development dimension. Since economic development is the major priority for most LDCs, it is essential for them to prepare development-oriented competition policy and legislation in tune with their development requirements.

Although LDCs are designing competition policy and enacting competition law due to a growing realization of their merits, most LDCs are worried about the possibility of their competition regime encroaching upon the pursuit of their development objectives. They are looking for mechanisms to ensure that they could design their

competition regime in a development-friendly manner. For instance, Nepal, an LDC, which has made a commitment at the time of its accession to the World Trade Organization (WTO) to prepare a competition law (WTO, 2003) needs to design a development-oriented competition policy and law. However, policy makers, who have limited exposure to these issues, are unable to reach a consensus on how to design and implement a development-oriented competition policy framework. This calls for a thorough analysis of the development implications of the competition policy and law to be prepared in Nepal.

The overall objective of this chapter is to prepare a policy document to identify the *prerequisites for the successful implementation of competition policy in developing countries and the mechanisms through which this may operate*, taking Nepal as a case study. In the process, the chapter also looks at various facets of competition policy and law including their application in various jurisdictions. Section 2 discusses development objectives of the LDCs, particularly Nepal, in the post-liberalization era. Section 3 investigates the constraints faced by developing countries and LDCs to implement competition policy and law. Section 4 briefly sketches the nature of anti-competitive practices in Nepal and their impact on various sectors of the economy and segments of the society. Section 5 discusses the issues of the development dimension of competition policy as adopted in other countries – their merits and demerits as well as their successes and failures. Section 6 discusses the *prerequisites for the successful implementation of competition policy* in Nepal. The final Section concludes and provides some policy prescriptions to His Majesty's Government of Nepal (HMGN), so as to help them design and enact their competition law.

2. Development objectives of LDCs in the post-liberalization era

LDCs have, for decades, been striving to find the right development strategy to enable them to promote sustainable development by reducing poverty and malnutrition, engendering development-oriented institutions, and promoting social justice. Over the past two decades, an increasing number of LDCs have placed their hopes on a development strategy based on increased participation in the world economy, through exports and inward foreign investment (UNCTAD and Commonwealth Secretariat, 2001: 1) to achieve the goal of sustainable development.

To this end, they have vigorously promoted an outward-looking economic development strategy. Indeed, as per the UNCTAD LDC Report (2000), trade liberalization in the LDCs has actually proceeded further than in other developing countries. In 1999, 60 per cent of the 43 LDCs for which data are available had average tariff barriers below 20 per cent and non-tariff barriers that covered less than 25 per cent of production and trade. Similarly, UNCTAD data on foreign investment regimes in the late 1990s show that out of a sample of 45 LDCs, only nine maintained strict controls on the remittance of dividends and profits and capital repatriation (Cuddy, 2001: 3). However, it is worrisome to note that the LDCs, despite serious efforts to

achieve their development objectives are not able to realize their potentials (Adhikari, 2004).

The efforts to integrate these economies with the outside world have also been supplemented by a wave of economic reform measures at home. Most LDCs have started their domestic economic reform measures – including privatization, deregulation and financial sector liberalization – due to the conditionalities of the Bretton Woods Institutions. These measures were not necessarily a product of thoughtful consideration aimed at instilling competition in the economy, but rather were a part of a donor-driven exercise. Nonetheless, these measures, in theory, are important from the perspective of enhancing competition in the marketplace. However, it is an irony that they have not been able to achieve even the purpose they were intended to serve, let alone promote competition. We now turn to look at the problems faced by the LDCs and the efforts made by them to achieve their development objectives.

2.1. Employment generation

Lack of productive employment opportunities and consequent exacerbation of poverty is the single major problem for most LDCs. Since the majority of the populations in these countries depend on agriculture for their livelihood, they are not only hit by international price fluctuation of the primary commodities, but are also affected by the lack of market access opportunities in the North. Their process of diversification into secondary and tertiary sectors has been glacially slow.

Therefore, creation of a viable industrial and service base for absorbing the ever-growing youth population that enters the employment market every year is one of the major objectives of most LDC governments. In the case of Nepal, this objective is reflected, for example, in the Tenth Five-Year Plan (2002–2007) of HMGN, which is also the Poverty Reduction Strategy Paper (PRSP) adopted by the government through a wider consultation with relevant stakeholders at various levels (National Planning Commission, 2002).

2.2. Promoting investment

In order to accelerate the pace of economic growth and provide employment opportunities to their growing populations, most LDCs are rigorously promoting investment. Against the backdrop of the reduction in official development assistance (ODA) and change in donors' priorities as well as focus, the LDCs are providing extra incentives to foreign investors to invest in their respective countries.

For example, in Nepal, under the "one-window" policy, foreign investors are provided with a one-stop clearance procedure for their proposal. Except for the limited number of sectors, excluded mainly on cultural and national security grounds, all economic activities are open to foreign investment. Approval is almost automatic, provided the relevant environmental criteria are fulfilled. However, most LDCs are lagging behind in terms of attracting foreign direct investment (FDI).

A study conducted by CUTS (2003a: 3–4) on the investment regimes of three LDCs – Bangladesh, Tanzania and Zambia – revealed that only Tanzania has improved its foreign investment performance, while Bangladesh and Zambia are lagging far behind. Similarly, as per the World Investment Report, 16 under-performers (with low FDI potential and low FDI performance) during 1999–2001 are LDCs (UNCTAD, 2003: 10).

2.3. Enhancing competitive ability

In the era of global competition, it is not sufficient for LDC companies to be locally competitive. They need to be globally competitive, for which they should possess some competitive advantage such as economies of scale, cutting-edge technology, marketing strengths, efficient production and distribution systems, and/or cheap labour (Adhikari and Ghimire, 2001: 7). The LDCs do not generally have a comparative advantage in any one of these areas except for the availability of cheap labour.

However, because of the low productivity of such labour, resulting mainly from lack of education and skills and poor health, even this comparative advantage of the LDCs has not been fully exploited. Therefore, one of the major development objectives of LDCs in the post-reform era is to identify and harness the potential areas of their comparative advantage, and at the same time enhance their competitiveness in the global market.

2.4. Removing supply-side constraints

In the LDCs, lack of linkage between production facilities, service and infrastructure facilities limits their potential to specialize in crucial productive sectors and reap the benefits of productivity gain. While poorly developed human resources have led to a paucity of managerial, entrepreneurial and technical skills, the ability to conduct adaptive research is severely constrained by a lack of incentive and entrepreneurial zeal.

Similarly, poorly developed infrastructure (e.g. transport, power and storage facilities), support services (e.g. telecommunications, financial services and other technical support service institutions), and a general lack of trade facilitation measures limit their ability to supply even otherwise competitively produced goods to the international market. Therefore, removing the supply-side constraints to be able to export by taking advantage of market access opportunities is another objective being pursued by most LDCs (Adhikari, 2004).

2.5. Diversification of export profile

The LDCs have not been able to diversify their domestic production structures, not only with regard to manufactured goods, but even with respect to their primary commodities. This renders them especially vulnerable to international market volatility. Of the 4,162 products exported by LDCs to 30 major trading partners in 2000, 127 accounted for 90 per cent of their total export trade. On average, the top three commodities exported by each LDC usually account for over 70 per cent of its total ex-

ports (WTO, 2001). The export concentration ratios (defined as the share of the principal export product in the total export value) have remained high and largely unchanged since 1980 for all LDCs. Several countries greatly depend on particular primary commodity exports, especially in sub-Saharan Africa.[1]

What makes the situation even worse for many LDCs is that, while exports of a single product may constitute a large share of their export basket, they count for relatively little in terms of the international supply, so that they are unable to influence world prices in a way that is beneficial to them (Chandrasekhar and Ghosh, 2000: 4). Therefore, diversification of the export profile with a view to reducing their vulnerability to global demand shock is another objective being pursued by most LDCs.

3. Impediments to effective implementation of competition policy in LDCs

It is generally accepted that competition policy and law is required for all the countries irrespective of the level of their economic development, partly because perfect competition is merely an economist's dream, and unattainable in a real life situation. The theoretical underpinning of their needs stems from the inherent nature of market failure, which is caused mainly by information asymmetries, natural monopolies, natural growth of firms and mergers and acquisitions (CUTS, 2002: ix). The problem is further compounded by the desire of firms to attain a certain degree of market power. These problems have led the prevailing wisdom to advocate the design and establishment of institutions that ensure that clandestine market power is not achieved and that those with market power do not abuse it (CUTS, 2002). However, it is not always easy for the governments of the developing countries and LDCs to effectively implement competition policy and law due to several inherent problems. While some of them are unique to LDCs, some others are found in a variety of shades in other countries too.

3.1. Conflict with other policy objectives

LDC governments tend to be inimical to the idea of implementation of competition policy and law because they, rightly or wrongly, believe that these actions unnecessarily constrain the ability of the governments to exercise their sovereign rights to achieve other genuine policy objectives. For example, given the fact that one of the major development objectives of the LDCs is to generate employment opportunities, they would be hesitant to expose their small and medium enterprises (SMEs) to foreign competition because of the latter's potential to provide employment opportunities.

Even in a developed country such as Japan, competition policy discipline was subordinate to the industrial policy. Its powerful Ministry of International Trade and Industry (MITI) never flinched from ignoring the basic tenets of antitrust regulations if they interfered with the export-oriented industrial policy for which it became famous (Moisés, 1998).

While one of the objectives of competition policy and law is to reduce economic concentration by regulating mergers and the creation of market power, firms in LDCs cannot attain a minimum efficient scale and be able to compete with the foreign firms if this objective is vigorously pursued by the State. Lachmann (1999: 12) is of the view that all the successful market economies began industrialization shielded by trade protection – the only exception being Hong Kong. Therefore, LDC governments should also be allowed to use interventionist policy in order to help their enterprises attain economies of scale so as to be able to compete with foreign enterprises. He argues that the "the initial costs of protection [not competition] will be outweighed by the long-run benefits of increasing competitiveness and participation in international trade" (Lachmann, 1999).

Realization that the government needs to pursue active industrial policy in the initial stage of industrialization led HMGN to bind tariffs at levels higher than those being applied, at the time of Nepal's accession to the WTO (WTO, 2003).[2] This may be, in part, a reflection of the failure of the strategy adopted by the government in the recent past to spur economic growth through unilateral liberalization of trade, investment and finance.

At times, rather than refraining from enacting the competition law with the fear that it might restrict the policy options of the government, some countries have attempted to strike a balance between conflicting objectives of the government at the time of drawing up the competition law itself. The South African Competition Act of 1998 provides a classic example of an attempt by a government to accommodate its conflicting objectives.[3]

3.2. Resistance from vested interests

"Competition is always in danger. Since it is uncomfortable or even threatening, business tries to avoid it. To use a metaphor: competition is not a weed that grows even if left alone; rather it is a cultural plant that needs constant government attention" (Lachmann, 1999: 19). Implementation of competition policy and law in countries where competition culture is lacking (which is the case with most LDCs) entails, among others, convincing the business enterprises to move beyond myopia. It is about asking them to weigh the long-term costs and benefits of competition policy and law implementation.

There is an inherent tendency among business people to see their (anti-competitive) actions as virtuous and viewing others actions as evil. Take the example of a domestic firm, which commands a dominant position in the market in the present context. It does not abuse its market power but is opposed to bringing its sector within the ambit of competition law. It does not know that since there is no entry barrier, a multinational corporation (MNC), with financial muscle as well as better knowledge, skills and expertise to run a similar enterprise, could enter the market and introduce predatory pricing. In such a situation, the firm would be the first one to

realize that bringing its sector within the ambit of competition law would have saved it from unfair competition.

For example, in the case of Nepal, it was found that manufacturers, who demand protection and oppose competition in their sector, complain about a cartel in the financial (mainly banking) sector, which by limiting their access to credit impedes their ability to become competitive. They do not realize that in the absence of the strict application of competition rules they could also be faced with the situation where the suppliers of raw materials form a cartel and raise the price of their inputs making it impossible for the former to source their raw materials at a market-determined price. Should such a situation occur, they could become staunch supporters of competition policy and law.

Interestingly, some businesspersons engaged in anti-competitive practices publicly defend their behaviour. Transport entrepreneurs, who are engaged in syndication (as discussed in detail below), defend their action as being welfare enhancing overall. According to them, a syndicate system is an orderly mechanism that assures the consumers of uniform price, and quality of service (as per their benchmark), and saves the consumers from the hassle of being annoyed by the call boys at the bus stations. In the absence of a syndicate system, as the argument goes, there could be unhealthy competition because the government does not have a system in place to determine the optimum number of buses that could ply a given route, which then results in misallocation of resources.

3.3. Lack of good governance

One of the reasons for the failure of the most LDC governments to implement policy measures aimed at spurring economic growth is the lack of good governance. In most LDCs, a public choice theory seems to apply perfectly with the government willing to provide concentrated benefits to a small group of the favoured and well-organized population (e.g. a business lobby), to the detriment of widely dispersed and unorganized groups (e.g. consumers).

A politics–business nexus, fuelled by the attitude of the people in power to make decisions based on their personal preference and connection, rather than on merits, has further exacerbated this problem. In the smaller LDC economies, where people tend to know each other fairly well and there is a strong cultural tradition to favour the relatives, friends and cadres, it is almost impossible to root out corruption and mal-governance. In Nepal, for example, mal-governance is one of the reasons for the failure of the government to contain anti-competitive practices, even if some of them are outlawed by the Consumer Protection Act 1997.

Adhikari (2002a: 17) documents yet another example of corruption contributing to anti-competitive conduct.[4] The manufacturers of polythene pipes, who are engaged in bid rigging, mentioned that the part of the rent they earned through bid rigging is, more often that not, shared with the officials of the public sector, who invite

the bid. They even say that the compulsion for rent sharing has led them to adopt bid-rigging practices. This has led to the creation of vested interests even on the consumers' side, who want to zealously maintain the *status quo.* These officials would always defend the riggers and would not be inclined to support the competition investigation, even when it is initiated by the competition authority.

3.4. Tension with sector-specific regulators

Despite massive changes in technology, several segments of the infrastructure in the LDCs are natural monopolies, because of the limited size of markets and the lack of entrepreneurial zeal to make risky investments in sectors with high gestation periods. Moreover, competition authorities do not have the required competence to deal with such complex issues as redistributive policy (through cross-subsidization) and universal service obligations (Tirole, 1999). Therefore, sector-specific regulators will continue to play a major role in ensuring that natural monopolies do not abuse their position in the market, and make optimal arrangements for the supply of public goods, for which they were created.

One of the responsibilities of the sector-specific regulators is to maintain price-cap regulation in the sectors under their jurisdiction – an activity that impinges on competition. While simultaneous jurisdiction is not uncommon even in developed countries, this is a source of tension in most LDCs because of a lack of clear-cut demarcation of authorities and responsibilities. Some of the tensions in LDCs as documented by Basant (2001) are presented below.

In Zambia, a clear overlap exists between the tasks of the Zambian Competition Commission (ZCC) and the Securities Exchange Commission (SEC). In a case where the ZCC required the shares of the acquired entity to be floated on the stock exchange in order to prevent the concentration of stock in the hands of the acquirer, the SEC allowed the acquirer to offer the share to the minority shareholders. Although this resulted in the acquirer having total control over the company with negative implications for competition, the ZCC could not prevent this as the SEC's decision prevailed.

The case of Tanzania is interesting as the sector-specific regulation was initially under the purview of the competition authority. Subsequently, some other sector-specific regulatory authorities were created. The conflicts between the competition authority and the Tanzania Communication Commission (TCC) became obvious when the former filed a complaint against the latter for permitting the dominance of two cell phone companies (Mobile and Tritel) in the country. The TCC had to provide detailed explanations for its conduct and subsequently registered other cell phone providers, e.g. Vodafone.

3.5. Resource and capacity constraints

The issues of resource and capacity constraints are perhaps some of the most significant problems facing competition authorities in the LDCs. Whilst the dismal re-

source base is linked to the fiscal crunch that confronts most LDCs and the need to balance and prioritize competing demands on the government budget, it is also a reflection of an absence of political backing for competition policy and law. Exclusive dependence on state funds has a disastrous impact on the capacity of the competition authority in terms of quality and quantity of staff, opportunities for training and human resource development, and support facilities and infrastructure, while also undermining its independence to a large extent (Adhikari and Knight-John, 2003).

The resources available to remunerate staff are a crucial determinant of the skills and expertise that the authority can attract. The salaries paid to employees of the competition authorities are lower than the levels in the private sector in most LDCs (CUTS, 2002).[5] As documented by De Zoysa and Wickramaratne (2001) even in a developing country such as Sri Lanka, staff of the Fair Trading Commission (FTC) were paid salaries that were lower than those in the rest of the public sector.

Competition agencies require a considerable degree of skill and competence to address complex issues ranging from how to determine dominance or at what level to set threshold limits or to how to evaluate competition cases using a “rule of reason” approach. However, in the developing countries and LDCs, competition agencies struggle with these issues and are unable to handle their caseload because of a lack of qualified staff. In Sri Lanka, for instance, the erstwhile FTC (now Consumer Affairs Authority) only investigated two mergers and 23 restrictive trade practices in the 1996–2000 period, while India’s Monopolies and Restrictive Trade Practices Commission (MRTPC) had to struggle with an enormous backlog of cases with only seven professional staff members (CUTS, 2003b: 43).

3.6. Lack of political will and independence

A common feature in most developing economies is the absence of political ownership and support for competition policy. This also translates to political interference in the activities of a competition agency, undermining its independence as a professional “watchdog” of competition. CUTS (2003b) lists some of the criteria that define independence: legal independence, where the competition agency is not a part of any government department and where members cannot be removed without proper justification, financial independence, and, *de facto* independence where it would have the cooperation of other government agencies in enforcing its decisions.

Legal or on-paper independence does not necessarily provide for *de facto* autonomy, as is evidenced in the case of Pakistan where the government interfered in several cases, most notably that of the cement cartel. The Indian tale of the soda ash and cement cases that set a strong lobby group comprising a few big industrial houses against an association of small builders and ordinary consumers also indicates the threat to independence from strong business lobbies (Adhikari and Knight-John, 2003). The reasons for the lack of political support relate mainly to the mal-governance issue highlighted in Section 3.3 above.

3.7. Absence of competition culture

A significant problem confronting most LDCs is the absence of a national constituency to support competition policy work. While a bottom-up approach – pressures from groups such as consumer and other civil society organizations (CSOs) that operate outside the government – is particularly relevant in countries that lack the political commitment to competition policy, this appears to be lacking in most of the LDCs.

Business enterprises, devoid of the sense of competition, are least prepared to listen to the idea of competition advocacy. Worse still, in the case of Nepal, they were found not even willing to provide their suggestions to the government and CSOs in helping them improve the content of the draft competition legislation, in which they will have a significant stake, once passed.[6]

Inculcating competition culture among the government officials is yet another challenge. A former Secretary at the Finance Ministry of Nepal, after having attended a Competition Policy Conference organized by the World Bank and the International Bar Association, among others, in New Delhi in March 1997, commented that he felt that the introduction of competition law would inhibit the foreign direct investors from investing in Nepal, as they would perceive it as yet another regulation!

As these examples point out, a conscious effort to promote competition through the implementation of competition policy and law may not be sufficient to infuse competition in the marketplace. Even if a state-of-the-art as well as home-grown competition law is enacted, it could encounter serious implementation problems if constituencies it is meant to serve are not convinced of its benefits.

4. Anti-competitive practices in Nepal and their impact on economic development

It is evident from the foregoing analysis that market failure is common in LDCs for various reasons. Nepal is no exception. There are various historical, cultural and social reasons, besides economic ones, contributing to the prevalence of anti-competitive practices in Nepal. While some anti-competitive practices were prevalent even prior to the initiation of economic reform measures in Nepal, others have recently surfaced.

4.1. Transformation of public monopoly into private monopoly

Most of the LDCs have initiated a privatization process as a part of the structural adjustment programme (SAP). Analysis of the privatization policy, for example in Nepal, reveals that despite serious efforts, they have not been able to make the privatization process as broad based as possible. If the privatization process is not conducted properly, that is without transparency, accountability, due process before the law and without contestability, it is quite possible that the process would simply

remove state monopolies and create private-sector monopolies (Musonda, Mbowe and Sampson, 2001).

In the case of Nepal, most of the public-sector enterprises, which were monopolies in the hands of the government, have either been transformed into private monopolies or are in the process of becoming so. Very few public enterprises have enhanced their competitive ability after privatization. Due to the absence of clear-cut guidelines, the lack of regulation, competition culture and a legal framework, and the virtual absence of post-privatization monitoring and an evaluation mechanism, the privatized enterprises have failed to infuse competition in the economy. Rather, they are weakening the competitive base of the economy (Adhikari and Adhikari, 2001).

4.2. Cartel

In LDCs, market-sharing and price-fixing cartels are prevalent in various degrees. For example, in Nepal, it is very normal for the business associations, which were established with the objective of protecting their professional interests, to have converted themselves purely into cartelizing bodies. Examples include the Nepal Bankers Association (NBA),[7] the Foreign Exchange Dealers Association of Nepal (FEDAN), the Colour Photographers Association of Nepal, the Nepal Association of Travel Agents (NATA), the Airlines Operators Association of Nepal (AOAN),[8] the Brick Manufacturers Association of Nepal, etc. So much so that even barbers in Nepal have formed their association, the Nepal Barbers Association, and its members are instructed to charge a given price for their services (Paudel, 2001: 14). The norm among these associations is such that those who undercut the price face strict sanctions from their associations, and at times even exclusion.

In the context of Nepal, there cannot be a more classic example than that of the sugar industry when one has to see how far cartel can go. In August–September 1999, leading sugar industrialists approached the government to increase the tariff on the import of sugar to 40 per cent so as to prevent Brazilian sugar from entering Nepal. Their justification was that since Nepal already had sufficient domestic capacity to produce sugar, importation was redundant and that a higher tariff was necessary to protect the "infant" sugar industry. When the government raised the tariff, domestic industries, a cartel as they were, stopped supplying sugar to the market and pressurized the government to increase the retail price of the sugar. The government, instead of clamping down on the cartel by utilizing the provision of the Consumer Protection Act 1997, yielded to the pressure. Interestingly, the cartel timed the move to the beginning of the festive seasons (when demand for sugar shoots up exceptionally), and succeeded in forcing the government to bow down (Adhikari, 2002b). Consumers are forced to pay a higher price for the local sugar because of the cartel. Even now, the sugar tariff remains at 40 per cent and its retail price is 29 rupees per kg, whereas the landed price of imported sugar would be 20 rupees per kg, if the tariff barrier were to be removed. This policy of the government has deprived the consumers of the opportunity to consume sugar at a much lower price.

4.3. Syndicate system

The major portion of the surface transportation system of Nepal is based on a syndicate system. This syndicate system is a collusive agreement among the transport entrepreneurs, who form an association, which determines the route and the frequency of plying buses or trucks for each member of the association. This system disallows any outsider to enter the road-transport network and if they do so they are not only faced with sanctions but also physical assault (Sharma, 2000). This system ensures that the consumers are made to pay what the syndicate wants, thus robbing them of their right to choose. Further, due to a lack of competition among the transport entrepreneurs, they have no incentive to upgrade or enhance the quality of the services provided to the passengers as they are fully convinced that this will not bring any extra benefit to them since the consumers have no choice but to use their services.

In January 2003, the Nepal Contractors Association Kaski (NCAK) filed a complaint at the District Administration Office (DAO) against the Gandaki Truck Operators Committee (GTOC) which was resorting to syndication in the name of cooperatives. The committee had been practising syndication after it announced its entry into the cooperatives system. This had compelled the consumers to pay an additional 1,000 rupees per trip for transporting, *inter alia*, sand and concrete. The truck operators increased the charge from 1,600 rupees per trip to between 2,200 and 2,700 rupees per trip after the formation of the “committee”. However, the DAO failed to take any action against the syndicate members (Bhadgaunle, 2003).

Despite a clear-cut provision outlawing syndication in the Consumer Protection Act 1997, the government could not muster enough courage to implement that provision because of the sheer strength and clout of the transport entrepreneurs. Whatever little effort made by the government to bring the culprits to heel has failed. The syndicate system, which is not only rampant but has gone unchecked, has ripped off the consumers. Moreover, this has caused considerable damage to the industries because of the higher input costs resulting from the higher freight charges.

4.4. Bid rigging

This practice is widely prevalent especially in the construction and/or supply sector, where contractors or suppliers sit down together and decide the price at which one contractor or supplier will receive the contract. It is decided beforehand who would be winning the contract and the norm is that the winner has to be from within their group. Then, the person/firm who receives the contract compensates the other contractors/suppliers. If such contracts are to be awarded on a perennial and regular basis, then the contractors/suppliers decide the timing and the amount of contract each one of them is going to receive on a rotation basis. The manufacturers/suppliers of polythene pipes to the Nepal Drinking Water Corporation (NDWC) operate under this system in Nepal (Adhikari and Regmi, 2001). This practice is not only hurting the consumers, but also the taxpayers because the NDWC is a natural mo-

nopoly funded by the government. And when it incurs unsustainable losses, the government comes to its rescue, by making use of taxpayers' money.

Another example reported in a newspaper is the bid-rigging practice followed by the suppliers of rations to the Royal Nepalese Army and Nepal Police (Kantipur, 2003). This practice is directly hurting the taxpayers. Similarly, some municipalities in Nepal have refused to follow the guideline of the prevailing financial regulations of the country, which requires the awarding of a contract to the lowest bidder, at the time of execution of the development project because of the prevalence of bid rigging among the contractors (Gyawali, 1997).

4.5. Tied selling

Tied selling can be of two types: (a) a subtle form of tied selling by combining the sale of a slow-moving item with fast-moving items; and (b) a blunt tied selling carried out by bundling related goods and services. Both types of tied selling are widely prevalent in Nepal.

Having to buy a slow-moving item in return for the seller selling a fast-moving item is a routine affair in the case of Nepal. Since the market is imperfect, the creation of an artificial scarcity through hoarding or limiting supply is quite common. Even when the product is abundant in supply in the intermediary markets, it reaches the consumers in a quantity and at a price desired by the producers and/or middlemen. Since it has become more of a routine, consumers are not surprised if they are asked to purchase 25 sacks of Indian cement while purchasing 50 sacks of Nepalese cement.

A more direct type of tied selling takes place in educational institutions (schools) and hospitals. In most of the privately run schools, it is mandatory for the students to purchase books, stationary and uniform from the school itself – ostensibly to maintain uniformity among the students and maintain quality. However, the hidden motive behind such business is to extract as much money as possible from the parents in the name of imparting "quality" education (Khadka, 1998). Similarly, in some of the private hospitals and nursing homes, it is mandatory for all patients to undergo the pathological tests in the same hospital or nursing home once they have consulted the physicians, even if the tests have been done very recently in another hospital of similar status or reputation (Paudel, 1998).

4.6. Predatory behaviour

As mentioned earlier, monopolist or dominant firms in LDCs are so powerful that they do not want to see any new firm entering the market and trying to steal away their market share. This may not be the case in bigger economies where size of the economy is such that it can accommodate a large number of firms. In small economies, firms operate either under a monopolistic or an oligopolistic market structure. Therefore, in order to preserve their monopoly position (and continue to earn rent),

they may attempt to drive out the competitors by reducing their prices to an unreasonably low level.

Another type of predatory intent, which is typically found in the case of LDCs, due to the small size of the market, is the predatory behaviour by a foreigner supplier. When predatory behaviour crosses a border, it becomes a case of dumping. One classic example of dumping, which was prevalent in the Nepalese market during the 1980s was the dumping of the *Maggi* brand of instant noodles by Food Specialities Ltd. (FSL), India (which later became Nestle India Ltd.). FSL was the only supplier of instant noodles in the Nepalese market (i.e. it had enjoyed a monopoly position), until Gandaki Noodles Pvt. Ltd. (GNPL) of Nepal started producing the *Rara* brand of noodles in direct competition with *Maggi*. In response to this, FSL slashed the price of its noodles to such a level that its sales price in Nepal was 25 per cent lower than that in India. Even though predatory intent was suspected, the Nepalese authorities could not do anything because Nepal did not have an anti-dumping law or institution.[9]

The price undercutting strategy was ostensibly adopted by FSL with the intention of driving *Rara* out of the market. However, FSL did not succeed in its endeavour and finally decided to maintain a low profile in the Nepalese market (Adhikari, 1997). Now there is stiff competition in the noodle market with the entry of new firms. While GNPL is losing ground too, *Maggi* noodles' share in the market has shrunk considerably.

A recent case of alleged predatory pricing behaviour that is visible in the market relates to the pricing of English language broadsheet dailies. There were two such newspapers in the country until 2002 – one private and one government owned. After the entry of the private newspaper *The Kathmandu Post* (TKP) in 1993, the share of the government-owned newspaper *The Rising Nepal* has shrunk considerably. In 2002, a new daily *The Himalayan Times* (THT) entered the market with an aggressive pricing strategy charging 2 rupees per copy, as opposed to the 4 rupees charged by the incumbent newspapers. THT was able to considerably increase its market share surpassing the circulation of TKP, which, in turn, fought back later by reducing the price to 1 rupee 50 paise. In response to this, THT has reduced its price to 1 rupee.

There is a suspicion among the competition experts that THT could have been indulging in predatory pricing. However, given the fact that consumers are gaining as of now and that there is no law to prevent such practices, it is unclear which course this price war will take in the future. One view could be that as long as there is a credible threat from the competitor, which could match the price howsoever low it might be, there is no reason for alarm. However, another view could be that TKP will be eventually wiped out of the market, clearing the way for THT to enjoy a near-monopoly position in the market and abuse its market power. The jury is still out to say the least.

4.7. Price discrimination

As per a study conducted by Adhikari and Regmi (2001) to document anti-competitive practices in Nepal, it was found that price discrimination was the most frequently occurring restrictive business practice. Seventy-eight per cent of the respondents interviewed during the survey mentioned that price discrimination was prevalent in the Nepalese market. Blatant price discrimination is observable in the financial sector – with banks providing lower interest credit for big borrowers and charging higher interest to small borrowers for the same category of loan.

The banking regulator (the Central Bank) used to impose a requirement on them, until recently, not to deviate by more than 0.5 of a percentage point from their published rates while discriminating between two types of customers, for each category of loan. Commercial banks, finding it difficult to discriminate between their customers by more than 1 percentage point, came up with an ingenious idea. They sub-categorized each loan category and preserved their right to discriminate between their customers by up to 3 percentage points.[10]

Banks justify their action by saying that they are basing their lending rates decisions on their risk perception, i.e. charging higher interest rates to customers with weak credit standing to compensate for a possible loss. However, this turns out to be a facile argument because the major portion of the banks' non-performing assets (bad debts) is concentrated in big business houses (belonging to the so-called corporate category).[11]

The major implication of such a discriminatory practice is the reduced access to credit for small business enterprises and start-up ventures, which not only imperils the competitiveness of existing small businesses, but also creates an entry barrier for new entrepreneurs. Since an alternative route for mobilizing capital (i.e. a capital market) is also not well developed in Nepal, market contestability is seriously lacking – at least in those sectors where capital requirement is high.

The Central Bank has also done away with the requirement not to deviate by more than 0.5 of a percentage point for each lending category arguably because it did not serve the intended purpose. Banks are now free to decide their lending rates, thus providing them with an opportunity to discriminate against the smaller borrowers to the extent that they feasibly could.

5. Development dimension of competition regimes and their relevance to LDCs

Though the overarching goal of competition policy is to promote economic efficiency and enhance consumers' choice, it can have several objectives. While some of them are complementary to each other, some others run at cross purposes. At the same time, competition policy does not function in a vacuum and it has to interact with various government policies. As mentioned earlier, there could be a considerable degree of conflict between competition policy and other policy objectives of the gov-

ernment. Promoting SMEs by shielding them from competition, promoting balanced regional development by offering incentives to those firms that invest in a particular location, and promoting "national champions" through trade protection and government supports – which are considered part of the boarder issue called developed dimension – can contradict the stated goal of competition policy.

The question of the development dimension is largely a Southern phenomenon, although this issue has received considerable attention in the policy-making processes of the developed countries as well. All the sectors of economies in the developing countries may not be equally capable of facing competition especially from foreign companies.

Further, the infant industry argument calls for sheltering nascent sectors of the economy from outside competition. Even the developed countries of today made use of such mechanisms in the past. For example, in Japan between 1961 and 1973, close to 1,000 cartels per year on average were exempted from antitrust law (Lachmann, 1999). However, in order for the infant industries to gain significant economies of scale and become globally competitive in the true sense of the term, such protection should be applied selectively, made conditional upon meeting performance standards, should be transparent, time limited, involve minimum discrimination, and be constantly reviewed. It has to be also recognized that providing protection to the domestic sector, particularly to infant industries, is the second-best option (Lachmann, 1999).

At the same time, there are arguments against merger control in LDCs, which could be detrimental to the developmental interest of the country. This arrangement clips the wings of those enterprises that wish to grow, so that they are never able to attain a critical mass and economies of scale (SAWTEE, 2003).

Against this backdrop, this section attempts to discuss the development dimension of competition policy in the following areas, mindful of the fact that there is a clear overlap between some areas.

5.1. National champion

Active industrial policy calls for governments' support for specific industries, possibly through approving economic consolidation and intervening in the industry structure, i.e. "picking winners" and channelling market forces into working for the particular interests of those winners (Pham, 2003: 1). A strong argument in favour of such "national champions" picked by the government, is that competition policy should not be too concerned with the emergence of dominant firms, or with mergers that will create firms with large shares of the domestic market, if large-scale operation is essential to succeed in the world market.

Generally, a strategy to promote a national champion is adopted by the countries in the initial stage of their industrialization. Once these champions become globally

competitive, they are exposed to international competition. Some advanced countries have reflected this commitment in their legislation. For example, the competition laws of the UK and the Netherlands, which no longer require promotion of national champions, propose to limit ministerial intervention to national security grounds at the most; other national interest deliberations will be left to the competition authorities (Mehta, 2002).

However, some other industrialized countries continue to develop "national champions" in some critical areas even if they conflict with the objective of competition policy. For example, the German Economics Ministry overruled, for the second time, a decision of the Federal Cartel Office (FCO) rejecting E.ON AG's proposed US$ 10.2 billion takeover of Ruhrgas AG, Europe's largest gas importer. The Ministry argued that the takeover would create a powerful national champion to negotiate in international markets, despite the allegations from German scholars that the Ministerial prerogative was tantamount to "keeping the back door open for industrial policy" (Pham, 2003: 3).

Equally illuminating is the example of the merger of two dominant dairy companies in New Zealand with an international marketing group, which was approved by the introduction of legislation to exempt them from the business acquisition provisions of the country's Commercial Act, with a view to enhancing their international competitiveness. The new merged entity, named Fonterra Co-operatives Group Ltd., now controls 95 per cent of New Zealand's milk supplies, contributing 7 per cent of its annual Gross Domestic Product (GDP) and ranks as the world's 14th largest dairy company (Pham, 2003: 4).

In Japan, which achieved spectacular GDP growth and growth in its share of world exports by 10 percentage points between 1950 and 1973, competition policy was subordinate to industrial policy, an essential concern of which was to maintain the private sector's high propensity to invest. The then-powerful Ministry of International Trade and Industry (MITI) not only encouraged a variety of cartels, but also encouraged mergers between leading firms in key industries believing that large-scale enterprises were required for the promotion of technical change and for Japanese firms to compete effectively with their western counterparts (Singh and Dhumale, 1999: 12).

The Korean government broadly followed the Japanese strategy of economic development. It also had a strong industrial policy which, as in the case of Japan, dominated competition policy. The government helped create mammoth conglomerates, the *chaebols*, which went on to capture global markets (Singh and Dhumale, 1999). Though Korea has one of the highest levels of industrial concentration in the world, the giant *chaebols* compete with each other fiercely for government support proving their mettle by meeting specified performance targets for exports, new product development, and technological change. As in Japan between 1950 and 1973, the Korean government until recently has purposefully coordinated industrial invest-

ments by competing *chaebols*, so as to prevent overcapacity and excess competition (Singh and Dhumale, 1999).

Virtually all the countries in the world, whether developed, developing or least-developed, have made use of the national champion argument to foster the competitiveness of their industries in one way or the other. It must be remembered that comparative advantages of today are mostly the result of successful government interventions of yesterday. For example, it used to be argued that economic development in Britain was possible only by following the free-trade policy. However, as recent research points out, Britain propagated free trade only in those areas in which it was already competitive; in all other sectors of the economy, its average tariffs were higher than in France – a country blamed for pursuing a blatantly protectionist trade policy (Lachmann, 1999: 11).

While some countries have made explicit provision in their legislation to give precedence to industrial policy, some economies have made use of industrial policy in a more subtle manner. For example, Taiwanese Fair Trade Law (competition law) contains a clause that gives explicit precedence to other laws where they conflict with competition law. Similarly, the Australian Trade Practices Act allows for the possibility of the Australian Competition and Consumer Commission (ACCC) to grant immunity on public-interest grounds for Merger and Acquisition (M&A) cases, which would or might otherwise breach the provision on "substantial lessening of competition". This mechanism is called "authorization" and cannot be overturned once granted (Pham, 2003: 3).

However, in the USA, where it is proclaimed that competition policy itself is industrial policy, competition authorities have gone ahead and provided approval for some large mergers that have an impact not only on their own market but also on the international scene, precisely because of their potential to become "national champions". The mergers between G.E. and Honeywell, Boeing and McDonnell Douglas, and Exxon and Mobil are examples of such large-scale mergers, which were approved, despite the fact that these mergers would have led to a high market concentration *ex post*.

Even when one looks at the control of merger and takeover from a broader perspective – not merely from the narrow perspective of the "national champion" argument, the debate centres on one issue – whether these activities are desirable or not from a development perspective. The philosophy underpinning merger control is that big is unavoidably ugly. Textbooks on Microeconomics and Industrial Organization suggest that bigness or market power could create massive rents for the business enterprise thus taxing its efficiency to the detriment of the consumers. However, as per another school of thought, big is not necessarily bad because it provides the enterprises with the opportunity to attain economies of scale, avoid duplication of assets, enjoy synergistic benefits, and invest in research and development (R&D).

All these features lead to cost reduction, which could ultimately be passed on to the consumers.

Those who subscribe to the second school of thought also argue that competition law may hinder the ability of domestic firms to become competitive because it makes it difficult for them to coordinate their business policies and consolidate operations through such strategies as M&As. They also feel that the risks, uncertainty and low profits associated with competition limit their ability to conduct R&D and innovate or improve product quality.

As mentioned above, in an increasingly globalized world, big firms are becoming bigger so as to compete globally, and competition authorities around the world are taking lenient stands on such practices. Therefore, there is no need for the competition authorities of the LDCs to frown upon firms having less than a 40 per cent market share (Adhikari, 2003a). This realization has led some small economies to adopt competition law without any merger control regulation. For example, Protocol VIII of the Treaty of Chaguaramas, which deals with anti-competitive business practices of the Caribbean Community (CARICOM) region, does not provide for merger control regulation (Stewart, 2000).

Due to a high degree of openness, merger regulation can become irrelevant to the small economies in particular LDCs. Openness means that local firms have to compete at the international standards in the domestic market. The majority of firms are micro-firms so there is a need to achieve a critical mass for developing economies of scale and scope.

5.2. Protection of vulnerable sectors/segments

As mentioned earlier, although the role of SMEs may not be that important in terms of generating export revenue, their contribution in terms of providing employment opportunities is enormous.[12] If we expose such enterprises to foreign competition, the vital nerve of the national economy may collapse. Therefore, it is necessary to shield these enterprises for a temporary period so that they could be brought up to speed and face competition from large domestic as well as foreign enterprises at a later stage.

The South African Competition Act explicitly states that ensuring SMEs have an equitable opportunity to participate in the economy is one of the objectives of the legislation. Similarly, Chapter VIII of the Revised Treaty of Chaguaramas provides for a *de minimis* rule (Article 181), by which the Commission may exempt from the provisions of this section (Chapter VIII) any business conduct referred to it if it considers that the impact of such conduct on competition and trade in the CSME (CARICOM Single Market and Economy) is minimal. It has been interpreted that such a *de minimis* rule provides a carve-out for the SMEs to be subjected to competition discipline of the CSME (SALISES, 2004). At a sub-national level, the United

States Virgin Island Anti-Monopoly Law provides for the exemption of import cartel agreements between small entrepreneurs engaged in retail sale.[13]

It is generally accepted that competition is good for all economic participants in the long run, but that it is bound to create displacement in the short term. Therefore, it is necessary to protect the interest of the poor, marginalized and vulnerable segment of society from the onslaught of competition in the short term. As has been made amply clear by the foregoing analysis, due to market failure, displacement is bound to occur in the LDCs. For example, trade and investment liberalization and the application of competition law provide benefits to the relatively better-off firms and people from the upper echelons of society, leaving behind the vast majority of enterprises and people to suffer the burden of adjustment.

While some governments have made conscious efforts not to subject vulnerable sectors and sections of society to the strict application of competition rules, some others leave it to the mercy of market forces. For example, at the time of accession to the WTO, Nepal was able to bind its tariff on agricultural products at 42 per cent on average, and for some of the sensitive agricultural products, the production of which was linked to the livelihood of the poor, marginalized and vulnerable farmers, the bound tariff is up to 60 per cent (WTO, 2003). These rates, coupled with the trade remedy measures available under the WTO Agreements (which can be used now), are likely to provide a cushion to the farmers against the possible unfair competition such as dumping or surging of imported agricultural products.

At the time of drawing up its Foreign Investment and Technology Transfer Act (FITTA) 1992, HMGN has also made a deliberate effort to protect some sectors of the economy from foreign competition. Listed in Annex 1B of the Act, most of them were included in the reservation list in order to protect the vocation of the indigenous and ethnic communities. The exclusion of travel agencies, trekking, rafting and pony-riding enterprises, and the operation of small lodges and hotels from foreign investment was designed to protect the employment opportunities of the *Sherpa* communities, who live in high mountains and have been excluded from the national mainstream for a long time. This community owns the majority of the business enterprises listed above.

Similarly, as explicitly mentioned in the South African Competition Act, one of the objectives of the legislation is to promote a greater spread of ownership, in particular to increase the ownership stakes of historically disadvantaged persons (i.e. the black community). Accordingly, such exemptions have also been inscribed into the law.

Finally, since the working class (i.e. labourers) is considered vulnerable in developing countries and LDCs, competition law in many jurisdictions protects the collective bargaining rights of the labourers. Since their service also represents an input into the production process, there could be a tendency among firms, pressured by competition, to take away such rights of the workers. However, as mentioned above, countries which not only promote competition as the only goal and take other socio–

economic interests into consideration, tend to preserve this right of the workers. Moreover, countries which have signed the Core Labour Standard of the International Labour Organization (ILO) are obliged to guarantee these rights. Some of the countries that have explicitly inscribed an exemption for collective bargaining rights of labourers include South Africa and Zambia.

5.3. Efficiency defences

As mentioned earlier, the fundamental purpose of competition law is to ensure the efficient use of resources through vigorous competition. For relatively small open economies characterized by a high concentration in many markets, firms may not be operating at a minimum scale of efficiency, which causes efficiency issues to be particularly important. Since most LDCs bear the above-mentioned characteristics, it is important for them to learn from the associated practices elsewhere.

There may be instances in which apparent restrictions of competition can mean more efficient resource use (World Bank and OECD, 1999: 124). Such restrictions can be broadly classified into two categories – pro-competitive and anti-competitive. The first category of restrictions includes a merger between two small competitors to make themselves into a more effective rival to a larger competitor, and a joint venture between two potential competitors to develop a new product.

The second category of restrictions includes two competitors merging to take advantage of economies of scale thus making better use of resources, but charging a higher price to the consumer because of the market power that they are able to enjoy post-merger. Some other real-life examples of restrictions falling into this category are: two potential competitors entering into a joint venture to develop a new product to eliminate duplicate research and development (R&D) and avoid the cost of racing to be the first in the market, resulting in a delay in the introduction of the new product/process to the market; and two multi-product competitors agreeing to specialize production with each supplying the needs of the other, providing each other with the opportunity to know each other's costs thereby leading to less price competition.

Some countries (Australia, Canada, New Zealand, the UK and the USA) have either a statutory or an administrative provision for an efficiency exception or defence. The European Union (EU) allows for the exemption of anti-competitive agreements that also bring about economic benefits. According to Article 85 (now Article 81) paragraph 3 of the Treaty of Rome, some collusive behaviour restricting competition in a non-minor way may be exempted because of sufficient beneficial effects. Four conditions are required:

- the agreement must contribute to the improvement of the production or distribution of goods or promote technical or economic progress;
- it must allow the ultimate buyers a fair share of the resulting benefits;
- the restriction must be necessary for the attainment of the objective; and

- the firms concerned must be unable to eliminate competition with respect to a substantial part of the product in question.

The trade-off of expected efficiencies against expected anti-competitive effects is universally recognized as difficult. Scholars have suggested elegant and objective methods of doing so, but there are significant difficulties in applying them. A widely recognized model developed by Oliver Williamson (1977) would permit a merger that on balance increases "total surplus", notwithstanding an increase in prices above the competitive level. That is, the cost savings resulting from efficiency gains generated by the merger must exceed the "dead-weight loss" caused by the expected anti-competitive price increase (OECD, 1996: 7). This approach is also known as the aggregate economic welfare approach or trade-off analysis (World Bank and OECD, 1999: 128). The major fallacy of this approach is that it ignores the redistributive consequences of the exercise of market power.

An alternative to the total surplus standard is the "consumer surplus" standard, which requires that the efficiency gains be so substantial as to ensure that the merger will not result in a wealth transfer from consumers to producers. This standard ordinarily would require the showing of a much greater magnitude of efficiencies than the total surplus standard (OECD, 1996: 7). This approach requires that the net effect increases or at least does not reduce consumer surplus. It is called the consumer surplus or pure consumer surplus standard because it prevents any redistribution of surplus from consumer to merging entities. It is also called a price standard because it does not allow a merger or agreement to increase a price materially (World Bank and OECD, 1999: 128).

Nevertheless, the consumer surplus standard is employed in some countries. The language of the European Commission (EC) merger regulation indicates that consumer surplus is the EU operative standard, as it was in the US, at least prior to the 1992 US Horizontal Merger Guidelines. In Canada, total surplus is apparently the relevant standard (OECD, 1996: 7).

Similarly, R&D cooperation is another area that is increasingly being accepted by competition regimes around the world as a means to enhance efficiency, outweighing its possible anti-competitive effect. For example, the Canadian Competition Act provides a defence for joint R&D ventures involving a specific programme of research that would not otherwise take place. Agreements among competitors with respect to cooperation in R&D are exempt from the criminal conspiracy provisions of the Act unless they lessen competition unduly with respect to prices, output, markets, customers, or channels of distribution (World Bank and OECD, 1999: 135). Similarly, the US courts are required under the National Cooperative Research and Production Act to judge joint research and production arrangement on a "rule of reason" basis.

There is considerable support for joint R&D at the conceptual as well as empirical levels. According to Jacquemin (2000: 25): "Cooperative R&D can be viewed as

a means of simultaneously internalizing the externalities created by significant R&D spillovers – hence improving the incentive problem and providing a more efficient sharing of information among firms." D'Aspremont and Jacquemin (1988) have used a model to study the impact of R&D spillovers on a firm's optimal R&D investment. In comparing the symmetric cooperative and non-cooperative solutions, they find that large spillovers lead to higher R&D expenditures and production levels under the cooperative scenario; this behaviour is superior from a social welfare point of view.

However, contrasting with these potential advantages of cooperative R&D, effects leading to a harmful reduction in competition must also be considered. One danger is that cooperative R&D could be a way for a dominant firm to avoid competition through innovation, by co-opting potentially innovative rivals and by controlling and slowing down the innovation race. A second situation involves an extended collusion between partners, resulting from their action in R&D and creating common policies at the product stage (competitive level).

Discussions about R&D can for example spill over into illegal discussions on pricing policy (Jacquemin, 2000: 26).

5.4. Export cartels

Export cartels are associations of firms that cooperate in the marketing and distribution of their product to foreign markets. The competition laws of virtually all countries exempt such export cartels from prosecution by domestic authorities (Evenett, Levenstein and Suslow, 2001). Previously, only developed countries exempted their export cartels from their competition disciplines, but now developing countries as well as economies in transition are joining the bandwagon. While some scholars and several WTO members have recently condemned such cartels, others have argued that they allow efficiency gains that actually promote competition and trade (Bhattacharjea, 2004).

The study of Evenett, Levenstein and Suslow (2001: 45) lists 12 countries (OECD countries and economies in transition) where national exemption is provided to the exporters by their respective competition laws. Out of these, four countries (Germany,[14] Japan, the UK and the US) had some sort of notification/authorization requirement, while eight others (Canada, Estonia, Hungary, Latvia, Lithuania, Mexico, Portugal and Sweden) do not even require the same. In these countries, there is very limited information regarding the number or activities of export associations, and most of the provisions relating to the exemption of export cartels were explicit. However, implicit exclusion is now the norm in the EU. Any export cartel formed for the purpose of exporting goods to non-EU countries is outside the scope of Article 81 of the Treaty of Rome.

In the US, export cartels are shielded from antitrust action by three statutes, two of which involve a registration procedure. Consequently, they are more visible to foreign competition agencies (and private researchers). The 1918 Webb-Pomerene

Act (WPA) gives registered export associations qualified immunity from Section 7 of the Clayton Act (which regulates mergers) and the Sherman Act, which otherwise prohibits "Every contract, combination … or conspiracy in restraint of trade or commerce among the several States, *or with foreign nations*" (emphasis added).

Likewise, Article 6 of Mexico's 1992 Federal Law of Economic Competition contains explicit provision relating to export cartel: "Associations or cooperatives that sell their products directly abroad do not constitute monopolies". This provision exempts export cartels formed by associations or cooperatives, which do not sell or distribute such goods within Mexican territory, subject to the fulfilment of certain requirements. It appears that Pakistan is one of the developing countries to have introduced exemption from export cartels in its competition legislation, namely the Monopolies and Restrictive Trade Practices Ordinance of 1971.

Other developing countries or countries in transition, which have either amended or replaced their earlier legislation, or prepared a completely new legislation, have introduced such exemptions in their laws. Probably they have started understanding the virtues of the same!

For example, Section 3(b)(i) of the 1998 South African Competition Act, which replaces the old Maintenance and Promotion of Competition Act of 1979, lists "maintenance or promotion of exports" as one of the possible grounds for granting an exemption for a restrictive agreement or practice.

Likewise, Section 5(ii) of India's 2002 Competition Act, which replaces the earlier Monopolies and Restrictive Trade Practices Act of 1969, is a more far-reaching "carve-out": "Nothing in this section [on anti-competitive agreements] shall restrict … the right of any person to export goods from India to the extent to which the agreement relates exclusively to the production, supply, distribution or control of goods or provision of services for such export." (Bhattacharjea, 2004).

As per Article 2(2) of Bulgaria's Law on the Protection of Competition, introduced in 1998: "…activities, the consequences of which restrict or might restrict the competition in another State, unless otherwise provided in an international treaty which has entered into force and to which the Republic of Bulgaria is a party". This provision could be interpreted to make an export cartel legal since the export cartel has a consequence of restricting competition in another State.

As mentioned above, currently the trend is towards making explicit mention of the exemptions provided to export cartels, given that it is pursued by almost every country. However, the debate on the efficiency implications *vs*. the "export of anti-competitive effect" (or beggar-thy-neighbour effect) of such a cartel is far from settled.

Based on the analysis of the export cartel practice of the American Natural Soda Ash Corporation (ANSAC) – a WPA association – and their efficiency claims, Bhattacharjea (2004), provides the following taxonomy of economic efficiency:

1. *Saving on variable costs:* of transportation, warehousing and handling, by being able to negotiate better rates for larger volumes.
2. *Saving on the fixed costs:* of market research and setting up and maintaining networks and facilities for shipping, customs clearance, storage, marketing and distribution, and liaison with government officials where necessary. These are likely to be specific to each destination, and individual producers might find that their volumes are too small to justify incurring such costs. Or they could avoid unnecessary duplication by centralizing these functions in a common agency.
3. *Pooling of risks:* Although not spelt out in any of the case reports, this appears to involve two separate considerations. First, access to the production facilities of many producers yields a more reliable source of supply, resulting in the cartel being better placed to meet orders. Second, common marketing gives each producer a share in a diversified portfolio of buyers, spreading the risks of non-payment by buyers, demand slumps, or disruption in deliveries caused by political or natural events in particular markets.

Similarly, as reported by Bhattacharjea (2004), an examination of Japanese export cartels in their heyday led to a finding that most of them did not appear to affect export prices or volumes; if anything, they contributed to cost reduction and quality assurance in some cases. In other cases, exporting firms cooperate by engaging in price fixing: either agreeing to sell their exports at the same price or to sell them through a single, joint sales agency that will accomplish the same thing. Firms may also use cooperative export organizations to jointly market products (Evenett, Levenstein and Suslow, 2001). These activities are clearly anti-competitive, with implications for the importing country's economy and consumers. They could have the same effect as hardcore international cartels (such as the infamous bromine, citric acid, graphite electrodes, steel tubes and vitamins cartels).

Despite criticisms, the international community does not seem to be too concerned about the export cartels, not least because of the limited volume of export made under such arrangements. No recent studies have been done to ascertain their impact. However, Dick (1992) reports that WPA associations covered 2.3 per cent of US exports in 1962 and a mere 1.5 per cent in 1976. The limited information available from other countries shows a declining pattern. The OECD reported in 1984 that between 1972 and 1982, the number of export cartels in the UK held constant, the number in Germany declined slightly, and the number in Japan declined markedly (Evenett, Levenstein and Suslow, 2001).

There is a general trend towards viewing export cartels as being beneficial for the developing economies. SALISES (2004) strongly supports both import and export cartels in the absence of which it would be difficult for small entrepreneurs to engage in international trade. Similarly, Scherer (2000: 395–403) acknowledges that most countries would be reluctant to prohibit cartels in commodities, which are major sources of export earnings, and recommends that any agreement should allow each country to exempt export cartels (or participation in international cartels) in up to

three industries, defined at the four-digit level of the Standard International Trade Classification (SITC). He also makes a qualified case for permitting developing countries to maintain cartels in industries producing manufactured exports, to allow for economies of scale, coordinated marketing, financing of technology development, and even coordinated export pricing so as to avoid charges of dumping in foreign markets (Bhattacharjea, 2004).

In their submission to the WTO Committee, Thailand, India, China, Indonesia and Egypt invoked the principle of "Special and Differential Treatment" to argue that developing countries should be allowed to continue to exempt their export cartels, on the grounds that they were comprised mainly of smaller firms, while requiring developed countries to abolish their exemptions (Bhattacharjea, 2004).

6. Prerequisites for the implementation of competition policy and law in Nepal

Having highlighted the imperatives of putting in place an appropriate mechanism to ensure competition in the marketplace in the LDCs, despite the small size of the market, we now list out the essential ingredients or contours of the competition policy and law. Care should be taken, however, to ensure that the objectives of competition policy and law are achieved without having to compromise the development objectives of the country concerned. Moreover, these measures should have at their core the objective of enhancing the competitiveness of the domestic enterprises.

6.1. Competition policy

Trade liberalization: Competition from foreign firms provides a vital spur to the efficiency of domestic firms. It does not, however, follow that a liberalized trade regime obviates the need for a national competition policy because a large part of LDCs' economies (such as retail, distribution) are not in traded sectors, and domestic consumers need to be protected from the abuse of dominance and restrictive trade practices by foreign firms (Jenson, 2001: 2). In order to have continued competition from foreign firms, it is also necessary to provide predictability in the domestic trade regime. Nepal's recent accession to the WTO is likely to be instrumental in locking-in the trade policy reform that the government had initiated since the early 1990s (Adhikari, 2003b). Though some of the sensitive sectors of the economy are still going to be shielded from foreign competition due to relatively higher tariff bindings, the majority of the sectors in the economy are going to face stiff foreign competition. This, in turn, is expected enhance the competitiveness of the domestic enterprises exposed to foreign competition.

Deregulation and privatization: Government controls, the imposition of a permit system, impromptu regulations and work processes, besides a dilatory bureaucracy, have contributed to dampening the private sector's entrepreneurial zeal and enthusiasm. Government organizations have only added to the nation's economic burdens. Various negative tendencies such as "rent-seeking" surfaced in the economic sys-

tem. As a result, Nepal suffered from low growth syndrome (Ligal, 1997: 14–15). In order to overcome these obstacles to private-sector participation and economic growth, the government initiated a series of economic reform measures including deregulation and privatization. However, in the context of Nepal, neither is the regulatory system up to speed[15] nor has the privatization process helped to infuse competition in the marketplace. Therefore, the government needs to initiate regulatory reform, make the privatization process more transparent and broad-based and institute a system of post-privatization monitoring to ensure that they contribute to the desired competitive outcomes. For example, as mentioned above, even if only regulatory reform in the banking sector contributed to eliminating discriminatory lending rates charged by the banks, the market contestability and competitiveness of the small incumbent, as well as the start-up domestic enterprises, would be enhanced.

Investment policy: A low level of domestic saving and a decrease in ODA are not the only reasons to encourage FDI. One of the major motives of encouraging FDI is to infuse competition in the domestic market. Another aspect of FDI which helps enhance the competitiveness of the domestic enterprises is the possible transfer of managerial skills and technology. This has already been seen from the experience of the commercial banks, which have not only been able to considerably upgrade their technology, but also are introducing new products to the market. Technology and skill transfers from foreign banks have helped local banks constantly upscale their services even after the former have left.[16] However, despite serious and genuine efforts on the part of the government, including the enunciation of a one-window policy, the success in terms of attracting FDI has been minimal. This is in part due to the current political crisis in the country and the deteriorating industrial security fuelled by insurgency.

Consumer protection policy: Although only briefly discussed in the earlier sections, consumer policy can complement competition policy by creating a strong constituency in support of building a competition culture in the economy. Given the propensity of the private sector to try and avoid competition as long as they can, the government should design an active consumer policy aimed at creating awareness among the consumers and building their capacity to advocate for the cause of promoting healthy competition with a view to complementing the former's effort to instil competition in the market.

6.2. Competition law

There is no hard and fast rule on what should be considered a benchmark for the enactment and enforcement of competition law, as this is largely a subjective issue and depends on a number of factors. It has been made abundantly clear that there is no "universal" law that fits every country. While the UNCTAD Model Law on Competition (2002) and the World Bank/OECD (1999) Model Law on Competition provide useful guidelines for enacting competition law, they should be tailored to specific requirements of the LDCs in general and in Nepal in particular. However, based on

the foregoing discussion, it is not impossible to lay down the essential contours of the competition law for a country like Nepal.

Preventive as opposed to curative measures: Rather than focusing on curative measures (i.e. penalizing the wrongdoers after the offence has been committed), competition law should be such that it would facilitate the prevention of the offence itself. The requirement to register all potential anti-competitive practices with the competition authority, as done under the former Indian Monopolies and Restrictive Trade Practices Act (MRTPA) is something worth emulating in Nepal. While competition authorities around the world have been moving towards "conduct" as the criterion to trigger action, focus on "structure" could help them adopt preventative measures. Mere existence of "market power" (or monopolistic tendency) is not anti-competitive, but if the same is not properly watched, market power is a potent tool for "market exploitation". For an LDC such as Nepal, given its institutional endowment and capacity, a focus on "structure" is a better tool to prevent anti-competitive practices from taking place.

In order to deter business enterprises from engaging in anti-competitive practices, fines and penalties should be considerably larger than the extra profits that they anticipate earning through their illegal behaviour (Khemani, 1995). Some countries have even found that the deterrent effect of penalties is enhanced considerably if the anti-competitive acts are characterized as a criminal offence and if individuals as well as enterprises are made liable – as found in the antitrust legislation of the USA. Moreover, it is advisable to base fines on the percentage of turnover rather than fixing an absolute amount. This will ensure on the one hand that small enterprises do not go bankrupt after having been fined by the competition authority, and on the other create a sufficient deterrent effect for companies with a high turnover to engage in anti-competitive conduct. Moreover, a minimum level of fine/penalty should also be specified such that the competition tribunal or courts cannot use their discretionary power to impose a negligible penalty on anti-competitive conduct of a significant magnitude.

Separation of investigative and adjudicatory powers: In order to promote specialization and to make an impartial judgment on the existence of anti-competitive practices, it is necessary to separate investigative and adjudicatory powers. Otherwise, the competition authority may become the investigator, prosecutor, judge and jury, all rolled into one (Khemani, 1995). Moreover, if both the powers are given to one agency, there could be a tendency in the competition authority to be biased in favour of the investigation report and the judgment could invariably go against the business enterprises, which have been seen as conducting anti-competition practices as per the report of the investigative agency. Should this happen, business groups will automatically be against the very existence of the competition authority (Adhikari and Knight-John, 2003).

Even in the case of adjudication, litigation should be used as the last resort and other mechanisms of alternative dispute resolution should be used as extensively as possible. Litigation tends not only to be costly but also to be adversarial in nature (Adhikari, 2003b).

Triggering an investigation: There must be clear criteria to trigger cases or investigations, in the absence of which, the law will create business uncertainty and undermine the competitive market process. While too strict an application of competition rules may impede the ability of companies to attain a critical size and tax their efficiency, too lax an approach may lead to the entrenchment of monopolistic enterprises in the market (Khemani, 1995).

The problem is further compounded by the fact that there are a number of grey areas in the administration of competition law. For example, a merger need not be harmful as long as it does not result in providing "market power" to a business enterprise. It is therefore advisable to specify the threshold level of "market power" for triggering an investigation at the time of drawing up the law. Likewise, while some business practices (such as cartels) are regarded as illegal in virtually all jurisdictions and hence prohibited, some other practices (such as exclusive dealings or vertical mergers) should be examined on a case-by-case basis applying a "rule of reason" approach (Adhikari and Knight-John, 2003).

Appeal mechanism: In order to enhance the credibility of the competition authority and to provide a fair opportunity for all parties to get access to justice, there should be an effective appeal procedure, whereby any party not satisfied with the decision of the competition authority on points of fact and/or law may appeal to a higher authority. The competition authority could also commit some errors of law and/or interpretation. However, the existence of an appeal mechanism poses a credible threat for the competition authority to exercise the utmost caution while delivering judgment against any business groups or enterprises (Adhikari and Knight-John, 2003).

Private as well as public enforcement: A sound competition law should include mechanisms that address the concerns of consumers and companies affected by anti-competitive practices. In some countries, private action for the redress of injury resulting from violations of the competition law may be instituted before an appropriate court or tribunal by those people (both private companies and consumers) who have been harmed (Knight-John, 2003). Such private action has at least two benefits: it supplements and reinforces public enforcement of the competition law, and it frees the competition authority from having to obtain such redress on behalf of private parties.

Prohibition and remedial orders: The appropriate remedy for many types of anti-competitive practices is to simply demand that the offending party stop engaging in the conduct or take other actions to eliminate the effects of the unlawful practices. Punishment is also appropriate if the conduct is egregious. However, some of the ill-

effects of anti-competitive behaviour are not readily apparent to business people, who may have engaged in the conduct initially in good faith. The competition law should empower the competition agency to prohibit the conduct or redress the harm caused by it (Adhikari, 2003c).

Protection of confidential information and avoidance of conflict of interest: If the competition authority were to receive cooperation from business sectors while conducting an investigation into a potential competition abuse case, they should institute a system for protecting the confidentiality of private information, which was acquired during the process of investigation or proceedings (Khemani, 1995). Such information, if handed over to competitors, could cause enormous businesses losses. Moreover, there lies a strong possibility that competitors would try to acquire and use such information for furthering their own profit motive, by using the officials of the competition authorities. Such activities should therefore be legislated as being illegal.

Competition advocacy: Since policy formulation is a dynamic and evolving process, the government is constantly involved in revising, reviewing and updating its policy space. At times, private restrictive business practices (RBPs) are often facilitated by various government interventions in the marketplace. Thus, the mandate of competition authorities should extend beyond mere enforcement of competition law. It must also participate more broadly in the formulation of its country's economic policies, which may adversely affect the competitive market structure, business conduct and economic performance. It must assume the role of competition advocate, acting proactively to bring about government policies that lower entry barriers, promote deregulation and trade liberalization, and otherwise minimize unnecessary government intervention in the marketplace (World Bank and OCED, 1999: 93). This makes the government and competition authority more accountable, increases awareness of the costs and benefits of alternative policies, and helps to ensure that government policy objectives do not work at cross purposes (Adhikari, 2003b).

Of late, concerns have also been expressed by civil society entities with regard to the narrow tailoring of the existing definition of competition advocacy, as it focuses solely on the role of competition authority. As such, there is a strong demand – and a very valid one – from consumer organizations to expand the definition of competition advocacy to include the roles of other interested parties (such as consumer groups), which have a significant stake in fostering competition.

Budgetary provisions: Implementing competition law is a resource-demanding task. The competition authority requires a considerable degree of skill and competence to address complex issues ranging from how to determine dominance or at what level to set threshold limits to how to evaluate competition cases using a "rule of reason" approach. However, in several countries, competition agencies struggle with these issues and are unable to handle their caseload because of a lack of qualified staff.

The apparent problems, especially an exclusive dependence on the government budget for funding the activities of the competition authority, bring us to the related issue of whether and how the authority can become financially independent. Adhikari (2002a: 30–31) provides a list of alternative means to raise resources. First, resources could be raised by way of fines. While this option has been challenged on the grounds that it could create an incentive for the competition agency to charge unduly high fines to function as a financially sustainable unit, the establishment of an appellate mechanism would allow a party to contest not only the decision of the authority but also the amount of the fine.

A second alternative could be for the competition authority to charge fees for the services that they provide to the government and business associations, while a third choice could be to introduce a system similar to a court fee whenever firms file complaints against their competitors. The advantage of this approach is that it would deter frivolous complaints. A final option could be to obtain support from the bilateral and multilateral donor agencies for funding and technical assistance. In summary, the most practical solution would perhaps be a mix between state and other sources of finance, with the former option progressively forming less of the resource base than the latter.

Independence of competition authority: A common feature in most developing economies is the absence of political ownership and support for competition law. This also translates into undermining its independence as a professional "watchdog" of competition. Some of the prerequisites to create independence within the competition authority include legal independence, where the competition agency is not a part of any government department and where members cannot be removed without proper justification, financial independence, and, *de facto* independence, where it would have the cooperation of other government agencies in enforcing its decisions.

As suggested by Adhikari and Knight-John (2003), some practical options for enhancing the independence of a competition agency would be to stipulate that the agency should be accountable to the legislature or to a Parliamentary Committee, for instance to fix the term of Commissioners so as to enable them to receive adequate exposure and experience, but not too long so as to run the risk of political or regulatory capture, and to provide for start-up funds from the government budget whilst leaving the responsibility for generating more funds to the agency through fines, fees or donor support, etc.

Exemptions and exceptions: Based on the review of exemptions and exceptions provided for in the competition legislation of countries around the world and given the peculiarities of the Nepalese economy, it can be argued that the following areas should be excluded from the application of competition law: (a) SMEs, (b) small farmers and farmers' cooperatives, (c) R&D cooperation between competitors for the introduction of new product or process, (d) joint purchasing or import of raw materials by small enterprises to reduce their costs, (e) trade associations formed to

gather and exchange statistics, determine product standards, exchange credit information, and institute environmental protection measures, (f) agreements entered into between the producers or suppliers to promote export, and (g) the collective bargaining rights of the workers. However, it is necessary for the government to review most of these measures periodically and to introduce a sunset clause to ensure that such exceptions are not provided permanently.

Based on the above analysis, it is necessary for Nepalese agencies drafting the competition law to be cautious about the process as well as the content of the legislation. Moreover, it is necessary for the government to take stakeholders into confidence before enacting the competition law. Once the law is enacted, a programme on competition education and advocacy should also be launched in order to create a competition culture among all the concerned stakeholders. Some useful initiatives are already under way on the side of CSOs.[17] It is necessary for the government to engage the private sector as well as other stakeholders in the process.

7. Conclusion

Despite serious efforts made by the LDCs to achieve their development objectives, they have not been able to do so due to a variety of reasons. While they have either consciously or spontaneously adopted various types of competition policy measures, including trade and investment liberalization, privatization, deregulation and trimming down of the government's role with a view to creating a space for the participation of the private sector in the economic development endeavours, they have not been able to infuse competition in their economies. Nepal is no exception.

Nepal has made a commitment to enact competition law at the time of its accession to the WTO. However, due to limited knowledge among the policy makers about the functioning of the competition policy and the design and implementation of competition law, they seem to be worried that competition law might remove the sovereign rights of the government to achieve legitimate policy objectives. Moreover, it is clear from the analysis of the functioning of the competition regimes in various developing countries that implementation of competition law is a stupendous task, not least because it is resource demanding and it requires a very high level of sophistication. Further, there is a fear that lack of political will, competition culture and the prevalence of mal-governance may imperil the prospects for their effective implementation.

Fortunately, however, a cursory glance at the competition regimes in developed and developing countries around the world suggests that they do not take "economic efficiency" as the sole criterion for judging the legality of various anti-competitive practices. Most of the competition laws do provide some policy space for the governments to achieve their development objectives.

It has been well established that competition law must be based on the socio-economic and political reality of each country concerned and that one size of compe-

tition law does not fit all countries. One also needs to understand that the implementation of a comprehensive competition policy and law requires a strong government, which many developing countries at a low level of industrialization do not have. Therefore, at the very least, for such countries there will need to be far fewer and simpler competition rules which are capable of being enforced. Clearly, it would be unfair, if not absurd, to subject a Sierra Leone-type country (or Nepal for that matter) to the same competition policy discipline as the US (Singh and Dhumale, 1999). Therefore, it is advisable for the LDCs to make full use of development dimension provisions while drawing up their competition policy and law.

Even if a state-of-the-art competition policy is designed and competition law enacted, taking development dimension fully into consideration and after a series of consultations with the stakeholders, their implementation could still be hampered by a number of factors. Unless and until a competition authority is provided with much needed independence – both in terms of decision making and budget – the chances are that it would not serve the intended purpose. If a minister is allowed to appoint the commissioners and authorized to remove them without any reasons given whatsoever, it would lead to disastrous consequences.

Another issue that merits attention is that the introduction of a development dimension to the competition policy does not mean that the government should use these measures on a permanent basis for all the sectors/areas. Therefore, the introduction of a sunset clause to the legislation itself could help remedy the likely problem of the creation of vested interests seeking eternal protection. Moreover, clear criteria should be laid down for providing exemptions and exceptions and the scope for discretionary decision making circumscribed. Discretionary power only means providing an incentive for the competition authority to engage in corruption.

One of the major objectives of competition policy and law implementation is to foster the competitiveness of domestic enterprises so as to enable them to compete in the international market. As has been made amply clear by the examples of Japan and Korea, rivalry among domestic enterprises at national level forces the enterprises to become competitive both at national and international levels.

It is worth sounding a word of caution, however. Competition policy is only one of the elements to help ensure competitiveness by forcing companies to be more efficient, engage in R&D and foster innovation in order to improve the quality of products and cut costs. There are a host of other measures that need to be taken in order to enhance the competitiveness of domestic enterprises – such as improving access to affordable credit, improving supply-side constraints, trade facilitation and above all good governance.

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Notes

1. For example, coffee comprises 82.7 per cent, 69.4 per cent and 63.6 per cent of the share of total export value of Uganda, Rwanda and Ethiopia, respectively. See Chandrasekhar and Ghosh (2000: 3).
2. On average, Nepal's applied tariffs on agricultural products are less than 10 per cent and on industrial products 12.5 per cent. However, the government was successful in maintaining its bound tariff on agricultural products at 42 per cent and on manufactured

products at 24 per cent on average. See WTO (2003).

[3] As per Section 2, the purpose of the Act is to promote and maintain competition in the Republic in order –
a) to promote the efficiency, adaptability and development of the economy;
b) to provide consumers with competitive prices and product choices;
c) to promote employment and advance the social and economic welfare of South Africans;
d) to expand opportunities for South African participation in world markets and to recognize the role of foreign competition in the Republic;
e) to ensure that small and medium-sized enterprises have an equitable opportunity to participate in the economy; and
f) to promote a greater spread of ownership, in particular to increase the ownership stakes of historically disadvantaged persons.

[4] It is, however, like a chicken and egg situation, making it extremely difficult to find out which was the cause and which was the effect – whether corruption led to anti-competitive practices or *vice versa*.

[5] For example, in Tanzania, salaries of the personnel at the competition authorities were on par with government (which is very low), and much lower than that of the private sector. See CUTS (2002).

[6] Convinced of the need to develop competition culture in Nepal, South Asia Watch on Trade, Economics & Environment (SAWTEE), a Kathmandu-based NGO has been implementing a 3-year programme entitled *Competition Advocacy and Education Project (CAEP)*. The first workshop under the Project was organized in Birat Nagar, an industrial town in Eastern Nepal. One of the objectives of the workshop was to provide an opportunity for the stakeholders to comment on the proposed competition legislation of the country. People from various walks of life made a significant contribution to improving the draft legislation, but business people were found to be least interested in making any major contributions.

[7] A comparison of the lending rates offered by the then 11 commercial banks in two periods (January 1998 and May 2000) for three categories of loan (priority sector loan, importers loan and loan against fixed deposits) conducted by Adhikari and Regmi (2001), revealed that there was a clear pattern of interest rate cartel, facilitated by NBA.

[8] A comparison of the airfare charged by the then six private airlines as of June 1999, as documented in Adhikari and Regmi (2001), revealed that there was a clear pattern of fare cartel, facilitated by AOAN.

[9] Nepal still does not have an anti-dumping law or institution.

[10] Earlier they used to have working capital loan (WCL) as a category. Later they provide separate interest rates for their "red-carpet" clients (corporate and multinational), then the normal category, within which they have two sub-categories – prime and others. The interest rate difference between, say, a multinational company and a customer falling within the "others" sub-category could be up to 3 per cent (10 per cent for MNCs and 13 per cent for the "others" sub-category of clients. See http://www.nibl.com.np/interest_rate.htm (accessed on 28 March 2004) for a sample interest rate structure of a Nepalese bank, namely Nepal Investment Bank Ltd.

[11] For example, in the case of Nepal Bank Ltd., the oldest commercial bank of Nepal (as of December 1999), of the total loans of 8.5 billion rupees, 33 per cent is concentrated in the top five big business groups. The Golchha organization, the largest business house in the country, alone accounts for 39 per cent of the total loans of these five groups. It is to be noted that 6.6 billion rupees is the bad debt out of the total outstanding loan of 8.5 billion

rupees. See Upadhyaya (2001). As per the latest information, which is not readily available due to reasons of confidentiality, the situation is reported to be even more alarming. See also Spotlight (2001).

[12] For example in the case of Nepal, SMEs account for 90 per cent of all enterprises, employ 95 per cent of the non-agricultural workforce and contribute 50 per cent of the industrial GDP. See Khatiwada (2001).

[13] Article 1505 (Exceptions), Provision 11 of the Act states "the establishment of formal agreements between small entrepreneurs engaged in the retail sale of the same or similar commodities for the purpose of bulk purchase of those commodities in order to meet in good faith, competition of businesses with substantially larges sales volumes. For the purpose of this paragraph, the term "small entrepreneur" means a merchant whose gross receipts from all sources in any year cannot reasonably be expected to exceed US$ 250,000 and who will not employ more than 12 persons."

[14] This requirement has recently been abolished.

[15] Refer to the example of price discrimination prevalent in the banking sector discussed in Section 4.7 above, which is mainly due to the inability of the Central Bank to control such malpractices.

[16] For example, Nepal Indosuez Bank Ltd. used to be a 50:50 joint venture bank between local shareholders (institutions and individuals) and the Credit Agricole Indosuez (CAI) Group of France. In 2002, the CAI group sold its 50 per cent stake to local shareholders, who then converted the name of the bank to Nepal Investment Bank (NIB) Ltd. No formal customer satisfaction survey has been conducted to assess the service level of the new entity, but, from casual observations, it can be concluded that the level of service has improved. The Bank having been judged "Bank of the Year" by the London-based Financial Times Group's – the Banker – for the year 2003 is a testimony to this. "As the only major bank in Nepal that does not have foreign banks as shareholders, NIB made significant improvements in its technology and services last year. These include the roll-out of debit cards for constant access to banking services, and telephone banking. It plans to launch internet banking and Visa credit cards soon" stated the release issued by The Banker on 03 September 2003, after handing over the award. Visit http://www.thebanker.com/news/fullstory.php/aid/593/Nepal.html for further details.

[17] For example, since February 2004, South Asia Watch on Trade, Economics & Environment (SAWTEE) has started a 3-year programme entitled *Competition Advocacy and Education Project* mainly with the objective of building a healthy competition culture in the country. This project is being implemented in close coordination with the Ministry of Industry, Commerce and Supplies (MoICS).

I.3. EXEMPTIONS AND EXCEPTIONS: IMPLICATIONS FOR ECONOMIC PERFORMANCE. THE CASE OF THAILAND

Deunden Nkikomborirak

1. Introduction

Every competition law provides for exemptions and exceptions. The question is whether, and to what extent, these exemptions and exceptions actually contribute to greater economic efficiency or the attainment of other societal goals. According to Khemani (2002), *exemptions* are broader in scope in that they often apply to sectors or industries, whereas *exceptions* tend to be narrower in scope in that they are determined on a case-by-case basis through the application of the "rule of reason" approach. For example, certain mergers and acquisition cases that are likely to result in a highly concentrated market may be granted an "*exception*" and allowed to proceed on the basis of a strong efficiency defence.

Exemptions from the application of a competition law are normally provided for in the competition law itself or by court, executive or administrative decisions, depending on the administrative and legal structure of the particular country. For example, *exemptions* for agricultural cooperatives, labour unions, liner shipping and export cartels are often specified in the competition law. Sectors with a *suis generis* law are generally exempted from the general competition law because a competition law does not have precedence over sector-specific laws such as the Telecommunications Act or the Electricity Act. Certain competition law does not apply to restrictive practices that have an effect outside the national boundary such that export cartels are granted an automatic exemption. Certain countries, like the United States, do not list exemptions in any legislation. Rather, they are defined by the court and congressional actions.

The above exemptions are *de jure* exemptions in that they are exemptions according to the law or regulations. There are, however, exemptions at the implementation level, or *de facto* exemptions. For example, the absence of necessary implementing rules and regulations may render certain sectors of the law inert, which is tantamount to a broad exemption until the particular provision becomes effective. In the same vein, an inability to enforce the law extraterritorially can also be taken as an exemption for businesses that are not incorporated locally.

Unlike *exemptions, exceptions* are not legislated, but are often determined at the administrative level. Usually, exemptions take the form of clearance of an *ex ante* notification of a potentially restrictive trade practice such as the pre-merger or pre-agreements notifications. Any administrative decision not to prosecute restrictive practices on whatever ground can also be taken as an exception on the basis of a rule of reason approach.

In general, the broader the objective of the competition law, the greater the discretionary power the administration has in granting exception to competition cases. For example, the primary objective of the competition legislation in Canada is to maintain and encourage competition, with emphasis on promoting economic efficiency. In the case of South Africa, Indonesia and many Asia-Pacific countries including Japan, South Korea and Taiwan, the competition law is expected to address not only economic efficiency, but also fairness and the promotion of small and medium enterprises. This would imply that exemptions could be granted on the basis of any one of these objectives.

This paper seeks to examine the scope and the nature of *de facto* exemptions and exceptions in the application of the Thai competition law since its enactment in 1999. The first section provides an overview of the Thai competition regime, including its structure, procedure and past performance. The second section addresses the nature of the exemptions and exceptions from both the law and its implementation. The third section assesses the impact of such exemptions and exceptions on economic performance of the sector(s) concerned. The final section summarizes the lessons learned and offers recommendations with regard to how to ensure exemptions and exceptions that are in the interests of the public.

2. The Thai competition regime

2.1. The law

Thailand has had a competition law since 1979 known as the Price Control and Anti-Monopoly Act B.E. 2522 (AD 1979). At that time, the objective of the law was to protect consumers from inflationary pressures and from widespread collusive practices among businesses that had led to excessive pricing. The provisions concerning anti-competitive practices were incomplete as they did not cover many vertical restraints, and sections on mergers and acquisitions were missing. While the price control mechanism was easily implemented, the anti-monopoly provisions were hardly enforced. This was because the law required that a business accused of anti-competitive practices had to be officially declared a "controlled business" by the competition authority – i.e. the Department of Internal Trade, Ministry of Commerce – before the law could be enforced. Since there were no clear rules by which a monopolistic business could be defined, only one business, ice manufacturing, was declared a controlled business in the two decades during which the law was in effect.

In 1999, the Price Control and Anti-Monopoly Act B.E. 2522 (AD 1979) was replaced by two laws, namely the Trade Competition Act B.E. 2542 (AD 1999) and the Goods and Services Price Control Act B.E. 2542 (AD 1999). The price control provisions were in effect separated from the anti-monopoly provisions. Two different commissions were formed. These are the Goods and Services Price Control Commission, which is responsible for price controls, and the Trade Competition Commission (TCC), which is responsible for safeguarding fair competition in the markets. The

secretariat of both commissions remains within the Department of Internal Trade, the Ministry of Commerce.

Compared with its predecessor, the new competition law is much more comprehensive in terms of its substantive provisions. The Act automatically applies to all enterprises and business activities with the exception of (1) state enterprises (2) cooperatives and agricultural cooperatives (3) central and regional government agencies and other businesses prescribed by Ministerial Regulations. The requirement that the competition authority declare an accused business to be a "controlled business" was dropped. The main substantive provisions of the law include abuse of dominance in section 25, merger control in section 26 and collusive practices in section 27. Types of abuse of dominance and collusive practices that may constitute a violation of the law were also specified. Certain practices, such as price fixing and bid rigging are governed by a *per se* rule, while other types of collusive practices and mergers are governed by a *rule of reason*[1].

In addition to the mentioned provisions, section 29 deals with unfair trade practices. It prohibits any act contrary to free and fair competition, which results in the obstruction, damage, and restriction of other business operations. The scope of the application of this particular provision remains unclear, as the letter of the law is rather broad and vague. This leaves much discretion to the administrator of the law. Businesses have questioned this "catch-all" provision and are pressuring the competition authority to pass implementing regulations that specify the types of behaviour prohibited by this particular section.

2.2. The administrative body

The Office of Trade Competition (OTC) resides within the Department of Internal Trade, the Ministry of Commerce. The Thai Trade Competition Commission (TCC) consists of the Minister of Commerce as Chairman, Permanent-Secretary for Commerce as Vice-Chairman, Permanent-Secretary for Finance and not less than eight, but not more than 12, experts in various disciplines. These experts are nominated by the Minister of Commerce and appointed by the Cabinet. The law strangely stipulates that at least one-half of the experts must be representatives from the private sector. Consequently, the current practice is to have three commissioners from the Federation of Thai Industries and another three from the Thai Chamber of Commerce. The Director General of the Department of Internal Trade is both a member and secretary of the Commission. Each appointed commission has a 2-year term. There is no staggering term so that a change in the government can change the entire composition of commissioners when their terms expire. Therefore, the Commission is very vulnerable to political influence.

2.3. Past performance

Since its inauguration in 1999, the Commission has deliberated on only four competition cases. These are cases concerning (1) a cable television monopoly, (2) a tied-

sale case, whereby a near-monopoly whisky producer was alleged to have tied the sale of beer with that of whisky, (3) unfair trade practices in the retail trade, and (4) exclusive dealing in the motorcycle market. No charges were made in the first two cases. In the case of the cable monopoly, the Commission decided that since cable charges are subject to approval by the Mass Communication Organization of Thailand (MCOT), the state-owned enterprise responsible for granting cable television licenses, the organization should be responsible for reviewing the charges (see more details in Box 1). As for the tied-sale case, the Commission found that there was

Box 1: The Cable Television Monopoly.

The nationwide cable television service in Thailand became a monopoly in February 1998 as the two incumbent operators, namely the International Broadcasting Corporation (IBC) and the United Television Network (UTV), merged. At that time, the Trade Competition Act was not yet legislated so that mergers were beyond state regulation. Against the wishes of the public, the merger was approved by the Mass Communication Organization of Thailand (MCOT), the government organization which was authorized to issue broadcasting licenses. The main justification for the merger was the need for the operators to consolidate, given the cost hike following a sharp depreciation of the baht in June 1997, following the financial crisis. The "efficiency defence" was that with a single operator, movie licenses could be procured at a lower cost since competition between the two operators was eliminated.

A little over a year after the merger, UBC raised its monthly subscription fee for its "gold package" - i.e. the subscription package offering the largest number of channels - by a whopping 22.47 per cent from 890 baht (US$ 22.25) to 1090 (US$ 27.25) in May 1999. Price hikes were justified by the fact that the company was still recording losses each year and that new channels were added to increase consumers' choice. A consumer group filed a complaint to the competition authority. It alleged that the cable operator abused its monopoly by charging excessive prices.

An expert subcommittee was assigned to investigate the case. According to the subcommittee's report, the merger halted the fierce price and non-price competition between the two incumbents. However, the subcommittee was not able to establish whether the price was excessive or not since that would have involved a much more complex exercise of cost assessment, which should be reserved for the sector-specific regulator. Nevertheless, the subcommittee found that UBC had abused its dominance by limiting the choice of consumers as it failed to offer a lower-priced package known as the "silver package" that had fewer channels. Consequently, customers were forced to subscribe to the "gold package" that included many expensive sports and movie channels. This was also a clear violation of the licensing condition.

The Trade Competition Committee agreed that the cable operator was a monopoly but decided to refer the case to the MCOT since the government agency was responsible for monitoring compliance with the licensing agreement as well as for approving tariffs. Although the tariff was not revised, public pressure has constrained further price hikes that were pending at the time. However, a few months later, a further price increase was approved by the MCOT. Subscribers are presently given the choice of subscribing to a less expensive package. However, the content of the package has been altered in that licensed channels (such as the CNN, Discovery) have been withdrawn. The remaining channels consist exclusively of in-house productions. Thus, the silver package no longer represents a "real choice" for consumers. It is hoped that once the independent sector-specific regulatory agency has been established, consumers will be better protected against abuse of market power.

evidence of abuse of dominance. However, since the definition of "dominance" has not yet been established, it was not possible to enforce section 25 of the law, which deals with abuse of dominance.[2] The case is therefore temporarily suspended until a formal definition of dominance is officially declared.

The third case concerns unfair trade practices in the retail trade. Since the economic crisis in 1997, most discount stores in Thailand are now owned by foreign multinationals such as Tesco of the UK, Carrefour and Casino of France and Royal Ahold of the Netherlands.[3] While these foreign retail companies compete rigorously among themselves and with Thai department stores, their extremely aggressive business culture has caused tremendous friction with suppliers, both large and small. Some of their business practices, such as mandatory enrolment in price-promotion schemes, preferential treatment for own brand products, and collection of various service fees were alleged to be unfair trade practices. The Thai Trade Competition Commission passed a "Retail Industry Code of Ethics" in response to suppliers' complaints.

The fourth and last case is a landmark case. It is the very first case that the TCC found an infraction of the law and decided to take legal actions against the defendant. In this case, a motorcycle manufacturer was alleged to have practised exclusive dealing in the sales of its product. This particular brand is very popular and holds approximately 80 per cent share of the motorcycle market. It is interesting to note that the particular company was found to have violated section 29 of the law, which concerns unfair trade practices, rather than section 25 on abuse of dominance, despite the fact that the practice obviously constitutes an abuse of dominance rather than an unfair trade practice. Although the Commission's decision can be explained by the fact that section 25 is still unenforceable, its failure to do the same in the case of the tied-sale discussed before raises suspicions that the enforcement is selective and discriminatory.

To sum up, the competition regime in Thailand is barely functioning as is evident in its performance. This can be attributed to many factors including political intervention, interest groups lobbying, legal loopholes and the lack of transparency in the administration. With so few cases having been dealt with since its inception 5 years ago, there is no doubt that the majority of anti-competitive practices go unchallenged. The question is why are these practices able to remain elusive to the reach of the law. That is the focus of the next section.

3. Exemptions and exceptions under the Thai competition law

3.1. Exemptions

This section examines the nature of both *de jure* and *de facto* exemptions under the Thai competition law. One can categorize various exemptions under the current competition regime into four types. The first type includes exemptions as stipulated in the competition law. The second type refers to exemptions that result from the

inability to enforce certain sections of the law due to the absence of the required implementing rules and regulations. The third type consists of regulated sectors where business practices may be governed by a sector-specific law. The last type of exemption applies to companies incorporated overseas whose restrictive practices are beyond the reach of the national competition law.

Exemptions de jure

Since the Thai competition law is only 5 years old and is rarely enforced, it is no surprise that there are very few exemptions. The provision for exemptions as appeared in the Trade Competition Act is as follows:

Section 4: *This Act shall not apply to the act of:*
1. *Central administration, provincial administration or local administration;*
2. *State enterprises under the law on budgetary procedure[4];*
3. *Farmers' groups, cooperatives or cooperative societies recognized by law and having as their object the operation of businesses for the benefit of the occupation of farmers;*
4. *Businesses prescribed by the Ministerial Regulation, which may provide for exemption from the application of this Act in whole or only in respect of any provisions thereof.*

Unlike most countries that do not exempt government agencies or state enterprises that are involved in commercial activities, Thailand chose to provide a blanket exemption for the entire government sector. The rationale for exempting the entire state sector is because it is believed that state enterprises do not operate on a purely commercial basis. Rather, they carry social obligations that may require them to carry out practices that are unintentionally anti-competitive. For example, low prices that can be seen as predatory pricing may help promote the universal service goal by ensuring affordability. High prices may be necessary for cross-subsidy when funding for a universal service is not available. Hence, to treat a state enterprise that carries social goals as a purely commercial entity would be inappropriate. The practical reason for exempting state enterprises from the general competition law is that – as one would expect – the state often operates in a monopolistic environment and can be an easy target for allegations concerning restrictive practices. Consequently, the new competition authority may be overwhelmed by complaints in relation to regulated businesses.

This fear of being overloaded with complicated regulatory issues is understandable when sectoral regulatory regimes are not yet in place. In the absence of a well-developed sectoral regulation that lays down clear rules with regard to competition structure and behaviour, throwing the entire state sector under the general competition law would indeed be equivalent to opening a Pandora's box. For example, private power producers may complain about the terms and conditions of the electricity purchase of the state electricity authority that is the designated sole buyer of electric-

ity in a single buyer model. Similarly, in the absence of rate re-balancing, the private local telecommunication operators may accuse the state-owned enterprise of unfairly conducting cross-subsidization between local telephone services and long-distance and international telephone services. In that case, the nascent competition authority would be inevitably drawn into highly technical and complex sectoral regulations that it is unlikely to be able to handle.

Clearly, the option of exempting state enterprises is not the first-best solution, but given the obvious capacity limitations of the competition authority, it may be the most reasonable second-best solution, depending on where the priorities of the competition regime lie. If the aim is to tackle restrictive practices carried out by state enterprises, then the exclusion will not be necessary. However, if the objective were to address private restrictive practices, then one would consider exempting the practices of government enterprises from the law in order to protect the competition authority from being forced to perform regulatory functions. At this point, it would be a practical rather than a theoretical question that needs to be addressed.

Of course, the option of exempting the regulated sector altogether is there. However, a sweeping exemption would imply that private operators that operate on a purely commercial basis would also enjoy the exemptions. While, in principle, all entities engaged in similar activities should be subject to the same set of rules and regulations to ensure fairness and non-discrimination, as long as state-owned enterprises can claim public service obligations, there will always be a case for exempting them from the competition law.

Besides state enterprises, the law also exempts farmers associations. This is understandable given that approximately 40 per cent of employment is still in the agricultural sector. Most farmers are indeed very small scale and, thus, placed at a disadvantage when bargaining with large food manufacturers or middlemen. Exemptions allow farmers to form cooperatives in order to enhance their relative bargaining power so as to ensure fair and stable prices for agricultural products.

Finally, the law allows discretion on the part of the Minister of Commerce to issue Ministerial regulations that designate additional exempt businesses. All Ministerial Regulations must be published in the Royal Gazette. To date, no businesses have been granted an exemption by means of the Ministerial Regulation.

Exemptions de facto resulting from the absence of necessary implementing rules and regulations

Although the Trade Competition Law automatically applies to all business entities with the exception of state agencies and enterprises and agricultural cooperatives, its enforcement is still pending on the passing of key rules. The law stipulates that the Trade Competition Commission has the duty and power to establish the threshold level of market share, and sales figures have to be established for section 25 (abuse of dominance) and section 26 (merger). The proposed threshold will have to

be approved by the Cabinet and published in the Royal Gazette. Without these figures, a company cannot be declared "dominant" and so its trade practices will not be subject to the particular disciplines provided under the law. Similarly, without a threshold level of post-merger market share or sales or assets figures, no companies are required to submit a request for permission to merge. In effect, provisions on abuse of dominance and mergers and acquisitions are currently inert.

The former Trade Competition Commission proposed a "dominance threshold" to be a one-third market share and a sales revenue of one billion baht (US$ 25 million at 40 baht per US dollar). As expected, these figures were opposed by large businesses whose market shares and sales exceeded the suggested limits. The OTC submitted the proposed definition of market dominance to the Cabinet for approval towards the end of 2000. Due to heavy lobbying by large businesses, however, the approval was effectively blocked. The change in the government in the beginning of 2001 placed everything on hold.

The issue emerged once again after a very long silence as the Commission failed to meet for over a year. But once the newly appointed TCC met in May 2002, the message was clear that the Commission did not believe in determining a market dominance threshold based on a threshold market share as required by the competition law. It opines that such a threshold would render the regime too rigid. References were made to a more advanced test of dominance such as the "hypothetical monopoly" test used in many countries. But no suggestions were made concerning how to make the provisions enforceable. The Minister of Commerce, as the Chairperson of the TCC, merely suggested that the OTC should take more time to study competition laws in foreign countries.

In 2003, at the height of the controversy over the exclusive dealing in the motorcycle market and unfair trade practices in the retail industry, the Trade Competition Commission suggested a sector-by-sector dominance threshold in order to make section 25 enforceable for these particular cases. It proposed two thresholds, a 20 per cent market share and US$ 700 million minimum annual sales for retail and a 33.33 per cent market share and US$ 130 million for motorcycles. This approach was heavily criticized by both sceptics and academics. Sceptics view the threshold for retail trade as being too high since none of the large discount stores that are the targets of complaints had such a large market share. Interestingly, the question of how the market was defined was not raised. Academics, on the other hand, view the proposed threshold market shares and minimum sales as arbitrary. They are, however, more concerned about the fact that the sector-by-sector dominance threshold will lend itself to a highly selective and discriminatory competition regime and will undermine the broad application of the law. In the end, the proposal was not submitted to the Cabinet. It is not clear whether the outrageous proposal served simply to diffuse public demand for a dominance threshold. From this event until the present, the Commission made no further efforts to make sections 25 and 26 enforceable.

Consequently, abuse of dominance practices and mergers and acquisitions continue to remain unchallenged.

Exemptions for regulated industries

Although the Trade Competition Act does not provide exemptions for regulated industries, in practice, the Trade Competition Commission refers cases that involve regulated industries to the government authority or the state-owned enterprise that is responsible for the regulation. This is evident in the case of the cable television monopoly as mentioned earlier, where the government leaves the question regarding cable tariffs to the state-owned enterprise responsible for handing out cable licenses and approving programs and monthly fees.

Except for telecommunications, Thailand does not yet have sector-specific laws that govern restrictive business practices in a regulated industry. The Telecommunications Act 2003 stipulates that the telecommunications industry is subject to the general competition law despite the fact that the law itself does contain certain provisions concerning anti-competitive practices, albeit not as comprehensive as those stipulated in the Trade Competition Act. The case of telecommunications is not to be taken as a precedent with regard to the relationship between the competition authority and the sector-regulatory authority. There is no clear policy in this regard.

Exemptions for companies not incorporated locally

Besides business activities that are granted exemptions by domestic laws, multinational companies operating outside the national jurisdiction are also beyond the reach of the domestic competition law. In theory, the Thai competition law applies extraterritorially, which means that all restrictive practices that have an effect on the domestic market are subject to the national competition law regardless of where the action may have taken place. In practice, however, it is almost impossible to investigate restrictive practices that take place outside the national boundary – i.e. export and international cartels – without due cooperation from the competition authorities of the countries where the multinational companies are registered. The fact that most competition regimes provide an exemption for cartels that do not have an effect on their own domestic market allows these collusive practices to remain in no-man's land.

3.2. Exceptions

Except for certain types of agreement, all provisions on restrictive practices in the Thai Trade Competition Act are subject to a rule of reason approach. Section 25, which deals with abuse of dominance, is as follows:

Section 25. *A business operator having market domination shall not act in any of the following manners:*

1 <u>*unreasonably*</u> *fixing or maintain purchasing or selling prices of goods or services;*

2 *unreasonably fixing compulsory conditions, directly or indirectly, requiring other business operators who are his customers to restrict services, production, purchase or distribution of goods, or restrict opportunities in purchasing or selling goods, receiving or providing services or securing credits from other business operators;*
3 *suspending, reducing or restricting services, production, purchase, distribution, deliveries or importation without justifiable reasons, destroying or causing damage to goods in order to reduce the quality to that lower than the market demand;*
4. *intervening in the operation of business of other persons without justifiable reasons.*

Indeed, words like "unreasonably" and "without justifiable reasons" provide a basis for the rule of reason approach in assessing abuse of dominance practices. In the absence of implementing guidelines that expand on these vague terms, there is much room for subjective discretion on the part of the administrative body.

Section 26 deals with mergers and acquisitions. As is the case in most competition laws, a pre-merger notification is required for mergers that are expected to result in a certain level of concentration in the market. But, as mentioned earlier, the threshold post-merger market share and minimum sales figure have not yet been established, rendering this particular section unenforceable. It is also unclear on what basis the Commission's permission may be granted as there is no mention of the types of defence that may be admissible, be it an "efficiency defence" or a "failing firm defence".

Section 26. *A business operator shall not merge businesses, which may result in monopoly or unfair competition as prescribed and published in the Government Gazette by the Commission unless the Commission's permission is obtained.*

The publication by the Commission under paragraph one shall specify the minimum amount or number of market share, sale volume, capital, shares or assets in respect of which the merge of business is governed thereby.

Section 27 concern agreements. Here, the law describes 10 different types of agreements. The law prohibits the first four types of agreements. These are price or quantity fixing and bid rigging. The third type of prohibited agreement – i.e. *entering into an agreement to have market domination or control;* is somewhat vague. It seems to refer to the "intention", rather than the actual trade practice, which can be very subjective.

As for the other types of agreement, businesses must apply for permission by filing an application with the Commission. Again, the law does not mention efficiency. Rather, it states that permissions may be granted if it is "commercially necessary" to undertake such agreements. There are no implementing regulations that would elaborate on what such a term means.

Section 27. *Any business operator shall not enter into an agreement with another business operator to do any act amounting to monopoly, reduction of competition or restriction of competition in the market of any particular goods or any particular service in any of the following manners:*

1 *fixing selling prices of goods or services as single price or as agreed or restrict the sale volume of goods or services;*
2 *fixing buying prices of goods or services as single price or as agreed or restrict the purchase volume of goods or services;*
3 *entering into an agreement to have market domination or control;*
4 *fixing an agreement or condition in a collusive manner in order to enable one party to win a bid or tender for the goods or services or in order to prevent one party from participating in a bid or tender for the goods or services;*
5 *fixing geographical areas in which each business operator may distribute or restrict the distribution of goods or services therein of fixing customers to whom each business operator may sell goods or provide services to the exclusion of other business operators from competition in the distribution of such goods or services;*
6 *fixing geographical areas in which each business operator may purchase goods or services or fixing persons from whom business operators may purchase goods or services;*
7 *fixing the quantity of goods or services which or to which each business operator may manufacture, purchase, distribute, or provide services with a view to restricting the quantity to be that lower than the market demand;*
8 *reducing the quality of goods or services to a level below that of previous production, distribution or provision, whether the distribution is made at the same or at a higher price;*
9 *appointing or entrusting any person as a sole distributor or provider of the same goods or services or those of the same kind;*
10 *fixing conditions or procedures in connection with the purchase or distribution of goods or services in or order to ensure the uniform or agreed practice.*
11 *in the case where it is commercially necessary that the acts under (5),(6),(7),(8),(9) or (10) be undertaken within a particular period of time, the business operator shall submit to the Commission under section 35 an application for permission.*

Finally, section 29 is a catch-all section that focuses on unfair trade practices. This is because Thailand models its competition law after that of South Korea, which – with its *chaebols* – is particularly concerned with the difference in the size of competing companies. Unfair trade practices do not necessarily concern competition in the market. Rather, they concern unfair practices resulting from unbalanced bargaining power between two business partners that may lead to one party taking advantage of the other by prescribing unfair conditions on trade.

The key feature that distinguishes section 29 from previous sections is that in this case an impact assessment is required. Again, there are no implementing

regulations or guidelines on what constitutes unfair trade practices, which leaves the business community uneasy about its extremely broad scope.

Section 29. *A business operator shall not carry out any act which is not free and fair competition and has the effect of destroying, impairing, obstructing, impeding or restricting business operation of other business operators or preventing other persons from carrying out business or causing their cessation of business.*

To conclude, while the Thai competition regime has very few *de jure* exemptions, it has plenty of *de facto* exemptions as a result of the administrative body's failure to pass the requisite implementing rules and regulations. The regime also provides the competition authority with broad discretionary power to grant exemptions given that the law does not specify the underlying objectives or identify priorities in its implementation. Vague and unclear terms, combined with the absence of implementing regulations and guidelines, render the competition regime obscure and unpredictable in terms of the scope of its application, exemptions and exceptions.

4. Economic impact of exemptions and exceptions

4.1. Impact of exemptions

Exemptions for state-owned enterprises

While the blanket exemption extended to state-owned enterprises[5] is understandable from a practical viewpoint as explained earlier, the absence of competition oversight in the state-owned commercial entities does have relatively grave consequences.

The number of state-owned enterprises (SOEs) in Thailand is currently numbered at approximately 60 (excluding those in the financial sector that was nationalized as a result of the economic crisis in 1997). A number of these enterprises hold a dominant position in the market, in particular those that operate in the utilities sector such as telecommunications, energy, electricity, transport and water. The exemption has allowed certain SOEs to pursue anti-competitive practices to stifle private competition or overcharge consumers where private competition is absent. The absence of sector-specific regulatory agencies – i.e. in telecommunications, water, electricity and transportation – allows these practices to continue unrestrained. The problem of anti-competitive practices is likely to be much more severe when the SOE performs the regulatory role itself.

For example, the Telephone Organization of Thailand (ToT), the state-owned domestic telephone service provider, hands out several domestic telecom concessions to private companies.[6] Through the conditions set out in these concessions, the private company has to obtain prior approval from the ToT concerning (1) tariff schedules; (2) tariff adjustments; (3) technical specification of telecom equipment; (4) introduction of new services and (5) location of new fixed-line installations. Indeed, the ToT does not hesitate to exploit its regulatory power to restrain private competition. For example, TT&T, a private concessionaire responsible for the provi-

sion of a telephone service in the provincial area, complained that the state enterprise refused to approve its request to reduce domestic long-distance charges in response to the ToT's own price adjustment. As a result, the company lost a significant portion of the market share. This is a blatant anti-competitive and unfair practice. Similarly, ToT's ability to dictate where the private concessionaire could install landlines also served to protect its own market.

Private concessionaires are not the only party affected by SOEs abuse of market power; consumers also bear the price of having state monopolies. According to a research report conducted by the Thailand Development Research Institute (Thailand Development Research Institute, 2002), the cost of a 128 kbps leased line in Thailand is highest among ASEAN countries. It is approximately 20 per cent higher than that in Malaysia and the Philippines, and 70 per cent higher than its counterpart in the Philippines. Since then, prices have come down considerably as a result of competition from the private concessionaire. Similarly, consumers and businesses are paying relatively high overseas telephone service tariffs where the Communication Authority of Thailand (CAT), the state monopoly in the toll market, has been the sole provider of the service by law. Although the high overseas telephone tariffs can be partly attributed to the high interconnection charge that the CAT pays to the ToT, which is supposed to be inclusive of contributions to the universal service fund, tariffs remain excessive. In the absence of a regulatory body and an exemption from competition law, these excessive prices have never been challenged.

Exemptions for agricultural cooperatives

Unlike many countries where agriculture still contributes to a significant share of the GDP, Thailand does not have a marketing board. The government's involvement in commodity trade has been limited to occasional price-support programs when there is a glut in the supply, or when the world prices of the particular agricultural product fall too low. Although the exemptions for agricultural cooperatives allow farmers the opportunity to join together in order to coordinate their actions to protect their interests, it cannot help solve farmers' problems. Thai farmers have not been able to form a coalition at national level to build their bargaining power against large food-processing manufacturers or middlemen simply because the number of farmers is very large and they are scattered across the country. Success stories of agricultural cooperatives have been limited to district-level only, which is hardly sufficient to support the price of agricultural products.

Exemptions due to the absence of necessary implementing regulations

The lack of enforcement of sections 25 and 26 of the competition law has left businesses and consumers at the mercy of large incumbents with market power. Obvious anti-competitive practices such as the tied-sale case have expanded to include the tying of soda and bottled drinking water at the expense of both large and small competitors in these markets. During 1995–2003, through various anti-competitive practices including tied-sale, exclusive dealing, cross-subsidization and predatory

Box 2: A Merger in the Cement Industry

The cement industry is notorious for its collusive practices worldwide. This may be the case because the industry tends to be concentrated as it displays a significant economy of scale. Moreover, high transportation costs limit competition from imports, while homogeneity of the product is favourable to price-fixing arrangements.

The cement industry in Thailand is also concentrated with the largest producer, Siam Cement PCL (SCC), taking a 40 per cent market share. The second and third largest producers are the Siam City Cement PCL (SCCC) with a 25 per cent market share and TPI Polene PCL with an 18.5 per cent market share. Both SCC and TPI Polene are local firms, while the SCCC is controlled by the Swiss multinational cement producer, Holcim AG. The three firms together control approximately 83.5 per cent of the market share.

Before the entry of TPI Polene, the industry was a duopoly. Prices were high and producers were content with relatively high ROA figures. The situation changed with the emergence of TPI Polene. As the lowest cost producer, it helped contain cement prices in the market during the bubble period. During the post-crisis economic slump, the company slashed prices in order to boost sales in a shrinking construction market. Prices of cement basically halved during the late-1999 to April 2002 period to the benefit of the construction industry.

The entire picture changed, however, with the news that SCCC is about to take a majority equity share in TPI Polene, which is in the process of restructuring. Another foreign suitor, Cemex from Mexico, appeared to be the front-runner in the beginning, but seemed to have fallen behind Holcim as it could not compete with the latter's offer. Should the choice of investor in the ailing TPI Polene simply be a business decision? The answer is no if the merger is likely to limit competition in the market, potentially resulting in high prices. This is where the role of the competition authority as a protector of public interest comes in.

According to the analysis of almost every security house in Thailand, the merger between the second and third largest producers will result in a duopoly in the market. With TPI Polene, the most aggressive competitor, taken over by a less aggressive producer, price competition would certainly be terminated. In fact, the price of cement in the market already doubled in anticipation of the merger as its due date drew near. That is, the fact that SCCC (or Holcim AG) was able to bid a higher price for TPI's equity share was not because of its superior efficiency, but rather because of its ability to generate a post-merger price hike.

In countries with an effective competition law, the competition authority would have certainly rejected such an anti-competitive merger. Unfortunately, section 26 of the Trade Competition Act 1999, which deals with mergers, remains ineffective in the absence of a threshold post-merger market share and revenue that would require a pre-merger notification. There is no doubt that the delay in establishing these badly needed implementing regulations has proved extremely costly for the Thai economy and its people.

pricing, the market share of the defendant in the beer market increased from almost zero to almost 70 per cent. In the absence of a requirement for pre-merger notification, a planned merger between two large competing cement companies is likely to lead to post-merger price collusion (see Box 2). More mergers in the steel industry in the pipeline will likely lead to a highly concentrated market.

Thai consumers are being forced to pay high prices for whisky as a result of unfair cross-subsidization between the whisky and beer markets. The price of ce-

ment has also increased with the pending merger, despite the fact that Thailand has the most efficient plant in this region according to a productivity report undertaken by McKinsey & Company (McKinsey & Company, 2002). In future, they may be paying higher prices for steel as well if the ongoing consolidation in the industry lessens competition in the market. The fate of small local bottled water manufacturers is left entirely to the whims of the large incumbents. It is therefore of the utmost urgency to make these sections in the law effective in order to stem the tide of these anti-competitive behaviours that threaten the survival of SMEs and thus, the livelihood of many families, as well as the welfare of all Thai consumers.

It is clear that the image of the OTC and the TCC has been reduced to nothing more than a "paper tiger". The fact that the Commission's reputation has been tarnished even before it had a chance to establish one is detrimental to the entire process of building a competition culture in Thailand.

It is not only the public that has lost faith in this agency, but also the OTC's own staff, which seem to be losing morale. These officers have been working very hard in developing the technical and analytical skills required to deal with competition cases and have put the acquired skills into use in preparing competition cases for consideration by the Trade Competition Committee. But all their efforts appear to be in vain when decisions are often made at the whims of the politician rather than based on the well-researched facts presented.

With continued political intervention and lobbying of interested business groups, the enforcement of the competition law is likely to remain stalled for the foreseeable future. However, there are solutions, albeit challenging and time-consuming ones.

Exemptions for companies incorporated overseas

As a small open economy, Thailand relies extensively on imports, which renders it vulnerable to price fixing and market-sharing agreements undertaken by international cartels. According to various studies, Thailand has been affected by many international cartels, including the vitamin cartel, the heavy electrical equipment cartel, the steel cartel and the cigarette cartel (The Economist, 2001). In the case of the vitamin cartel, the size of the loss in terms of overcharges paid was US$ 78.45 million from a total import value of US$ 271.61 million (Evenett, 2003) for the period 1990–1999 during which the cartel operated. Unfortunately, similar estimates of the cost of other cartels are not available.

Thailand is also affected by shipping cartels that are beyond the reach of the domestic competition law. Like export cartels, liner shipping is often exempted from anti-trust provisions in industrialized countries with national shipping lines. The exemption allows liner conferences to allocate markets and set freight tariffs. Thai exporters have complained about various ancillary charges that are often applied, such as terminal handling charges and adjustment factors for fuel and currency fluctuations. These are designed to transfer risks from shipping companies to shippers

without a clear formula. As a result, small Thai shippers that lack bargaining power to negotiate more favourable rates have had to shoulder high costs that further disadvantages them in terms of cost competitiveness.

To the author's knowledge, the Thai Frozen Food Association has been the only trade association in Thailand that is able to unite in order to counter the market power of liners. The association was able to obtain preferential freight rates and bargained with the liners to waive the terminal handling charges. Unfortunately, other attempts to follow the success of the frozen food group failed, mainly because large players in the industry were unwilling to sacrifice their competitive edge over smaller players that had less bargaining strength and thus, faced higher freight rates. The liners divide shippers by offering different rebates for shippers of various sizes. Larger shippers are content with the deal they have secured, and are unwilling to help smaller shippers that compete with them in the market. Without the large shippers, smaller shippers can never hope to build up enough bargaining power to counter the liners.

To better balance the negotiating power between domestic shippers and international shipping companies, the government is considering passing domestic regulations that require international liners to consult the national shippers' council or association before any price increase is enacted. A Maritime Bill was drafted that stipulates that adequate notice of a rate increase must be given to the local regulatory agency and that shipping liners must negotiate with shippers before any increase. The Bill proposed that liners intending to increase freight rates must give 90 days' notice to the Office of the Maritime Promotion Commission and outline the reasons supporting the increase. If the state does not object within 15 days, the new rates can be enforced. If the two parties fail to reach an agreement, an arbitration committee made up of impartial outsiders would be formed and its decision would be final. In 2001, a new government came into power and did not push the bill further. Malaysia is considering a similar law.

4.2. Impact of exception

Since the promulgation of the Trade Competition Act, the Trade Competition Commission granted exceptions to two cases. The first case is the cable monopoly, where the exception is based on the fact that the service is regulated by the state enterprise, the Mass Communications Organization of Thailand (MCOT). The second case concerns unfair trade practices in the retail trade where the TCC decided to pass an Industry's Code of Ethics rather than examine in detail whether any of the practices that were the basis of complaints violate section 29 of the law.

In the first case, the decision to refer the case to the responsible regulatory body seems reasonable. In many countries, the competition authority does not have jurisdiction over regulated industries. However, in the case of Thailand, reference to the sector-specific regulator may not be suitable, given that these regulators sometime hold commercial interests in the private businesses that they regulate.

For example, in the case of the cable monopoly, the state enterprise that is responsible for regulation is entitled to a 6.5 per cent revenue share from the private concessionaire that it regulates. As a result, it has an interest in ensuring a healthy profit margin for the licensee. The blatant conflict-of-interest no doubt renders the regulatory regime ineffective. Similarly, high fixed monthly fees for mobile services were sustained for a considerable period of time despite public outcry because the government enterprises responsible for handing out these concessions enjoy a large revenue share from the private concessionaires.

In the second case of a large discount store, the issue is relatively complex as it involves unfair trade practices resulting from unbalanced bargaining between large multinational discount store chains and smaller local suppliers. There were complaints about predatory pricing, slotting allowances, own brands, mandatory participation in in-store promotions, forced rebates, etc. Most of these practices may have reasonable commercial justifications and may contribute positively to the welfare of consumers that include also small moms and pops stores that buy products from these discount stores for resale; however, some may in fact constitute unfair and discriminatory practices, in particular against smaller suppliers. In the absence of a transparent procedure, the decision not to prosecute was viewed with much suspicion by the public.

5. Lessons learned and policy recommendations

The Thai experience shows that while *de jure* exemptions may be justified on economic, social or even practical grounds, *de facto* exemptions resulting from the administration of the law can be problematic. Exemptions for state-owned enterprises and exceptions provided for regulated private companies have certain justification, but proved to be costly to the Thai economy when effective regulatory regimes are not yet in place. But, given that both the general competition regime and the sector-specific regulatory regime are not functioning, perhaps the exemptions make little difference in terms of economic performance.

The maladministration of the competition law leads to wide-ranging exemptions and exceptions from its application that are not as visible as the case above. The failure to pass the necessary implementing rules rendered key provisions on abuse of dominance and mergers and acquisitions unenforceable. The lack of transparency in the administration also leads to discriminatory treatment of exemptions and exceptions. For example, the whisky-beer tied-sale case was provisionally exempted on the basis that the section on abuse of dominance was not yet enforceable without a dominance threshold. The motorcycle exclusive dealing case, on the other hand, was charged under a different section that does not require a proof of dominance, despite the fact that both cases constitute an abuse of dominance. Similarly, the failure to thoroughly investigate, assess and report possible infractions of the law in the case of the alleged unfair trade practices in the retail industry seems to confirm the selective enforcement of the law.

The impact of these exemptions and exceptions vary, depending on the scope and scale of the alleged restrictive practices and the nature of players in the market. In the case of exemptions provided for state-owned enterprises that operate mainly in the utilities sector, consumers have had to pay higher prices for many of the monopoly services in the absence of a sector-specific regulatory regime that can perform an overseeing role in lieu of the general competition authority. The impact on the competing private companies is not as grave as in the case of restrictive practices in the manufacturing sector where many small and medium enterprises prevail. Indeed, these enterprises are more vulnerable to anti-competitive practices by larger competitors than are, say, large telecommunications companies. That is why the inapplicability of sections 25 of the law on abuse of dominance has had grave consequences on the competition environment.

The inability to apply national competition laws to foreign suppliers without registered assets in the domestic jurisdiction also imposes significant costs in particularly small countries that are often on the receiving end of cross-border restrictive practices undertaken by large multinationals. It is hoped that one day there will be a binding multilateral rule that will be able to effectively deal with these restrictive practices.

What does the Thai experience suggest? First, it shows that independence of the competition authority from both business and politics is extremely crucial in an environment where there are not sufficient checks and balances within the political, administrative and social environment. The composition of the Thai Trade Competition Commission is the converse of independence. Second, it illustrates that it is necessary that a competition law is fully enforceable upon its enactment. It would be a mistake to leave requisite implementation laws or rules to the administrative body, in particular when the body is vulnerable to political interventions and business lobbying. On the third and related point, where the administration is not transparent, it is perhaps better to minimize the discretionary power on the part of the administrative authority by legislating simple and straightforward rules rather than leave them to the authority. The legislative process is much more transparent than the administrative process. Indeed, a more flexible but complex regime can be desirable, but it also lends itself easily to discriminatory application of the law that can be devastating to the competition environment. Broad administrative power should be reserved for competition regimes that are more transparent and subject to effective checks and balance mechanisms. Finally, it is of the utmost importance to ensure transparency and due process in the administration of the competition law. One can ensure that exemptions and exceptions are justified if stakeholders have the opportunity to present their views, submit evidence and appeal in cases where they are not content with the decision. The availability of detailed implementing rules and regulations, disclosure of commission's decisions and minority views and the reasons for supporting them, notifications in the rule making, etc., can do much to enhance the transparency and ensure overall impartiality and effectiveness of any competition regime.

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Notes

[1] In a civil law tradition, rule of reason implies that such practices must obtain approval from the administrative authority concerned.

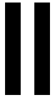
[2] This issue concerning exemptions will be discussed in detail in section 3.

[3] The Thai partner has recently bought back all equity shares of the “Tops” supermarket chain in which Royal Ahold once held a majority share.

[4] This includes all enterprises whose majority of the equity share is held by government agencies or state enterprises.

[5] The definition of a state-owned enterprise is an enterprise with state ownership exceeding 50 per cent of equity share.

[6] This is because, prior to the legislation of the Telecom Act 2001, only state enterprises were allowed to own and operate telecommunications network and services. Thus, private telecom companies could only operate through a build-transfer-operate (BTO) arrangement, whereby the private company installs the network, and then transfers ownership of the network to the state enterprise before it starts operation. In exchange for its investment, the private company obtains long-term exclusive access to the network.



Regulatory design and competition policy implementation

II.1. REGULATORY DESIGN AND COMPETITIVENESS: EVIDENCE FROM A SAMPLE OF BRAZILIAN INFRASTRUCTURE SECTORS

Gesner Oliveira, Eduardo Luiz Machado, José Ricardo De Santana, Bruno Dario Werneck

1. Introduction

The objective of this paper is to establish a positive relationship between competitiveness in infrastructure and regulatory design.

Competitiveness means systemic cost reduction in the economy that may occur at the plant level, at the economic group level or at the sectoral level. Although competitiveness defined in this way is not easy to measure, it is possible to use an indicator of effectiveness of the regulators' action as a variable that affects competitiveness.

The effectiveness index is the result of the regulators' action and reflects the success in eliminating market failures, increasing both sector productivity and consumer satisfaction. Although regulators do not act directly upon competitiveness, they influence it through their role in promoting competition.

Thus, the goal is to test the hypothesis that the level of independence of the regulatory agencies has a positive impact on the effectiveness index thereby affecting competitiveness.

The expected result is that sectors with independent agencies will present a higher effectiveness index.

Although most elements of institutional endowments are common to all sectors within the same country, regulatory design can vary across sectors. Empirical data show that there are a wide variety of government choices for regulatory design, producing different outcomes across sectors.

This chapter is divided into six sections, including this introduction. Section 2 will briefly describe the conceptual framework. The objective of this part is to define what can be considered a good regulatory design.

Section 3 contains indexes that capture aspects of what was considered to be a good regulation. In particular, two indicators will be used: i) the independence index

(II) for a regulatory agency; and ii) the effectiveness index (EI) for the performance of a regulated sector.

Section 4 provides the basic institutional information about the regulatory agencies created in Brazil in the second half of the 1990s.

Section 5 provides a brief summary of the performance of the regulated sectors of the regulatory agencies discussed in Section 4. The objective of the section is to rank the selected sectors according to both the II and EI proposed in Section 3.

Finally, a test of the hypothesis that more independent regulatory agencies lead to better performance is provided. The test will only be a partial and qualitative one because there is not a large enough sample of countries and sectors. But the methodology will be ready for a cross-country comparison, which would be the natural extension of this work.

2. Conceptual framework

One of the objectives of the literature of institutional design is to evaluate the influence of a regulatory system on sector performance. Successful regulatory policy improves both efficient and private investments. The way a country's political and social institutions interact with regulatory processes and economic conditions influences the confidence of investors and the performance of privatized utilities.

The research will use the conceptual framework development by Levy and Spiller (1996). They suggest that credible commitment to a regulatory regime can be cultivated even in what appears to be a problematic environment and that without that commitment long-term investment will not take place. These authors understand regulation as a design problem with two principal elements: regulatory governance and regulatory incentives. The first one refers to the social mechanisms to restrain government discretionary moves and to solve conflicts between firms and regulators.

The second one involves specific norms related to price regime, subsidies, competition policy, entry barriers and interconnection rules. The two elements are choice variables for governments undertaking public sector reforms, limited by the institutional endowments of the country.

They argue that the credibility and effectiveness of a regulatory framework vary with a country's political and social institutions. Three complementary mechanisms are in place to restrain arbitrary administrative action:

- Substantive restraints on discretionary actions by the regulator;
- Formal or informal restraints on changing the regulatory system; and
- Institutions to enforce the restraints.

In addition to influencing a regulatory system's ability to restrain administrative action, political and social institutions also have an independent effect on the type of regulation that can be implemented and therefore on the appropriate balance be-

tween commitment to a particular regulatory system and flexibility in response to economic changes.

Policy makers' choice of regulatory governance is constrained by the specific institutional endowment of the nations, which determines the form and the range of options for resolving them. In turn, choices about regulatory incentives are also constrained by institutional endowment and by the governance features built into the regulatory system. Chart 1 shows the main elements of a nation's institutional endowments for the two regulatory components.

Chart 1: Elements of Regulatory Components

	Elements
Governance	Legislative and executive Judicial Custom and other informal Character of the contending social Administrative
Incentive	Administrative Distributive politics Regulatory

Source: Adapted from Levy and Spiller (1996)

The first element, legislative and executive institutions limit a country's options for regulatory governance. It consists of formal mechanisms for appointing legislators, for elaborating laws and regulations, and for determining the relations between the two institutions. The second one, judicial institutions, consists of formal mechanisms for appointing judges, determining the internal structure, and for resolving disputes among agents. An independent judiciary is an important aspect of the institutional environment.

An important finding of Levy and Spiller (1996) is that although the incentives affect performance, their full impact occurs only if the proper regulatory governance structure is in place.

The conceptual framework developed by Levy and Spiller (1996) permits one to analyse the interaction of the country institutional endowment (the regulatory institutions' structures) and performance. The government can attenuate the scope for government opportunism and reassure investors by appropriately designing the regulatory agencies. Specific rules regarding the agency's budget, the process of nomination and substitution of regulators, and the requirements for making different types of decision are examples of desirable characteristics of a good institutional environment as argued in Mueller and Pereira (2002).

Good governance of the regulatory agency can improve sector performance. Therefore, the existence of poor governance structures is a relevant feature to be taken into consideration in the institutional environment in Brazil.

The existence of political instability demands independent institutions, and a professional and competent administration to ensure policy stability. An II is supposed to evaluate the independence level of Brazilian regulatory agencies.

It is taken for granted that agency independence *per se* is not enough to assure good performance in the regulated sector. For example, a hostile policy environment, a fragile macro environment, the absence of clear rules and limited discretion all have a negative impact on sector performance. But the assumption is that agency independence is crucial for obtaining good sectoral performance.

3. Indicators of independence and effectiveness

This paper applies particular methodologies to estimate an index of the independence of competition agencies (II) and an index of the effectiveness (EI) in order to rank a sample of Brazilian agencies. The II consists of compound qualitative criteria: existence of group decisions, financial independence, decentralized nomination of counsels, the requirement of certain technical skills for holding positions in the agency, stability on the job for counsellors, influence of other institutions in the decision-making process and the authority to apply sanctions.

The EI consists of a compound of different quantitative indicators such as price and investment. Using these two indexes, we rank the following Brazilian regulatory agencies:[1]

- the Brazilian Electricity Regulatory Agency (ANEEL);
- the Brazilian Telecommunication Regulatory Agency (ANATEL);
- the Brazilian Petroleum Regulatory Agency (ANP);
- the Brazilian Overland Transportation Regulatory Agency (ANTT);
- the Brazilian Waterways Transportation Regulatory Agency (ANTAQ).

Using data on regulation in these deregulated sectors in Brazil, the research intends to provide evidence that regulation design affects sectoral performance. Empirical data comes from the Brazilian Institute of Geography and Statistics (IBGE), the Competition Defence Administrative Council (CADE), regulatory agencies and consumer protection agencies.

3.1. Independence index (II)

The notion of an independent regulatory system is an important theme in the regulation literature. Although it is accepted that independence is a necessary attribute for an effective regulator, the concept is difficult to define because it has multiple dimensions.

Moreover, to be independent, not only should a regulator be physically and operationally separated from those it regulates, but it should also be empowered to carry out policy by making objective, well-reasoned, written decisions arrived at through transparent processes, and based on a complete, public record. Regulators should be free from undue political influence during this process, and impartial decisions based on the record should not be undermined for political reasons. Finally, the scope and substance of a regulator's jurisdiction should be clearly mandated by statute, and there should be adequate funding to carry out its responsibilities.

Independent agencies should have the following characteristics:

- Stable and very well-defined functions
- Autonomy in making decisions
- Financial autonomy
- Technical specialization
- Transparency

In relation to the functions of the agencies, the latter should be very clearly defined by statutory mechanisms and rules set by Congress. This not only diminishes investor's risk in relation to discretionary actions of the concessionary power but also heightens the ability of consumers to check on fulfilment of aims set by a sector's regulatory agency. Furthermore, delineation of functions is also a form of ensuring that companies carry out the determinations of the regulatory agent – as in the case of the authority of the agency to apply sanctions without the right to appeal to the Executive Power.

Decision-taking autonomy is important in the sense that an agency is independent in relation to government. This means that agency directors should not be subject to dismissal for reasons related to disagreeing with government on the course of regulatory policy.

Financial autonomy has helped to increase the degree of decision-making autonomy and diluted government pressure. Financial autonomy is only feasible when the agency's revenues come from its own resources, for instance from licensing fees for concessions or fees charged for overseeing regulated companies.[2]

Technical specialization reduces asymmetries of information between the company and the regulator, reducing the risk of capture. In that sense, technical training for agency directors is a means of reducing company pressure on the agency.

Finally, transparency is essential to obtain social legitimacy for the agency's work. In order to appreciate the views of the different interest groups, agencies should ensure that there are many channels of communication with consumers. This can be facilitated by public consultations, holding hearings prior to taking decisions and publishing documents for preliminary appreciation.

- The stability and delineation of functions are determined by statutory mechanisms and rules established by Congress; they may be evaluated on the basis of

the following aspects: i) less influence of other institutions in the decision-making process and ii) greater authority to apply sanctions;

- Decision-making autonomy may be assessed by: i) board members being designated jointly among the Powers, ii) board members holding secure mandates, and iii) a pluripersonal criterion for agency decisions;
- Financial autonomy is determined by an agency having its own budget and funding arrangements, and
- The technical capability of an agency will depend on the criterion for designating members being their technical specialization

In relation to the delineation of functions, less influence of other bodies of the direct administration in decision-making processes – as determined by their intervention in the procedures of the agency, such as the power to bring cases before the agency, proceed to conduct investigations, make agreements, etc. – heightens the agency's degree of autonomy, since it will have greater authority to mediate or arbitrate disputes. An agency's credibility is greater when – after conducting all investigations and analyses – it has the authority to apply any sanctions necessary without them being reviewed by other instances of the administration. In Brazil, there is no trend for intervention by other bodies of the direct administration in decision-making processes; sanctions applied by regulators cannot be appealed to other administrative instances of the Executive Power.

In the case of decision-making autonomy, firstly a joint designation procedure favours plural representation of interests and reduces the political commitment of regulators with the Executive Power. Secondly, one must emphasize the importance of a pluripersonal decision-making process, since commissions – instead of superintendencies, for example, which are more unipersonal in nature – enable greater decision-making autonomy, if only because it is more expensive for an economic agent to influence a joint decision-making process with several regulators than when a decision is a single individual's responsibility. Finally, holding secure tenure of a position means that regulators are protected from threats of dismissal as a means of bringing pressure to bear on decision taking. Secure tenure in a position may be assessed by the existence of a fixed-term mandate, its duration and the degree of freedom of the Executive to remove regulators from their positions.[3]

In the designation procedure for all regulatory agencies in Brazil, the President proposes the head of the agency and appoints him or her after approval by the Senate. In other words, appointments are centralized. Concerning secure tenure for agency presidents and board members, they have mandates for a certain period that does not coincide with that of the President. However, there are strong restrictions on the President's ability to dismiss agency directors. Finally, the decision-making process is pluripersonal.

In relation to budget autonomy, having their own funding lessens the degree of subordination of agencies in relation to the direct administration, which could other-

wise steer decisions by threatening to alter budgets. In the Brazilian case, agencies usually enjoy certain autonomy in budgeting.

In relation to the requirement of technical specialization, i.e. the reputation and specific knowledge of the regulators, this feature reduces risk of capture and heightens the social legitimacy of decisions. In Brazil, in general, technical specialization is a priority criterion when selecting agency directors.

In relation to the transparency of the regulatory process, one must emphasize the effort made by the agencies to provide information for consumers and other interested agents. However, debate continues concerning the means of ensuring regulatory authority accountability.[4] Although this is an important discussion, the issues reach well beyond the scope of this study.

This work adapts a methodology to calculate the Independence Index (II) originally proposed by Gheventer (2003). The degree of independence of the agency depends on seven factors:

Decision Process (DP): This attribute characterizes the nature of the decision process. It can be individual or collective. Some agencies have a civil society member (ombudsman). In this case, the attribute value will be higher;

Budget Autonomy (BA): It is supposed that the existence of own resources reduces the degree of subordination of the agency in relation to the direct administration;

Nomination Process (NP): This attribute differentiates nomination processes between individuals and the collective, the latter receiving a higher value;

Technical Specialization (TS): reputation and knowledge in the field on the part of regulators. This should reduce the capture risk and increase the legitimacy of the decisions;

Leader Stability (LS): The stability in the position means that the regulators are protected from political and other pressures. The following elements determine the stability of the regulators: the existence of a fixed mandate, its duration and the degree of freedom of the Executive to fire the regulator;

Political Interference in the Decision Process (PI): The interference of the direct administration in the procedures of the agency;

Enforcement Capability (EC): adequate instruments to implement the legislation, especially the sanctions.

The measurement criterion of the independence degree is quite simple. A value of 1.0 point is attributed to each element that has a crucial role for the independence of regulatory agency. The absence of an institutional characteristic that favours inde-

$$II = \sum_{i=1}^{7} a_i; \qquad a_i \in \{0;0,5;1\} \quad (1)$$

pendence is allocated the value zero. For some factors, a middle value (0.5) is attributed.

At the end, the partial points are added. Equation 1 formalizes the II. where *i* represents each specific attribute and a_i represents the score.

The larger the agency punctuation, the larger is the independence index associated with the agency.

3.2. *E*ffectiveness inde*x (E*I*)*

The design of effective regulatory agencies involves defining regulatory scope and policies. This chapter uses an adaptation of an indicator proposed by Afonso and Garcia (2001) to calculate the Effectiveness Index (EI) of the Brazilian regulatory agencies. These authors use a similar methodology to that developed by the United Nations to create the Human Development Index (HDI) to propose a quantitative measure of the Infrastructure Development Index (IDI). The idea is to create an index that permits one to assess agencies´ capabilities to obtain good competitive conditions in the regulated sectors.

The first step is to choose both economic and social indicators to compound the sector index. Two historical series were chosen for each regulated sector.
Real Price Index (PI);
Investments Index (INI);

The second step is to combine the two series to construct one series expressed by Equation 2:

$$EI = \beta_1 * PI + \beta_2 * INI \qquad (2)$$

The next step is to estimate the parameter ($ß_i$) weights. Afonso and Garcia (2001) suggest the "Main Component Method" (MCM) to determine the $ß_i$. values. This statistic framework estimates the parameters by means of linear combinations of the series. For this, the method maximizes the variance of the series linear combination. The optimization problem presented above uses Equation 3 as a restriction:

$$\sum_{i=1} \beta_i = 1 \qquad where \;\; i \in \{1;2\} \qquad (3)$$

With the values obtained in the optimization process for the parameters, a new series is constructed starting from Equation 2, and the first component is denominated. Having calculated the first component, the objective is to obtain the second component. A new restriction is then imposed on the optimization problem: the vector of parameters of the second component should be orthogonal to the vector of

parameters of the first component. In this way, the new objective is to obtain parameters that maximize the variance of the linear combination that are not correlated to the parameters of the first component. This procedure is repeated successively up to the number of series used in the maximization (two in the present case).

4. Changes in the Brazilian institutional environment and the regulatory agencies

The institutional environment in Brazil was significantly altered during the 1990s with less direct intervention in economic activity and the state taking on more of a regulatory role. The creation of regulatory agencies was one of the key features of this process of institutional change. This section analyses the elements of the Brazilian regulatory framework and the factors indicative of the conditions that determine regulatory agency independence in relation to pressure from government or the regulated enterprises.

The first part of the section examines changes in relation to the previous institutional environment. The second part presents the characteristics of the current institutional environment and deals with the issue mentioned above, based on an examination of the regulatory agencies' independence.

4.1. Transition to the current institutional environment

The institutional situation in place in Brazil through the 1980s dates back to the process of industrialization of the country in the 1930s. Under this model – known as the import substitution model – the State built up a productive structure, mainly involving infrastructure and intermediate goods and services, in order to encourage industrialization. In addition to the prominent presence of the State, this model was also characterized by a closed economy producing mainly for the domestic market. On the basis of this structure, the Brazilian economy showed high growth rates that were sustained through the 1970s.

By the 1980s, however, this model was no longer feasible due to the lack of external funds and a financial crisis of the Brazilian State. These factors, combined with falling productivity in the state sector led to criticisms against the utility monopolies providing public services. In the 1980–1989 period, the annual growth rate fell to 1 per cent *versus* 7 per cent in 1970–1979.

By the early 1980s, inflation had already soared to three digits. In the early 1990s, reforms were carried out with the purpose of a) raising Brazilian companies' exposure to foreign competition;[5] b) reducing the role of the State in the productive apparatus, with privatizations; and c) boosting the inflow of external funds, with capital account liberalization.

Some authors claim that liberalization favoured higher productivity[6] and aided macroeconomic stabilization policy, contributing to reverse the inflationary spiral as of 1995, as the data in Chart 2 suggest.

Chart 2: Brazil – economic indicators – 1990–2001

	GDP growth (%) (1)	Av. rate (%) (2)	Inflation (IPCA) (%) (3)	Productivity (Jun) (1991=100) (4)	Trade balance (US$ bn) (5)	Capital inflow (US$ bn) (6)
1990	-4.35	32.1	1620.97	86.31	10.8	0.6
1991	1.03	25.2	472.69	104.99	10.6	3.8
1992	-0.54	20.8	1119.09	108.70	15.2	14.5
1993	4.92	16.5	2477.15	116.58	13.3	12.9
1994	5.85	14.0	916.43	123.59	10.5	54.0
1995	4.22	13.1	22.41	123.71	-3.5	10.4
1996	2.66	13.6	9.56	124.78	-5.6	22.0
1997	3.27	13.6	5.22	142.29	-6.7	10.9
1998	0.13	13.6	1.66	146.75	-6.6	18.6
1999	0.81	13.6	8.94	142.02	-1.3	3.5
2000	4.36	13.6	5.97	150.47	-0.7	8.7
2001	1.51	12.0	7.67	146.93	2.6	0.9

Sources: (2) Averbug (1999: 47) and Oliveira (1996: 78); (3) Fibge; (4) Ipea data; (1), (5) and (6) the Central Bank.

The second phase of the privatization process was characterized by capital account liberalization.[7] Federal Law No. 8031/90[8] enacted the Privatization Program, which began the process of reducing direct state intervention in the Brazilian economy. Its first phase covered the 1991–1994 period and focused on privatizing industrial-sector enterprises such as steel, petrochemicals and fertilizers, which did not require the introduction of a specific regulatory framework. Receipts from privatization amounted to US$ 8.6 billion in this period (Chart 3).

Chart 3: Brazil - privatization programme (1991–1998)

Sector	Number of companies	Assets sold	Debt transferred	Total
Federal companies	81	46581	11326	57907
Steel	*8*	*5562*	*2625*	*8187*
Petrochemicals	*27*	*2698*	*1003*	*3701*
Electricity	*3*	*3907*	*1670*	*5577*
Railroads	*6*	*1697*	*-*	*1697*
Mineral extraction	*2*	*3305*	*3559*	*6864*
Telecommunications	*21*	*26970*	*2125*	*29095*
Others	*14*	*2442*	*344*	*2786*
State-govt firms	26	23724	5311	29035
Total	107	70305	16637	86942

Source: Pinheiro and Giambiagi (1997).

The second privatization phase (1995–1998) comprised the sale of state-owned companies most directly active in infrastructure sectors such as telecommunications, electricity and railroads. In all, the program represented US$ 86.9 billion; of which US$ 70.3 billion corresponded to actual revenue from sales.

In the second phase of the privatization program, given the nature of the sectors involved, specific regulatory frameworks were required. Brazil already had some government agencies with regulatory powers,[9] but they did not have the same characteristics as the regulatory agencies created in the second half of the 1990s, as part of the process of transforming the role of the State in the economic sphere.

The reconfiguration of the institutional environment, replacing the closed economy and its direct intervention by the open economy along with regulation, was related to private-sector pressure to protect investments. Since investments involve long-term contractual commitments, the independence or autonomy of regulatory agencies reduce the uncertainty in relation to returns on capital, and make it less vulnerable to any intervention by the Executive in the regulated sector.[10]

4.2. Characteristics of the current institutional environment

The creation of the regulatory agencies accompanied the process of opening infrastructure sector markets to private-sector organizations, either through total privatization – as in telecommunications and rail transport – or through partial privatization – as in the case of electricity – or by means of a mere permission for private organizations to enter the market without privatizing the state company – as in the case of oil.

In markets such as road and air transport, where there was no longer any direct state participation, the trend was toward allowing new competitors to enter these sectors, and to introduce or strengthen competition. In the case of the infrastructure sectors, regulation became an indispensable instrument in the quest for consumer welfare.

According to Viscusi, Vernon and Harrington (1997: 302), regulation is a restriction imposed on economic agents' discretionary decisions, and is guaranteed by the power to sanction. Such restriction is necessary in the presence of market failures, such as in the case of public goods, market power, externalities or asymmetrical information, which are typically found in infrastructure sectors.

The major objectives of regulation are: i) seeking economic efficiency, ensuring the least costly service for users, ii) ensuring the quality of the services provided, iii) ensuring universal service and iv) preventing the abuse of monopoly power.

The trend in regulation has been to move toward introducing incentive mechanisms or favouring indirect regulation. In the first case, operators that are still natural monopolies were induced to aim at similar targets to those reached in competition

situations. In the second case, regulators encouraged monitoring of a competitive structure to create an environment that is as neutral as possible for agents.

4.2.1. Regulatory framework

To be effective, regulation has to be established on the basis of a regulatory framework setting the rules for the sector in which each institution has very clearly defined functions, attributions and responsibilities. Setting clear rules in relation to the working of the market tends to reduce uncertainties and make investments more attractive. The regulatory framework must have the following instruments:[11]

- Control over market entry or exit,
- Competition policy,
- Definition of tariffs and incentive mechanisms,
- A means of monitoring concession contracts,
- Independent regulatory agencies.

The aim of having control over entry is to ensure productivity and efficiency, thus enabling a monopolist to exploit economies of scale and produce at the lowest possible cost. The aim of having control over exit is to avoid harming the consumer due to a sudden departure from the sector that may cause interruption of services.

Competition policy aims at ensuring access to essential infrastructure; this is crucial during the transition from a monopolistic environment to a competitive one, since the knowledge or information possessed by incumbent and incoming companies may be asymmetric. During this period of transition, regulatory policies must seek to encourage the creation of a competitive environment, in the most neutral way possible for agents. In this respect, an important point is regulating access to certain infrastructure features that are crucial for the sector. This regulation may involve equality of access through breaking down or separating structures and regulating interconnection prices.

In the case of ensuring access, the aim is to avoid discriminatory practices against entrants through prices or low-quality connections. In the case of structural separation between competitive and monopolistic segments, the aim is to eliminate practices such as cross-subsidies or discrimination of access. In relation to interconnection prices, regulation should act through the agency's power of arbitration, when there is litigation between parties. As well as regulation of access, it is also important to monitor the market concentration process and supervise market agreements, stock acquisitions and any abuses of market power.

The aims of tariff setting, which must take into account the required technical standards and targets, include: i) ensuring low prices and high levels of production, ii) inducing utilization of installed capacity with maximum revenue and least cost, and iii) minimizing strains between allocative, distributive and productive efficiencies. In infrastructure sectors, the optimum price from the point of view of allocative effi-

ciency (price equal to marginal cost) merely remunerates variable costs, prejudices productive efficiency and limits the portion of revenue available for investment.

On the basis of these aims, there are three rules for tariff policy. The first is based on the internal rate of return for firms, and seeks monopoly rent, but does not encourage cost minimizing, since investments obtain guaranteed remuneration. The second is a *price cap* geared to a consumer price index minus a productivity factor. The aim is to encourage productivity and efficiency while avoiding the use of controls requiring costly information. Finally, *yardstick competition* sets standards for assessing performance used in analysing costs and prices – this mechanism is used to compare companies in the same sector that are natural monopolies at regional level. The remuneration of a company is defined comparatively in relation to the performance of other companies in the sector. The aim is to reduce inter-company costs, reduce asymmetries of information and encourage economic efficiency.

Monitoring concession contracts is necessary to oversee service quality, execution of investment plans and service targets. The advantage is that its assists the regulator in reviewing and setting tariffs, although this involves high regulatory costs. In this process, fines and penalties must be set for possible flaws in provision of services and for non-execution of targets as stipulated.

Finally, and most important for the purpose of this paper, regulatory agency independence is crucial to the proper functioning of a regulatory framework. It is crucial for agencies to enjoy independence in relation to both the government and to other agents in the sector, so that the regulator may act in defence of the consumer's welfare and have the authority to arbitrate disputes between shareholders, consumers, companies and government.

4.2.2 Regulatory agency independence

The aim of a regulatory agency is to ensure the proper functioning of regulated markets. Agencies' roles are important in sectors requiring systematic publication of regulations, frequent resolution of litigation, and specialized knowledge and constant monitoring of the market. In the Brazilian case, the role of regulatory agencies, as corporate entities under public law, involves supervising, regulating, rule making and implementing policies drafted by ministries. At times, agencies also perform arbitration and mediation.

The regulation process involves agency costs – since the (regulator) agent may not be aiming at the targets of the principal (legislator) – and the risk of capture, since the regulated company may influence the agency's decisions.

There is also a problem related to the fact that the Executive Power may wish to influence decisions made by agencies. Indeed, there may be conflicts between the immediate aims of the regulatory agencies and the goals of the State – for instance, in relation to the universalization of a service or product. In this case, the State may seek to act through measures that involve the agency more directly, such as setting

investment targets for concession contracts or tariff regulation, or through measures that do not depend on the direct involvement of agencies, such as granting direct subsidies to economic agents or to a certain section of the community.

The means of minimizing problems related to pressures from other agents not only involve a regulatory framework with very clearly defined rules, but also independent agencies whose characteristics were already discussed in Section II.

4.3. Creation and functioning of the Brazilian regulatory agencies

The general characteristics of the institutional environment posed in the previous section show certain specificities depending on the sector regulated. Chart 4 shows, in chronological order, the independent regulatory agencies created in Brazil in the second half of the 1990s.

Chart 4: Brazil - Regulatory Agencies

Regulatory agency	Sector	Law
ANEEL	Electricity	Law No. 9427, 1996
ANATEL	Telecommunications	Law No. 9472, 1997.
ANP	Oil	Law No. 9478, 1997.
ANVISA	Health	Law No. 9782, 1999.
ANS	Health	Law No. 9961, 2000.
ANA	Water	Law No. 9984, 2000.
ANTT	Transport	Law No. 10233, 2001.
ANTAQ	Transport	Law No. 10233, 2001.

A common feature in the functions of the above agencies is promoting concessions for the use of public resources or provision of services. This section analyses characteristics related to the regulatory framework and the independence of agencies in separate sub-sections.

4.3.1. Regulatory framework

In relation to the regulatory framework, we will pose the specific sector characteristics of four of the elements that make up the regulatory framework, namely control of entry and exit, regulation of competition, setting tariffs and monitoring concession contracts.[12] The fifth element – independence – has already been addressed.

4.3.2. Control of entry and exit

Control over entry and exit in these markets depends on a number of factors including the type of technology used in the sector. In telecommunications and electricity, for instance, more competition is allowed, whereas natural monopolies continue to exist in basic sanitation and transport. Law of Concessions No. 8987/95 governs conditions for entry or exit as well as the functioning of private enterprise in infrastructure sectors. Concession holders will only be able to cancel contracts unilater-

ally if a court rules that contractual rules are not being followed by the concessionary power.

4.3.3. Regulation of competition

Competition policy and control of the monopoly power had greater importance in sectors that moved forward more in the privatization process and in which, for the following model and for the technological characteristics, the access to the essential

Chart 5: Regulation of competition

Regulatory Agency	Competition Controls
ANEEL	– Sector legislation sought to promote competition through de-verticalization of generation, transmission, distribution and commercialisation segments. The companies had to set up subsidiaries or have separate accounting for these branches of activity; – Free access to the transmission network by any agent of the electricity system, aiming at new means of commercialisation through the Wholesale Electricity Market (local acronym MAE). Negotiations are subordinated to operational planning, programming and decision by the National Electricity System Operator (ONS). ONS also manages all generating and distribution companies' transmission assets; – The legislation also posed restrictions on share ownership, crossed shareholdings and electricity purchasing policy among agents.
ANATEL	– Regulation of competition includes measures that require prior notification of any merger or acquisition between market agents; – Incumbents were obliged to allow their competitors access to disaggregated elements and/or alternative points in their networks; – The General Telecommunications Law gives Anatel power to monitor market behaviour, as in the case of interconnection agreements. Parties to these agreements seek to inhibit tariff subsidies by means that include artificially reducing tariffs, unauthorized use of information obtained from competitors, omission of technical information, obstruction, and restraint.
ANP	– No specific rules were adopted, except the orientation that ANP should notify CADE of any fact that constitutes an infraction against the economic order; – There are only restrictions against Petrobrás setting up specific subsidiaries for each of its activities in the sector.
ANTT	– In the freight segment: There is no specific regulation for the road transport sector, For railroads, the concession contracts for lines now exploited by private enterprise establish interconnection obligations with other lines, carrying mutual traffic with other concession holders and mechanisms for control shareholder concentration in their the capital, In the case of the airports, there are equal access rules for marketing and sales channels and there is coordination of flight plans and routes that all airlines are subjected to. – In the urban passenger transport segment, regulation is decentralized on state and municipal levels, and there is no specific provision for defence of competition: In the case of interstate and international road transport, all infractions against the economic order must be notified to the Economic Law Secretariat (local acronym SDE) by order of the Ministry of Transport. Transporters with relations of economic interdependence among them are not allowed to exploit services on the same route.
ANTAQ	– In the freight segment: There is no specific regulation for port and waterway activities.

infrastructure is shown to be decisive for the functioning of the sector, as is the case, for instance, in telephony, electric power and even railroads.

Chart 5 shows the regulation of competition for the regulatory agencies.

Chart 6: Tariff setting

Regulatory Agency	Tariff setting
ANEEL	– Tariffs for the distribution and transmission segments, which are still monopolies, are regulated by the *price cap* criterion. In the case of distribution, the tariff reduction factor, which determines the extent to which productivity gains are passed on to consumers, was null in the initial periods of the contracts. In relation to transmission, investments in transmission lines were remunerated on the basis of benchmarks for network usage and connection cost charges.
ANATEL	– Services operated in the public regime are subject to *price cap* tariffs. In the concession contracts, differentiated reduction factors were stipulated for readjusting tariffs of local and long distance wireline telephony services. – Services operated in the private regime may enjoy tariff freedom, unless the tariff is one of the factors to be assessed in the bidding process for the authorization.
ANP	– In the oil and natural gas sector, a period (until August 2000) was set for liberation of prices of all basic byproducts for refineries and processing units. – In the piped gas sector, privatized companies are subject to price-caps, obtained by grouping several items included in the cost of the service. These prices are subject to variations in the IGP-M (wholesale prices) indicator and to review procedures every five years.
ANTT	– Tariff regulation for the highway network works on the federal or state level. The basic tariff for highway tolls is set by the concession holder itself, in agreement with the criterion of more supply and lower tariffs. There are some state concessions where the initial tariff is preset by the concessionary power. Since there is no set methodology, higher costs due to inflation, or to additional works and works or services completed in advance are often passed on to users. – Railroads set maximum and minimum tariffs for services, depending on distance, product type and geographical region, and there is not necessarily a precise definition of the method used to set them. – In the case of air transport: The Civil Aviation Department (local acronym DAC) sets tariffs for using airport infrastructure and cargo or passenger transport, although administrators may reduce prices; Tariffs charged by airlines for use of this infrastructure must be reduced in the same proportion as discounts in promotional flights; Charter fares were decontrolled; Monitored liberalization of domestic air fares was introduced within limits stipulated by the DAC Readjustments are annual and must be approved by the DAC. – In the case of urban passengers transport, setting, review and readjustment of tariffs are based on cost spreadsheets submitted by companies to the concessionary power. In interstate and international passenger transport the criteria for tariff readjustment must follow changes in service costs, and there is no provision for a reduction factor for consumers in relation to productivity gains.
ANTAQ	– In the case of freight transport, tariffs are set by each of the port authorities.

4.3.4. Tariffs and incentive mechanisms

There is much heterogeneity in relation to tariff regimes for infrastructure sectors, and there is no clear methodology for setting, readjusting or reviewing tariffs. In general, the cost of service or internal rate of return is taken into account. In some cases, it was sought to use the price-cap rule to encourage productivity gains, but not always pass-through to consumers. Yardstick competition mechanisms that would tend to reduce asymmetries of information favouring companies have not so far been introduced in infrastructure sectors. Chart 6 presents the agencies tariff settings.

Chart 7: Monitoring concession contracts

Agency Regulatory	Monitoring concession contracts
ANEEL	– Although not standardized, concession contracts provide for fines and penalties for non-fulfillment of service quality levels. These contracts did not set universalization targets. There were plans for construction works aimed at expansion and enlargement of the electricity system, and the difference between costing of the works and the limits for investment allowed under the duties of concession holders was to be offset by state governments.
ANATEL	– The concession contracts stipulate obligations such as universalization of services and their quality levels for wireline telephony concession holders. The contracts set targets for expanding facilities and service financed, in the short term, by own revenue.
ANP	– Concession contracts for exploring and producing oil set periods for exploration and production development projects. Concession holders assumed an obligation to adopt technical standards for rationalizing output and controlling the depletion of reserves; – Technical requirements for modernization and capacity enlargement were established for the activities of oil refining and natural gas processing; – In the case of oil products, controls prioritize fuel quality. In the distribution of natural gas, the privatized companies' concession contracts set targets for universalization of services and quality standards, and concession holders may be penalized for non-fulfillment of contracts.
ANTT	– Concession contracts for the exploitation of highways are standardized; there are schedules and targets for investments in conservation and modernization. Concession holders are subject to a fine for not meeting deadlines or for defective conservation of highways; – In the case of the railroads, the contracts set rules for: a) evaluating quality of services (provision and security), setting minimum levels of production and annual reduction in accident indexes, b) stipulating three-year investment plans. Concession holders may be fined for non fulfillment of contractual targets; – In airports, local administrations exercise control over and inspection of contracts for use of infrastructure. In relation to operating passengers routes, monitoring is performed by the DAC through periodic inspection of aircraft and companies; – In the case of urban passengers transport, monitoring of investment plans and quality of services is up to the concessionary power.
ANTAQ	– In the case of the ports, there are several specificities in the concession contracts stipulating fines for non-fulfillment of investment obligations and enlargement of operational capacity - supervised by port authorities.

4.3.5. Monitoring concession contracts

Monitoring of concession contracts has made most progress in the segments where the privatization process has advanced most and where more direct and frequent consumption of services by most of the population is a feature, as is the case of use of telephony, electricity and highways or turnpikes. Chart 7 summarizes the monitoring contracts system.

4.4. Regulatory agency independence

In relation to regulatory agencies specifically, we shall examine characteristics indicating the extent of their independence, which shall be reflected in the results for the index of independence (II) reported in the subsequent section.

4.4.1. Secure tenure and delineation of functions

Precise delineation of the functions of agencies is provided by the rules determining the ministerial connection of the agency, its attributions and the influence of other institutions in the decision-making process.

Chart 8: Regulatory agency independence

Regulatory agency	Ministry related to the agency
ANEEL	**Mines and Energy.**
ANATEL	**Communications.**
ANP	**Mines and Energy.**
ANTT	**Transport.**
ANTAQ	**Transport.**

As shown in Chart 8, ministerial connections of agencies were conceived on the lines of the legal form of a quasi-independent government agency (*autarquia*)[13] under a special regime, connected to a Ministry, but not hierarchically subordinated to it.

The creation of the regulatory agencies as quasi-independent agencies under a special regime was important to ensure financial and structural independence, and to avoid subordination to any particular Ministry. This enabled these agencies to enjoy political and decision-making independence, and to take decisions on the basis of technical rather than political criteria, as is frequently the case in Ministries and bodies subordinated to them. Under this approach, the regulatory agencies have the status of State entity. Agencies assume specific functions, and especially that of the concessionary power, which may be delegated to other authorities, as noted in Chart 9.

The action of an agency will not necessarily be connected only with the sector it is part of. In cases involving more than one sector, decision making requires coordi-

Chart 9: Rights Granted by Agencies

Regulatory Agency	Rights "granted"	Power to delegate the agency's power to grant concession
ANEEL	– Authorization for execution and exploitation of electricity services and facilities. – Authorization for thermoelectric generating stations.	ANEEL may sign agreements, to decentralize activities, with States or the Federal District.
ANATEL	– Concession and authorization for the exploitation of telecommunications services under public or private regime.	No.
ANP	– All rights regarding activities of exploitation, development and production of oil and natural gas on Brazilian territory. – The collection of technical material consisting of data and information on Brazilian sedimentary basins is also considered an integral part of the nation's oil resources and ANP is charged with collecting, maintaining and managing the latter. – Authorization for the construction of refineries and gas processing units and for expanding capacity. – Authorization for the construction of facilities and transporting oil, oil products and natural gas. – Authorization to exercise the activity of importing or exporting oil, oil products, natural gas and condensed gas.	No.
ANTT	– Concession to exploit railroads, highways, freight and passenger transport. – Authorization for passenger transports by road under the charter or hire regime.	Yes
ANTAQ	– Concession to exploit navigable waterways and organized ports. – Authorization for the construction and operation of private port terminals.	Yes

(In cases of companies holding authorizations or concessions for generating electricity for public services the right to use water resources is granted for the period coinciding with the duration of the authorization or concession contracts granted by ANEEL).

nation across agencies. However, there is no overall legal provision governing relations among agencies or their relations with the other entities of the Government, in particular with the competition authorities.

An agency may delegate concessionary powers to another agency or work together with it in the decision-making process, without this constituting interference in the delineation of its functions, or in the extent of its independence from these other agencies. Institutional cooperation is important not only to avoid the duality of regu-

latory power, but also to ensure enforcement and credibility of regulation and to harmonize procedures and procedural rules as in the case of defence of competition and consumer rights. This is the case with ANATEL, ANEEL and ANP, for example.

ANATEL legislation charges the agency with overseeing competition policy and exercising legal competences in relation to control, prevention and repression of infractions against the economic order. Its work is conducted jointly with that of CADE, CVM and the Consumer Defence Commission.

ANEEL legislation charges the agency with overseeing competition policy, making rules to curb market concentration and provides for joint action with state agencies and the Secretariat of Economic Law.

The legislation creating the ANP merely enjoins that CADE must be notified of matters involving infraction against the economic order. Note that there is an institutional vacuum in the basic sanitation sector due to the controversy over who has the power to grant concessions for these services in metropolitan regions. The issue is whether states or municipalities have concessionary powers.

The level of independence of agencies is only affected when other organs of the direct administration influence the decision-making process. Moreover, the degree of independence of agencies is reduced when they enjoy less autonomy to apply sanctions – this occurs when the sanctions they apply may be reviewed by administrative instances of the Executive.

4.4.2. Decision-making autonomy

Its decision-making autonomy is a mark of the independence of a regulatory agency in relation to government. This requires security of tenure for directors, so that they may make decisions even in situations where they may disagree with government regulatory policies. It is therefore important to note the following points: i) appointments procedures, ii) duration of mandates, iii) possibility of dismissal, and iv) decision-making mechanisms.

In relation to the first aspect, the designation of directors, as shown in Chart 10, is established by a centralized process, in which the President proposes regulatory agency directors to be approved by the Senate.

In relation to the second aspect, a fixed mandate for agency directors helped to prevent them from being influenced by political pressures and to fulfil the objectives set by the legislation that created the regulatory agency. Mandates are fixed and, in general, the period is the same or less than the term of office of the President. More specifically, regulatory agency director mandates may be 4 years (ANEEL, ANP, ANTT and ANTAQ) or 5 years (ANATEL) without there being any apparent reason for the differences. It is argued that the possibility of repeated mandates for ANTT and ANTAQ directors would affect their independence, since there might be an incentive to a director to be conciliatory in relation to the government to obtain another mandate.

But even with a fixed mandate, directors can be under pressure to make decisions if the government can easily dismiss them. In the case of Brazil, the grounds for dismissal of a director are limited and explicitly set by law. This ensures that directors enjoy technical autonomy and reinforces the characteristics of the mandate.

Chart 10 Agency Directors

Regulatory Agency	**Procedure for designating agency directors**	**Director's mandate**	**Repeated mandates**	**Dismissal of directors**
ANEEL	Proposed by the President and appointed by the President after Senate approval.	4 years.	No.	For any reason in the first 4 months of the mandate. After that period only if there is (i) administrative improbity, (ii) a final conviction for a penal offence or (iii) unjustified non-compliance with the management contract.
ANATEL	Proposed by the President and appointed by the President after Senate approval.	5 years.	No.	Only if there is (i) administrative improbity, (ii) a final conviction for a penal offence or (iii) unjustified non-compliance with the management contract
ANP	Proposed by the President and appointed by the President after Senate approval.	4 years.	No.	Only if there is (i) administrative improbity, (ii) a final conviction for a penal offence or (iii) unjustified non-compliance with the management contract
ANTT	Proposed by the President and appointed by the President after Senate approval.	4 years.	One re-appointment.	Only if there is (i) final conviction by a court, (ii) definitive decision in an administrative disciplinary procedure or (iii) obvious non-compliance with the attributions of the position.
ANTAQ	Proposed by the President and appointed by the President after Senate approval.	4 years.	One re-appointment.	Only if there is (i) final conviction by a court, (ii) definitive decision in an administrative disciplinary procedure or (iii) obvious non-compliance with the attributions of the position.

The legislation that created each regulatory agency did not provide for a mandate for the Attorney General of each agency. Since regulatory agencies have their own corporate entity, the Attorney General heads the attorneys in each regulatory agency body. These are responsible for defending the regulatory agency in lawsuits; internally they analyse cases under way in the regulatory agency – from internal agency issues, such as sale processes, to issuing legal opinions on new regulations and their application to cases. Since the Attorney General has the function of being counsel for the agency, he must enjoy the confidence of his "clients" – the agency's directors – and be attuned with their interests. Otherwise, there may be a fatal clash of aims in the agency's operations and in defending its positions. Chart 10 presents characteristics and rules for directors' mandate.

Chart 11: Management Structure of Agencies

Regulatory Agency	Board	Decisions
ANEEL	– Collegiate regime, board composed of a Director General and four Directors. – There is an Attorney General as part of the organizational structure.	Majority.
ANATEL	– Collegiate regime, executive board consisting of a President and 4 board members. – The organizational structure includes Consultative Council, an Attorney and an Ombudsman.	Majority.
ANP	– Collegiate regime, board consisting of a Director General and four Directors. – There is an Attorney General as part of the organizational structure.	Majority.
ANTT	– Collegiate regime, board consisting of a Director General and 4 Directors. The organizational structure includes an Attorney, an Ombudsman and an Inspector General (whose duty is to supervise the functional activities of the agency and conduction of administrative and disciplinary proceedings).	Majority, Director General has casting vote.
ANTAQ	Collegiate regime, board consisting of a Director General and 2 Directors; The organizational structure includes an Attorney, an Ombudsman and an Inspector General (whose duty is to supervise the functional activities of the agency and conduction of administrative and disciplinary proceedings)	Majority, Director General has casting vote.

Chart 11 shows the management structure of the regulatory agencies and their means of deliberation. In the case of Brazil, as part of the process of establishing regulatory agencies, there was awareness of the importance of having a collegiate management body, which lends a pluripersonal character to decision making and obstructs attempts to "capture" the agency.

4.4.3. Financial autonomy

Even when regulatory agencies enjoy functional independence, ensured by the mandate granted their directors, there must be financial independence – otherwise regulatory agencies will inevitably be subjugated to the will of the controller of the budget In the case of Brazil, although Congress may have some influence on the performance of the regulatory agencies through approval of the federal budget, the latter is strongly influenced by the Presidency. Some degree of financial autonomy is indispensable, particularly in relation to the Executive Power, otherwise the performance of an agency will be totally undermined by political motivations or it will act exclusively in response to pressure from lobbies.

Chart 12 shows regulatory agency budgets since 1998 and the 2004 budget forecast with values deflated by IPCA-IBGE indicators. Note that the agencies' budget is quite constant.

Chart 12: Budget of selected Brazilian Agencies (in R$ '000, at 2004 values using average IGP-M each year)

Regulatory agency	1998	1999	2000	2001	2002	2003	2004
ANP	422,183	318,851	434,870	874,917	1,420,919	1,680,931	2,189,439
ANATEL	1,058,991	839,396	825,389	1,032,965	1,228,723	754,665	823,483
ANEEL	406,102	322,381	323,602	393,247	303,129	240,076	219,041
ANTT	--	--	--	--	188,659	109,403	108,720
ANTAQ	--	--	--	--	44,340	35,549	35,892

Source: Budget Execution 1998–2002. [14] [15]

4.4.4. Technical specialization

Technical specialization is important in selecting management staff for the agency. Obviously, there also has to be capable staff for the technical work related to regulatory problems in each sector.

In relation to staff, the legislation stipulates the constitution of an effective team and the recruiting of specialized technicians for a certain period, with no requirement for a bidding procedure. However, certain operational difficulties and some judicial orders have prevented the formation of a permanent staff of employees in each regulatory agency. This situation leads to a high turnover of employees, which makes

members of staff even more vulnerable to capture. This prevents the regulatory agency from institutional building.

Given that situation, the solution was to recruit temporary, requisition civil servants from other bodies and fill commissioned (non-tenure) positions.

Chart 13 shows in decreasing order, the numbers employed in each regulatory agency.

Chart 13: Number of Employees of the Agencies

Agency	Employees
ANATEL	1,486
ANP	657
ANTT	483
ANEEL	325
ANTAQ	143

4.4.5. Transparency

Having presented the mechanisms aimed at ensuring the necessary independence of regulatory agencies, one must now analyse the means of providing transparency and participation of society in regulatory agencies. As noted above, these are elements of *accountability* for regulatory agencies which contribute to their effectiveness by overriding the different conflicting interests for the sake of the public interest. Transparency in the administration of agencies helps to reduce the risk of capture and provides social legitimacy for their initiatives (Chart 14).

The role of the *ombudsman*, as instituted in certain regulatory agencies, was created with the aim of facilitating communication between society and regulatory agencies, and also functions as an inspector. This position too has a mandate.

Finally, Chart 15 shows how the issue of quarantine arrangements was dealt with in the legislative initiatives that created each of the regulatory agencies.

5. Results

5.1. Independence index (II)

Section 2 described the II as the sum of seven agency attributes. The first one, the decision process (DP), measures the institutional format of the decision process. Three different formats are observed for this attribute in Brazil. When the decision process is individual the agency obtains 0. If the decision is collective 0.5 point is attributed. Finally, the maximum value is obtained when the board contains a civil society representative.

Budget Autonomy (BA) is the second attribute. The objective is to distinguish the agencies that possess own resources and the ones that do not. It is supposed that the existence of own resources reduces the degree of subordination of the agency in

Chart 14: Instruments for Transparency and Participation in Agencies

Agency Regulatory	Organized participation of society	Transparency / Accountability
ANEEL	– Any decision making process that may affect the rights of the economic agents in the electricity sector or those of consumers, arising from administrative action of the Agency or from draft legislation proposed by ANEEL, will be preceded by a public hearing.	– Meetings of the ANEEL board for the purpose of settling disputes among economic agents of the electricity sector or between the latter and consumers, or to rule on infractions committed against the law or regulations, may be held in public, at the board's discretion, and be electronically recorded, with the interested parties having the right to obtaining transcriptions. – ANEEL management will be hired through a management contract negotiated and entered into between the Management and the Executive Power within ninety days of the appointment of the Director General, and a copy of the instrument must be forwarded for registration at the Court of Accounts, where it will be used as reference material for operational auditing.
ANATEL	– The Agency has the competence to implement, within its sphere of attributions, the nation's telecommunications policy, issue rules on the licensing, provision and usage of telecommunications services under the public regime, with prior public consultation for proposals to be submitted to the President.	– Deliberative board sessions for settling disputes between economic agents, or between the latter and consumers and users of telecommunications goods and services, will be held in public; sessions may be electronically recorded and interested parties have the right to obtain transcriptions.
ANP	– Initiatives concerning draft legislation or alterations of administrative rules that may affect economic agents' rights or those of consumers and users of oil industry goods and services will be preceded by a public hearing summoned and directed by ANP.	– Deliberative sessions of the ANP board held for the purpose of settling disputes between economic agents and between the latter and consumers and users of oil industry goods and services will be held in public.

	– The internal regulation of ANP will rule on the procedures to be adopted to settle conflicts between economic agents and between the latter and users or consumers, with the emphasis on conciliation and arbitration.	
ANTT	– Draft legislation initiatives, alterations of administrative rules and the board's decisions when settling disputes that affect the rights of economic agents or users of transport services will be preceded by a public hearing. – Any interested party is entitled to submit petition or appeal against actions of the agency, within 30 days of their becoming official.	– Decisions taken by the agency's board will be recorded in publicly available minutes together with relevant documents whenever publicity does not endanger the security of the Country or violate confidentiality.
ANTAQ	– Draft legislation initiatives, alterations of administrative rules and the board's decisions when settling disputes that affect the rights of economic agents or users of transport services will be preceded by a public hearing. – Any interested party will be entitled to submit a petition or appeal actions of the agency within 30 days of their becoming official.	– Decisions taken by the agency's board will be recorded in publicly available minutes together with relevant documents whenever publicity does not endanger the security of the Country or violate confidentiality.

relation to the direct administration. Thus, the agency which is financially dependent upon the State is attributed the value 0, while the independent agency obtains the value 1.

The nomination process (NP) attribute differentiates between individual and collective decision making. The latter received a higher value (1), while the former received a lower value (0).

The fourth attribute is the leader's technical specialization (TS). In this case, the higher value is obtained for leaders with reputation and knowledge in the field. Domah, Pollitt and Stern (2002) stress the importance of the requirement for professionally trained staff in regulation in order to decrease the corruption level in developing countries.

Stability in the position means that the regulators are protected from political and other pressures. The leader stability (LS) evaluates the existence of a fixed mandate, its duration and the degree of freedom of the Executive to fire the regulator. The higher value is obtained with the presence of this characteristic.

Chart 15: Quarantine arrangements for the agencies

Agency Regulatory	Quarantine
ANEEL	12 months before direct or indirectly providing services to companies under regulation of or overseen by the agency, including controlled companies, affiliates or subsidiaries, under penalty of conducting administrative advocacy. During the impediment period, a former-director may continue to provide services to ANEEL or any other organ of the direct public federal administration with remuneration equivalent to that of the position previously held.
ANATEL	For 1 year after leaving a position, a former-board member may not represent any person or interest before the agency.
ANP	12 months before providing services to a company in the oil industry or distribution under penalty of committing administrative advocacy. – During impediment, any former-director not dismissed under the terms of Article 12 may continue to provide services to ANP or to any body of the Direct Administration, for remuneration equivalent to that of the director's position held.
ANTT	– For 1 year after leaving the position a former-director may not represent any person or interest before the agency.
ANTAQ	For 1 year after leaving the position a former- director may not represent any person or interest before the agency

The possibility of interference on the part of the direct administration in the procedures of the agency is evaluated by the PI attribute. In this case, the existence of an intermediary level is observed between the higher and lower value.

Chart 16: Regulatory Agencies Rank

Agency	DP	BA	NP	TS	LS	PI	EC	Score
ANATEL	collective	yes	centralized	yes	yes	uncertain	high	**5,5**
	1	1	0	1	1	0,5	1	
ANEEL	collective	yes	centralized	yes	yes	uncertain	high	**5**
	0,5	1	0	1	1	0,5	1	
ANP	collective	yes	centralized	yes	yes	yes	high	**5**
	1	1	0	1	1	0	1	
ANTAQ	collective	yes	centralized	yes	yes	yes	medium	**4,5**
	1	1	0	1	1	0	0,5	
ANTT	collective	yes	centralized	yes	yes	yes	medium	**4,5**
	1	1	0	1	1	0	0,5	

Finally, the enforcement capability (EC) evaluates the sanctions instruments to guarantee the execution of the law. In this case, the same values were given. The value of 1 is obtained for regulatory agencies with high punishment capacity. Chart 16 shows a rank of infrastructure regulatory agencies.

Chart 17: Data Series (1995–2003)

Agency	Price	Investment
ANATEL	Phone Price Index**	Phone Lines Availability
ANP	Fuel Price Index*	Brazil Oil Production
ANEEL	Residential Electric Tariff	Installed Capacity
ANTT	Transport Price Index**	Investment
ANTAQ	Port Tariff	Load Volume

* IGP-DI (Getúlio Vargas Foundation) ** IPCA (Statistic and Geographl Brazilian Institute)

5.2. Effectiveness index estimation

The methodology to estimate the effectiveness index (EI) of the infrastructure of regulatory agencies follows a similar methodology to that developed by the United Nations to create the Human Development Index (HDI). The main difference consists of the utilization of the "Main Component Method" (MCM) for the estimation of the parameter weights.

Chart 18 indicates the annual EI estimation for the five agencies.

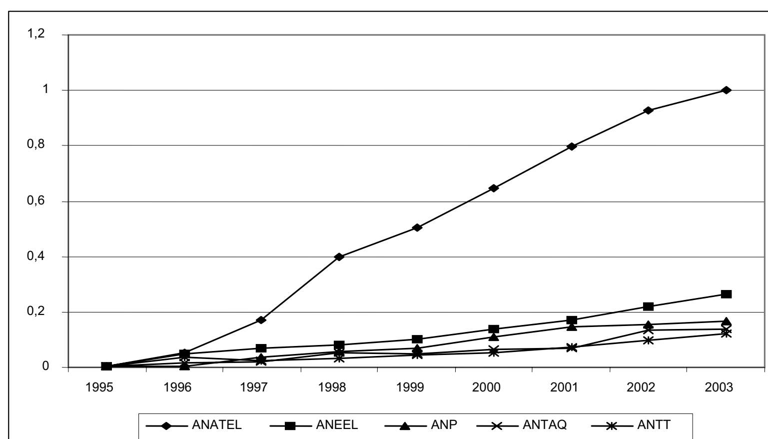


Chart 18: Effectiveness Index (1995–2003)

In general, investment data are considered strategic by firms and, therefore, subject to restricted access. The adopted procedure chose a group of proxy variables that allow inferring the behaviour of investment over time. Chart 17 indicates the series used in the EI estimation:

Three aspects of the results shown in Chart 18 are noteworthy. First, the significantly higher level of EI for the telecommunications sector. Second, the increasing EI for all sectors. Lastly, the identical ranking between EI and II previously calculated for the regulatory agencies. The appendix contains the EI values obtained for each agency.

6. Conclusion

The results of the last section suggest a positive relationship between the level of independence of the Brazilian regulatory agencies and the performance of their respective regulated sectors as measured by the effectiveness index.

We think this result is not a coincidence. As stated in the introduction, the effectiveness index is the result of the regulators' action and reflects the success in promoting a more competitive environment. This in turn will lead to greater competitiveness.

This suggests that the reform of the Brazilian regulatory system, which is presently under discussion in Congress, should strengthen the mechanisms for independence of the regulatory agencies.[16]

A natural extension of this work will be to verify whether the result obtained for Brazil holds for a large sample of countries and sectors at different points in time.

Appendix

Index numbers used for the calculation of the effectiveness index

Agency	Year	Price Index	Investment Index	EI Index
ANATEL	1995	0,0119	0,0000	**0,0061**
ANATEL	1996	0,0606	0,0474	**0,0554**
ANATEL	1997	0,2279	0,1099	**0,1733**
ANATEL	1998	0,5945	0,1996	**0,4074**
ANATEL	1999	0,6100	0,3952	**0,5157**
ANATEL	2000	0,6978	0,5970	**0,6642**
ANATEL	2001	0,8011	0,7914	**0,8170**
ANATEL	2002	0,8768	0,9816	**0,9533**
ANATEL	2003	1,0000	1,0000	**1,0260**
ANEEL	1995	0,0119	0,0000	**0,0061**
ANEEL	1996	0,0888	0,0118	**0,0516**
ANEEL	1997	0,1222	0,0163	**0,0710**
ANEEL	1998	0,1383	0,0254	**0,0840**
ANEEL	1999	0,1706	0,0368	**0,1064**
ANEEL	2000	0,2211	0,0544	**0,1413**
ANEEL	2001	0,2740	0,0648	**0,1738**
ANEEL	2002	0,3499	0,0868	**0,2240**
ANEEL	2003	0,4247	0,1026	**0,2705**
ANP	1995	0,0119	0,0000	**0,0061**
ANP	1996	0,0000	0,0088	**0,0045**
ANP	1997	0,0433	0,0272	**0,0362**
ANP	1998	0,0448	0,0684	**0,0581**
ANP	1999	0,0272	0,1074	**0,0690**
ANP	2000	0,0691	0,1498	**0,1123**
ANP	2001	0,1227	0,1697	**0,1500**
ANP	2002	0,0927	0,2197	**0,1603**
ANP	2003	0,0912	0,2414	**0,1706**
ANTAQ	1995	0,0119	0,0000	**0,0061**
ANTAQ	1996	0,0263	0,0082	**0,0177**
ANTAQ	1997	0,0316	0,0104	**0,0215**
ANTAQ	1998	0,0741	0,0276	**0,0522**
ANTAQ	1999	0,0741	0,0232	**0,0499**
ANTAQ	2000	0,0741	0,0526	**0,0650**
ANTAQ	2001	0,0741	0,0655	**0,0716**
ANTAQ	2002	0,1864	0,0792	**0,1363**
ANTAQ	2003	0,1864	0,0925	**0,1431**
ANTT	1995	0,0119	0,0000	**0,0061**
ANTT	1996	0,0294	0,0463	**0,0388**
ANTT	1997	0,0474	0,0001	**0,0244**
ANTT	1998	0,0660	0,0018	**0,0348**
ANTT	1999	0,0818	0,0099	**0,0471**
ANTT	2000	0,0921	0,0096	**0,0522**
ANTT	2001	0,1349	0,0155	**0,0772**
ANTT	2002	0,1783	0,0137	**0,0985**
ANTT	2003	0,2345	0,0130	**0,1270**

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Notes

1. We excluded a few institutions such as ANCINE in the movie industry because they do not fit the typical pattern for a regulatory agency.
2. "Own funds" are not necessarily those raised from fees charged to supervised companies, but may be revenues that do not depend directly on a higher administrative body.
3. The existence of fixed-term mandates, for a reasonable period of delegation (at least as long as the presidential mandate) and where removal may take place only in situations stipulated by law, enables agencies to ensure continuity of policies in relation to alterations in the political environment.
4. The work of the regulatory agencies is disciplined by the legislation; it was the complexity of the subjects involved that prompted the Legislative Power to delegate the power to regulate certain sectors of economic activity to specialized bodies. Congress has the competence to alter the legislation and thus of disciplining the work of regulatory agencies. One criticism heard in the current debate refers to the fact that the actions of the regulatory agencies are not being appraised by the Legislative Power. In this sense, the agencies may in fact be occupying functions that should be assumed by elected representatives.
5. Trade liberalization, reflected in the reduction of basic import taxes from 33.4 per cent in 1990 to 13.9 per cent in 1998, exposed domestic companies to foreign products, thus curbing price increases despite growing demand, and leading to the restructuring of certain

sectors of the Brazilian economy.

[6] The monthly index was taken for June; base *100* was the monthly average for 1991.

[7] According to Baumann (1996), one result of capital account liberalization was that inflows of foreign portfolio investments rose from US$ 800 million in 1992 to US$ 7 billion in 1993.

[8] Published April 12, 1990.

[9] Such as the Central Bank (BACEN), created by Law No. 4595, of 31 December 1964, or the Superintendence of Private Insurance (SUSEP), created by Law No. 73, of 21 November 1966, or the Securities and Exchange Commission (CVM), created by Law No. 6385 of 7 December 1976.

[10] This point is raised by Gheventer (2003: 180–189) on the basis of observing a correlation between autonomy and economic liberalization.

[11] For a more detailed discussion of this point, see Pires and Piccinini (1999) for instance.

[12] The characterization used in this section is based on the work of Pires and Piccinini (1999).

[13] The first Brazilian legal enactment to introduce this quasi-independent government agency status was Law No. 6016 (November 22, 1943). Nevertheless, the Federal Savings Bank, which was constituted in 1861, is seen by many as Brazil's first quasi-independent agency (*autarquia*).

[14] Budget provided by Budgetary Law – 2003.

[15] Budget provided by Budgetary Bill – 2004.

[16] A complete analysis of the proposal sent to Congress by the Executive would transcend the scope of this paper. But a short technical note about the subject is enclosed.

II.2. COMPETITION POLICIES, MARKETS COMPETITIVENESS AND BUSINESS EFFICIENCY: LESSONS FROM THE BEER SECTOR IN LATIN AMERICA

Alfredo Bullard

1. Introduction

The purpose of this paper is to shed some light on the possible relationship between the different approaches to competition policy in a number of Latin American countries in connection with developments within a specific industry, namely the beer industry. This study purports to evaluate what would be the best policy to be adopted based on the characteristics of the industry in Latin America.

Latin America presents a range of situations that vary from countries with no competition legislation[1] to countries whose legislation includes not only anti-competitive behavioural control[2] but also market structure control (mergers and acquisitions control). In addition, there is Peru, whose legislation contains behavioural but no structural control. Table 1 shows the different competition policy options adopted in a selected number of Latin American countries (see Table 1).

As we can see, Guatemala, Ecuador and Bolivia are countries that have no competition legislation at all, Peru has competition legislation focused only on behavioural controls, while the legislation of Argentina, Brazil and Mexico includes both behavioural and structural controls.

Are these different approaches to competition policy related to the concentrations of the industry within these countries? And even if we find such a relationship, will it be due to the competition legislation in each country, or will it simply be the result of regional trends arising from market forces? In the case of the beer industry, the latter seems to be the answer, as we will see below.

Little can be done from the point of view of structural controls in small, fragmented markets such as those found in many Latin American countries that are allied to the regional trends of the industries, and where structural controls may even prevent the efficiencies that some concentrations would bring to the markets. In this case, we may argue that a competition policy without structural (merger) controls would allow concentrations to bring efficiencies to particular markets, provided that we enforce a vigorous antitrust behavioural policy oriented to facilitate access for new entrants to these markets.

The conclusions of this report are subject to several limitations. The first, and probably the most obvious, is that it is difficult to draw conclusions for the overall economy on the basis of the analysis of only one industry. Although the beer industry has some interesting characteristics, it cannot be considered as a representative market from which to make general policy recommendations.

The second limitation concerns the availability of information. Unfortunately, in Latin America, it is not easy to find sufficient reliable information that may allow the preparation of a detailed and complete study. Sometimes, the prices or production figures are not available or, if so, the information is unofficial. Nevertheless, examining the evolution of regional markets can provide important information to be considered as guidance for policy implementation.

Therefore, this study must be considered as a preliminary comparison of the status of the beer industry in seven countries (Peru, Argentina, Venezuela, Panama, Bolivia, Ecuador and Guatemala) that have different competition laws and policies. The comparison allows the tracking of the industry's evolution and, interestingly, a view on the transformation of a fragmented market in various countries into a regional market in which the players start moving in another dimension. In this sense, the most important information might be that gleaned from the history of each of the analysed markets and that relates to the competitiveness of its companies.

As will be seen later, there is no clear evidence showing that the different approaches to competition legislation have had clearly different impacts on the form and structure of the investment. However, as already mentioned, these conclusions are only preliminary due to the lack of adequate information.

Without prejudice to the above mentioned, and although the analysis of the beer market cannot be used to make generalizations across all economies, we have selected this market for the following reasons:

1. It is a market that has been shown to be particularly dynamic in the last decade, with continuous changes in company ownerships, newcomers entering the different national markets and others exiting, structural changes through mergers and acquisitions, strategic alliances, etc.
2. These changes are occurring in countries that show very different approaches to competition policies. In some countries, there is no competition policy, in others, there is competition legislation without merger control and, in others, there is control of concentrations in competition law.
3. Thus, virtually all Latin American competition authorities have encountered one or more cases related to the beer industry.
4. Finally, there exist some general data that, although incomplete, allow us to arrive at some interesting conclusions.

2. Analytical background: distinguishing between competition policies that may enhance industry and those that may hinder competitiveness and efficiency

The beer industry has been subjected to radical structural changes worldwide. Until the end of the past decade, in many Latin American countries, the sector had more than one manufacturer; however, since 1994, the trend toward horizontal concentrations has increased. This phenomenon has given rise to several changes with re-

spect to the type of regulation and the application of competition policies. Discussion has focused on the effect of these concentrations transcending national spheres, as well as on the behaviour of the market players and the role performed by the regulators in this context. On this last point, and due to the lack of competition law in some countries, it is worthwhile to weigh up whether to opt for a behavioural or a structure control approach.

It is important to analyse the relationships that exist between competition policies, market competitiveness and business efficiency. Although competition policies and competitiveness are closely related they are not the same thing. The existence of competition policies does not guarantee competitiveness, which depends on several other factors, such as business supply capacity, appropriate infrastructure, the existence of a level of transaction costs in the economy, the effects of taxation systems, etc.

It must be admitted, however, that properly designed and implemented competition rules can create an atmosphere conducive to greater competitiveness. Just as when one football team is encouraged to play against a much better one, and its ability to compete improves, the elimination of cartels puts companies under such competitive pressure that it encourages them to become either more competitive or to exit the market, leaving room for new entrants. The same may happen with the elimination of anti-competitive practices, which delay the entry of new companies into the market and leave the few existing players with poor incentives to improve their competitiveness. The development of legal monopolies weakens the ability of companies to compete efficiently against new entrants into the domestic market, or to becoming competitive at an international level.

On the other hand, some competition policies might discourage competitiveness. For example, a competition policy preventing companies from achieving economies of scale could reduce competitiveness; the same could happen where innovation or new investment might be discouraged if the competition authority rejects the pooling of R&D resources. The application of such policies without clear guidance might discourage investment or innovation thereby affecting industry competitiveness

Although high levels of monopoly may have negative consequences for consumers, its prohibition without a clear approach may also affect them. The competitive process is nurtured by the aspiration of every entrepreneur to increase his/her market share. Their efforts to reduce costs and prices, as well as to improve quality and service, are precisely oriented to increase their firms' market shares. It is because companies desire to become the largest that they can compete and give optimal service.

If a company invests so as to improve its production by producing better quality, cheaper and safer products for consumers with the purpose of pushing out its competitors and then is deprived of its right to grow, it will stop investing. Thus, consumers will be deprived of the benefits of such investment.

Irwing Kaufman, the famous North American judge who resolved the United States v. Alcoa[3] case used to say: "...the successful competitor, having been urged to compete, must not be frowned upon when he wins".

Similarly, Viscusi, Vernon and Harrington (1997: 266) noted that the intentional acquisition of market power by using undue strategies must be treated differently from those cases in which market power is achieved by internal growth or development arising from entrepreneurial effort, product superiority or by a simple historical accident.

When commenting on North American legislation, these same authors note: "given the existence of monopoly power, the second part of the rule of reason test is to determine whether the monopoly was acquired and/or maintained by practices that cannot qualify as superior efficiency or historical accident. That is, a monopoly over widgets because of superior efficiency in producing widgets is not in violation of the Sherman Act" (Viscusi, Vernon and Harrington 1997: 266).

It is important not to lose sight of the invisible impact of prohibiting monopoly. Usually, we only look at the consequences of such a monopoly when the incumbent takes advantage of it by increasing prices and limiting consumer options, but we do not see how much society would lose if competition incentives were reduced by means of growth penalization or business reorganization.

If market concentration responds to consumer preferences, then such a concentration is legitimate. This does not mean that only internal growth is justified. It could come from other channels, such as a mergers and acquisitions. Under this hypothesis, although the initial concentration may be the consequence of a business action, if it generates efficiencies from which the consumers benefit and if no entry barriers exist, consumer preference for the products and services of the new monopoly is a signal of approval that the legal systems must respect. It also must be added that there are no clear incentives for companies to merge, if such a merger is not going to generate efficiencies that may reduce costs and improve the functioning of the productive process. If the merger is not efficient it will increase production costs and affect not only consumers but also the company itself.

Bork (1993) comments in respect of internal growth efficiencies and corporate mergers as follows: "…both internal growth and horizontal merger eliminate rivalry, and they do so more permanently than do cartel agreements. Prices are fixed and markets allocated within firms. The reason we do not make these eliminations of rivalry illegal per se is that they involve integration of productive activities and therefore have the capacity to create efficiency. Contract integrations (including those integrations involving price-fixing and market-division agreements) are also capable of producing efficiency. The law of contract integration and of ownership integration should, therefore, be made symmetrical. There is no justification for suspending the per se rule in one area and not the other" (Bork, 1993: 264).

Similarly, Ross (1993) when commenting on the works[4] of Ronald Coase and Oliver Williamson[5] says: "Thus, the implications of the "theory of the firm" is that antitrust law should not be sceptical of mergers, joint ventures, or contract agreements among firms, and should be wary of interfering with these ways of efficiently doing business." (Ross 1993: 4).

Therefore, the capability to achieve consumer preferences must not be penalized, except for those practices that may distort such preferences or obtain results that may conflict with such preferences. This is the role of competition policies, if we do not want to see competitiveness affected.

And the truth is that monopoly cannot be questioned in itself, as it was established in the European common system when resolving the famous Michelin case: "To state that a company has a dominant position is not a reproach in itself, it only means that regardless of the reasons that has placed it in a dominant position, the concerned company has a special responsibility for not permitting that its conduct may prevent the Common Market from a genuine and not distorted competition".[6]

Therefore, we should suggest a more cautious analysis, with a special emphasis on behavioural controls with respect to merger control rules for developing countries.

It is pertinent to differentiate from the beginning between the concepts of competition law and those of competition policy, the latter being a wider concept referring to all those government measures that influence the intensity of competition in local markets or affect the freedom of economic enterprises to trade.[7]

Having in mind this concept of competition policy, it is worth questioning which role the growing competition law should accomplish within this context. As already seen, the growing wave of transnational mergers and acquisitions has aroused a new interest in analysing the necessity to promote competition laws in developing or emerging economies, considering the effects that concentrations of international scope might have not only in the countries' domestic markets but also at a regional level.

Hence, it is convenient to define the different options likely to be adopted by the governments within the framework of their competition policies. A first political option could be to give priority to market deregulation and to fight against existing access barriers (bureaucratic and logistic), and to leave the solution of dominant position and unfair competition problems to the private sector through the judiciary (no behavioural or structural controls).

A second government policy option, which would involve greater State participation, is the creation of a competition agency to intervene ex post in the control of specific anti-competitive behaviour by sanctioning such practices and abuses of dominant position in the market.

A more interventionist third option would consider, in addition to the behavioural control, a structural control framework with the purpose of granting authorizations ex

ante to mergers and acquisitions which may affect the competitiveness and efficiency of domestic markets.

There is also the possibility of creating specific regulations for certain sectors characterized as natural monopolies or network industries. This is a fourth option that could run parallel to those previously mentioned. Finally, there is a fifth option that goes beyond national boundaries which seeks to establish at a sub-regional level the same kinds of controls as already mentioned (CAN, MERCOSUR, etc.).

A local market could be efficient and competitive if it has few access barriers and high substitutability on the supply and demand sides, in case of price increases. However, some markets may face greater access barriers, because the specific industry requires large investments in production and/or distribution, due to lack of an adequate infrastructure or due to market characteristics, as in the case of network industries.

Let us now analyse the beer industry and become familiar with the access barriers existing in the countries under analysis, thus allowing us to see how this market is similar to a network industry, where the control of an appropriate distribution channel may determine the success of a penetration strategy performed by potential competitors.

3. Production and commercialization of beer

At this point, we will describe how the beer industry is structured, and later we will list the characteristics of this market in each of the countries under analysis.

3.1. The product

Beer has a short consumption period that forces brewers to:

- make large investments in the infrastructure necessary for its conservation in storehouses and for its transport;
- carry out strong advertisement campaigns that promote the consumption of the product and
- develop a distribution network that reaches distant locations quickly.

Therefore, the short consumption period of beer represents a market access barrier for new competitors. The time and the investment needed for entry is considerable; thus, when beginning the production process, the new enterprise must sell the product within the following 6 months, causing the initial investment to become a sunk cost. Also, due to the short consumption period, beer is a product that requires a marketing strategy and its constant distribution to ensure loyalty to the specific brand.

A network of intensive distribution is necessary to place the beer in the majority of localities where consumers exist. This is another access barrier because the distribution network can be limited due to existing vertical agreements between competitors and their distributors, who will not easily accept a new entrant.

3.2. Industry structure

As we have seen, beer is a massive consumption product that demands a presence in a large variety of sale points. In this sense, the distribution of beer requires a specific infrastructure, such as a large fleet of trucks, strategically placed distribution centres and adequate logistic planning of shifts and routes. On the other hand, the efficiency of the distribution chain depends on whether effective commercialization means are available, its ability to support large volumes of beer and its geographical reach, which thus demonstrates the importance of the traditional distribution channel.

The inability to access a distribution chain already controlled by one or more incumbent enterprise represents an entry barrier. In this case, the need for the distribution chain and the production of beer to complement each other makes access to the chain, when dealing with the only form of commercialization,[8] absolutely necessary. The lack of access to a distribution network can occur in two forms: when vertical integration exists, where access to the network is impeded because of the absolute control by the enterprise that currently uses the network, or, when vertical relationships between the distribution agents exist, where access may be denied establishing determined conditions in each contract relationship, which is the case in exclusivity conditions of zones and brands.

Finally, depending on the distribution channels mentioned previously, the retail outlets include “open bottle” localities, supermarkets, gas stations and other modern stores, in addition to liquor shops and bars, as well as small neighbourhood shops located nationwide, which are termed traditional channels. These small shops are difficult to reach, increasing the investments in distribution.

4. The beer market in Latin America

4.1. Characterization of Latin American markets

Latin America[9] is the world’s fourth largest beer producer (211 million hectolitres annually). It is widely surpassed by the production in Europe (478 million hectolitres) and other countries of the Americas (260 millions hectolitres mainly due to the United States and Canada with 232 and 23 millions of hectolitres, respectively). In Latin America, Brazil and Mexico are the largest beer-producing countries, with annual outputs of 83 and 58 million hectolitres, respectively, followed by Venezuela (19 million hectolitres), Colombia (14 million hectolitres), Argentina (12 million hectolitres) and Peru (6 million hectolitres).

Although certain differences exist in the beer markets that are related not only to demand but also to production level, nevertheless, they do have some similar characteristics.

1. Access barriers: The differentiation of products generates an important barrier to the entry of new players, as their penetration into the market would be difficult if

they are not aware of consumers' preferences. There are also barriers imposed by consumers who identify with specific trademarks, such as Corona in Mexico, Brahma in Brazil, Quilmes in Argentina and Cristal in Peru, that are very well positioned in their respective markets.

On the other hand, Latin American beer companies have had a tendency towards upward and downward vertical integration, concentrating not only on supplier companies (i.e. bottle or can suppliers) but also on distribution systems (i.e. wholesalers). This significantly reduces the capability of new entrants to penetrate the market, thus narrowing the supply and distribution channels.

In addition, the cost of moving from other beverage industries to beer and vice versa is very expensive, given the high capital requirements that are incurred in the installation and starting up of beer companies. As a result, the incumbent companies use the presence of economies of scale to the detriment of potential competitors (Carrillo and Kocnim, 1993: 35).[10]

2. Exit barriers: The beer industry is highly specialized and this constitutes not only a problem for the potential entrant but also a significant exit barrier for the companies already positioned in the market. In addition, the strategic interrelations existing in this industry make it difficult for companies to withdraw from it.[11]

3. There are large beer companies at regional level that have positioned their products in their respective local markets and have succeeded in expanding their presence in Latin America, for example the Bavaria Group in Colombia, the AmBev Group in Brazil and the Modelo Group in Mexico. Broadly, there are eight main beer producers in the region holding approximately an 85 per cent market share of the Latin American market. This is an important characteristic of the industry, because market rivalry depends on a small number of competitors with great economic power. Therefore, although one can see barriers to entering a national market, there are important players with resources and "broad-shoulders" at regional level ready to undertake entry into national markets.

Below, we will analyse a group of countries, Argentina, Bolivia, Peru, Ecuador, Venezuela, Panama and Guatemala, to characterize the markets at the Latin American level. Table 3 shows the typical concentration levels of the industry in the region. We will briefly describe the market status and its relevant characteristics in each country, noting the similarities and differences.

4.1.1. Argentina

Argentina's per capita beer consumption is seventh in all of Latin America. The main players in the Argentine beer industry are the AmBev/Quinsa Group which has an 84 per cent market share and its main brands are Quilmes Cristal, Heineken, Imperial, Iguana, Quilmes Light, Bierckert, Andes, Norte, Liberty, Quilmes, Bock, Palermo, Brahma Chopp and Brahma Bock.

Next, there is the CCU Group (Compañía Cervecerías Unidas) with a 13 per cent interest, and whose trademarks are Budweiser, Schneider, Santa Fe, Rosario, Cordoba, Rio Segundo and Salta, and finally the Isenbeck Group with a 3 per cent interest with the Isenbeck (5.6 per cent), Warsteiner and La Diosa brands.

Argentina's most representative sales unit is the returnable 1-litre bottle. In 2001, the Quilmes Cristal trademark was in the premier sales position (46.1 per cent), followed by Brahma Chopp (14 per cent), Palermo (5.8 per cent) and Andes (5.1 per cent). Argentina's beer imports have been decreasing over the last 10 years, with an import volume in 2002 of only 1.7 per cent approximately of the apparent consumption measured per volume.[12]

Thirty per cent of Argentine sales are in the opened bottle sector, while the closed bottle channel accounts for 70 per cent. Within the closed bottle channel, which is the main channel, most of the sales are through traditional retail units (54 per cent), followed by self-service stores (20 per cent), hyper and supermarkets (15 per cent) and finally kiosks and mini-markets (11 per cent). Beer transportation is practically all done by trucks, and the freights per box represent 20 per cent over output price.[13]

Evolution in recent years

The entry of international companies into Argentina's market during the 1990s (Isenbeck, AmBev and CCU Groups) gave rise to two sales groups: high-profile trademarks (comprising the leader companies' premier trademarks, such as Quilmes, Brahma, Isenbeck, Budweiser and Heineken) and low-profile trademarks (comprising the leader companies' less prestigious trademarks, such as Bieckert, Palermo, Schneider, Diosa and all the regional trademarks, as well).

Over the last number of years, it was observed that Argentina's regional and national trademarks were absorbed by leader companies, which extended their trademarks portfolio and maintained their traditional beers by using niche or segment strategies or as secondary trademarks, with the purpose of not diminishing first class trademarks in price wars. This happened in the case of CCU with Schneider, Santa Fe, Salta, Córdoba and Río Segundo trademarks and in the case of CMQ (Quilmes before being acquired by AmBev) with the Bieckert, Palermo, Norte and Andes trademarks.[14]

In 2002, AmBev obtained authorization to acquire abroad 230.92 million shares which represented 36.05 per cent of the voting shares and 37.5 per cent of the value of Quilmes Industrial Societé Anonyme, a company that controlled Cervecería y Maltería Quilmes. However, the authorities subordinated the transaction to comply with a series of disinvestments and commitments established for the purpose of ensuring competitive conditions.

According to the transaction terms, Quilmes' shareholders could choose to convert their securities into shares in AmBev once a year over a 7-year period, in such a manner that if all shareholders opted for the change, AmBev might assume the com-

pany's majority control, and would be able to demand total merger in 2009. Likewise, under this transaction AmBev agreed to distribute Quilmes' products in Brazil.

4.1.2. Bolivia

Bolivia is one of the countries with lower beer consumption per capita in the region. Among its most representative trademarks are Paceña, Ducal and Taquiña. It is mostly presented in a 620-ml glass bottle. The group formed by Cervecería Quilmes and AmBev controls 98 per cent of the Bolivian market. Recently, the Quilmes Group from Argentina purchased the shareholding of Cervecería Boliviana Nacional from Santa Cruz, Cervecería Boliviana Nacional of La Paz and Taquiña from Cochabamba. In May 2002, AmBev acquired an interest in this group through its strategic association with Quilmes.

4.1.3. Peru

In Peru, the per capita consumption of beer is low, apart from in Lima, where 59 per cent of the population consumes beer and it is the third most popular product for personal consumption.[15]

The Backus Corporation is the country's only beer group, controlling more than 99 per cent of the national market through three manufacturing companies: Unión de Cervecerias Peruanas Backus y Johnston S.A.A. (83 per cent), Cervesur (15.2 per cent) and San Juan (1.8 per cent). The leading trademarks are Cristal (56.5 per cent), Pilsen Callao (20.4 per cent) and Cusqueña (9.1 per cent). The remaining 1 per cent of the market is supplied by imported beers such as Heineken, Holsten, Dressler and Corona.[16]

Beer is mostly sold in returnable 620-ml glass bottles, followed by boxes of 1.1-litre bottles (12 bottles per box). At this point, it is worth mentioning that the main difference between the popularly consumed beers and the imported varieties is their packaging and presentation, as the imported beers are distributed in cans or small glass bottles (330 ml) whose participation in the channels of distribution of typical closed bottles is virtually zero.

Chart 1 shows the most popular beer brands by socio-economic class. What emerges from the chart is that Cristal is the most popular (71 per cent), followed by Pilsen Callao (16 per cent). This difference is due to the fact that socio-economic classes B, C, D and E prefer Cristal while the highest class (A) prefers Pilsen Callao and Cusqueña (see Chart 1).

With respect to places of purchase, grocery stores are the most popular (74 per cent), followed by supermarkets (11 per cent). As Chart 2 shows, grocery stores or corner shops are the most commonly used by socio-economic classes B, C, D and E, while supermarkets tend to be used by class A. Therefore, Peru's main retail points are grocery stores or corner shops (see Chart 2).

In Peru, beer is distributed through direct or indirect distribution channels. The direct channel is via the Backus sales force, with 29 distribution plants that operate 63 per cent of the entire distribution chain; indirect distribution is through contracts with wholesalers under specific terms. This channel comprises 800 wholesalers, i.e. 37 per cent of the entire distribution channel. This means that the industry is integrated vertically downstream and controls production distribution directly. This trend has been maintained during the last number of years, since the number of intermediary distributors has been decreasing.[17]

Evolution in recent years

The Backus Corporation (Cervecería Backus y Johnston S.A), started its acquisition process in 1994 with the purchase of 62 per cent of the common shares of Compañía Nacional de Cerveza SA, which gave it controlling power over Sociedad Cervecera de Trujillo S.A, as well as of the remaining 50 per cent of Maltería Lima S.A capital stock. In 1996, Cervecería Backus y Johnston S.A. merged with several companies (Compañía Nacional de Cerveza S.A, Cervecería del Norte S.A and Sociedad Cervecera de Trujillo S.A.) to create the Unión de Cervecerías Peruanas Backus y Johnston S.A.A, which obtained an 80 per cent share of the local beer market.

In 2000, Backus launched a takeover bid (OPA) for the acquisition of the common shares of its competitor, Compañía Cervecera del Sur del Perú S.A.A. (“Cervesur”), acquiring 97.85 per cent of the aforementioned company’s capital. This transaction is said to have occurred because Cervesur required a capital injection in the production and distribution of its products.[18].

In 2001, the Chilean brewing company UCC sold its 6.71 per cent Backus interest. This transaction implied the transfer of 5,391,424 Series “A” Common Shares. Afterwards, Lince Netherlands B.V., part of the Polar Group of Venezuela, purchased Backus’ 10,684,831 Series “A” shares, increasing its shareholding by 18.34 per cent.

After a controversial purchasing deal on the stock exchange, the Colombian Bavaria Group is now in control of Backus with 74.38 per cent voting shares and 38 per cent investment shares. The Venezuelan Cisneros Group has 22.3 per cent and the Peruvian Bentin Group 18 per cent, and smaller Peruvian shareholders hold the remaining shares.[19]

In March 2003, AmBev announced that it would be opening a new brewery in Peru.[20]

At present, the incumbent (Backus) and the new entrant (AmBev) are involved in many legal procedures before the competition, trademark and judicial authorities. These processes are related to the interchangeability of bottles, and vertical restraints on the distribution channels.

4.1.4. Ecuador

Ecuador also has a lower per capita level of beer consumption. Ecuador's main trademarks are Pilsner, Club, Dorada and Biela. The 578-ml glass bottle is the most popular size. In 2002, the Bavaria Group purchased Cervezas Nacionales de Ecuador, giving it 85 per cent of the market. However, at the end of 2003, AmBev also entered Ecuador's market through the acquisition of Cerveceria Suramericana giving it 13 per cent of the market.

At present, the incumbent company and the new entrant are involved in a legal wrangle before the trademark authority. Cervezas Nacionales has claimed has claimed ownership over the design of the bottles of beer, and is demanding that AmBev does not use similar bottles in the production and distribution of its products.

4.1.5. Venezuela

Venezuela's beer industry is one of Latin America's main markets due its high per capita consumption level. The main player in the Venezuelan market is C.A. Cervecería Polar, present since 1941, which holds 70 per cent of the market. Second, is Cervecería Regional, incorporated in 1927, holding 20 per cent of the market. This Company maintains a strategic association with the transnational Interbrew since 1977, with whom it developed new packaging of its trademark, Regional Light. The third company is C.A. Cervecería Nacional, which entered the Venezuelan market in 1995 and is associated with the Brahma trademark since 1994. C.A. Cervecería Nacional controls 10 per cent of the Venezuelan beer market.

Most of Venezuela's beer is sold in returnable glass bottles (77 per cent during 2002), followed by cans (15 per cent), non-returnable bottles (8 per cent) and barrels.[21] However, it is important to note that the current trend is mainly for cans and non-returnable bottles. On the other hand, the companies fix routes for exclusive distribution to their wholesalers, as well as a maximum price for them to sell their products to retailers (such as C.A. Cervecería Polar).

4.1.6. Panama

Panama is one of the countries with greater relevance in per capita beer consumption. The main player in this market is Cerveceria Baru Panama, which started its operations in 1958. This company holds 35 per cent of the market, having Soberana, Panama and Cristal among its main trademarks. However, Cerveceria Nacional has been purchased by the Bavaria group. This company holds 65 per cent of the market, with its main trademarks being Atlas, Balboa, Balboa Ice, Lowenbrau and HB.

Panama's beer sales are mainly through returnable glass bottles. The participant companies are in charge of distributing the products by using their own truck fleets to transport the product from the factory to the storehouse, as well as to the points of retail. They establish commercialization strategies, which include the execution of exclusive contracts to the detriment of competitive products.

With respect to its recent history, in May 2001, the Bavaria group purchased 45 per cent of Cerveceria Leona from Colombia. This concentration allowed the consolidation of the Bavaria market in Colombia. The Bavaria Group also owned Cervezas Nacionales de Ecuador, through which Bavaria acquired control of Cerveceria Nacional of Panama.

In December 2001, the Commission for Free Competition and Consumer Affairs of Panama – CLICAC – was requested to authorize the economic concentration between Cerveceria Baru Panama S.A. and its subsidiaries, with the Bavaria Group S.A., which had acquired control of Cerveceria Nacional and subsidiaries. After analysing the corresponding transaction documentation, the Commission determined that the entity arising from the economic concentration in question would acquire a dominant position sufficient to fix prices and apply anti-competitive practices to the detriment of importers who would be unable to effectively react to or counteract such market power. Therefore, the Commission rejected the authorization for the economic concentration on the grounds that it undermined, restricted, damaged and prevented free competition in an unreasonable manner.

4.1.7. Guatemala

The Beer market is important for Guatemala's economy, as it represents more than US$ 400 million per year, i.e. 1.7 per cent of Gross National Product (GNP). However, unlike Panama, its per capita beer consumption is one of the lowest in the Region and in all Latin America.

Until September 2003, Guatemala had only one beer company, Cervecería Centro Americana, which was vertically integrated and distributed eight national trademarks and four imported brands. The main brands are Gallo, Monte Carlo, Gabrito, Pozada Draft, Moza and Victoria. However, in September 2003, AmBev entered the Venezuelan market with an installed capacity of 1.1 million hectolitres per year. Finally, a third beer company, which will produce one national trademark and distribute one imported trademark, is about to enter the market. Before the entry of the new competitors, the local brewery controlled 95 per cent of the market.

At present, AmBev and Cerveceria Centro Americana (represented by the Gallo trademark) are involved in a legal process. Cervecería Centro Americana has declared the hypothetical existence of a "system for the protection" of its bottles, and is demanding that AmBev does not use the same kind of bottles in the production and distribution of its products (the typical amber-coloured bottle is used).

4.2. Concentration processes and problems associated with access to national markets

As can be seen, different countries in Latin America have, in the last number of years, been involved in mergers and acquisitions in the beer market, which can be explained not only by a decrease in domestic consumption that has affected weak companies, but also by the expansion process of larger beer companies in the re-

gion within a framework of progressive elimination of protectionist policies against foreign competitors.

Also, the level of per capita beer consumption in Latin American countries is quite low in comparison with other countries (for example European countries). Therefore, everything points to the significant growth prospects of this market. However, as already explained, the existence of access barriers has made the entry of new competitors difficult.

In effect, the beer industry encounters notable structural access barriers in every Latin American country. Beer production is a very specialized industry, therefore a factory in the business of producing juices or refreshments could hardly be transformed into a brewery, if the latter would be more lucrative. Also, the cost of the processing and packaging plants, supplies and logistic chains are so expensive that national investors would be very wary of financing the launching of a project of such magnitude in this class of market.

Therefore, the alternative is that the competition level in Latin American countries may be determined by the modernization and expansion of those companies that are already in situ, or by the progressive penetration by larger regional beer companies into each country. This process has been developing in the last number of years, where national markets led by one or more long-standing manufacturers have been purchased by larger regional business groups in the process of expansion, such as the Bavaria Group from Colombia and AmBev from Brazil.

However, the access of regional beer industries to local markets is difficult due to the lack of adequate distribution networks to allow easy access to consumers, in view of the “traditional” form of distribution that these markets have. In other words, a market in which distribution and consumption is carried out through modern methods, i.e. small cans and non-returnable bottles distributed by independent wholesalers would make vertical integration with the distributor unnecessary and may result in a more open channel in terms of the presence of imports; the “traditional” distribution mechanisms involve the sale of large returnable bottles from very small grocery stores located in each neighbourhood. In this last case, the specialized knowledge and logistic demands imposed by traditional distribution channels make vertical integration with the distribution area necessary.

An example of this is Peru’s case, where the greatest difficulty to be faced by the new competitor will be at the grocery store or corner shop where beer is acquired by the public. In addition, the competitor must use large returnable bottles that are sold in boxes of 12 units, and, therefore, the delivery trucks used must be specially adapted to these circumstances. This adds new difficulties for the entry of new competitors into the market.

On the other hand, the predominance of traditional distribution channels explains the few incidences of market imports, such as in Peruvian case, as its packaging and

distribution system requirements differ from those traditionally used to reach the public.

As already seen, an indicator of these access difficulties to national markets is the fact that new competitors tend to penetrate markets through the acquisition or establishment of alliances with already existing beer companies, with the purpose of using their existing logistic networks. This is the only way to guarantee success regarding market penetration, and must be well supported by marketing strategies and strong advertising campaigns.

In addition, the access barriers already described could be even stronger if the company controlling national sales is a monopoly. This does not mean that the entry of a new competitor in such cases is impossible, but it will obviously be more difficult as it will require larger investments and more time to arrive at an adequate way of accessing certain classes of market. Local companies are aware of this fact, and it would also be possible that one of the processes involving local mergers and acquisitions at local level is bound up with a defensive strategy against the potential entry of foreign competitors.

Considering the structural barriers existing in the beer market, it is possible to suggest as a hypothesis that the existence or not of legislation establishing concentration control may be useful to speed up or slow down the process of access by new competitors to large, structurally complex markets in which companies with monopolistic power can strategically use the economies of scale and scope obtained through market concentration and integration to impede access to potential competitors.

Such a strategy, however, would not be applicable to small markets that would be individually unattractive to new competitors, unless they were highly concentrated, had high prices and low per capita consumption indicating significant opportunities for expansion. In such a case, behavioural control by itself would be enough to uphold the market dynamics, and the structural control could be reserved for regional markets when integrating two or more countries with smaller markets.

4.3. Causes and reasons for regional integration

The same entry barriers affecting companies involved in industries such as the beer industry, also generate incentives for local companies, whether middle- or small-sized, already participating in the market, to form strategic alliances or concentrate operations so as to create efficiencies and manage to survive within a context of constant threat from larger regional companies.

Enforcing competition in markets such as the beer industry proves to be expensive. Thus, the tendency is to establish alliances and relationships between Latin American beer companies and large globally based breweries, mainly from the United States and Europe. As there could be many causes for concentration and strategic alliances, we will mention those that can provide comparative and competitive advantages to the region.[22]

Access to new technology: Technological advances in the beer sector are essential for the processes of beer production and distribution. These advances are more appreciated in developed countries where companies generate economies of scale through more efficient processes that reduce production costs per product unit. Regarding distribution, integrated logistic systems in a wider chain of distribution help to achieve better efficiency by expanding the range of products. Integration, accordingly, may seek to obtain better technologies through alliances established between beer companies with a worldwide presence and other local or regional companies, such as the Dutch case involving Heineken, which acquired part of Quilmes by providing the technology to create more efficient productive processes in exchange for greater penetration of the European trademark into one of Latin America's largest markets.

Optimization of productive processes: Where relatively low-level consumption occurs, local beer companies need to optimize usage of supply capacity, and this is usually done through the process of concentration. This need to optimize production also leads to expanding of trademarks and developing new products in order to stimulate demand. This process includes the exchange of information and technology with international beer companies, as well as geographic expansion towards regional and international levels. In this way, the companies will seek to achieve economies of scale in production and economies of scope in the distribution.

The existence of an economic niche in Latin America: The beer companies consider the region as being promising, not only for the traditional preference for this kind of beverage, but also because of the climate. Larger beer companies, as well as local companies, support their investment policies because of the consumption potential offered by the region. Even a small business may achieve a greater market share through a strategy of expansion with already existing companies. For example, Heineken,[23] Miller Beer and Anheuser Busch, the first one from the Netherlands and the last two from the United States, have entered the region since 1994 in this way rather than making direct investments.

Access to an established distribution network: A company has several options to enter a new market, such as taking over or merging with an existing company with the purpose of rapidly achieving knowledge of a regional market (gaining years of experience) and obtaining easy access to a distribution network that is already established and operative. Similarly, strategic alliances among breweries reduce the possibility of committing errors in emerging, but yet unknown, markets of great potential. Another alternative may be starting from scratch (greenfield investment); however, this strategy needs large investment in infrastructure, as well as knowledge of the local market (involving time, research efforts and clients willing to try out new products). For example, the launching of Bara's Soberana trademark from Panama cost US$ 15 million over 2 years without achieving local distribution, in addition to US$ 4.2 million annually for ensuring consumer awareness of the trademark.[24]

Achieving international competition: The integration phenomenon as well as the mergers of regional beer leaders are in turn helped by the desire to avoid expensive rivalry with their global competitors. Integration allows commercialization and distribution of national trademarks in a foreign market, as well as the distribution of associated trademarks at local level, achieving more efficient competition against other international competitors. At the same time, it means savings in import costs, transport and tariffs. In conclusion, competition is currently considered at international level rather than at country level.

Time for market entry: Installing the infrastructure for beer production is time consuming. For example, it took 3 years for a beer in Cost Rica to achieve a 5 per cent of market share after its entry into the market. The launching of Brahma products in Brazil took 2 years after starting up production. It is not only a matter of time, but also of product quality and its acceptance by local consumers. Using the experience of a company already participating in the local market can save all this.

Strategy: Considering the fact that the entry to a market with a new trademark implies sunk costs, it is easier to do so through mergers, license concessions or joint ventures with companies already participating in the market that have established and accepted trademarks.

5. Latin America institutional framework

5.1. General framework

Historically, local authorities have developed two regulatory mechanisms clearly differentiated in competition matters: behavioural control and structural control.

Behavioural control applies to anti-competitive conduct after it has been observed (ex post control), with the purpose of determining its illegality and to impose sanctions and corrective measures accordingly, in order to remedy the damage caused to competition. It applies to anti-competitive agreements, such as cartels (price fixing, market sharing and the like) as well as abuse of market power by a dominant firm.

On the other hand, structural controls are ex ante controls, with the purpose of evaluating the potential anti-competitive effects of a business concentration operation (merger or takeover) before its occurrence, in order to decide whether or not it must be prohibited, or if it must be made subject to determined conditions. This mechanism for previous evaluation allows the avoidance of costs that would be generated by those companies if they were obliged to "split" after the concentration operation has been completed. It also allows balancing the efficiencies sought by the concentration against the laws of competition it would provoke.

Local authorities may also have mechanisms allowing the evaluation of restraints that would result in distribution agreements (exclusive clauses, fixing of minimum selling prices), but this may also be feasible in the framework of behavioural and structural controls.

In order to establish the possible relationships existing between the institutional frameworks of competition law and the beer market conditions in a selection of countries, we will divide them into three groups according to the regulation mechanisms developed in their respective legislation:

- Countries with behavioural and structural controls
- Countries with behavioural but no structural controls
- Countries with neither behavioural nor structural controls.

5.2. Countries with behavioural and structural control

5.2.1. Argentina

The Competition Law (Law 22.622) governing Argentina from 1980 to 1999 only established behavioural controls governing the National Commission for the Defence of Competition. The Law for the Defence of Competition (Law 25.156) by means of which concentration control was incorporated into Argentine legislation was promulgated in 1999, establishing the obligation to notify the appropriate authorities of any economic concentration operations with synergistic results, which exceed the size provided by law. Law 25.156 also prohibits conduct the purpose or effect of which is to limit, restrict, distort or twist competition or market access or that may constitute an abuse of market power by working against the economic public interest. The entity in charge of applying Law 25.156 is the National Tribunal for the Defence of Competition.[25]

5.2.2. Venezuela

In Venezuela, the law for promoting and protecting the free exercising of competition has been in existence since 1992, and is enforced by the Superintendency for Promotion and Protection of Free Competition – PRO-COMPETENCIA. This law contains a general prohibition of all conduct or contracts that limit free competition, while different articles of the law specifically cover stated unlawful business practices such as collusive and exclusion practices, abuse of dominant position and the previous control of economic concentrations.

With respect to the previous concentrations control, Regulation 2 of the aforementioned law establishes the application of an authorization procedure for those economic concentration transactions exceeding a specific volume of companies, to be established by PRO-COMPETENCIA. Likewise, the said Regulations establish, in general, the principles to be considered by such an entity when evaluating the effects that a specific transaction of economic concentration may have on the market.[26]

5.2.3. Panama

In Panama, the governing law since 1996 is Law 29 by means of which rules and other measures regarding competition defence are dictated, and the Executive De-

cree 31 of 1998, which is enforced by the Commission for Free Competition and Consumer Affairs – CLICAC. In general, this law sanctions any act, contract or practice, which limits or restricts free competition in the production, processing, distribution, supply or commercialization of products or services. In particular, it sanctions market abuse of dominant position, as well as those arranged agreements and practices that restrict free competition, by classifying the unlawful practice in antitrust, absolute and relative practices.

The law referred to above establishes a previous verification procedure for those economic concentration operations, such as mergers, control acquisition or any other grouping operation among suppliers, clients and other economic agents who compete among themselves. Likewise, it prohibits economic concentrations whose effect is or could be reducing, restricting, damaging or preventing, in an unreasonable manner free economic competition and free concurrence of equal, similar or substantially related products and services.[27]

5.3. Countries with behavioural control but no structural control

5.3.1. Peru

Since 1991, Peru has a law prohibiting monopolies, controlling and restrictive practices of free competition (Legislative Decree 701 and its amendments), which establishes sanctions against arranged agreements and practices that restrict competition as well as the hypothetical abuse of dominant position in the market. Its enforcement is carried out by the Commission for Free Competition of the National Institute for the Competition Defence and Intellectual Property Protection – INDECOPI. The law is limited to the prohibition of certain anti-competitive behaviour expressly provided by law and to impose fines in those cases where a violation is verified. Except for the electricity sector, Peru has no general legislation for structural controls on mergers.

5.4. Countries without behavioural or structural control

5.4.1. Bolivia

Although Bolivia has been discussing competition rules since 1991, when it adopted CAN Decision 285, the country has not yet adopted any competition legislation establishing either behavioural or structural controls. It only has general provisions contained in its Criminal Code and Commerce Code and sectoral rules for markets, such as electricity, sanitation, telecommunications and transport (De Léon).

5.4.2. Guatemala

Guatemala has no specific law establishing either behavioural or structural controls under specialized authorities on matters of competition defence. It only has some provisions contained in the Criminal Code and Commerce Code on prohibition of monopolies, cartels and unfair acts, as well as sectoral rules for energy, bank and

telecommunications markets. However, a Competition Law Bill is now in discussion in the Guatemala Congress.

5.4.3. Ecuador

Similarly to Guatemala and Bolivia, Ecuador has no specific regulation on competition defence matters. In 2002, a Competition Law passed by the Ecuadorian Congress (which included behavioural and structural controls) was challenged by the President of the Republic.

6. Conclusion: behavioural control, structural control, both or neither

As mentioned earlier, it appears that no clear relationship exists between the different institutional models of application of competition legislation and how the beer industry of the countries under analysis has developed. The kind of alliances and business reorganizations that took place do not appear to be related to such legislative action.

The same can be said with respect to the level of prices in the beer industry. As shown in Table 2, although there are huge price differences among the different countries, it is not easy to identify any correlation between price and the institutional model of competition legislation in each country

However, this may not be surprising. Competitiveness depends on several factors of which only one, and probably not the most significant, is the existence of a specific model of competition legislation. It must be added that adequate application and implementation of such legislation, regardless of the model each country may adopt, could generate a greater or a lesser impact. Therefore, neither is it surprising that in some cases a merger control decision has favoured the competitiveness of one country to the detriment of another. The evaluation of the advantages and disadvantages of the analysis made in each case by the competent authority is beyond the scope of this study. The information is too scarce due to the few cases filed, although the the industry is probably the leader in the region in terms of cases filed by the competition authorities.

Nevertheless, there are several common characteristics that appear to be indicative of the kind of problems that arise and of the best policy to be adopted according to the different situation that pertains within each Latin American country.

As already mentioned, a possible public policy option would be to give priority to market deregulation and the reduction of existing access barriers (bureaucratic and logistic), leaving the resolution of cases of abuse of dominant positions and unfair competition to private actions before the courts. To have a competition law does not mean one has a magic wand that allows the creation of competitive and efficient business, but a market that encourages competitiveness, together with an efficient judiciary to solve conflicts that may arise, might suffice to discipline companies involved.

However, this is an idealistic solution and is not in accordance with the reality of Latin American markets. Justice administration is exercised under poor conditions, slow and formalistic processes, and judges who are without enough experience of competition matters, overburdened by regular proceedings, subject to corruption and suffering from limited resources.

This reality leads us to point out that Latin American countries require at least a competition agency allowing them to sanction anti-competitive behaviour, i.e. restrictive agreements, abuses of dominant positions and unfair competition that may affect competition and the entry of new players into the market. This is obvious in cases filed in Venezuela and Peru, where it can be seen how the companies already in the market act strategically to make it difficult, in one way or another, for new competitors to access and remain in the market. There are several ways to make access difficult for new companies, mainly through exclusion agreements regarding distribution, as well as through the creation of obstacles in using the packaging necessary for distribution of beer to consumers. As the research on these matters is somewhat complex, it is better to leave it in the hands of specialized agencies, such as the competition agencies.

However, is it enough to have one specialized competition agency capable of sanctioning unfair and anti-competitive behaviour, or is it also necessary that the competition agency exercises a preventive control of the economic concentrations that may affect market competitiveness? The beer market is precisely one that tests this option.

Latin American markets, in general, except for Argentina, Brazil and Mexico, are small and even smaller in Central America. Local companies in these countries may reasonably initiate expansion and economic concentration processes with the purpose of achieving efficiencies by obtaining economies of scale, reach and scope. This is a factor that we must take into consideration, since survival of these local firms in increasingly competitive international markets may depend on the adoption of a concentration policy. In this case, the main thing to do is to monitor these companies, so as to avoid unfair and anti-competitive conduct, in addition to providing legal mechanisms that allow them to generate efficiencies.

Behavioural control is the most important control in these markets. As we have already seen, the beer market has great possibilities for expansion due to its low consumption at per capita level in most of the countries under study. Large regional beer companies are very interested in entering in new markets, even if they are small. Therefore, it is foreseeable that these markets will become more competitive in the coming years. This could also happen in Peru, a country that only has behavioural controls, if the entry of the AmBev Group into the market finally materializes and it manages to take a portion of the market from Backus, which is controlled by the Bavaria and Polar groups.

On the other hand, local authorities, yet inexperienced in handling structural control mechanisms, might wrongly apply them. In effect, as Rodríguez notes (1998: 17): “The potential competition doctrine, by its nature, presumes that market concentration in closely concentrated markets is related to problems of competition, while concentration which tends to be a necessary matter of concern in competition is not a sufficient condition. Brazil’s beer market is an interesting example of bad use given to statistics on concentration. While Brama had 46.6 per cent of the market and Antarctic 31.9 percent in 1995, this participation has decreased from 50.3 per cent to 40.8 per cent, respectively, in 1989. During this period, the largest third beer had increased its participation from 0.2 per cent to 5.5 per cent. These changes suggest the existence of a substantive competitive threat from the existing competitors against leader companies.”.

It is possible for antitrust authorities to make mistakes when analysing the efficiencies that the concentration approach is looking for, as has happened in controversial cases, even in industrialized countries. Lack of experience, political pressure and regulatory agencies with little institutional framework in Latin America may multiply the possible errors.

It is not recommended to adopt merger controls in the case of those Latin American countries where markets are still small. Notwithstanding, as the tendency towards competition at large regional company level is increasing, it would be advisable to establish merger controls at regional or sub-regional level, in order to make it possible to maintain competition incentives within the regions, in addition to obtaining greater integration of the local markets of Latin American countries.

As already indicated, the available information does not suggest an alternative development of the markets, whether with concentration control or not. If we add to this, the existence of competition authorities with little experience and few resources, it probably would be advisable to have them concentrate on behavioural controls, thus releasing us from any risk of error that could make competition legislation become a delay factor for the development of competitiveness.

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Table 1. Institutional framework: Latin American countries.

Country	Structural control	Behavioural control	No structural/no behavioural control
Argentina	Yes	Yes	-
Bolivia	No	No	Yes
Brazil	Yes	Yes	-
Colombia	Yes	Yes	-
Costa Rica	Yes (ex post)	Yes	-
Chile	Yes	Yes	-
Ecuador	No	No	Yes
Guatemala	No	No	Yes
Mexico	Yes	Yes	-
Panama	Yes	Yes	-
Peru	No	Yes	-
Venezuela	Yes	Yes	-

Source: Annual Reports of Quinsa, Bavaria, AC Nielsen and AmBev, and market information.
Own elaboration.

Table No. 2 Beer Prices in Several Latin American Countries (US$)

Country	Litre	Bottle 620 ml
Guatemala	1.380	0.8556
Honduras	0.8247	0.5113
Nicaragua	0.7725	0.4790
Panama	0.7526	0.4666
El Salvador	0.7503	0.4652
Peru	0.6700	0.4154
Colombia	0.5400	0.3348
Bolivia	0.5254	0.3257
Venezuela	0.5140	0.3187
Uruguay	0.5127	0.3179
Ecuador	0.5111	0.3169
Chile	0.5092	0.3157
Brasil	0.4140	0.2567
Paraguay	0.4065	0.2520
Argentina	0.2240	0.1389

Source: Annual Reports by Quinsa, Bavaria, AC Nielsen, AmBev and market information
Own elaboration

Table 3. Concentration rates in selected Latin American countries.

Country	Concentration rate (HHI)
Venezuela	5400
Panama	6025
Argentina	7234
Peru	9604
Ecuador	9801
Bolivia	9801

Source: www.ambev.com.br, Promar International (2000).
Own elaboration.

Chart 1. Most popular beer brands by socio-economic class.

Favourite Beer Brand					
	Total	Socio-economic class (per cent)			
		A	B	C	D\E
Cristal	71	22	49	75	79
Pilsen Callao	16	36	25	16	12
Cusqueña	9	34	22	7	4
Others	3	6	4	1	5
None	1	2	0	1	0
Real base	427	47	138	139	102
Weighting factor (per cent)	100	4.3	15.7	33.7	46.3

Total: 100 per cent vertical.
Base: Total of interviewees of legal age who buy beer.
Source: Apoyo Opinion y Mercado S.A.

Chart No.2

Beer Favourite Brand					
	Total	Socioeconomic Level %			
Answers		A	B	C	D\E
Store	74	15	54	76	84
Supermarket/self-serv.	11	64	33	8	1
Bar	5	2	2	4	7
Liquor store	5	17	5	4	4
Others	5	2	5	7	4
No opinion	0	0	1	1	0
Real Base	427	47	138	139	102
Weighting Factor	100%	4.3%	15.7%	33.7%	46.3%

Total: 100% vertical.
Base: Total of full age interviewees who buy beer
Source: Apoyo Opinion y Mercado S.A.

Notes

1 For the purposes of this study, legislation or competition rules are understood to be those rules usually referred to as “anti-trust”. Therefore, other related rules linked to market matters, such as unfair competition, consumer protection, dumping, subsidies and the like, are not dealt with herein. On the other hand, the concept of competition policies shall be used in a wider sense when referring not only to antitrust legislation but, also, to measures adopted to create greater competition, such as economic opening, bureaucratic barriers elimination and procedures.

2 By behavioural controls, we refer to those prosecutions of anti-competitive arrangements (mainly cartels) and sanctions for the abuse of a dominant position or market power (refusal

to deal, prices and terms discrimination, binding clauses and the like), as will be seen later.

[3] 148 F. 2d 416 (2d Cir. 1945).

[4] Commenting on Ronald Coase's "The Nature of the Firm" and Oliver Williamson's "Markets and Hierarchies: Analysis and Antitrust Implications".

[5] Commenting on Ronald Coase's "The Nature of the Firm" and Oliver Williamson's "Markets and Hierarchies: Analysis and Antitrust Implications".

[6] Subject 322/81 Michelin *v.* Commission (1983). Rep.3461.

[7] One of the problems undermining internal markets competitiveness in Latin America is the deficiency and, even in some extreme cases, the non-existence of a logistic chain (ports, roads, means of transport and technology) that may allow an efficient connection of markets among themselves. This is reflected in structural access barriers that make local markets less competitive due to the lack of adequate structure for the development of production and commerce, which constitutes an important point in the countries' governments' agenda and that in our opinion is related to more general competition policies, outside the scope of this chapter.

[8] Given the large quantities of beer produced and the short expiry dates, efficient distribution of beer will also be able to support such conditions.

[9] We consider Latin America as America ALAFACE, since its members are mainly countries of the region: Brazil, Mexico, Venezuela, Colombia, Argentina, Peru, Chile, Dominican Republic, Ecuador, Bolivia, Paraguay, Guatemala, Panama, Costa Rica, Honduras, Uruguay, El Salvador and Nicaragua. American countries outside the ALAFACE sphere are the United States, Canada, Cuba, Jamaica, Guyana, Puerto Rico, Trinidad and Tobago, Haiti, Bahamas, Holland Antilles, Surinam, Santa Lucia, Belize, Barbados, Martinique, San Vincent, Granada, Antigua, San Kitts, Dominica and the Cayman Islands.

[10] "Likewise, a huge operation allows equipment and machinery specialization in contrast to the small-scale use of multipurpose machinery (Carrillo and Kocnim, 1993: 35)

[11] In Latin America, several alliances have been taking place between beer companies at regional and continental level (i.e. Bavaria from Colombia and Regional from Venezuela).

[12] Dictamen Con. No.376. Operación de Concentración Económica Cervecería y Maltería Quilmes y Companhia de Bebidas das Américas S.A. Buenos Aires: 2002.

[13] *Ibid.*

[14] *Ibid*.

[15] "Beer Industry in Peru (La Industria Cervecera en el Perú") Apoyo Consultoría. Lima, 1995.

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[17] BACKUS Memory 1999.

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[19] Apoyo y Asociados. Op. Cit.

[20] www.ambev.com.br.

[21] Resolution No. SPPLC/004-2002 of 1 February 2002 PROCOMPETENCIA.

[22] Sources include the ALAFACE web site (www.alaface.com) and the main newspapers from Latin American countries.

[23] The Spain Competition Court, when the rejected Heineken and Cruz Campo concentration was being considered: "The perspective of slow demand expansion is one of the players that are conducive to a concentration process in the Spanish Beer market" File of economic concentration c 44/99 Heineken – Cruz Campo.

[24] Resolution No.139-02 dated May 15, 2002. Concentration Process Bavaria Group–Cervecería Barú Panamá. CLICAC. P. 122-123.

[25] National Commission for the Defence of the Competition web site – CNDC. www.mecon.gov.ar/cndc.

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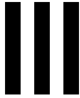
[27] Web site of the Commission for Free Competition and Consumer Affairs – CLICAC. www.clicac.gob.pa.



Competition policy as a stimulus for enterprise development

III.1. COMPETITION POLICY AS A STIMULUS FOR ENTERPRISE DEVELOPMENT

George K Lipimile

Framing the issue

"Competition is always in danger. Since it is uncomfortable or even threatening, business tries to avoid it. To use a metaphor: Competition is not a weed that grows even if left alone; rather it is a cultural plant and needs continuous government attention".
Lachmann (1999: 19).

1. Introduction

Prior to 1990, most of the Southern African countries witnessed deterioration in their standard of living arising from the general decline in their countries' economic performance. Despite economic reforms of the late 1980s and 1990s, these countries continued to face the challenge of growing and diversifying their economy, while simultaneously addressing widespread and worsening poverty levels.

One of the widely recognized principal obstacles to economic growth has been a strong government presence in business through the huge parastatal sector, which was estimated to represent over 80 per cent of the industrial and commercial activities of the country. An evaluation of these economic arrangements proved that the parastatals were not contributing to sustainable economic growth and their contribution to the treasury was negligible in relation to the huge investment they represented. The parastatals were also not sustainable business ventures and in most cases required government financial support. The governments of these states, therefore, saw it as prudent to reverse the *status quo* by making fundamental changes in the organization of economic activity supported by the economic liberalization policies of the World Bank and the IMF. The timing and extent of these liberalization measures has varied between countries. The measures resulted in widespread privatization, deregulation and internal and external liberalization.

In most Eastern and Southern African states, the history on the enactment of competition law is still very recent. The advent of economic and political liberalization in the region, dating from the 1990s, witnessed far-reaching market-oriented reforms leading to considerable diminution in the direct role of the State in economic activity. The central theme of this process was the switch from the system of central planning or control of the economy to the use of market forces as the means to allocate resources. It was anticipated that the "free play" of supply and demand would, in the long run, determine market prices throughout the economy, allowing productive resources to be allocated in an efficient manner. Structural adjustment programs were adopted that included market-oriented reforms notably in the areas of deregulation of prices, including the reduction or elimination of subsidies, administrative allocation of key product inputs, privatization of public enterprises or state companies, as well as the liberalization of trade and investment regimes. The common aspiration underlying these reforms was that reduction of government's direct involvement or intervention in economic activity would, by providing enterprises with more freedom and stronger incentives, stimulate entrepreneurial activity, business efficiency, productive investment and economic growth. It was also seen as a means of enhancing consumer welfare through improved quantity and quality of goods and services at prices determined by the market rather than by administrative decisions. It was accepted that market liberalization within appropriate regulatory and competition frameworks is essential to sustain enterprise development.

In recognition of the major role of competition law and policy in the success of the policy reforms, governments adopted competition policies and enacted competition laws. For example, in the COMESA/SADC region, there are now six countries out of 22 that have adopted competition laws, most of which were introduced in the 1990s. Competition rules were primarily designed to preserve an unrestrained interaction of competitive forces that will yield enterprise development through the efficient levels of investment in discovering new production technologies, new production processes and new products. The role of competition law and policy was, therefore, seen to provide strong incentives for achieving enterprise development through:
(i) Enhancing market access for new investors
(ii) Protecting the economy from restrictive business practices
(iii) Fostering economic efficiency and consumer welfare.

Lack of adoption of an appropriate competition law and policy, and the continued protection of vested interests in developing countries has tended to have the negative effect of hindering enterprise development. This has resulted in lack of innovation, increase in costs of production, slow adjustments and destruction of jobs.

This chapter seeks to provide a general overview of how national competition policy promotion and the related challenges faced by developing countries have furthered enterprise development. The paper starts with a brief discussion on the need for the adoption of competition law and policy by developing countries[1] (with an emphasis on the COMESA region). The chapter further discusses some of the prob-

lems encountered during the introduction of competition law and policy in these economies. Firstly, how has competition interacted with other enterprise development policies such as privatization, investment and small, medium and micro-enterprises (SMMEs) policies? Secondly, to what extent do anti-competitive or exclusionary practices inhibit enterprise development? To answer these questions, the chapter reviews a number of cases illustrating how the major elements of competition law, as contained in most legislation of developing countries, had an impact on enterprise development in the Eastern and Southern African countries. This has been illustrated by anti-competitive cases dealt with, particularly by the Zambian, Kenyan and Zimbabwean Competition Authorities.

2. A case for competition law and policy

After the transition to market economies, developing countries realized that the benefits of market-oriented reforms were likely to be fully realized only if enterprises acted under the spur of competition, to create a level playing field by reducing barriers to entry which originate from anti-competitive practices and that consumer wishes and opinions were reflected in market performance. It was further recognized that countries that had undertaken trade liberalization measures had every interest in ensuring that the welfare and efficiency benefits arising from such measures are not lost due to anti-competitive practices by firms. A well-functioning market mechanism is essential in this respect. For example, price liberalization in the market dominated by monopolies in the form of parastatal companies, unless specific efforts are made to ensure the existence of competition, will end up with monopolistic price rises without corresponding competitive price equilibrium. For the least developed countries, the poor benefit directly from lower prices of the staple food. It is now accepted that there is a link between measures to enhance competition in developing countries and economic growth. However, empirical evidence from most developing countries on mechanisms through which competition policy contribute to enterprise development is rather scarce.

Competitive markets enhance the welfare of the general community by fostering efficiency in production. Competition offers the promise of lower prices and improved choice for consumers, higher economic growth, and increased employment opportunities. This is why almost all developing countries are giving their full support to the enactment and the establishment of a strong and effective competition policy in their countries.

The ultimate objective of competition is the promotion of economic efficiency. In developing countries, competition policy has greatly assisted in bringing about the desired economic growth by introducing competitive measures and policies, which promote economic efficiency by eliminating business practices which harm economic efficiency. Competition policy "establishes broad principles that are designed to preserve an unrestricted interaction of competitive forces that yield the best allocation of resources, the lowest prices and high quality products and services for customers".[2]

In other words, competitive markets will enhance the capability of enterprises in developing countries "to produce goods that consumers need, in the quantities they need, applying the most efficient production methods and marketed and distributed in the most efficient manner". [3]

It is through the introduction of competition in the markets of developing countries that enterprises will be compelled to re-invest in new production technologies, new production processes and new products. The promotion of productive, allocative and dynamic efficiency will make enterprises in developing countries achieve economies of scale, enhance international competitiveness and promote Research and Development capacities. At the same time, it should be recognized that it is not always the 'economies of scale' or the 'critical mass' that encourage enterprises to compete internationally, it is also important that there is domestic rivalry rather than national dominance to create enterprises that are internationally competitive. Competition stimulates increased efficiency in innovation, production, and resource use, which in turn leads to enterprise development and increased aggregate welfare. Further, competitive markets provide macroeconomic benefits. Competition provides enterprises with incentives to adjust to internal and external shocks, and these individual adjustments help reduce the cost of such shocks to the macroeconomy. [4]

3. Scepticism about the implementation of competition law and policy

Misconceptions, legitimate concerns, and in some instances, controversy have continued to persist regarding the introduction and enforcement of competition law and policy in developing countries.

There is still lack of clarity on the interface between industrial and competition policy. The two policies have tended to give incompatible objectives in their implementation. Whereas industrial policy may generally address the government's support for specific industries, mostly by enhancing economic consolidation and intervening in specific market sectors, competition policy on the other hand, tends to be more universally applied to all sectors of the economy, to protect the general competition process and not particular competitors. This is in contrast with the industrial policies of developing countries that justify the unequal treatment of various economic actors in order to achieve economies of scale and gain efficiency.

In most developing countries, competition has not been fully accepted as an economic tool. It is regarded as a 'foreign' concept brought about by the conditionalities of the World Bank and the IMF. To most developing countries, trade liberalization is largely perceived to be one of the IMF and World Bank retaining policies threatening their national policy space and largely favouring and being supported by multinationals. Given the unpopularity these policies are currently receiving in most developing countries, the introduction of competition has also continued to receive negative comments. As one newspaper wrote: "the acceptance of these World Bank and IMF terms is clearly a very painful decision by our government. We share the bitter feeling of impotence that our government has in the face of these problems and difficul-

ties… We say this because the programmes and policies the IMF and the World Bank have been imposing on us and other poor countries have brought misery and social upheavals”. [5]

The overarching challenge confronting competition authorities in developing countries, as a result, relates to their stature and standing within the ranks of key stakeholders or interest groups as well as the public at large. They all, in other words, struggle with correcting the various negative misconceptions and it is this that constitutes the gravest challenge confronting competition authorities in developing countries. I shall attempt to reduce this diverse range of problems to a few main ones, which continue to cause difficulties to the implementation and enforcement of competition law and policy by competition authorities.

Box 1: **Support for the establishment of competition law and policy in the COMESA member states**

“The local business communities of most Southern African states do not share the idea that effective competition shall bring about the desired economic development in their respective countries. Results of interviews with businessmen and government officials in different COMESA member states showed that there was lack of knowledge or understanding of competition law and policy. Many were undecided about whether their governments should divert resources from other scarce priorities to introduce competition law and a competition authority in their country. With some exceptions, such as Kenya, Zambia and Zimbabwe, citizens were not even convinced that lack of a regional competition policy constituted an economic problem worthy of their respective government’s attention. While countries with national competition legislation were more likely to cite competition law and policy as an important economic tool, those who lacked the legislation were less likely to see competition as an important issue. The survey was carried out in the 22 COMESA member states”.

Source: COMESA Consultancy Report on the establishment of the Regional Competition Regulation, 2002

The introduction and enforcement of competition law and policy in developing countries has generated public concern. This disquiet has arisen because most developing countries have yet to acknowledge the role of competition in development. They do not see the benefits of competition to their fragile economies. “Developing countries have continued to argue that the enacting of competition law is a low priority worth considering only after other more urgent policy measures have been introduced”. [6] The policy makers did not appreciate that the introduction of competition was necessary for rural development and is one way to reduce poverty and hunger. Access to employment, education, health and social services still remain the major issues of concern. It is important in this regard to remember that most African states have pressing issues related to health, education and poverty alleviation and have to develop programmes in these areas. Further, it is also argued that there are equally important policies that promote competition without necessarily enacting a specific competition legislation and establishing a competition authority. This argu-

ment refers to other policies, such as liberalization of international trade, privatization and deregulation.

It is further evident that in most developing countries, competition policy is heavily overshadowed by the need to protect local industries. Many of these countries will strongly entertain the protection of certain industries under the misguided notion of "destructive competition". Their Governments continue to shield certain industries, especially those owned by Government, from competition pressures. This also relates to the question of unequal competition between large multinational corporations and domestic companies in developing countries. It is argued that the playing fields are tilted in favour of multinationals that invariably have considerable market power. On the other hand, the multinationals have accused governments of not creating a level playing field between themselves and national firms, which are government supported, hence the multinationals' demand for 'national treatment'.

It is generally felt, and rightly so, that local industries are not strong enough to withstand competition from foreign companies operating in the same markets. They strongly argue that free markets will result in the demise of local industries. The markets of the developing countries are characterized by inefficient technology that can be easily displaced by the superior and efficient technology of foreign firms entering the market. If trade protection were to be removed, these firms would collapse, as they cannot stand international competition. The introduction of competition into such weak economies would further limit their ability to base their economic development on the promotion of national champions or the development of local entrepreneurial capabilities and other industrial policy considerations. In a nutshell, protectionism of local industries is deeply rooted and highly publicized by the local community and local business. This is a matter of vested interests. The argument continues to receive great support from the politicians and non-governmental organizations (NGOs).

The above arguments have been in most instances used to justify why governments in developing countries should give industrial policy precedence over the need to effectively enforce competition law and policy. As a result, competition systems in most countries in the region continue to be distorted by the Government through regulations, interventions and lack of effective infrastructure.

On the other hand, it has been difficult, in those countries that have embraced the concept of competition law and policy, to clearly demonstrate convincingly that "competition works" in such economies and to show the actual benefits. The question is how does one explain the occurrence of a particular phenomenon and attribute the positive outcome to the enforcement of competition law and policy. It has become imperative for developing countries to show the positive effects of competition enforcement on the markets.

In summary, for the creation of competitive industries in market-driven economies, new competition regimes should not introduce just another form of regulation

of the market. A competition regime, however, will only bring positive results if it is part of a broader industrial policy framework, which includes deregulation, trade and investment regulation, and privatization.

It is important to understand that competition is one among several other tools which government can utilize to bring about economic growth. Competition as an economic policy tool can be used in isolation or in combination with other policy tools, i.e. privatization, investment and deregulation. However, competition policy has an extensive interface with other government policies. The nature of this interface may be such that the aims of different government policies can be complementary, or be in conflict with competition policy. The presence of any form of government intervention on the other hand can be a factor taken into account in competition analysis.

4. Competition and privatization

In many instances, the objectives of the competition policy have always been in conflict with the desired objectives of privatization. In most developing countries, privatization, like competition, was strongly encouraged if not required under structural adjustment programmes of the World Bank and the IMF.

The uncoordinated approach by developing countries in the introduction and implementation of the privatization policy on the one hand and the competition policy on the other has continued to undermine their value in economic development. In most COMESA/SADC countries, the emphasis on the privatization programme initially overshadowed the need to address competition issues during the early stages of the liberalization programme. The delay in the introduction and implementation of competition laws resulted in a situation where the privatization of public companies had already commenced and was almost complete. The reason for this is simple. The World Bank, who dictated the structural adjustment programme, at the time and even up to now, had failed to recognize and appreciate at the time of implementing the privatization programme that the two programmes are complementary and that they should commence and be implemented at the same time.

Consequently, it was too late when it was realized during the privatization process that if the sale of state-owned enterprises does not take into account the competition principles, the whole privatization process would end up turning the state mo-

Box 2: Competition *versus* privatization

"The IMF argues that it is far more important to privatize quickly; one can deal with the problems of competition and regulation later. But the danger is that once a vested interest has been created, it has an incentive, and the money, to maintain its monopoly position, squelching regulation and competition, and distorting political process along the way… Whether the privatized monopolies were more efficient in production than the government, they were often more efficient in exploiting their monopoly position; consumers suffered as a result".[7]

Source: Stiglitz (2002).

nopoly into a private "hard-core" monopoly. This has now caused great worry to many governments. There was also a thorny issue of local participation of the indigenous people in the purchase of public companies. It was evident that the local people had no readily available local capital to purchase these companies. Further, it was realized that most of the indigenous people did not have the financial muscle required to buy these companies and later on invest in the capital goods and technology required to operate larger companies. In spite of these constraints, governments were still committed to the implementation of the privatization programme. The privatization programme above all, has become the most viable tool for attracting foreign direct investment in most developing countries. This is because it is multinational firms that participated in the privatization policy and bought most of these public companies.

The manner of sale of these public companies remains a major concern to competition authorities. In most developing countries, there was failure on the part of the policy makers to integrate the competition principles in the formulation of the privatization process. Firstly, there was a need for the privatization policy to clearly specify that during the privatization of state-owned enterprises, the privatization modes of sale chosen should ensure that monopolies are not created. Consequently, the privatization authority should be obliged to consult the competition authority on the competitive position of the market when selling a company, and/or there should be a provision to compel it to take into account competition considerations.

Secondly, there is a need to remove policy conflicts in the manner of sale of public companies. For a privatization authority, it does not matter to whom the privatized company is sold or whether such a sale will lead to a concentration which will create or strengthen a dominant position. Whereas for a competition authority, the important consideration is whether or not such a sale shall impede competition in the market. The privatization agency will seek to obtain the highest price for a state enterprise on sale. The competition authority will be concerned about the effect or the outcome of such a sale on the market. It is now accepted that it is not ownership *per se* which is the main determinant of economic performance, but rather the degree of competition in the market.

In this overall context, it is not difficult to accept why the need for competition policy becomes crucial in the privatization process. In the new privatized domestic economic environment, competition and regulatory policies become essential. The failures of the privatization programme and its unpopularity among policy makers has continued to impact negatively on any benefits associated with the introduction and enforcement of competition law and policy. The interface between the competition authority and the privatization agency should be clearly defined in the respective policies in order not to undermine each other or bring about a conflict of interests. In the event where both policies are in place, it is important for the policy makers to harmonize them by amending the relevant legislations to overcome this problem.

5. Competition and investment

From the above, it can be seen that competition and investment policies share a broadly compatible underlying rationale: they provide strong incentives for achieving economic efficiency. Both policies provide a framework for encouraging international flow of productive, long-term investment, which contributes directly and substantially to economic and technological development, employment and economic growth. Investment policy measures include microeconomic policy measures such as restriction on foreign direct investment and ownership requirements aimed at enhancing competition in the domestic and regional markets. In fact, a mainstream competition law provides domestic and foreign investors with some assurance that they will find a 'level playing field', thereby encouraging enterprise development and investment in general.

Box 3: General critique of the privatization policy

"To ensure that citizen's rights are protected, governments have the right and responsibility to regulate the national economy. These powers should include the right to protect strategic areas of their economies, finance, energy, and communication by establishing public enterprises. And the right to protect sensitive areas known as the 'commons' – the environment, health care, culture – through government-run public services".

Source: Post Newspapers, Zambia

The effective enforcement of competition law and policy is an important element of a successful industrial strategy since it opens up markets and places appropriate pressures on producers to become more efficient. In addition, the existence of a competition policy enhances a country's credibility and attracts foreign direct investment since, from the perspective of potential investors, it helps to create a stable and predictable environment. Foreign direct investment provides much needed resources for developing countries. These include capital and intangible assets such as technology, know-how, access to markets, brands, managerial skills and entrepreneurial ability that are essential for developing countries to industrialize, develop and create jobs to alleviate the poverty situation in their countries.

On the other hand, competitive market forces ensure that there are sufficient levels of investment in discovering new production technologies, new production processes and new products. Competition encourages firms to perform better since their chances of making a profit increase through innovations or technical advances while penalizing poor performance and inefficiency.

In most developing countries, there is usually specific legislation dealing with the investment policy of the country. It is important to note that FDI has been growing rapidly in the world to the extent that 'investment' has become the principal organ

linking economies of the developed countries to a number of national economies of developing countries.

It has become evident that in the hope of creating a competitive environment, certain private-sector policies in the form of investment incentives have discriminated against the local industries or local investors. Most legislation in developing countries provides for certain measurable economic advantages (incentives) to categories of enterprises (mostly foreign firms) and, hence, has caused competition distortions in the markets. These distortions manifest themselves in general incentives such as tax holidays, exemptions from paying duties, site allocations, etc. This should not be mistaken for a case of advocating for the abolishment of incentives to foreign investment. Whenever incentives are offered to foreign investors, there should be a corresponding offer of the same incentives to the local companies. Competition policy requires that the treatment of investors should not be on discriminatory basis. The investment law and policy should be conducive and equally accessible to all enterprises, irrespective of nationality, i.e. whether foreign or local. It is important when awarding incentives to foreign investors that the local investors in the form of local firms enjoy the facilities as well as in cases where they make similar or substantial investments.

Lack of competition considerations in the investment codes has allowed discrimination against local investors. The local industries in developing countries lack access to foreign capital, technological know-how and a competition culture. Most of the investment laws require the local firms to bring into the country capital equipment and finance which is unaffordable if they have to qualify for the incentives. Consequently, it has always been the multinational companies and their affiliates who have continued to benefit from the incentives. This has put local firms without any connection to foreign capital at a competitive disadvantage. The introduction of competition law and policy has provided the disadvantaged local firms with an avenue where they can lodge complaints of unfair competition and receive redress.

In any case, foreign investors are likely to penetrate those markets where they are sure that there will be an effective legal framework to protect their investment. An effective enforcement of competition offers the desired protection.

6. Small, medium and micro-enterprises

There is a growing recognition of the importance of small, medium and micro-enterprises (SMMEs) to the economies of developing countries. The development of SMMEs is important for economic growth, poverty alleviation and the economic empowerment of the local communities. SMMEs tend to be concentrated in relatively labour-intensive activities, so they play an important role in employing the growing labour force and they alleviate the severe unemployment that threatens the survival of the poor.

Most competition laws of developing countries have a specific provision, which addresses the small-scale sector. In these countries, the promotion of SMMEs is set among the overall objectives of competition law and policy. This is because of the realization in developing countries that the development of SMMEs is an important factor towards the creation of jobs, generating wealth and the provision of satisfying carriers for a growing number of entrepreneurs. For example, the competition legislation of South Africa provides that: "the purpose of the Act is to promote and maintain competition in the Republic in order to ensure that small and medium sized enterprises have an equitable opportunity to participate in the economy".[8]

A competition law, which is properly enforced and applied universally across all sectors of the economy, is likely to benefit and market the operations of small firms more efficiently and contribute to the expansion of the SMMEs sector as a whole. However, there may be strong reasons for some developing countries to exclude SMMEs from the application of the law on the basis of objective and non-intrusive criteria. These countries have opted for the protection and nurturing of the SMMEs or have given some form of temporal protection to sunset industries from the application of competition law. The rationale behind this type of protection is often to consolidate the small-scale sector, thereby reducing the negative effect of domestic competition as well as preventing large or dominant firms from driving out the small firms. The Zambian, Malawian and Zimbabwean competition laws, which have included this as their objective, acknowledge that this is: "to expand the base of entrepreneurship".

In view of the weak, uncoordinated and fragmented nature of the SMME sector in most developing countries, it was felt prudent by the governments of these countries to exempt them from the application of competition law in order to accelerate the development of this critical sector in their respective economies. It is recognized that there is need to deliberately formulate policies and programmes whose implementation will eventually promote competition in the SMME sector. The governments also realize that there should be a deliberate policy at specifically integrating the promotion of competition in the SMME sector because without such a policy, the sector will not develop.

The main reason for the exclusion is that the objectives of SMME promotion go beyond the sphere of competition policy. It is realized that the SMME sector is an informal sector, which employs a considerable number of people. The small sector has all along been weak, uncoordinated and fragmented. Operators of small-scale industries are desperately lacking in resource endowments such as finance capital, access to credit, collateral security, as well as in basic artisanal production and business management skills. In this connection, SMMEs cannot withstand competition from multinational firms who reign superior on the market. Consequently, most developing countries have specific legislation on SMME development. These countries have seen the need to enact within their national laws a law which comprehensively addresses SMME issues and which aims to steer the development of a policy for this

sector. In most developing countries the SMMEs have to a certain extent been able to:

- Create jobs at relatively low capital cost, especially in the fast-growing service sector;
- Provide a vehicle for introducing a more equitable income distribution;
- Develop a pool of skilled and semi-skilled manpower as a basis for future industrial expansion;
- Improve forward and backward linkages between economically, socially and geographically diverse sectors of the economy;
- Provide opportunities for developing and adapting appropriate technological and managerial approaches;
- Promote subcontracting arrangements and acting as ancillaries to large-scale enterprises.

However, it should be recalled that competition law aims at facilitating competition among potential rivals by reducing artificial barriers to competition and by allowing market participants to interact independently. Consequently, the protection of SMMEs may in many instances harm consumers and may entail costs for the country. The protection of inefficient firms is deliberately preserved in the market, without any guarantee that these SMMEs will succeed in being competitive and viable enterprises.

It is further important to mention that the competition *de minimis* principle affects the application of competition law to the SMMEs. Most of the competition laws require that for any conduct or practice to be within the ambit of the law, there must be an 'appreciable' effect on competition. An agreement or a practice, which has only a small or minor effect on competition in the relevant market, may be regarded as *de minimis* and, as such, outside the scope of the law. The *de minimis* principle by its limitation nature has the effect of causing the activities of SMMEs to fall outside the scope of competition law. It is common for competition authorities to introduce a quantitative test of appreciability whereby agreements or practices engaged in the production or distribution of goods, or in the provision of services do not fall under the prohibition of the law, if the aggregate market shares held by all of the participating undertakings (SMMEs) do not exceed a given threshold.

Competition has been the main guarantor for the sustained development of the small-scale sector. A successful SMME strategy requires that the SMMEs effectively compete with other operators in the market. The idea of protecting the SMME sector from the general application of competition policy has the effect of having a direct or indirect adverse impact on the development of enterprises in the national economy. However, "The fact that a sector or a firm is partly subsidized or is protected for industrial policy reasons does not mean that competition law cannot, as a matter of principle, be applicable to this sector or this firm. Competition law can be applied to practices which go beyond what is allowed by public authorities…".[9] Competition policy offers an effective mechanism against anti-competitive practices or abusive

conduct by large firms, whether competitors, suppliers or buyers. Consequently, the culture of competition should be embedded in the development and the running of the small-scale sector to enhance enterprise development. Any incentives to this sector should be done through completely separate legislation in order to preserve the process of competition in the economy.

In conclusion, it is not necessary or desirable for developing countries to give any special treatment to small and medium sized firms under their competition legislation because there is already a greater degree of implicit protection of SMMEs in the “rule of reason” approach. This in most cases is in addition to the *de minimis* rule; suffice to mention that hardcore horizontal agreements are prohibited *per se*, regardless of the size of the firm.

7. Main elements of competition law with direct impact on enterprise development

It is now important to look at the main elements of competition law as they are incorporated in the statutes of most Southern African states, while reflecting on how the implementation and enforcement of these provisions has contributed to enterprise development. The three major elements are the merger control provision, the restrictive business practices, and the abuse of dominant position. In general, the foregoing elements of competition law prohibit or provide a means for developing countries to address conduct that may hinder enterprise development. It enables developing countries to use the competition legislation to enhance enterprise development by prohibiting conduct that does, or is likely to, restrict output and increase price, impede market expansion or new entry, reduce product or service quality or stifle innovation. Competition can also prohibit firms from obtaining market power through mergers or any means other than skill, foresight, and industry.

7.1 Merger control provision[10]

In developing countries, mergers, if not properly monitored, can sometimes produce market structures which are anti-competitive in the sense of making it easier for a group of firms to cartelize a market, or enabling the merged entity to act more like a monopolist. This is because in these countries, there are fewer firms in the market; hence, it can become easier for them to collude. However, there is a belief in some countries, particularly those with smaller markets and economies, that merger control is not necessary because it impedes the restructuring of firms trying to obtain the “critical mass” necessary to compete in world markets, and that having a “national champion” even abusing a monopoly position on the domestic market allows it to be competitive in foreign markets. Therefore, merger-control provisions have a crucial impact on market structure and enterprise development in developing countries.

For some of the countries in the COMESA/SADC region, it can be argued that due to the smallness of the economy, and more so to their lack of a strong industrial or manufacturing base, they do not need a merger control regulation. Although this

argument has significant merit, and is gaining growing recognition, the principle has serious shortcomings, which need to be addressed. For example, it has been found that monopolies might enjoy their monopoly rents at the expense of economic development and domestic consumers without necessarily becoming more competitive abroad. Studies have also shown that it is difficult for a business to become more competitive in the global market when domestic competition is weak. Also, other countries, again mostly developing countries, while acknowledging the importance of merger control, feel that they have limited resources to embark on the full merger investigations required for effective merger control.

On balance, the need for merger-control provisions is greater than the convenience of their absence. Apart from the need to identify and prevent those mergers that are harmful to competition, there is also the possibility that by not having a merger-control system, a country might deprive itself of the legal powers to challenge foreign and domestic mergers which might have an adverse effect on its territory and thus undermine both the national and global competitiveness of its export-oriented companies, including the 'national champions'. Through the merger-control regulations, developing countries are able to verify if the efficiencies produced by a merger are sufficient to compensate for the harm to competition. When reviewed properly by a competition authority, a merger can provide a better environment for or attract investment in the identified sectors, with beneficial impacts on employment levels.

Developing countries are ripe for active involvement in merger control given the government's agreed desire to embark on the privatization of the public enterprises into a vibrant private sector. Experience in countries such as Zambia, Zimbabwe and Malawi and many other developing countries that have undertaken the privatization process has shown that foreign firms tend to take over competing domestic firms. For example, a local public firm dealing in cement or sugar is likely to be taken over by multinational firms engaged in a similar business activity such as Lafarge or Illovo, respectively. Consequently, we have witnessed the turning of public monopolies to private monopolies. Privatization in most cases does not lead to greenfield foreign direct investment. Competition issues arise when local firms are at risk of being taken over by foreign firms dealing in the same business. This creates stronger private monopolies, which leads to market foreclosure. The merger-control provisions under national competition law guard against the stifling of enterprise development through anti-competitive mergers.

Mergers and other forms of acquisition have accounted for more than 80 per cent of direct foreign investment in the Southern African states. The merger-control provision has offered developing countries a facility to monitor and check the entry into the national market of undesirable business behaviour. This allows domestic firms not to be subjected to anti-competitive business practices which may lead to their demise.

Box 4: Coca Cola Company/Cadbury-Schweppes merger

In December 1998, Cadbury Schweppes Plc of the United Kingdom sold to the the Coca Cola Company (TCCC) of the United States of America its commercial beverage brands outside the United States, Continental Western Europe and certain other territories worldwide. In December 2000, TCCC submitted to the CC in terms of section 35 of the Competition Act a merger application for authorization of its proposed acquisition in Zimbabwe of beverage brands owned by Cadbury Schweppes Plc.

The brands acquisition transaction was evaluated as a horizontal merger as defined in section 2 of the Competition Act. Consultations were made with the parties and other competition authorities that had also considered the transaction in terms of their countries' competition legislation, i.e. the Australian Competition & Consumer Commission, the Zambia Competition Commission and the Competition Commission of South Africa.

The Commission identified from a consumer survey undertaken that the relevant product market was '*ready to drink*' *soft drinks of a carbonated and non-carbonated nature* (TCCC had submitted that the relevant product was all beverages, including tea and coffee, and even bottled water). In that market the merging parties' pre-merger market shares were 76.9 per cent (Coca Cola brands) and 12.5 per cent (Cadbury Schweppes brands) resulting in a combined post-merger market share of 89.4 per cent. It was however found that the proposed merger will not create a monopoly situation in the relevant markets, which is highly contestable, nor will it lessen actual competition in the soft drinks bottling and distribution industry. It was also found that the proposed merger had considerable public interest benefits in the form of generation of foreign currency from the continued export of local beverage brands such as the *Mazoe* brands, creation of employment, more efficient use of resources and the continued availability of Schweppes brands on the market.

The Commission therefore authorized the transaction subject to conditions, which included that the Coca Cola Company undertake to purchase Schweppes Zimbabwe Limited as a going concern and to establish an appropriate shareholding structure (to include indigenous shareholders) to oversee the operations of the new company to be formed; that the Coca Cola Company undertake to maintain the local *Mazoe* and *Calypso* brands on the Zimbabwean market and develop them into regional brands with wider circulation; and that the Coca Cola Company undertake to promote and develop Zimbabwean suppliers and supplies with respect to the raw materials necessary to produce the finished product brands.

An Undertaking to the above effect was signed between the Competition Commission and the Coca Cola Company on 30 May 2001.

Source: Competition Commission, Zimbabwe

Cross-border business transactions, including investment and business concentrations and alliances are now becoming the norm in the region, thereby justifying merger control at the national level. Without an effective national competition law and policy, the domestic firms may form anti-competitive alliances to make it difficult for foreign firms to penetrate the local markets. The merger notification approach of Zambia, Zimbabwe and Malawi has a lot of merit and could be justified to control anti-competitive mergers.

For instance, the global Coca Cola/Cadbury Schweppes merger was reviewed in the COMESA region by the competition authorities of Zambia and Zimbabwe. The merger was notified to, and reviewed by, the two competition authorities separately

even though its effect was regional in view of the almost free trade between COMESA Member States. In the case of Zimbabwe, the merger was approved with certain conditions, which included partial divestiture and undertakings on the part of the merging parties to develop local beverage brands. In Zambia, the merger was also conditionally approved but with different undertakings "aimed at enhancing competition, including the obligation on TCCC (The Coca Cola Company) to notify its exclusive dealing arrangements, restrictive territorial allocation agreements and stop price fixing arrangements". In doing so, the competition authorities tried to ensure that the

Box 5: The takeover of Cadbury Schweppes by Zambia Bottlers Ltd

Introduction and relevant background

The Coca Cola Company (TCCC) and Cadbury Schweppes (CS) Plc signed an agreement for the purchase by TCCC of the CS commercial beverages brands and the trademarks outside the United States, continental Western Europe and a few other countries. In Zambia, TCCC lodged a notification under Section 8 of the Act to acquire Cadbury Schweppes Zambia (CSZ) Limited. TCCC produces carbonated soft drinks in Zambia, while Cadbury Schweppes produced both carbonated and non-carbonated drinks, as well as clear beer (whisky black).

Major findings

TCCC had a 92 per cent market share in carbonated soft drinks in Zambia, while CSZ had 8 per cent. Their products are almost perfect substitutes. Imports of competing products are negligible and are mainly done by Kazuma Enterprises on a niche-market basis, including Pepsi products from Namibia. The takeover of Cadbury Schweppes brands in Zambia by TCCC was to effectively eliminate competition and any possible entry into the carbonated soft drinks market in Zambia, especially since ownership and or authorized use of patents and know-how are key to success in the sector. However, Cadbury Schweppes Plc had not made substantial investments in Zambia and had only awarded the Zambian operation a franchise to use its trademark and beverage brands. The Zambian operation needed re-capitalization. The parties submitted that TCCC would infuse its expertise in the beverage sector and assist CSZ achieve efficiencies. Third-party concerns were raised regarding the concentration of economic power in TCCC in Zambia as well as the future of Goldspot in Ndola, which is an SME with a TCCC franchise for secondary brands.

Commission decision

There existed entry barriers in the carbonated soft drinks market in Zambia, even before the notification of this transaction. In Zambia, the transaction entailed elimination of a vigorous competitor by TCCC and consolidation of TCCC market power and likely abuse of the same in relation to distributors and retailers. However, CSZ required re-capitalization. CS had already sold the brands to TCCC and CSZ did not have the franchise to produce the brands. Closure of CSZ would have had worse effects on both the social and economic spheres in the country. The transaction was authorized with conditions, which included the following:

- TCCC was to cease operation of any exclusive dealing and territorial restraint arrangements in Zambia;
- TCCC shall not fix prices or excessively advertise the recommended price;
- TCCC and cooperating bottlers in Zambia would continue to comply with the provisions of the Competition and Fair Trading Act.

Source: Zambia Competition Commission

merger has not had a negative impact on enterprise development. It should, however, also be noted that while the merger affected other COMESA countries such as Uganda and Malawi, the absence of merger-control provisions in those countries prevented it from being notified and reviewed by the affected countries. As such, the countries could not obtain countervailing concessions on the merger's consummation as Zambia and Zimbabwe did. Enterprises in Uganda and Malawi could not be protected against potential negative effects of the merger

Box 6: Rothmans of Pall Mall/British American Tobacco merger

In January 1999, British American Tobacco (BAT) Plc of the United Kingdom announced that it had reached an agreement with the shareholders of Rothmans International, Compagnie Financiere Richemont AG of Switzerland and Rembrandt Group Limited of South Africa to merge their international tobacco businesses. Subsequent to the completion of the international merger between BAT and Rothmans International, Rothmans of Pall Mall (Zimbabwe) Limited in September 1999 applied to the Competition Commission in terms of section 35 of the Competition Act, 1996 for authorization to acquire the entire issued share capital of British American Tobacco Zimbabwe Limited.

The merging parties gave as one of the reasons to merge the declining market for cigarettes in Zimbabwe. It was presented that the Zimbabwean manufactured cigarette market had declined to such an extent that it was no longer big enough for the continued viability of two manufacturers as evidenced by the poor performance of BAT Zimbabwe Limited in its financial year ended 31 December 1998.

The case was evaluated as a horizontal merger as defined in section 2 of the Competition Act. Through its investigations, the Commission noted that although the merger would result in a creation of a monopoly situation in the relevant market (i.e. the manufactured cigarette market), it had other public interest benefits. Section 32(5) of the Competition Act includes as such benefits the creation of greater economies of scale resulting in more efficient use of resources, the generation of foreign currency through exports, and the stabilization of product prices on the local market. The *failing firm* defence put forward by the merging parties was also considered a strong point in this connection.

The Commission therefore authorized the merger with certain conditions aimed at alleviating the adverse effects of the monopoly situation created. The conditions related to the disposal of surplus cigarette-making equipment to third parties interested in entering the Zimbabwean cigarette-making industry and constant surveillance by the Competition Commission of future cigarette price increases, with price rises needing the Commission's justification, while the monopoly situation created remains in existence.

Source: Competition Commission, Zimbabwe

It is interesting to note that the same transaction, which was global in nature, was also assessed by the Zambia Competition Commission (Box 5). It is important to note that both Zimbabwe and Zambia in their respective assessment of the transaction had authorized the transaction on condition that the relevant market is not foreclosed by restrictive business practices by the merged firm. Zimbabwe further gave a condition that the merged firm undertakes to promote and develop Zimbabwean

suppliers in the supply of the raw materials necessary to produce the finished products. It is evident that the competition authorities in their respective countries were addressing the need to promote enterprise development and linkages with the SMMEs.

The competition authorities of Zambia and Zimbabwe also separately reviewed the global Rothmans of the Pall Mall/British American Tobacco merger. The Zimbabwean authority approved the transaction with conditions of both a structural nature (partial divestiture aimed at promoting new entry into the cigarette-making industry) and behavioural nature (undertakings not to increase cigarette prices for a specific period of time). The Zambian authority unconditionally approved the merger since it was found that "the concentration was likely to enhance competition as market offerings were likely to be enlarged in terms of brands". In both cases, competition law was used to promote enterprise development through expansions of the sector.

Box 7: The takeover of Chilanga Cement by Lafarge of France

The Commonwealth Development Corporation (CDC) and Pan African Cement (PAC) notified the Commission under Section 8 of the Act of their intention to sell their 50.1 per cent shareholding in the Chilanga Cement PLC to Lafarge SA of France pursuant to a Sale and Purchase Agreement entered into by the parties on the 4th December 2000. The Commission first rejected the transaction because Lafarge had failed to show how the transaction was to produce benefits to the economy. Lafarge did not also give undertakings that guaranteed continued operation of the Chilanga Cement plants in the presence of fears of Lafarge using Chilanga Cement as a raw material source with supply of cement in Zambia coming from outside. Chilanga Cement is the only cement producer in Zambia, with substantial upstream and downstream integrations to SMMEs.

The Board of Commissioners reviewed the second submission from Lafarge and conditionally authorized the transaction after Lafarge gave substantive Undertakings to the Commission, which included the parties committing the following:

- To increase production at Ndola to 85 per cent capacity utilisation within the next 3 years of the date of this Undertaking.
- To supply cement to Burundi at an ex-works price no higher than Mbeya's ex-works price for the Burundi or Great Lakes Regional market.
- Recognizing the fact that Chilanga has capacity constraints, the supply of cement will be on a priority basis as follows: the first priority will be the local market, particularly on the Copperbelt, the second will be DRC and the third priority will be Burundi for Ndola works.
- While in pursuit of its corporate goals, Lafarge and Chilanga Cement PLC will endeavour to be compliant with the Competition and Fair Trading Act, CAP 417 of the laws of Zambia and implement a compliance programme under the management of a senior executive at both works as the Compliance Officer.
- Not to use methods of price announcements which have the effect of price fixing.
- Not to operate exclusive distribution contracts without notifying the Zambia Competition Commission.
- That within 3 months of the signing of this Undertaking, develop for consideration by the Commission, a Trade Practices Program.

Further, Lafarge was to make a mandatory share offer to the minority shareholders who would want to sell their shares, in accordance with the stock exchange regulations.

Source: Zambia Competition Commission

Other notable examples include the acquisitions by Lafarge of France of major cement companies in Zambia, Zimbabwe, Tanzania and Malawi. Even though the acquisitions had the effect of drastically changing the structure of the whole regional cement market, individual countries on national rather than regional considerations reviewed them separately. In Zambia, Lafarge had to give undertakings to the competition authority that due to capacity constraints; priority for the supply of cement shall be the local market before consideration of exports. There was to be an increase of productive capacity within a stipulated time, and that the price of cement in Zambia shall not be disadvantaged by the production of cement by other subsidiary plants in the region. Again, we witnessed pre-conditional approval of the mergers in Zambia and Zimbabwe who had competition laws in place. Both countries were aware that Lafarge the biggest producer of cement in the world, could, if not regulated properly, foreclose enterprise development in the sector. Lafarge was made to increase production by rehabilitating plant and machinery in their respective countries.

The research carried out by COMESA/SADC in its member states revealed that in countries without the enforcement mechanism of competition rules, mergers have produced market structures that have made it easier for a group of firms to cartelize the market, and this has enabled the merged entity to act more like a monopolist. It is evident that if Botswana had a competition law at the time of the merger of Metro and Safelina, [11] the merger could have been assessed differently. It was also observed that most of these countries have very few firms in their markets; hence, it is attractive for these few firms to merge in order to avoid competition among or between themselves.

Similarly, the Lafarge takeover of cement plants in Tanzania and Malawi could have received a competitive scrutiny if the national competition authorities had been operational. It is evident that the competition concerns which were addressed by both the Zambian and Zimbabwean national competition authorities could also be of concern in Tanzania and Malawi. Further, the undertakings given by Lafarge to both Zambia and Zimbabwe could have an uncompetitive effect in neighbouring countries especially those without competition law and policy. The conditionalities by both Zambia and Zimbabwe clearly show that a country is able to direct the FDI coming into the country, and that competition law can be used to stimulate development into sectors which were currently foreclosed.

The Southern African states require an effective merger-control regulation given the advanced stage they have reached in integrating the economic activities of the region, particularly in the area of trade cooperation. Cross-border business transactions, including investment and business concentrations and alliances, are now becoming the norm in the region, thereby justifying merger control at the regional level. There is, therefore, great need for an effective enforcement of the merger-control provisions in the national competition laws in order to deal with cross-border transactions and to direct investment in a competitive manner in the national economies. The majority of developing countries will find it difficult without national competition

laws to stop anti-competitive behaviour by the local subsidiaries of merging multinationals in industrial countries. These multinational corporations may behave competitively in Europe because of the effective competition rules but may indulge in anti-competitive practices in developing countries.

Box 8: Pretoria Portland Cement/Portland Zimbabwe Merger

In August 2001, Pretoria Portland Cement Company Limited (PPC), a leading cement manufacturer incorporated in the Republic of South Africa, filed an application with the Commission in terms of Section 35 of the Competition Act for authorization to acquire the entire issued share capital of Portland Holdings Limited (Porthold or Unicem), the leading cement manufacturer in Zimbabwe. Anglo American Corporation, the largest shareholder of Porthold, wanted to re-focus its operations on its core business activities (principally mining) and was disposing of its non-core investments. PPC on the other hand wanted to increase its cement investments in the Southern African region in the face of stiff competition from Lafarge S.A. of France, which had recently acquired Blue Circle Industries cement plants in Zambia, Tanzania, Malawi and Zimbabwe.

Investigations revealed that this horizontal merger did not change the structure of the cement industry in Zimbabwe. Porthold remained the leading player with about 50 per cent share of the market, followed by Circle Cement (28 per cent), Sino-Zimbabwe (15 per cent) and ZimCement (7 per cent). The merger, therefore, did not create a monopoly situation nor did it lessen the degree of competition in Zimbabwe since PPC was then not a participant in the Zimbabwean cement market. PPC was only stepping into the shoes of Anglo-American Corporation. The Commission also accepted the efficiency reasons given for the merger and found other public interest benefits arising from the transaction such as: (i) additional efficiencies in production; (ii) introduction of a wider range of cement products; (iii) significant inflows of foreign currency into Zimbabwe from PPC's plant modernization programme; and (iv) promotion and maintenance of effective competition in Zimbabwe and the region. One concern raised from stakeholder submission, however, was the possibility that PPC, or any other company that could subsequently acquire Porthold from PPC, could close down the Zimbabwean plant and supply cement from South Africa given the surplus capacity existing in the South African cement market.

The Commission therefore authorized the merger on two conditions, that PPC should honour its commitment to maintain Porthold and continue the production of cement in Zimbabwe; and should PPC in future decide to dispose of Porthold by sale or otherwise, such disposal should be subject to the condition that Porthold will be maintained and continue producing cement in Zimbabwe, and that PPC should inform and consult the Commission of any such disposal before proceeding. The conditional authorization of the merger was accepted by PPC and was embodied in a written Undertaking between that company and the Commission.

Source: Competition Commission, Zimbabwe

7.2 Restrictive business practices

Most developing countries with competition policies have enacted laws, which identify a range of permissible and impermissible horizontal and vertical restraints and exercises of market power by firms in a dominant position. These restrictive business practices can, if left alone, not only harm the domestic economies and domestic

consumers of developing countries but also harm enterprises seeking to develop or gain access to the international markets.

Consumers International observed that “rivalry between firms can take place fairly through striving for greater efficiency and innovation or through producing higher quality goods to secure a greater share of customers. But a company can also compete unfairly through predatory pricing, exclusive dealing, or forming cartels with its competitors in order to dominate the market”.[12] These types of restrictive business practices are seen as unfair, or anti-competitive, because they distort competition in the market in order to maximize profits. It is competition law which regulates business activities in order to prevent and prohibit, in certain circumstances, anti-competitive behaviour which may hinder the growth of the economy in developing countries.

The COMESA/SADC market is endowed with a majority of countries without competition law and policy. In such a market environment, restrictive business practices often occur with the blessing or encouragement of the national governments. In these countries, exclusive dealing contracts and other exclusionary practices have effectively closed the markets and in some cases acted as barriers to a market.

The restrictive business practices in such an environment are also encouraged by lack of enforcement by domestic competition authorities. Moreover, lack of enforcement by a competition authority may also give tacit approval to private firms that their anti-competitive behaviour is allowable. “Government policy makers may even be more pro active and encourage firms to allocate market share or develop interlocking distribution networks in the belief that such actions will stabilize or benefit a domestic industry in the early stages of its development”.[13]

One important factor of the COMESA market is the absence of a strong manufacturing sector. The structure of wholesale and retail distribution and the strong presence of South African retail franchises have evolved rapidly in recent years. Regarding distribution, the domestic market is characterized by the following trends:

- Concentration, expressed in terms of a reduced number of larger operators, and closer vertical links between manufacturers, wholesalers and retailers. This is the case in the sugar, beer, cement and energy sectors in most COMESA countries.
- Development of networks of independent traders, primarily in reaction to trends towards concentration and the growth of large integrated groups originating from South Africa. In general terms, retailers without dedicated facilities and the capacity to bypass the wholesaler (mostly the local businessmen) are unable to compete with the major retail groups (South African firms) in terms of price and service.
- A general reduction in the number of independent local distributors or traditional wholesalers, whereas the concept of wholesaling is slowly dying off and overtaken by strong multinationals.

- A series of transformation in the retail sector – an increase in number of hypermarkets, a rise in franchising and a proliferation of forms of distance selling which excludes local businessmen is a prominent feature.
- The above factors have the effect of hindering enterprise development in developing countries. That is why most competition laws address these restrictions in order to eliminate them from the market.

The economies of these countries reveal a special market phenomenon, which requires COMESA member states to focus their competition law to regulate markets efficiently. Most restrictive business practices are divided into either horizontal or vertical restraints practised by the major firms in the market. Given this dilemma, it is important to elaborate on those and other types of arrangements and competition cases, which are prevalent in the markets of some of these countries and have been found to be harmful to the growth of industries.

7.2.1 Vertical agreements and market access

Vertical restraints have repeatedly given rise to competition concerns in the COMESA/SADC region due to the several multinationals which possess market power operating in the region and the various agreements entered into by the key market players. Generally, vertical restraints refer to arrangements or agreements between operators at different stages of the production and marketing chain.

Before the introduction of competition laws, foreign and domestic firms operating in the COMESA/SADC region had entered into contractual arrangements with distributors of their products that placed some limitations on the ability of the distributors to handle the products of competing manufacturers or to sell products outside a particular territory. This was common with transnational firms who enjoyed a monopoly position in the region in the clear beer, cement, sugar and soft drinks sectors. In most cases, these firms inherited distribution chains all over the country, which were made possible by the previous parastatal status or government involvement in businesses.

Similarly, under such a market environment, vertical distribution practices also prevented a foreign entrant (as well as a domestic firm) from developing the distribution networks necessary to penetrate a market.

During the post-privatization period, it became apparent that the continuation of the restrictive business practices by the new private firms had the effect of restricting the growth of industries. For example, a new entrant firm was required to establish a new distribution network to run parallel with the existing one. This was the case of the monopoly status of the clear beer firms in Zambia, Malawi and Zimbabwe. It became difficult for new firms to enter the market due to the increase of the cost of entry or they were precluded from entry by existing dominant firms. During the assessment of the takeover of the Coca Cola Company by South African Breweries PLC, the competition authority in Zambia commented that: “the Commission has observed that the Coca Cola Company has in the past abused its dominant position

mostly by means of vertical restraints. Through vertical restraints, the company strictly controls the contact of all downstream distributors… The practice is nothing more than a selective distribution and an exclusive distribution system where a distributor has the exclusive right to distribute a product within a specified territory or to a category of customers”. [14]

In Zambia, and most probably in the other countries in the COMESA/SADC region, there is evidence that the key monopoly firms in their respective markets have managed to keep imports out of their home markets. These firms have done this through the control of the local and regional distribution networks via vertical integrated structures in the respective countries in which they operate. They have further restricted the cross-border redistribution of their products among countries in the region. For example, through a company policy, a third-party resident in Zambia cannot import clear beer from South African Breweries in South Africa. The only authorized importer of South African Breweries beer products in Zambia is its subsidiary firm, Zambia Breweries. This has, as a result, foreclosed import competition in clear beer from South Africa.

The establishment of national competition authorities in these countries had to challenge the existence of anti-competitive practices by the private monopoly firms in their respective countries. The removal of the exclusive distributorship agreement and territorial restrictions allowed more entrepreneurs to enter the market. The competition authorities of Zambia and Zimbabwe compelled the brewery companies and other dominant firms not to use their dominant position as suppliers to coerce independent distributors and/or retailers from buying or distributing competitive imports or other products. In so doing, there was an expansion of entrepreneurship and the unemployed youth in the respective countries were able to engage themselves in businesses by distributing the various products. Further, due to the increased number of distributors, the products became easily available on the market and a distributor was able to keep various products from different manufacturers under one roof thereby offering the consumer a choice. The creation of employment also had a positive effect on poverty levels in the communities. In Zambia and South Africa, to comply with competition rules, the distribution network of clear beer and carbonated soft drinks has been contracted out to the local communities. To enhance competition among the distributors, the supplier has gone further to give loans to the micro-distributor to purchase vehicles. Such schemes have created employment and brought wealth into the communities.

7.2.2 Horizontal agreements

Horizontal Agreements refer to implicit or explicit agreements between firms competing with identical or similar products in the same market. Horizontal agreements commonly referred to as hardcore cartels may involve two or more domestic enterprises attempting to fix prices or otherwise limit competition in local markets through

bid-rigging agreements, customer allocation agreements and output restriction agreements.

Box 9: Exclusive dealing arrangements between Hybrid Poultry Farm and Galaunia Farms Limited

During investigations into alleged cartel activities in the poultry industry in Zambia in 1998, the Commission became aware that there existed restrictive business arrangements involving Hybrid Poultry Farm (HPF – a day-old chicks rearer with 60 per cent market share then), Galunia Holdings Limited (GH – a commercial chicken broiler rearer), and Tamba Chicks (Tamba – a day-old chicks rearer with 30 per cent market share then). ZCC advised the parties to notify the said exclusive agreements as required under the Competition and Fair Trading Act Cap 417 of the laws of Zambia. At the time, parallel investigations were launched on the sale of Tamba Chicks. GH management was interviewed.

During the investigations it was revealed that in the sale of Mariandale Farm, which specializes in the raising of Day-Old Chicks (DOC) into table birds, HPF required GH to only purchase DOC from itself. Further, GH was also required to consider HPF's right of first refusal should it intend to resell Mariandale Farm. GH was also not allowed to raise any type of poultry, at the farm, apart from broiler chickens, including the provision not to go into the business of a chicken hatchery. The parties also agreed that GH should be accorded the right of first refusal should HPF intend to sell some of its shares and that HPF should be given the first right of refusal to participate in an out-growers scheme should GH come up with one. The ZCC noted that the parties to this transaction are the two leading players in the poultry sector's upstream (HPF) and downstream (GH) subsectors. HPF is the dominant producer of DOC in Zambia with a 60 per cent market share. GH with its Mariandale and Diamondale Farms has an uptake of 48,000 DOC per week and hence is the largest buyer in the poultry sector.

The exclusive dealing arrangements appear to have been over and above the offers each party made and hence the considerations made by the other. The excesses hinge on the ulterior motives of the parties in as far as the poultry sector is concerned. The parties seem to have taken advantage of their dominant market positions upstream and downstream – where each party was dominant. The parties were, both by motive and concerted practices, foreclosing competition both in the DOC, table birds (broiler) and frozen chicken.

These practices were in direct contravention of Section 7 of the Act and have the tenets of distractive cartel behaviour. The Board of Commissioners found all the exclusive dealing provisions in the sale and purchase agreements by the parties anti-competitive and nullified them.

Source: Zambia Competition Commission

The majority of developing countries, which have adopted competition laws, have despite significant differences in the scope of these laws, demonstrated clear consensus that hardcore cartels should be uncovered and prohibited. The rationale behind the prohibition is that such agreements serve no purpose other than to shift surplus from consumers to producers, at the cost of dead-weight losses, organizational inefficiencies and rent-seeking. In such a market environment, it is difficult for enterprises to register growth.

Box 10: Investigations into allegations of horizontal restraints between the Kenya Association of Hotel Keepers and Caterers *versus* Wines & Spirits Distributor (Coast Branch)

Pursuant to section 13 of the competition legislation the Chief Executive of the Kenya Association of Hotel-Keepers and Caterers (KAHC) lodged a complaint on 26th September 1994 to the Minister through the Commissioner, alleging that there was a meeting by the National Distributors of Wines and Spirits Association (Coast Branch) held on the 29th June and 7th July, 1994, at which resolutions were passed that contravened the Restrictive Trade Practices, Monopolies and Price Control Act section 7(1) (b)(iii) by recommending to its members to fix prices.

The evidence presented was a copy of the minutes of the proceedings, which revealed that the law, as stated above, had been contravened – the minutes had been signed by eight (8) members with their respective rubber stamps bearing their names and addresses. In this instance, the Commissioner invoked section 15 (1)(a) informing the distributors that allegations have been made and that specific evidence was presented to substantiate the allegations. Hence, the distributors were required to comment on the alleged resolutions and indicate what remedies they proposed to bring their trading practices into conformity with the Act within fourteen (14) days from the date of the Commissioner's letter.

Only one member responded within the stipulated time. The members also ignored a second reminder to deliberate on a consent agreement. The Commissioner then invoked section 16, which requires the holding of a hearing on the desirability and contents of proposed recommendations of a Ministerial order regulating the trade practices in question. This was to be done on 9th February 1996. However, this meeting was attended by only two of the expected eight members of the association. Consequently, the Commissioner, under section 17 of the Act, recommended that the following issues regarding the institution of a Ministerial order be formally gazetted:

(a) that the resolutions passed by the National Wines and Spirits Distributors (Coast Branch) during their meetings held on the 19th June, and 7th July, 1994 were in contravention of section 7(i) (b)(iii) of the Restrictive Trade Practices, Monopolies and Price Control Act in so far as trade agreements in restraint of trade are concerned and should therefore be rescinded immediately.
(b) that the distributors shall cease to make and enforce joint decisions that infringe any section of the Restrictive Trade Practices, Monopolies and Price Control Act, unless there is valid commercial reason that should be notified through the Commissioner after such decisions are made.
(c) that the distributors shall publish a circular in the three (3) local daily newspapers indicating that the decisions made during the said meetings shall not apply during the course of trade in Wines and Spirits within Kenya and a copy of such publication be sent to the Minister for Finance.

The Minister concurred with the said recommendations and hence the gazettement of the order on 27th February 1996 copies of which were sent to all member of the association. This case is still open because there is no evidence to show that the distributors complied with the Ministerial order especially part (c).

Source: Kenya Monopolies and Prices Commission

Although almost all the countries have legislation against hardcore cartels, the developing countries in Eastern and Southern Africa still suffer from the continuation of the legacy of the previous socialist system. The countries in the region are yet to fight against the vice of "price-control", which has the effect of "price fixing".

The phenomenon of price control is still widely acknowledged by most governments in the region due to the high poverty levels. There is still a fear that if prices are left to market forces, the firms through anti-competitive means may resort to exploitative pricing. Under the price-control regulations, the prices of most essential goods and services are statutorily controlled by the government.

The price-control statutes in spite of the introduction of the market economy and competition laws have not been repealed. The situation is such that governments have opted to maintain some degree of price controls in certain sectors while at the same time liberalizing prices in non-essential sectors. It will take time before we see the full liberalization of prices on all goods and services in the region.

The markets in most Southern African states to date are still characterized by various horizontal agreements between and among firms operating both at national and regional level. The competition authorities in the region have investigated several cases involving price fixing, output restrictions, market allocations, etc. It is evident that decisions by firms pertaining to these market prices are as a result of administrative decisions from the headquarters of the multinational firms in South Africa. There is a lack of consideration for local market conditions. The strategy by multinationals in the region is more of a regional strategy as opposed to national market considerations. This was revealed during the investigations against price fixing and transfer pricing in cement factories owned by CDC in Zambia, Malawi and Tanzania. It was found that prices are fixed in South Africa at the headquarters of CDC.

The developing countries have not been very successful in fighting cartels operating in their respective countries. This is despite the volume of commerce affected by the international cartels, which have pointed to their costly consequences for their markets.

The adverse impact of cartels has not spared the developing countries in the COMESA/SADC region. In spite of the great need for international cooperation in the enforcement of competition law and policy, the immediate danger facing developing countries is the effect of international 'hard-core' cartel activities on developing country consumers. There have been studies carried out on the effects of international cartel activities on developing countries. The conclusions and findings arising from these studies are of important relevance to developing countries, especially for the COMESA/SADC region.

The important questions to ask are:

1) Are the developing countries in a position to challenge and contain the cartel activities in their markets?
2) Are developing countries better equipped in terms of resources and logistics to prohibit cartel activities in their markets?

Box 11: The alleged collusion and price-fixing cartel in the petroleum sector by oil marketing companies (OMCs)

There was a fire incident at the Indeni Petroleum Refinery in May 1999 in Ndola, Zambia. Following this incident, the Government of the Republic of Zambia (GRZ) issued a statutory instrument no. 119 of 1999, which reduced the customs duty on imported petroleum products from 25 per cent to 5 per cent. Consequently, the Energy Regulation Board (ERB) issued licences for the importation of petroleum products to nine (9) OMCs, namely BP, Caltex, Mobil, Agip, Total, Jovenna, Engen, Ody's and Agro-fuel. Following the resumption of production at Indeni, the government of the republic of Zambia issued Statutory Instrument (SI) No. 54 of 2001 that reinstated the 25 per cent import duty on all petroleum products effective 18th May 2001. On 29th May, 2001 the ERB received a joint written complaint from the OMCs about the effects of the S.I. on their business. On receipt of the letter from the OMCs, the ERB brought to the attention of the government through the Ministry of Energy and Water Development (MEWD) the concerns raised by the OMCs. The Ministry in turn assured the OMCs that it would take up their concerns on customs duty to the relevant authorities. However, while the government was in the process of holding consultations with all stakeholders, the OMCs unilaterally increased the prices of petroleum products on 30th May 2001.

On 31st May 2001, ERB wrote to all OMCs individually directing them to revert to the old prices. The OMCs responded by asking for a meeting on 1st June 2001. Consequently, on 1st June 2001, the ERB held a meeting with OMCs. The OMCs stated that they would maintain the new prices for the next 3 weeks to recover anticipated losses. The ERB informed them that the directive to revert to the old prices while their complaint was being looked into remained in force. After the meeting, the OMCs responded through a joint letter informing the ERB that the new prices would remain in effect for 4 to 6 weeks thereby continuing to defy the directive given by the ERB. The ERB then responded to the joint letter individually re-stating that the directive remained in force.

The ERB Board Chairman further reiterated this directive during a press conference on 1st June 2001. During the press conference, he directed the OMCs to reduce the fuel prices to the original levels or risk having their licenses suspended or revoked. By Monday 4th June 2001 none of the OMCs had complied with the ERB order. In order to address this act of defiance from the OMCs, the ERB held consultations with ZCC. The two institutions reviewed the conduct of the OMCs.

The investigations conclusively determined that the OMCs were acting collusively in the conduct of their businesses as evidenced through their spokesman's letters to the ERB several times. The ERB had cautioned the OMCs but they defied it. The **motive** has been clearly to prevent competition amongst themselves and especially, price competition. During the period January to May 2001 it was demonstrated that price competition was possible in Zambia but was short-lived as the big players in the market managed to put it off through predatory pricing to the point when it hurt all OMCs. Cartel conduct was perpetrated under the leadership of BP and Caltex and the ultimate aim was to prevent competition amongst the OMCs.

Recommendations

All the OMCs, more especially BP, Caltex and Total, should be prosecuted under the Competition and Fair Trading Act for price fixing. There is evidence to show that:

i) there was an agreement on price increases;
ii) there was an agreement on a standard formula according to which prices will be computed;
iii) there was an agreement to adhere to published prices;
iv) there was an agreement to use a uniform price as the starting point for negotiations;
v) there was an agreement not to sell unless agreed-on price terms are met.

It was recommended that the trade association by the OMC serviced by Caltex should be abolished. The evidence induced so far shows that this association provides a forum for cartel activities. The association facilitates information sharing, adopting particular contracting or pricing practices that make it easier for a cartel to operate of for the OMCs which are in an oligopolistic market to avoid competing with each other, even without any explicit cartel agreement.

Source: Zambia Competition Commission

These are some of the important questions, which show how vulnerable the markets in developing countries are. It is really very doubtful whether a developing country at national level or individually can stand up against international cartel activity.

It is now evident that the negative impact of cartelization has been greater in developing countries, especially in those countries still without competition law or without an effective national competition policy. Although the impact of cartelization on the development of industries in developing countries is difficult to quantify, what we are certain of is that most of the many companies in Europe, which have investigated and prosecuted, are well established in Africa and have very long-standing trading ties with governments in developing countries. In some cases, major developing contracts have been awarded through bilateral and multilateral agreements with donor agencies to some of these companies.

The assessment carried out in 1997 reveals that developing countries imported US$ 81.1 billion of goods from industries which have seen a price-fixing conspiracy during the 1990s. These imports represented 6.7 per cent of imports and 1.2 per cent of GDP in developing countries.[15]

The introduction of competition laws in the region has contributed in the fight against hardcore cartels, hence promoting enterprise development in most developing countries. Although it can be argued that the enforcement of competition law in the region is generally too weak to make an impact in fighting cartels, sufficient deterrent has been achieved at national level (Boxes 10 and 11). Further, knowledge by private firms of the risks involved alone in violating the competition laws is sufficient to deter a company from engaging in cartel behaviour that it perceives as advantageous. The competition laws have increased public awareness about the detrimental effects of domestic and international cartels. “Without an effective competition policy framework, enterprises can too easily collude to create artificial shortages that boost prices to monopoly levels, rig bids, or divide markets by allocating customers, suppliers, territories or lines of commerce”.[16] The competition laws against cartels have contributed in the protection of consumers and enhanced enterprise development, especially the firms operating in developing countries with weaker economies from the harmful effects caused by hardcore cartels. The cases in Kenya and Zambia shown in Boxes 10 and 11 are incidences of the many cases of cartel activities in the region. They clearly demonstrate that various forms of cartels are prevalent in our markets and that they have created waste and distorted trade in our economies. The various forms of cartels have reduced the productivity capabilities of enterprises and hindered their development.

7.2.3 Abuse of dominant position

It is important to appreciate that most of the big firms or multinationals, which were operating in developing countries prior to the introduction of market reforms or the introduction of national competition laws, misused their market power to the detri-

ment of other small firms and the consumers. The absence of competition rules in the market allowed dominant firms or monopolies to engage in anti-competitive practices, which amounted to abuse of market power.

Given the structure of the Eastern and Southern African countries' market, its oligopolistic nature gives rise to many firms being dominant in their respective sectors. Competition in a market with few suppliers, none of them controlling the market but each relatively large (oligopoly) is much more likely to be distorted if one of those suppliers takes over or acquires an interest in another, than in a market characterized by fierce competition among many suppliers. Consequently, there is lack of vigorous competition in most countries in Eastern and Southern Africa as the market is characterized by single dominance in the sugar distribution, cement manufacturing and distribution, diamond mining and marketing, beef market, wholesale and distribution, and in both clear and opaque beers. In addition, there is in most of these countries a concentration of South African franchises in the retail sector. This has led to some difficulties for the local businessmen to penetrate or participate in the commercial activities in their respective countries, especially the trading and manufacturing sector. In fact, evidence shows that the proliferation of the South African franchise trading chains has had an effect of eliminating competition from small indigenous firms and foreclosing market.

Box 12: Preliminary probe into allegations of predatory pricing in the clear beer brewing and distribution industry

In December 1999, Nesbitt Brewery (Pvt) Limited of Chiredzi complained to the Competition Commission that National Breweries Limited was engaged in predatory pricing, having drastically reduced the price of its clear beer in Chiredzi to levels that were unprofitable, with the intention of driving Nesbitt Brewery out of the market.

The investigations conducted by the Commission revealed that the clear beer industry in Zimbabwe is highly concentrated with an HHI (Hirschman-Herfindahl Index) concentration index in excess of 8,000. Nesbitt Brewery was a new entrant into the clear beer market challenging the long-standing monopoly position of National Breweries, which held a market share of 90 per cent. National Breweries has a national distribution network while Nesbitt Brewery only operates in Chiredzi. The investigations further revealed that the National Breweries had run a beer promotion in Chiredzi from May 1999 to April 2000 when the Competition Commission started gathering information on the case. The promotion included free snacks and T-shirts, lucky-draw tickets, free beers and substantial price reductions. The promotion was only held in Chiredzi where Nesbitt Brewery is based and sells the bulk of its beer. The National Breweries retail prices for its beer in Chiredzi during the promotion period where below its normal landed prices in that town.

The Commission found the alleged practices to be predatory within the terms of section 2 of the Competition Act. Although National Breweries stopped the practices as soon as they became aware that the Competition Commission was investigating them, the Commission made them formally undertake that they would desist from future practices aimed at driving Nesbitt Brewery out of the market.

Source: Competition Commission, Zimbabwe

The big franchise trading chains have continued to abuse their dominant position through vertical restraints. They do this through market foreclosure and reduction in competition in a market. Market foreclosure means that entry into a market is made more difficult or more costly. Competition law enforcement has been used to prohibit enterprises from abusing their dominant position through vertical restraints. The cases in Boxes 12, 13 and 14 demonstrate how the use of competition law to abuse of dominance has enhanced enterprise development.

The COMESA/SADC region has continued to witness a situation where a monopoly company from one country has raised prices to consumers in another country above the levels that would prevail in competitive markets. For example, the national competition authorities have received several complaints against Multichoice Company, a DSTV service provider in the region. The allegation against the service provider is that it is involved in excessively high prices and discriminatory prices and other terms or conditions among subscribers of different countries in the region. This conduct has been found to be anti-competitive by some countries in the region because it exploits customers and other suppliers. Complaints have also been made against Lafarge in the cement industry (Box 13), and South African Breweries in the clear beer sector (Box 12). Both companies have been accused and found guilty by competition authorities of predatory behaviour, anti-competitive vertical restraint and/ or refusing to supply existing or potential competitors.

The existence of market power or the possibility of such power being created or augmented is a key consideration in the analysis of many competition law cases. Generally speaking, abuse of dominant position refers to the ability of a firm (or a group of firms acting jointly) to profitably maintain prices above competitive levels for a significant period of time without an effectual competitive or countervailing response. It is in a market of this nature where the likelihood of abuse by dominant firms is prevalent. Such a market requires regulation to facilitate the competitive process and to prevent collusion among incumbent firms. Competition law is concerned not with the fact that a firm is dominant, but rather the abuse of that dominant position. A firm enjoying a dominant position can use its market power to adversely affect competition. It can:

- eliminate competition in a market where the firm is engaged;
- prevent the emergence of new competitors or restrict competition in a market in which a company is engaged by introducing barriers to entry;
- affect the terms and conditions of supply in a market;
- discourage or repel innovation in the relevant market.

The enactment of national competition laws in the region have attempted to address the problem of abuse of a dominant position by prohibiting firms from wilfully obtaining or attempting to obtain a monopoly by any means other than by a superior product or service, business acumen or historic accident. The competition rules have dealt with dominance by prohibiting abusive or exclusionary conduct. As a result, the distributors of products produced by monopoly firms have been able to deal with

Box 13: Investigation into allegations of restrictive and unfair trade practices in the cement distribution industry

In December 1998, the Competition Commission commenced a preliminary probe into various allegations of restrictive and unfair trade practices in the cement industry, which were leading to shortages and excessive prices of cement on the local Zimbabwean market. The allegations came from complaints made to the Commission by the cement trade and the general public, as well as from newspaper reports.

Four companies were involved in the production and distribution of cement in Zimbabwe: (i) Portland Holdings Limited (Unicem) of Bulawayo, (ii) Circle Cement Limited of Harare, (iii) Zimbabwe Cement Company (Pvt) Limited (ZimCement) of Norton' and (iv) Techniks (Pvt) Limited of Gweru. Only Unicem and Circle Cement were involved at all stages of cement production, from the quarrying of limestone to the final product. The other two companies were more involved in blending operations. A new cement manufacturing plant, under a joint venture between China and the Industrial Development Corporation (IDC), was nearing completion in Lalapanzi. The cement industry was found to be highly concentrated, with a Herfindahl-Hirschman Index (HHI) of 4,602. The two largest players in the industry (Unichem and Circle Cement) controlled a combined market share of over 90 per cent.

The evidence gathered section 28 of the Competition Act confirmed some of the allegations levelled against Unicem and Circle Cement, and others which came up during the course of the investigation, such as: (i) restricting the distribution of cement; (ii) enhancing or maintaining the price of cement; and (iii) supporting or promoting the distribution of cement by inefficient and uneconomical means. No evidence was found to support the allegations of: (i) prevention or restriction of entry into the cement industry; (ii) undue refusal to distribute cement; and (iii) collusive arrangements between the cement producers. With regards allegations of collusion between Unicem and Circle Cement, it was found that the fact that Unicem was a more efficient producer than Circle Cement was clearly reflected in that company's lower retail prices on the market. It was also found that even though the two companies had natural markets in the northern and southern parts of the country, because of high transports costs of distributing their products, the companies' products were sold in either of their 'natural' markets.

The Commission therefore ordered Unicem and Circle Cement, in terms of section 31 of the Competition Act, to discontinue and terminate the identified restrictive practices.

The Commission's investigation also identified other public interest concerns in the distribution of cement on the local Zimbabwean market, such as lack of transparency in the distribution of the product, lack of distribution outlets in remote rural areas, high import duties on cement raw materials and discriminatory sales tax regime in favour of large buyers. The Commission made appropriate recommendations to the relevant authorities and parties on the alleviation of the concerns.

Source: Competition Commission, Zimbabwe

competing products and deal with competitors in the market. The foreign firms have been prevented from using their subsidiaries in developing countries to exploit their market positions unjustifiably. The introduction of competition rules has cleared the market of restrictive business practices to enable enterprises to freely carry out business and to develop.

Box 14: Allegations of abuse of dominant position: Mastermind Tobacco Kenya Limited (MTK) *versus* British American Tobacco (Kenya) Limited (BAT)

MTK lodged a complaint under section 13 of the Cap. 540 laws of the Kenya, which stipulates… "any person who considers himself aggrieved as a result of Restrictive Trade Practices may submit a complaint to the Minister, through the Commissioner…" MTK alleged that BAT had engaged in threatening to stop supplying wholesalers, stockists and retailers with its products if found stocking MTK's cigarettes; slanderous campaign against MTK and persuading farmers not to supply MTK with tobacco; BAT personnel had actively campaigned against MTK in major outlets like bars, retail and wholesale shops, kiosks, etc. to stop these important outlets from stocking MTK's products; intimidation of traders to the extent that the weaker ones had refused to stock MTK's products; and that BAT had engaged in a campaign of misinformation to discredit and damage the reputation of MTK in the tobacco-growing areas.

Investigations under Section 6(1)(i) and Section 14 of the Act, revealed that:

BAT had provided its distributors, stockists and retailers with free shelves and cigarette dispensers with strict instructions not to display competitor's cigarettes.

BAT paints the premises of its distributors free of charge as a way of advertising and to avoid competition.

BAT provided its distributors and stockists with free signboards with neon lights.

BAT had verbally threatened to withdraw supply to any distributor who handles competing products.

The Provincial Administration had allocated BAT and MTK areas of operation, for purposes of preserving peace and security in the areas affected by disagreements between the two companies. This was in connection with contracting farmers to grow and sell tobacco.

MTK was being pushed to marginal areas where the cost of production for tobacco was quite high.

Farmers welcomed the entrance of MTK into the market since it pushed tobacco prices up.

That MTK was buying tobacco illegally from BAT-contracted farmers.

On 24th July 1991, the Permanent Secretary, Finance, wrote to the Ministry of Agriculture and copied to the Office of the President informing the two about the contravention of the said section by the two ministries of which the Permanent Secretary, Agriculture, replied to and assured Treasury that zoning was a temporary issue pending the Commissioner's recommendations as to the lasting solution. Legal opinion on the gazzetment of zoning tobacco-growing areas was sought from the Attorney General's Office but was not given. The case has been pending waiting for the same.

Recommendations

To promote competition, distributors/stockists and retailers of cigarettes should be free to sell all brands of cigarettes produced in Kenya. Zoning is a dangerous precedent because in the long run companies may develop some sense of ownership to these zoned regions and therefore create barriers to entry for new forms. Further that farmers should be free to choose which company to sell their produce to depending on the prices and other contractual arrangements.

Source: Kenya Monopolies and Prices Commission

8. Conclusion

A recent report by the OECD agrees that lack of a competition culture among developing countries is the central impediment to the appreciation of the benefits of competition law and policy: "It appears that the 'lack of a competition culture' is due to the self-interest of those who expect to lose with the introduction of competition and who have the power to oppose it. Competition promotes and accelerates economic wealth".[17] The creation of competitive markets empowers the poor, provides them with productive employment, and increases their access to other productive resources.

Many developing countries have adopted trade liberalization measures and have in turn incorporated competition policy in the management of their economies. These countries agree that the market economy facilitates competitive markets, so as to promote economic efficiency.

In this chapter, we have attempted to demonstrate how the introduction and enforcement of competition in the Southern African countries has halted restrictive business behaviour and the subsequent effects on enterprise development. It has further demonstrated by evidence of cases how developing countries with competition legislation have become vulnerable to competitive restraints. The lack of competition regulation in economies of developing countries has continued to harm buyers, eventual consumers and the economy as a whole. However, countries with competition laws have been demonstrated to have the necessary tools to fight private anti-competitive behaviour.

The enforcement of competition has not only eliminated anti-competitive behaviour but has also offered tangible benefits to the community. At the Global Forum on Competition, the developing countries that were represented reported that: "Competition law and policy is not an end in itself. It is a key prerequisite for development through economic growth". It was further accepted that there are difficulties in demonstrating through advocacy work how enforcement against private anti-competitive conduct has contributed to economic development in developing countries. There are several reasons for this, which include: "the most important effects of competition law enforcement often appear only in a longer perspective, when the impact of halting a competitive restraint may be hard to isolate from other factors. Also, the indirect effects of law enforcement may be much more important than the direct effect on a particular anti-competitive behaviour. A third difficulty is that competition law enforcement often goes hand-in-hand with regulatory and structural reform, meaning that the observed effects of the liberalization of markets are due to the combination of law enforcement and other government action promoting competition".[18]

There is also need to clear the debate on the popular perspective of the developing countries on whether they need a competition law and policy. It is still argued at various economic *fora* that less-developed economies and small markets can, at best, sustain one or two firms in an industry capable of achieving economies of scale, undertaking research and development and securing world markets in com-

petition with advanced trading partners and multinationals, as a stimulus for other sectors. This argument has been strongly used by developing countries to give industrial policy precedence over competition policy, given the low level of development and limited capital resources in developing countries.

This continued uncertainty on the benefits of competition law enforcement still requires greater attention by the policy makers, especially the executive arm of governments. The first issue to address should be the design of competition law and policy, and the enforcement mechanism in the market. It is important for developing countries that an optimal level of competition fits well with the industrial policy rather than having "excessive" competition. This approach will allow developing countries an opportunity to establish industrial capacity and achieve commercial success in world markets. This strategy, if applied in an apt manner, can bring about dynamic benefits to society. There is a danger of applying unfettered competition in the undeveloped markets of developing countries. There is always the undesirable possibility of too much competition leading to price wars and ruinous rivalry, which may be harmful to future investments. To avoid these fears, developing economies should observe that there is: "… an optimal degree of competition which would entail sufficient rivalry to reduce inefficiency in the corporate use of resources at the microeconomic level, but not so much competition that it would deter the propensity to invest". [19]

The approach was also accepted by BIAC when it submitted that: "for developing countries an effective competition law must be flexible enough to permit rationalization and consolidation that are frequently essential in order to maximize efficiencies and economic welfare in the course of structural adjustment. An overly ambitious application of competition law risks deterring socially desirable investments in innovation and technology transfers which rely on protecting intellectual property right". [20]

The enactment of competition laws in developing countries has become a necessity, since it is a matter of economic self-defence. [21] It is these countries that suffer more from the anti-competitive practices than developed countries, given their weak institutional infrastructure and the small size of their markets. It is also important that UNCTAD is given the required mandate to start the implementation of the Set of Multilaterally Agreed Equitable Principles and Rules for the control of Restrictive Business Practices (RBPs), which were adopted by the UN General Assembly in 1980, and reaffirmed by the Fourth UN Conference in Geneva in September 2000. "While universally applicable to all transactions in goods and services and all countries and enterprises, the Set provides that states, particularly developed ones, should take into account in their control of RBPs the development, financial and trade needs of developing countries, especially for promoting domestic industries or other sectors". [22] The vision of flourishing competitive economies in the COMESA/SADC region shall remain nothing more than a mere aspiration, if individual member states at national level, and the regional institutions at regional level, do not effectively enforce competition.

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III.2. COMPETITION POLICY AND ENTERPRISE DEVELOPMENT: EXPERIENCE FROM SOUTH AFRICA

Trudi Hartzenberg

1. Introduction

Competition policy reform was high on the agenda of South Africa's new government after the first democratic elections in 1994. The African National Congress (ANC) had espoused strong socialist principles during the years preceding South Africa's democratic transition. However, by the time the ANC came to power, the winds of political and policy change had shifted substantially, internationally and in South Africa too. Instead of a policy of nationalization of private enterprises, the ANC looked to competition policy as an instrument to regulate private enterprise, and to address the legacy effect of apartheid and economic isolation on domestic markets. South Africa's Competition Act, no. 89 of 1998 (Government of South Africa, 1998), which was drafted and promulgated after an extensive and inclusive policy-making process of consultation and debate, reflects the political concerns of the ANC.

In addition to economic efficiency, the Competition Act explicitly includes equity and distributive goals. The preamble to the Act notes the high levels of concentration of ownership and control, ineffective checks on anti-competitive practices and restrictions on economic participation, especially by black South Africans due to apartheid laws and policies, and articulates a conviction that credible competition law and institutions to effectively implement the law are necessary for an efficient economy. Furthermore, the Act says that an economic environment balancing the interests of workers, owners and consumers will benefit all South Africans. A hallmark of the Act is thus its concern with public-interest issues, equity and justice, balanced with the traditional economic efficiency concerns.

This paper focuses broadly on the role of competition policy in enterprise development in South Africa, and more specifically on South Africa's new Competition Act and particular public-interest objectives, such as the promotion of small and medium enterprise (SME) development and empowerment of previously disadvantaged individuals. The purpose of this exercise is to draw lessons for developing countries as regards the role of competition policy in enterprise development.

Although South Africa's history is in many respects unique, there are important lessons that can be drawn from the legacy effect on markets, enterprises and consumers, and the implications for the competitive process for other developing countries. High levels of concentration are common, for example, not only in South Africa, but also in other southern and eastern African countries. Markets are small, consumers are not well informed of their rights, and the capacity to effectively implement competition policy and law is limited. Challenges of unemployment, low levels of domestic and foreign investment, as well as a history of excessive government

regulation and its adverse effects on competition are also common to many developing countries.

2. Developing a competition policy for a new South Africa

South Africa's apartheid legacy and its consequent marginalization from the global economy produced very specific market structural characteristics, and concomitant competition policy challenges. In addition to the insular nature of the South African economy resulting from global marginalization, its domestic policy stance further compounded the competition challenges. Import substitution industrial policy and capital controls, for example, promoted local enterprise development through local content programmes, and limited outward investment opportunities.

High levels of concentration, both in ownership and control, and conglomerate organization structures coupled with strong vertical integration were typical of many industries and markets. Many firms had diversified their activities, investing in a variety of unrelated economic activities, and focused, almost exclusively, on the domestic markets, as a result of economic sanctions.

The South African economy was characterized by a dual structure with a modern, almost-exclusively white formal economy, and a less-developed, almost exclusively black, predominantly informal economy. This dichotomous economic structure, and the apartheid laws which prevented black South Africans from participating in certain economic activities and geographic areas, meant that participation in the formal economy, and opportunities to develop formal and growing businesses were limited for black South Africans. By contrast, the formal economy developed markets and industries that became in many cases highly concentrated with effective economic barriers to entry, in addition to the racial regulatory barriers of the apartheid regime.

It was recognized by the ANC that these challenges would have to be addressed by a range of economic and social policies and, in addition to a substantive focus on trade and industrial policies for transformation of the economy, competition policy became the policy option for the regulation and development of enterprise to enhance the economic opportunities and participation in the formal economy of black South Africans.

The ANC mapped out an extensive policy reform programme in the early 1990s, prior to the first democratic elections in 1994. The 1992 Policy Guidelines for a Democratic South Africa provided an overview of the policy revamp envisaged. As part of this process, an assessment of South Africa's competition challenges and the efficacy of the existing competition law was undertaken. A complementary initiative was a review of South Africa's industrial strategy (Joffe *et al.*, 1995). Key focus areas of the industrial strategy project were:

- Markets and ownership structures
- SMEs and the conglomerates

- Technological and institutional capacities
- Human resource development and workplace organization

Although this investigation into the development of an industrial strategy for South Africa focused narrowly on the manufacturing sector, the issues identified were also relevant to agriculture, mining and the services sectors. Many of the findings of this project related to competition issues, and in 1995, the new Department of Trade and Industry (DTI) started a 3-year programme of consultation with competition experts and a broad range of stakeholders in South Africa to develop a new competition policy. The product of this extensive exercise was put forward in 1997, as DTI's Guidelines for Competition Policy, intended to stimulate discussion and debate on the role of competition policy in the restructuring of the economy (Government of South Africa, 1997).

Another complementary policy area that enjoyed much attention during the policy reform process was small business development. In 1993/4, an extensive empirical and theoretical study was conducted to identify key constraints to small business development in South Africa. A number of small business support initiatives were developed to actively promote small business development, with the expectation that small business would become an engine of growth and employment creation. These initiatives included, *inter alia*, financial schemes (loans or credit guarantees), skills-support schemes and technology-transfer schemes (www.dti.gov.za).

The 1997 DTI Competition Guidelines considered the existing competition law of 1979, and found it inadequate in a number of respects to address the challenges at hand. The 1979 Maintenance and Promotion of Competition Act did not contain any provisions related to vertical or conglomerate configurations or concentration of ownership. There were no pre-merger notification requirements. The 1979 Act contained no explicit prohibitions, and the final yardstick for decisions was the "public interest", which was not defined in the Act. The *ad hoc* and inconsistent decisions of the Competition Board were thus not unexpected. The Competition Board was appointed by the Minister of Trade and Industry, and a special court was to hear appeals; but never actually heard any. A regulation issued by the Minister of Trade and Industry in 1984 declared some practices *per se* to be unlawful. These included resale price maintenance, horizontal collusion on price, terms or market share and bid rigging. There were, however, no prosecutions despite this regulation.

Effective implementation of a strong competition policy was viewed as an important tool with which to regulate private enterprise, given that the ANC's policy of nationalization, which had been espoused prior to its election, had been abandoned, when the ANC came to power.

Specific goals of competition policy included the dilution of the high level of concentration of economic power, on the grounds that this was detrimental to balanced economic development. In particular, competition law was to reduce the domination

of the economy by a white minority, and to promote greater efficiency of the private sector.

After a comprehensive policy process, which included debates within the National Economic Development and Labour Council (NEDLAC), a new competition law, the Competition Act, no. 89 of 1998 (Government of South Africa, 1998), was promulgated and became effective in September 1999. The Act provides for the establishment of three specific institutions to implement the law: a Competition Commission, a Competition Tribunal and a Competition Appeal Court.

The Competition Act incorporates features which reflect the unique challenges facing South Africa's economic development. It permits and, in certain cases, requires consideration of equity issues such as empowerment, employment and impact on SMEs. Enterprise development is thus an important focus for South Africa's new competition policy and law. Although equity considerations are explicitly incorporated into South Africa's competition law, political channels are not permitted as a means of appealing these issues. There is also no ministerial power to override the decisions of the competition agencies, as there had been previously.

The introduction of South Africa's new competition policy and law took place within the broader context of a new industrial policy, a liberalized trade policy and revamped labour legislation in the second half of the 1990s. This was a new era in policy making for economic transformation.

3. Key features of South Africa's Competition Act

The Competition Act no. 89 of 1998 (Government of South Africa, 1998) covers all economic activity in South Africa, and has extra-territorial reach to the extent that the Act applies to "all economic activity within, or having an effect within, the Republic." The nature and extent of this extra-territorial reach has been tested in one case thus far; the Botash case dealing with the effect of an American export cartel exporting soda ash to Botswana (Competition Commission, 2003). Both Botswana and South Africa are members of the Southern African Customs Union (SACU); hence, with a common external tariff, imports into Botswana can be expected to have an effect within South Africa.

South Africa is a member of the SACU, and its members concluded a new Customs Union Agreement in 2002. This Agreement requires that all members of SACU have a competition policy and that they collaborate in the implementation of that policy.

This new SACU Agreement and its competition policy provisions are important in the context of regional integration developments in southern Africa. The SACU countries have a long history of economic integration (SACU is the oldest customs union in the world), and South African enterprises have extensive interests and operations in all the member countries. Recently, enterprises in the smaller SACU member states have raised complaints about the behaviour of South African enterprises in

their countries, with requests for assistance via trade remedies. It may well be that this option is being sought because these countries do not have competition policy and implementation agencies, and no regional competition policy or institutions exist either. This situation raises the issue of competition policy and enterprise development in the southern African region, where only one member state currently has a competition law and implementing agencies. Without recourse to competition law remedies, enterprise development in the smaller countries could be adversely affected by the enterprises from South Africa.

Currently, South Africa is the only member of SACU that has an operational competition policy and law. Namibia passed a Competition Act in 2003, but has yet to establish the Namibian Competition Commission provided for in the Act. Both Swaziland and Botswana have draft competition laws, and Lesotho has embarked on an economic mapping exercise and the development of an inventory of laws affecting competition.

The new SACU Agreement is a framework agreement, requiring the development of several Annexes on specific issues. Articles 40 and 41 of the Agreement require that an Annex on restrictive business practices be developed. This Annex is expected to provide details on the nature and extent of collaboration in the implementation of competition policy in the customs union.

The South African Competition Commission is an investigatory body, to which competition complaints may be addressed. It also conducts preliminary investigations into merger impact assessments, and makes recommendations to the Competition Tribunal. The Competition Tribunal is an adjudicatory body (or court of first instance) to which the Commission may refer complaints for further investigation and adjudication, and which considers large merger transactions. The third institution is the Competition Appeal Court, which hears appeals arising from Tribunal decisions. This is a court dedicated to competition matters.

The overall purpose of the Competition Act is to promote and maintain competition, in order

"(a) to promote the efficiency, adaptability and development of the economy;
(b) to provide consumers with competitive prices and product choices;
(c) to promote employment and advance the social and economic welfare of South Africans;
(d) to expand opportunities for South African participation in world markets and recognize the role of foreign competition in the Republic;
(e) to ensure that small and medium-sized enterprises have an equitable opportunity to participate in the economy; and
(f) to promote a greater spread of ownership, in particular to increase the ownership stakes of historically disadvantaged persons."

(Government of South Africa: Competition Act, no. 89 of 1998)

The Act's policy purpose thus focuses in the first instance on economic efficiency. South African competition law also explicitly includes public-interest considerations, in the articulation of its purpose; it therefore attempts to balance efficiency concerns and the broader development priorities in the competition framework.

The focus on SMEs is important against the background of the structure of the South African economy. High levels of concentration, and the conglomerate structure of business in many sectors from mining, to manufacturing and services, are important challenges for small business development in South Africa, besides the common challenges that SMEs face more generally. The conglomerate structure of business in South Africa and the strong vertical linkages that exist in many industries can prove to be effective barriers to entry for smaller enterprises.

The goal of promotion of a greater spread of ownership, especially as regards historically disadvantaged persons, reflects the concerns about the skewed distribution of income and wealth in South Africa. South Africa had for many decades one of the most unequal distributions of income in the world, with strong racial fault lines through the distribution. Greater spread of ownership and SME promotion are deemed to be important to ensure longer-term balanced and sustainable development.

The Act's preamble refers to the political motivations that provided the rationale for the policy reform process of the new government. The particular problems facing competition law and its effective enforcement, including practices, some of which were promoted and supported by apartheid policies and laws, led to high levels of concentration of ownership and control, inequitable constraints on economic participation by the majority of South Africans, and ineffective restraints on anti-competitive trade practices. This legacy is viewed through an equity lens, rather than an efficiency lens. In the 1979 competition legislation, public interest, although included in the Act, had not been defined. The new legislation articulates four pillars of public interest. Perhaps the most distinctive pillar of public interest in the South African competition legislation is empowering historically disadvantaged persons. The Competition Act, in this respect, echoes the focus in South Africa's Constitution on full and equal enjoyment of all rights and freedoms, and enshrines the economic empowerment of black persons in South Africa in the Act.

Policy statements related to economic efficiency and consumer benefits provide for flexibility in application. References to adaptability and development of the economy extend beyond an interpretation of economic efficiency in a static welfare sense, to incorporation of dynamic considerations including market entry, firm mobility and innovation.

Consumer interests are also included in a broad sense; not only is price important, but consumer choice matters too. Thus, maintaining the scope of choice may possibly be supported despite perhaps higher prices. A particular challenge emerges from the lack of consumer organization in South Africa. Consumers in South Africa (and this is also the case in many other developing countries) are generally not well

informed of their rights and the potential to pursue complaints through the competition authorities, and South Africa does not have specific consumer protection legislation. Advocacy is thus a key challenge for the South African competition authorities.

The rules of the Competition Act draw on international experience; the rules on restrictive practices derive from the EU Treaty and the merger regulation is similar to that of Canada. Besides select *per se* prohibitions, in general a violation of the Act is contingent upon demonstration of a net anti-competitive effect.

Exemptions which provide a counter to the prohibitions contained in the Act, also incorporate competition-plus issues. Exemptions, which have to be time-bound, may be granted for reasons which include the promotion of exports or the promotion of SMEs or firms controlled by historically disadvantaged persons. The scope for exemptions is broad; suggesting that even *per se* prohibited acts may be condoned if they contribute to the identified exemption factors.

A particular reason for consideration of an exemption application is “ensuring economic stability”. The rationale for including this, potentially extensive consideration, was to facilitate ministerial input on industrial-policy concerns or issues of national interest. Ministerial designation is not sufficient to ensure an exemption on such grounds; this has to be considered by the Competition Commission, and it will decide if the statutory standard is met.

Merger control provisions are very detailed, and public-interest issues feature prominently in merger review. Specified merger thresholds will determine the process of notification and assessment. Large mergers are investigated by the Competition Commission, whose decision forms a recommendation to the Competition Tribunal that may accept, reject or amend the Commission’s decision. Small and intermediate mergers are investigated by the Commission and a decision is made, which may be appealed to the Tribunal. Decisions by the Tribunal in all cases may be appealed to the Appeal Court and there is no ministerial override, as had been the case under the previous competition regime.

The merger evaluation process is clearly outlined in the Act. First, it has to be established whether the merger is likely to substantially prevent or lessen competition (SLC test). Second, if it has been decided that the merger will lessen competition, then it must be established whether the merger will result in “technological, efficiency or other pro-competitive gains” that will outweigh the anti-competitive effects of the merger. Third, irrespective of the outcome of the evaluation of the competition impact of the merger, a public-interest test has to be conducted. Thus, even though a merger may not have an adverse effect on competition, it still has to be reviewed on public-interest grounds.

Explicit criteria to consider in the SLC test are included in the Act (Section 12A (2)); however, a measure of flexibility remains with these. These criteria serve to some extent the purpose of general guidelines for the conduct of a merger assess-

ment. They include barriers to entry, import competition, history of collusion, vertical integration and the "failing firm" argument.

If the authority decides that the merger is likely to substantially prevent or lessen competition it must then assess whether the merger transaction will result in any efficiency gains. The efficiency test is therefore included as a defence for an anti-competitive merger transaction. The nature of the balance between the SLC test and the efficiency test poses significant challenges to the authorities, in that a weigh-up of a competition compromise and efficiency benefits (both static and dynamic) has to be considered. It has been conceded that perhaps following the USA in bringing the efficiency test into the competition assessment, alongside other factors already included in the Act, may make the task of the authorities more manageable.

The public-interest test is mandatory in all merger assessments. Section 12A (3) of the Competition Act specifies the public-interest test:

"(3) When determining whether a merger can or cannot be justified on public-interest grounds, the Competition Commission or the Competition Tribunal must consider the effect that the merger will have on –

- a particular industrial sector or region
- employment
- the ability of small businesses or firms controlled by historically disadvantaged persons to become competitive; or
- the ability of national industries to compete in international markets."

(Government of South Africa, Competition Act (op cit))

The public-interest test in the South African Competition Act is distinctive for a number of reasons. First, the public-interest test is explicitly included in the Act, and also delineated very specifically in terms of the criteria above. This means that very select public-interest concerns enjoy a focus in the context of competition assessments. Second, the test empowers the competition authorities to prohibit or allow a merger that does or does not, respectively, pass muster on the SLC test. Third, the competence to allow or disallow a merger on the basis of a public-interest consideration is accorded to the competition authority, not any other Minister or stakeholder representative. The Act does, however, require that the Minister of Trade and Industry (or another Minister directly affected by the merger) be served a copy of the merger notification, so that they can plead the case before the competition authorities.

In the case of intermediate or large mergers, the primary acquiring firm and the primary target firm must provide a copy of the merger notice to any registered trade union that represents a substantial number of its employees, or the employees or their representatives if there are no registered trade unions. Any person, whether or not a party to the merger transaction may submit any document, or relevant information for consideration by the competition authorities. Also, the Minister of Trade and

Industry may participate in any intermediate or large merger as a participant to make representation on any public-interest matter.

Although there has been expected criticism concerning the inclusion of public-interest issues in the Competition Act, their inclusion has to be read in context. Major challenges to sustainable development in South Africa are employment creation and black economic empowerment. Explicit reference to these factors is thus to be expected in a significant area of policy and law such as competition, and in some sense provides a balance of considerations in the challenge to develop a set of complementary policies and laws to facilitate enterprise development and the achievement of broader socio-economic objectives.

Recognizing the importance of the interface between sector regulation and competition law, the Competition Act (as amended, 2000) specifies that the Competition Authorities and Sector Regulators have joint jurisdiction in relevant sectors. A Regulators' Forum is being established to implement this provision of the Act and it makes the Competition Commission responsible to "negotiate agreements with regulatory authorities to coordinate and harmonize the exercise of jurisdiction over competition matters" within a specific sector or industry.

Thus far, the Independent Communication Authority of South Africa (ICASA) and the Competition Commission have developed a memorandum of understanding, which delineates their respective jurisdictions, and the National Electricity Regulator (NER) and the Competition Commission have agreed to a workable collaboration arrangement.

4. Supporting enterprise development through competition policy

Substantively, the work loads of the Competition Commission and the Tribunal have overwhelmingly been concentrated on merger control. This distinguishes South Africa from developing and transition economies with new competition agencies, and highlights the political concerns in South Africa about the high concentration of economic power. Through pre-notification and merger assessment, a demonstration effect, in the area of merger control, provides evidence of South Africa's new competition law's strong impact. While the explicit consideration of public-interest concerns emphasizes their pervasive policy importance, checks and balances in the Competition Act ensure that decisions are transparent and void of direct political control. It is useful to reflect on the experience of South Africa since the implementation of the new Competition Act. As regards merger control, competition law practitioners indicate that, in the early days, merger notifications were mostly undertaken by lawyers (filling in the required information in forms provided by the competition authorities). Now no merger filing would be complete without a detailed impact assessment. Lawyers and economists now work together in an inter-disciplinary manner to assess the likely impact of the proposed transaction.

Competition law forms an important part of effective market governance. The rules of the market game, including competition rules, can enhance market outcomes by promoting not only the achievement of efficiencies, but also greater equity. To this extent South Africa's competition law is progressive in its explicit incorporation of public-interest considerations; whereas even mature jurisdictions shy away from such potentially contentious territory.

With South Africa's history, the inclusion of public-interest concerns makes good policy sense. The nature of the South African economy, its grossly unequal distribution of income and wealth, and hence, too, its inequality of economic opportunity have to be addressed by a coherent set of policy initiatives. Thus, employment creation, black economic empowerment and SME development are familiar objectives across a range of economic policies. A challenging question is to what extent different policies can impact on the promotion of SMEs – what specifically can be the contribution of competition policy in this regard.

It may be quite obvious that, especially in the short term, direct industry support policies, such as the provision of credit or marketing support, may be more visibly effective in supporting SMEs. However, the contribution of competition policy, while in some cases being more indirect, can play an extremely important role in ensuring that SMEs not only get access to specific market opportunities, but also do not fail because of anti-competitive practices.

Competition policy and the law which gives effect to this policy provide indispensable checks and balances to ensure that the market process works without being rigged by larger firms or firms that may have market power, which can be used to the disadvantage of other market participants. This does not mean that there should be no casualties of the market and the process of competition, but competition should be fair and without prejudice.

The following merger transactions and the decisions of the competition authorities will illustrate the impact of public-interest considerations in merger impact assessments. Specifically the cases will highlight the consideration of SME and empowerment concerns.

Pioneer Foods – SAD Holdings: small business impact

Pioneer Foods has diverse interests in milling, baking, poultry, animal feeds and branded consumer goods. The merger transaction involves the purchase by Pioneer of all shares in SAD and all of its subsidiaries. SAD has business interests in nuts, vinegar, dried flowers, dried fruit, wine and salads. This is a large merger transaction and, hence, it was first reviewed by the Competition Commission and then referred to the Competition Tribunal for further investigation and approval.

Assessment of the relevant markets of the two parties indicated that there are only two markets with product overlap and, hence, relevance for the merger assessment. These are ready-to-eat (RTE) cereals and jar vegetables (salads). The latter

is a very small market with a third-party dominant producer: Tiger Brands. The RTE cereals market is one in which both small and large enterprises participate. International brand leaders such as Kellogg's are in this market, as are small home-based producers of RTE cereals for health-conscious consumers. There are, thus, various drivers of competition in the RTE market. And it may be argued that a finer delineation of more than one market is necessary to effectively assess the impact of the proposed merger transaction.

The geographic market for RTE cereals is defined as the South African national market, and there is limited import competition. This is because distribution and sales are primarily through supermarket chains which operate nationally.

The salad market proved to be a small market with low entry barriers contested by many small producers, and one large player. The Tribunal concluded that merger would not change the *status quo* in the salad market. This conclusion was based on an assessment of the nature of competitive activity, the role of the one large player and the contestability of the market. It therefore focused substantially on the RTE cereal market in its assessment of the merger impact.

Market definition proved an interesting exercise; breakfast cereals comprise hot cereals and muesli products. If the cereal market is taken as a single market, including both hot and muesli products, then Tiger Brands (which is not involved in the transaction) would be dominant. However, if branded cereals are defined as the relevant market, then Kellogg's is dominant. In the muesli market, taking a narrow market definition, then Nature's Source (which is a subsidiary of SAD, the primary target firm) is dominant.

The Competition Tribunal was persuaded that consumers display a high degree of substitutability especially among hot cereals and muesli products (the parties had submitted extensive price elasticity studies to indicate that the appropriate market definition was RTE cereals). Consumer demand was highly price elastic, and the cross-price elasticities indicated high degrees of product substitution.

It was concluded that even if muesli was defined as a separate "niche" market, this market demonstrated very low barriers to entry. This was an important consideration because on the one hand large-scale producers face significant barriers to entry, while on the other hand the barriers to small-scale producers were very low (many produced from home, and sold their products from specialist health shops or other non-retail chain outlets).

What became apparent to the Tribunal was that the small producers compete vigorously among themselves, and very few grow to the extent that they can attempt to compete with the likes of Kellogg's or Pioneer Foods. An important issue in this case was the nature of interaction between large-scale producers and the supermarket chains. The retail food market in South Africa is an oligopolistic one, with a few large chains of retail supermarkets competing actively with one another. They pro-

vide a strong source of countervailing power to the power of large-scale producers of consumer food products, including breakfast foods. One of their strong bargaining chips is allocation of shelf space in supermarkets. The market leader is accorded prime space, followed by the house brand, then the number two player follows and other players after that. Competition is thus intense as retail chains and suppliers bargain on price and shelf space, for example.

Taking into account these dynamic drivers of competition in the RTE market, the parties to the transaction argued that it was reasonable to conclude that far from reducing competition in the RTE market, the proposed merger may be expected to increase the level of competition as Pioneer Foods' bargaining power *vis à vis* the retail chains is likely to be strengthened, and that Kellogg's, the market leader, is likely to face more substantial competition.

The conclusion of the Tribunal was that the merger would not harm small business prospects, and the contestability of the RTE market would not be adversely affected by the merger. The merger was approved unconditionally. "It is possible for small-scale players to continue to enter the market by developing niche brands. The merger is not likely to adversely affect the potential of small-scale or niche entrants to the market" was the conclusion of the Tribunal.

This decision highlighted the fact that in some cases it may be possible to define the market not only in terms of product and geography, but it may be necessary to consider size of firms. In this case, the large firms (competitors of Kellogg's) can be said to operate in a market delineated from the market where small, niche (home) producers compete intensively with one another. It is quite unusual for small, niche producers to grow to the extent that they migrate to the large-firm market.

Two additional brief reviews of competition cases where SMEs were important considerations are noted here.

The *Bernina–Saskor* case (Competition Commission, 2002) arose from a complaint by an independent service provider alleging that Bernina–Saskor, the sole importer and supplier of Bernina sewing machine parts in South Africa, had instructed its franchisees not to provide the complainant with Bernina machine parts. The Commission concluded, and the respondent concurred that the respondent had contravened the provisions of the Act (Section 8(d) (1)) in that he had required a supplier not to deal with a competitor, and a Consent Order was concluded. In terms of the Consent Order, the instruction to franchisees was withdrawn immediately, and parts would be supplied to any customers. The machine parts would be used, typically, by small (often independent) enterprises repairing sewing machines. The restrictive practice was, thus, adversely affecting a niche market of small (even micro) service providers.

A group of 33 individually owned pharmacies (who had formed an association called Ring Pharmacies), are all SMEs. Ring Pharmacies had been engaging in joint

marketing initiatives to assist them to compete with pharmacy chains. They applied for an exemption so that they could continue to conduct joint marketing initiatives to enable them to compete with established chains of pharmacies.

In recent years, in South Africa, pharmacy chains have proliferated, and the small individually owned pharmacy has become a rarity. The exemption was granted for 5 years to enable these SMEs to compete with the large chains. This decision recognizes the benefits of small, individually owned pharmacies, some of which may not have been targeted by the pharmacy chains as a result of their location of performance. The decision is thus pro-active support for small enterprises to compete in a market which has experienced a new reconfiguration as the chains have become commonplace.

Economic empowerment of historically disadvantaged persons is a key policy objective. Empowerment is achieved through many initiatives including employment equity requirements. The role of competition policy in empowerment is illustrated in a case that highlighted very different interpretations of this public-interest consideration by the Competition Commission and the Competition Tribunal.

Shell–Tepco Merger – Empowerment of historically disadvantaged persons

The Shell–Tepco merger took place in the oil industry. This industry is a high volume, low margin, capital intensive industry, and in South Africa also highly regulated.

Price control, especially retail price maintenance, and import control are key features of the regulatory dispensation. Maximum prices are set for petrol (gas), diesel and paraffin, from which dealers may discount. Stakeholders in the industry and the Department of Minerals and Energy have set goals to achieve Black Economic Empowerment (BEE) in the industry. At the time of the merger, BEE in the oil industry was in its infancy with BP being the leader in this regard. Shell was therefore very interested in this merger which would provide it with an empowerment partner.

Shell South Africa (SA) manufactures and markets petroleum and petroleum products directly and indirectly through subsidiaries and franchise outlets in South Africa. A distinction is made between the retail and commercial markets. The retail market is business-to-business which buys in bulk either on tender or contract or at negotiated prices. In the retail market, products are sold to consumers through retail franchise networks such as petrol stations. The geographic market for the commercial segment is national because of “hospitality” agreements among oil companies in terms of which they swap product (with regulated specifications) at different locations determined by the location of the refineries and customers. This means that a commercial customer can go to any depot with which the contracting oil company has a hospitality agreement.

The geographic market for retail is sub-national. Data were only, however, available at the magisterial district (local council) level, and hence this influenced the geographic market definition of the retail segment.

Shell is one of several oil majors operating in South Africa. At the time of the merger transaction, Shell SA was the second largest national player in the retail diesel and commercial paraffin markets, the third largest player in the retail petrol market and the fourth largest national player in the commercial petrol market.

Tepco, in contrast, was one of the smallest players in all relevant markets. Tepco is a wholly owned subsidiary of Thebe Investment Corporation. It markets and distributes petroleum and petroleum products as its main business.

An important consideration in this case was the role of government-induced regulation in the oil industry. Although the Department of Minerals and Energy has embarked on a process of managed liberalization, regulation still accounts for much of the distortion in the various markets in the industry. Another important consideration was that product specifications, specifically, are regulated. The relative product homogeneity facilitates substitution by consumers and thus enhances competition among suppliers. In the commercial market segment, where prices are not regulated, customers interviewed by the Tribunal indicated that they can negotiate prices with suppliers, and this prevents the abuse of even a dominant position in a narrowly defined geographic market.

The merger passed the SLC text – no lessening of competition was anticipated in the relevant markets, which were defined as the marketing and distribution of petroleum products nationally in South Africa.

However, the Commission conditionally recommended that the merger be approved, on the grounds that the merger would remove Tepco as an independent player in the petroleum industry, and would inhibit the ability of a firm owned or controlled by historically disadvantaged individuals to become competitive. The conditions for approval were:

- Tepco should remain an independent company jointly controlled by Thebe and Shell; and
- Tepco's brand should be maintained to ensure its independence.

The first condition would require a restructuring of the deal that the parties had put together, and neither wanted. Tepco indicated that it was experiencing structural difficulties and hence it wanted to be taken over by Shell – after the deal it would be owned and controlled by Shell.

The Tribunal criticized the Commission's recommendation as patronizing, indicating that empowerment is not "further obliging firms controlled by historically disadvantaged persons to continue to exist on a life-support machine".

The second condition was viewed as linked to the first by the Tribunal and subjected to the same criticism – there was no reason to prolong the existence of a non-viable brand. Tepco's locations were in high-risk markets that other suppliers were not prepared to supply. Thus, its exit from the market did not remove an effective competitor.

The Tribunal emphasized that the parties are free to make whatever deal they chose – provided that they meet the approval of the competition authorities.

The Tribunal overruled the Commission's recommendation, and approved the merger unconditionally. One of the reasons for the Tribunal's decision was that Tepco could drain the financial resources of its parent company if it were forced to remain independent in the market. The conclusion to the Tribunal's decision is instructive:

"The role played by the competition authorities in defending even those aspects of the public interest listed in the Act is, at most, secondary to other statutory and regulatory instruments – in this case the Employment Equity Act, the Skills Development Act, and the (Empowerment) Charter itself spring to mind. The competition authorities, however well intentioned, are well advised not to pursue their public-interest mandate in an over-zealous manner lest they damage precisely those interests that they ostensibly seek to protect." (www.comptrib.co.za)

This case raises very important considerations in the interpretation of the public interest in the context of a merger assessment. While public-interest concerns are explicitly incorporated into the merger assessment process, it is recognized that they should be interpreted very cautiously, and that the role of other policy initiatives in promoting those public-interest objectives may be far more important that that of competition policy and law.

A current case, concerns the privatization of state-owned enterprises and the role of competition policy. Perhaps one of the most challenging areas to address competition issues is in the realm of state-owned enterprises, and this is illustrated by the Telkom case. South Africa has embarked cautiously on the privatization route, and in those cases where state-owned enterprises have been privatized, a key consideration has been the maximization of asset value rather than the introduction of competition. This has important implications for enterprise development. State-owned enterprises in infrastructure service provision can have seriously deleterious effects on enterprise development; far more so than specific abuses of dominance or restrictive practices involving consumer products markets.

Advice from the Bretton Woods Institutions during the 1980s to governments in developing countries was to privatize and liberalize, with virtually no mention of competition policy and law. In developing countries with small markets, and in many cases larger foreign-owned enterprises or subsidiaries of multinational corporations, operating alongside many small and medium-sized domestically owned enterprises,

the withdrawal of the state from productive economic activity left a lacuna which was readily filled by private concentrations of economic power, often private monopolies.

It was soon realized that market governance mattered very much, and perhaps especially so in developing countries. Rules are necessary for markets to function efficiently – and the competition rules were very important in this regard. The beginning of the 1990s heralded the era of regulatory reform, and soon the wave of competition policy and law development gathered momentum, more slowly perhaps, but also, in developing countries.

An interesting case which is currently being considered by the competition authorities concerns Telkom, the current sole provider of fixed-line telephony services. The South African Value-Added Network Services Association (SAVA) has lodged a complaint against Telkom, on grounds including the following:

- Telkom's refusal to provide telecommunications facilities to SAVA members to construct their networks
- Discriminatory pricing with respect to leased-line services
- Refusal to lease access facilities to value-added network services providers
- Bundling of services.

The Commission has found that Telkom has abused its dominant position, and the complaint has been referred to the Tribunal for determination. The outcome of this case has important implications for consumers and for business especially SMEs. Enterprise development can be seriously affected by providers of services such as telecommunications, transportation and other network-based services. Privatization in developing countries should be conducted with due recognition for the benefits of promoting competition in the provision of services previously provided by state-owned monopolies. These basic services provide an important infrastructure for enterprises and can impact significantly on the overheads of small enterprises, limit their ability to communicate with customers and suppliers and to market their products or services.

5. Conclusions

South Africa's experience in the development of its competition policy and law in the 1990s offers important lessons for other developing countries. First, the development of competition policy took place during a comprehensive policy reform programme. While this may not be feasible in other countries, it is important to note from this experience that due consideration for the policy synergies, perhaps among the collection of microeconomic policies such as trade, industrial, competition and labour market policies, is important.

Second, many developing countries are still engaged in, or planning to privatize state-owned enterprises. While an obvious concern in such a privatization exercise is undoubtedly revenue generation, and hence the protection or enhancement of asset value is key, the potentially negative effects on enterprise development across

markets and sectors requires careful consideration of the promotion of competition in such markets.

Third, a very important aspect of the development of competition policy and law is the building of a competition culture. In some developing countries, economies are still in a transition from socialist-type or highly controlled economic systems. The private sector is an emerging one, and the benefits of competition may not be appreciated or be obvious to all stakeholders in the economy. An inclusive process of discussion and education around competition issues may assist to develop a competition culture that will enhance the benefits of enforcement.

Even in South Africa, where a comprehensive policy process involved a broad spectrum of stakeholders, competition law practitioners indicate that it is sometimes difficult to obtain information from even large enterprises, for merger filings or investigation of competition complaints. The perception seems still to be that competition law implementation is a bureaucratic process, a hassle factor for business. The collaboration of competition champions (perhaps larger businesses) to extol the virtues of effective implementation of competition can play a role in this regard. In South Africa, for example, South African Breweries, now a multinational beer producer, has a well-publicized compliance programme for managers, and this has assisted to raise the profile of competition policy in the private sector.

In merger regulation for example, trade unions are explicitly involved in the merger notification process. Thus, competition policy becomes not only an issue for management but also for employees.

Fourth, South Africa's experience in implementing competition has highlighted the importance of capacity building. In South Africa, as in many other developing countries, there is not a long tradition of collaboration between lawyers and economists. Lawyers seldom study economics and economists are not likely to study law either. Competition policy and law requires an inter-disciplinary approach, bringing lawyers and economists together. This is also a new area of study in South Africa, especially in the legal field, and this is probably similar in many developing countries.

A particular challenge as a result of the skills shortage has been the high rate of staff turnover at the Competition Commission. Commissioners with little more than a year's experience have become very sought after in legal firms and in the private sector. Capacity building should therefore be an ongoing exercise.

Fifth, the specific challenges faced in the case of South Africa at the end of the apartheid era also hold important lessons for developing countries. Distortions by government regulation, high levels of concentration in ownership and control, and vertically integrated conglomerate organizations were not conditions supportive of a strong competition culture and robust competition processes. This meant that the usual objective of competition policy to promote competition and economic efficiency was important, but at the same time, broader public-interest objectives were also

important. Public-interest objectives mattered in the context of competition policy even though they were also to be pursued through other policy channels.

While public-interest objectives are important, their introduction into competition policy and law has to be handled very carefully. South Africa's experience with its 1979 Maintenance and Promotion of Competition Act offered clear lessons in this regard.

The 1979 Act put the public interest as the final criterion against which competition decisions would be tested, but did not define the public interest. This led to *ad hoc* and conflicting case law, and this was compounded by the political influence that could affect or override decisions by the Competition Board.

In the new Competition Act, the public interest is explicitly articulated. Specifically four public-interest pillars are identified, and bounds are placed on the permissible recourse to public-interest issues in competition cases.

For developing countries, this is important to note. While it may be desirable to include public-interest considerations explicitly to limit the scope of interpretation, care has to be taken both in the drafting of the law and in the implementation of that law. Caution must be exercised to ensure that decisions are credible and a consistent body of case law amplifies the letter of the law. Effective and consistent implementation of competition law is perhaps the most important advocacy tool in a developing country. There may be occasions where the promotion of public-interest objectives will be better served by policy interventions other than competition policy, and the competition authorities should be bold enough to hold back on such decisions (as was the case in the Shell–Tepco merger discussed earlier).

Developing countries should note that the specific pillars of public interest that are identified need careful consideration. The unique South African history led to the delineation of four pillars of public interest: small and medium enterprise development and black economic empowerment, employment, impact on a particular industry or region, and the ability of national industries to compete in international markets. In the implementation of competition law thus far, it is in the case of merger control, that employment, economic empowerment and small enterprise development have featured most prominently. The ability of national industries to compete in international markets has not yet been considered to be positively key in any merger assessment.

In general, and specifically for developing countries, it is important not to overload the competition policy agenda. There are objectives (including, in particular, public-interest objectives) that can be more effectively achieved through other policy channels. Policy coordination and inter-policy consistency is critical, especially for developing countries that are faced with the challenges of market development, with in some cases an emerging, rather than a robust, private sector, especially a small business sector. The number of public-interest issues included in the competition

policy agenda should therefore be strictly limited, and through effective implementation of the competition law, synergies with other policy initiatives supporting these public-interest objectives should be developed.

Although the public-interest test in merger review is clearly specified, the Competition Tribunal has been cautious in its consideration of this test. This is a singular lesson for developing countries. If the credibility of the competition authority is to be established in the application of a public-interest test then cautious application is recommended.

The South African experience has also shown that, despite resistance at the multilateral level to engage in negotiations to determine competition rules, it is not possible to avoid competition issues in bilateral negotiations. South Africa (and SACU) is currently negotiating a free trade agreement with the United States and competition policy is definitely on the agenda, as it is also in the negotiations with the European Free Trade Area (EFTA) to conclude a free-trade agreement. It seems fair to say that such trade negotiations highlight the potential impact on domestic markets if competition policy does not exist.

The new generation trade agreements include trade-plus issues such as investment, and the entry of new firms, perhaps large ones, may have serious effects on the nature and intensity of competition in developing country markets. The absence of competition policy and law could mean that domestic firms do not have any armour should the newcomers engage in anti-competitive practices. So, while developing countries welcome and actively compete for foreign direct investment, they should ensure that competition policy and law is in place to ensure that competition is fair and that enterprise development is facilitated not frustrated.

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III.3. THE EVOLUTION OF COMPETITION POLICY AND ITS IMPACT ON ECONOMIC DEVELOPMENT IN KOREA[1]

Joseph Seon Hur

1. Competition policy and economic development[2]

For the 22 years that Korean competition law, the Monopoly Regulation and Fair Trade Act (MRFTA) of 1981), has been in effect, the Korea Fair Trade Commission (KFTC) has strived towards the formation of a market economy in Korea. As the government body in charge of competition law and policy, the KFTC has had immense influence on Korean economic development by correcting market failures stemming from imperfect competition and overcoming resistance and various obstacles to the market economy. This chapter has two purposes. One is to rethink the importance of competition policy as a core institution in the domestic economy and the other is to draw lessons from the Korean experience for the benefit of other developing countries with less, or no, experience in competition law enforcement. This will be done through analysis of how competition policies influenced Korean economic development in the last two decades.

The goal of national competition policies in a market economy is to increase economic efficiency and consumer welfare through promoting competition.[3] Since competition plays as crucial a role in a market economy as blood does in the body, government has an essential role to play in promoting and monitoring competition to ensure smooth development of the market economy. As the communist bloc collapsed and global integration of the world economy accelerated in the 1990s, a lot of developing countries and transition economies have been adopting competition law *en masse*. Developed countries are also reinforcing competition law enforcement policies. In light of such trends, we can be assured that, in the near future, competition policies will be core policies in those countries striving for sustainable economic growth regardless of their current economic status.

What lies beneath the adoption of competition law and its reinforcement in many countries is the belief that competition policies play a significant, positive role in economic development. That fierce competition among corporations has an important influence on economic development by enhancing efficiency and thus improving social welfare was proved valid to a certain extent by economic theories and empirical studies. It is difficult, however, to find straightforward data on the effect of competition policy on economic development.[4] Theoretically, it is not too hard to guess that competition policy would have positive effects on economic development since it promotes competition. However, there are certain limitations in proving this by empirical analyses. First, this is because other factors such as free trade and investment, regulatory reforms and privatization also contribute to economic development through promoting competition. These variants are so closely intertwined that it is not easy to differentiate between them. Secondly, the histories of competition policies in

many countries are not long enough to make chronological analyses to see their relationship with economic development. Lastly, it is hard to discover appropriate variants that can measure the intensity of a country's competition policies.[5] Under these circumstances, it would be meaningful to see what influence competition policies have had thus far in the economic growth and development in Korea, which is known as a country of successful economic development.

In the next section, I will divide the Korean economic development process into three stages to examine the accomplishments and the problems of past economic policies. I will provide observations on past policies for the formation of a market economy and the developments of the MRFTA. The subsequent section will include analysis on how the KFTC has influenced Korean economic development and consumer welfare during its 22 years of competition policy enforcement. Finally in the conclusion, a few lessons from the Korean experiences will be discussed.

2. The Korean economic growth process and competition policy development

2.1. Government-led economic management: from the 1960s to the 1970s

2.1.1 Bright and dark sides of the fast economic growth led by the government

Throughout the 1960s and the 1970s, the Korean government pursued the so-called unbalanced growth strategy that strategically concentrated its financial and tax support on export-oriented industries. As a result, Korea achieved remarkable economic development, thereby increasing its GDP by 30-fold (US$ 21 billion in 1961, US$ 616 billion in 1979) and GDP *per capita* by 20-fold (US$ 81 in 1961, US$ 1647 in 1979) in less than 20 years.

This unbalanced government-led growth strategy is viewed as having been inevitable considering Korea's past economic status as a small market with a lack of resources and limited technology. However, when examined from the "competition perspective", this early stage can also be viewed as the period of government intervention and protection with limited domestic and international competition. In other words, this period was when market economic function was often substituted by government intervention. In the 1960s, government intervention was considered relatively neutral as government supported industry according to export performance. In the 1970s, however, government designated strategic industries and concentrated its support on certain companies so that it grossly distorted the market function. This resulted in unintended structural problems arising in various areas of the economy. The absence of competition distorted the operation of the market and allowed monopolistic/oligopolistic markets to take root while the concentration of economic power in the hands of a few (the *chaebols*) cast a dark shadow over the Korean economy as a whole. The reason why Korea was able to achieve high economic growth despite these structural inefficiencies is because conditions in the international economy

were working to Korea's advantage at the time. Developed countries that advocated free trade turned a blind eye to the protectionism of developing countries under the GATT system.

2.1.2. Failed efforts to introduce competition law

There was certainly no lack of efforts to introduce the principles of competition in this period. In 1963, the so-called "three-powder case"[6] had provoked public opinion to the view that socio-political measures were necessary to deal with the abuse of monopolies. After that, proposals to legislate the Fair Trade Act were submitted to parliament in 1966, 1969 and 1971, with criticism on monopoly issues. These efforts, however, were thwarted every time. There was an absolute lack of general consensus on antitrust policies. Industries protested too, claiming that the most urgent problem in the Korean economy was to accumulate corporate capital and to produce an adequate supply of goods.

Finally, in 1975, the "Price Stability and Fair Trade Act" was legislated and was to precede the current MRFTA. Since the early 1970s, the domestic economy had been going through tough times due to price instability caused by augmentation of imported raw material prices and higher exchange rates. To tackle the problem, government legislated the "Price Stability and Fair Trade Act" in order to have flexible control over prices. This Act prescribed two contradictory objectives, price stability and observation of fair trade, though it focused more on the former than the latter. There were regulations on monopoly but they were mainly on cases of abuse, rather than on the issue of market structure. In practical terms, collective activities could not be regulated although they were prohibited due to the inherent shortcomings of the Act. The Act did not have the desired effects in the late 1970s either in terms of price stability or fair trade while Korea was struggling with an overheated economy and the second Oil Shock.

Finally, as we approached the late 1970s, ineffective over-investment was intensified by blind policy measures to protect the heavy and chemical industries. The Oil Shock and domestic political unrest aggravated the situation and brought about stagnation in the 1980s.[7] Economic stagnation in that period was unrelated to the cycle of economic ups and downs and its primary causes were the structural problems in the Korean economy that had accumulated during its compressed growth process. Accordingly, government started pursuing the legislation of a significant antitrust law to guarantee the clarity of the legal system and the efficiency of its operations.

2.2. Efforts to diffuse competition principles and economic crisis: from 1981 to 1997

2.2.1. Shift in economic policy trends and implications of the adoption of the MRFTA

Growth-oriented strategy led by government in the 1960s and 1970s subordinated the economy to politics and caused structural problems such as undue politico-

economic ties, income inequality between social classes or regions and abuses of monopoly. As we entered the 1980s, along with the global promotion of deregulation and markets opening to foreign trade, Korea attempted to discontinue government-led growth policies. The change was attempted under three clear goals: liberalization, stability and market opening. With the process of liberalization came domestic competition stimulation and market opening with the introduction of external competition, and competition at last started to take root as a central concept in the management of the Korean economy.

Against this backdrop, Korea's basic competition law, the "Monopoly Regulation and Fair Trade Act" was legislated in December 1980 and enacted in April 1981, despite strong opposition from industry. The MRFTA was intended to change the government-led economy to a market economy. This was not merely an adoption of a legal mechanism. It signified a paradigm shift in national economic management. Through the MRFTA, the Korean government demonstrated its determination to actively adopt a market economy. Previously, several attempts had failed to introduce antitrust laws that could alleviate the side-effects of the past growth-oriented strategy and the paralysis of market functions. With greater economic expansion and complexity, however, the inefficiency of government intervention was clear. Monopolization was intensified with economic growth and this weakened the domestic economy to undermine Korea's international competitiveness.

The adoption of the MRFTA was a significant turning point that paved the way for the continuous development of the Korean economy. It can be regarded as a declaration introspective of past economic policies to revive market functions in the future. It also reflects the government's determination to renew completely the economic constitution which was weakened by intensified monopoly.

This shift in economic policy of the 1980s produced considerable results. Since 1982, prices have become more stable and a one-digit price increase rate has been maintained. From 1986 to 1989, Korea achieved an international accounts surplus for the first time. From 1981 to 1991, the average annual GDP growth rate reached a noteworthy 8.7 per cent.

2.2.2. Developments of competition policy

Since the enactment of the MRFTA in 1981, substances and priorities in Korean competition policy have evolved with market conditions and economic development stages. Accordingly, the organization and manpower of the enforcement authority, the KFTC, have steadily been reinforced[8] to enhance its status. While the first competition law was modelled on the systems of other countries, Korean competition policy has evolved to meet the needs of its own economic situation. This helped to gain public support for competition policy so that it can quickly and successfully take root in Korea.

First, to strengthen protective policies for SMEs (small and medium enterprises), the KFTC established the "Fair Subcontract Transactions Act" which was initially an

article in the MRFTA. In 1986, the KFTC adopted the “Adhesion Contracts Act” to prevent large-scale consumer damages arising from unfair stipulations and to ensure fair trade.

At the end of 1986, a system aimed at dealing with the concentration of economic power in the *chaebols* was introduced in the MRFTA. It is true that the *chaebols* considerably contributed to the economic growth of Korea, but as the economy became market oriented in the 1980s, the *chaebols* became obstacles that hindered the diffusion of competition principles and social equity. *Chaebols*, born from the post-selective protection of the government, were worsening the monopolist market structure by expanding their economic power through unfair means of capital multiplication such as mutual shareholding. The government sought policy measures through the revision of the MRFTA in response to the national consensus on the seriousness of the issues and the urgent necessity for countermeasures. The economic power concentration control system enacted in 1987 is a system peculiar to Korean antitrust policies that was made to seek balanced development. It would suppress excessive concentration of economic power and enhance the vitality of domestic economy by making the *chaebols* focus on substantial growth rather than on unreasonable expansion.

In 1988, the KFTC was the first to declare “deregulation” and embarked on reforms in 18 industries. It was then that the KFTC’s regulatory reform efforts really started. It aimed to abolish direct price control or market entry regulations by the government and to facilitate an environment where the market can function on its own.

The KFTC’s enhanced status and reinforced functions since the enactment of the MRFTA meant that the direction of the government’s economic policy steadily changed to focus on autonomy and competition rather than protection and regulations.

2.2.3. Change in the economic environment and the financial crisis

Though both domestic and international economic settings changed significantly since the beginning of the 1990s, the Korean government and industries missed the chance to restructure the economy as they contented themselves with their old practices, only to cause the 1997 financial crisis.

While the increase in demand from the foreign market stagnated from the beginning of the 1990s, many firms in developing countries emerged as strong competitors to Korean corporations in the global market. Domestically, competitiveness of export price has greatly decreased as the labour cost rose continuously. Amid all this, Korean corporations faced fiercer competition in the world market as the international economy integrated and borderless competition unfolded. From the mid-1990s, the WTO was in operation and Korea was admitted to the OECD. As these events intensified the market opening pressures and the waves of globalization, cor-

porations encountered greater competition in the international market. Also, the need for pro-competition restructuring for the Korean economy was getting greater.

Korean corporations were losing the competitive edge in this context since their growth had depended to a great extent on government protection and assistance. *Chaebols* were unable to swiftly adapt to the changing environment. They were sticking to old growth strategies that had guaranteed success in the past, i.e. a strategy to multiply affiliated corporations by increasing production input financed through external loans. Hitherto, the KFTC had tried to reform the *chaebol* structure and business practices through controls on cross-shareholding and restrictions on the total amount of shareholding of other companies. However, those measures had little visible effects without a comprehensive control mechanism for *chaebol* activities. Though government attempted deregulation and market opening to remedy structural problems, much of the government-led economic system, operating through regulations and protection policies, still remained. Structural problems and inefficiency persisted in the Korean economy and strategic industries were gradually losing ground.

Although the KFTC made early efforts to restructure the Korean economy based on market economic principles, it failed to make fundamental changes in government policies and corporate behaviour. For example, the KFTC attempted to ban cross-debt guarantees between companies affiliated to one of 30 *chaebols*, only to meet resistance from industry and the relevant government authorities that led to failure.[9] From the beginning, the KFTC's functions and status were continuously evolving and it made progress in encouraging competition within the overall economy. However, it had not attained the authority and resources to determine the path of national economic policy.

Still, we cannot conclude that the achievements of applying antitrust policy was thus far trivial because the primary cause of the 1997 economic crisis can be traced back to structural problems, i.e. a weak market competition system. If we look at the Korean economy in the 1990s, before the financial crisis from the competition perspective, competition policy was more or less taking root in the product market, though it was unsatisfactory in the production factors market and enterprise ownership market. If we could say that competition has been taking root in every aspect of the economy during the post-crisis restructuring process, this would be the achievement of the KFTC's past efforts to instil the pro-competition mentality in every corner of its economy.

2.3. Towards the advanced market economy: from 1998 to the present

2.3.1. Structural reforms and strengthened enforcement of competition law

The 1997 economic crisis has generated national consensus that market competition should be the core economic principle. Under these circumstances, the Korean government has promoted reforms in four main sectors, corporations, finance, la-

bour and public services, after the crisis. We can assess that, as a result, structural defects that had been fixed for 30 years have been significantly removed and that the pivotal point was laid for the market economy. First, in the corporate restructuring case, increase of small shareholders' right, introduction of external board members and reinforcement of accounting standards have improved the corporate governance structure and transparency. Cross-debt guarantees between affiliates of *chaebols* have been completely eliminated and the debt ratio of manufacturers has been pushed below 200 per cent. A permanent restructuring system run primarily by the board of bondholders has been set up. In the case of the financial institutions, the soundness and profitability have improved through the large-scale investment of public funds and their supervisory functions have advanced. In the public sectors, efficiency has increased through reduced manpower and consistently promoted privatization. As for labour problems, the situation continues to improve through increased flexibility due to the constant system improvements and the common culture of competition law and principles is being accepted widely.

The KFTC has played a pivotal role in corporate restructuring. It provided the basic environment where various means of interconnected *chaebol*-style management could be replaced by independent management systems, by reinforcing controls on the concentration of economic power.[10] During the process, law enforcement by the KFTC, such as the corrective measures against cartels and prohibited activities of trade associations, was made much stricter[11]. The KFTC provided the foundation for market economy to be settled also by actively promoting competition advocacy that ensures market competition through participating in regulatory reforms and a privatization process for public enterprises.

2.3.2. Reform accomplishments and the remaining tasks

Korea overcame the financial crisis and swiftly regained international credibility by carrying out comprehensive reforms. Since 1999, it attained high economic growth rates and a large national economic surplus while maintaining stable consumer prices. It made its final debt repayment to the IMF in August last year, 3 years earlier than planned. Korea is now one of the top five countries with the highest foreign currency reserves with US$ 100 billion compared to US$ 4 billion at one point in the financial crisis. International Financial Information Services are upgrading Korea's credibility to the level prior to the crisis.[12] Foreign media and investment institutions are also speaking highly of Korean restructuring achievements.

However, it is difficult to say that these changes are sufficient for continued steady growth, even though competition policy and restructuring efforts have prepared a foundation for sound development of the market economy. In particular from the competition policy perspective, the market economic principles have not been established in every part of the economy. The Korean market still has many sectors with high market concentration. Businesses have only begun to renovate through M&A and select managers through competition. The level of competition is also low in

markets for labour and capital, for example. Therefore, we must continue to push for reform towards greater competition.

3. Impact of competition policy on economic growth and development

The competition policies that Korea employed for the last 22 years have had a significant impact on how the Korean economy works and what course of development it has taken. The most straightforward way to estimate the impact on economic growth and development is through quantitative analysis using statistical tools. This would allow us to see changes in GDP *per capita* or corporate productivity and competitiveness in relation to the implementation of competition policy. But, as mentioned previously in the introduction, it is not only difficult and complex to undertake primary analysis which proves the relationship between competition policy variables and macroeconomic growth and development, but the exercise is also beyond the scope of this chapter. Thus, in this chapter, I begin on the theoretical and empirical basis that concludes the positive correlation between competition variables and economic growth and development. From this point of view, it is possible to provide indirect proof of competition policy's positive effect on economic development just by showing that competition policy implementation generated great competition. On the other hand, since it is somewhat easy to estimate consumer and social welfare improvements through actual examples, many of my arguments will depend on this aspect. In the following pages, I will try to show that competition policy has provided a microfoundation for continuous economic development by dividing competition policy categories into monopoly regulation, cartel regulation and competition advocacy (regulatory reforms). I will also show how efficiency and welfare have increased through law enforcement.[13]

3.1. Market regulations on monopoly and oligopoly, competition promotion through cartel regulations and social welfare improvement

3.1.1. Increase in economic efficiency through regulations on monopoly and oligopoly

3.1.1.1. Regulations on monopoly and oligopoly in Korea

Korean monopoly regulation has consisted largely of identification and disclosure of market-dominating corporations and restrictions on abuses of market dominance. This system was first adopted when the MRFTA was enacted in 1981 and was used until 1999. It was a system unique to the Korean economy. The KFTC designated market participants with certain dominant characteristics each year and imposed *ex post facto* regulations on abuses of market status. But it has been noted that these measures are not sufficient to reform monopoly or oligopoly structures at their core since it focuses on enforcement of law after the violation has occurred. To make market structure more pro-competitive, the KTFC established and enforced the reform policies targeting the market structure. In the 1999 Amendment to the MRFTA,

the designation system for market dominant enterprises was abolished. Now, market dominance is determined on a case-by-case basis.

The M&A control system is a typical means of competition policy aimed at prevention of monopolization. The KFTC reviewed 5,506 cases for M&A in total from 1981 to 2000. Among them, corrective measures were ordered in only 13 cases where the KFTC recognized competition restraints and injunctions were ordered in only four of those 13. Observing that nine out of 13 corrective measures were ordered after the financial crisis, we can say that the M&A regulation policy has been more active since then.[14]

3.1.1.2. Reducing market concentration[15]

Due to growing free trade and investment as well as 20 years of competition policy implementation, the Korean market structure is gradually becoming more pro-competitive.[16] As we can see in Table 1, the industrial concentration ratios in the mining and manufacturing sectors have gone down generally since enforcement of the MRFTA. The index shows that concentration was temporarily intensified between 1997 and 1998 because the economic crisis in 1997 reduced the number of corporations and business activities. In 1999, however, the index is even better than before the crisis. Since the number of businesses has decreased compared to that before the economic crisis, this can be translated to mean that competition structure has greatly improved in the Korean market.

Table 1. Trends of average industrial concentration ratios in mining and manufacturing

Year	1980	1990	1995	1997	1998	1999
CR^3 (%)	62.4	52.8	47.8	48.6	50.0	45.4

Table 2. Number of industries according to concentration ratio class (No., %)

Concentration Ratio (CR_3) Class	1980	1990	1995	1997	1998	1999
Under 0.20	18 (4.3)	89 (15.0)	91 (15.2)	88 (14.7)	87 (14.7)	92 (19.0)
~ under 0.50	133 (32.1)	214 (36.1)	259 (43.3)	268 (44.7)	258 (43.6)	222 (45.8)
~ under 0.70	93 (22.5)	107 (18.0)	111 (18.6)	102 (17.0)	92 (15.5)	65 (13.4)
~ under 0.90	85 (20.5)	84 (14.2)	69 (11.5)	67 (11.2)	79 (13.3)	55 (11.3)
Over 0.90	85 (20.5)	99 (16.7)	68 (11.4)	74 (12.4)	76 (12.8)	51 (10.5)

Table 2 divides the industrial concentration ratio into several classes and shows the number of industries and their gravity in each class. According to this, industrial

concentration in mining and manufacturing has generally improved since 1980. Looking at the table, we can see that there is a tendency for industrial gravity to decrease in classes with high concentration and to increase in classes with low concentration.

3.1.1.3. Empirical studies on efficiency enhancement effects of monopoly regulations

(i) Decreased loss of social welfare

Economic logic would conclude that prices in monopolies are likely to be higher than in the competitive market. In monopolistic and oligopolistic situations, corporations can easily raise prices using market dominance. In addition, since the producers are few and corporate consensus can easily be reached, the possibility of explicitly or implicitly raising prices or preventing their reduction is greater. This being the case, the possible loss in social welfare is also greater than in a competitive market as less production results in higher consumer prices. In addition, long-term negative effects can result because there is little competition to stimulate technological innovation (which confers dynamic efficiency).

Jeon (2002) has reached conclusions worth pointing out through his statistical analysis of the social cost effects of Korean monopolistic and oligopolistic structures formed during past government-led rapid economic growth. According to the study on social welfare loss in 22 manufacturing industries from 1981 to 1998, the loss in 1995 was estimated to be 12.5 billion won (3.31 per cent of the GDP), which is considerably higher compared to the same index for the US or other developed countries. However, if we look at changes in the annual size of social welfare loss, it was 8.45 per cent of GDP in 1981 whereas it was 7.07 per cent in 1985, 4.87 per cent in 1990, 3.31 per cent in 1995 and reached 3.36 per cent in 1998. That clearly shows the decrease in welfare loss caused by the monopolist market structure. The decreasing tendency can partly be explained by other factors such as free trade, but most of all it can be regarded as the result of the government's adoption and implementation of competition policy since the early 1980s that steadily improved domestic anti-competitive markets and induced competition. In conclusion, it can be said that monopoly regulations have contributed greatly to the steady increase in economic welfare in Korea through improved market structure.[17]

(ii) Improved consumer welfare and the regulation of market dominance

Kim and Moon (1999) used the Lerner Index[18] to estimate how designation of market dominant enterprises has contributed to competition and consumer welfare. They selected nine items that had dominating parties in the market during the 6 to 12-year period from 1981 to 1997, and chose representative corporations for each. They calculated the Lerner Indexes before and after designation as monopolistic enterprises.

Lerner Indexes before designation seemed to be higher than those after designation for all nine products. This means that, though actual showings of monopoly

regulations by the MRFTA were insignificant,[19] the fact that corporations are subject to *ex post facto* regulations once pointed out as monopolistic enterprises, has actually contributed to weakening the monopoly and to making the market more competitive by producing indirect regulating effects. The decrease in excess profit of monopolistic corporations means an increase in consumer welfare and causes efficient production that in turn makes a contribution to the continuous economic development.

3.1.2. Pulling the market economy development through cartel regulations

3.1.2.1. Harm from the cartels

Cartels comprising monopolistic corporations or business associations are the activity in which corporations collectively decide prices or supply sizes that should be decided independently. Cartels are the most important target of the antitrust policy since they are often so powerful that they can impede the operation of the market principles. Cartels provide excess profits for the participants, but on the social level, they bring inefficiency and social welfare loss. Thus, it is an essential task for development of the national economy to prevent cartelization. This will directly increase consumer benefit and, furthermore, enable the rise in dynamic economic efficiency by preventing the establishment of the monopolistic structure and by recovering market competition. Particularly in Korea, it has been critical to curb cartels because a considerable number of legalized cartels existed as remnants of the days when rapid growth and collaborative activities were widespread due to the monopolistic market structure.

3.1.2.2. Restriction on cartels and its economic effects

The KFTC has put a lot of effort into investigating cartels and the intensity of law enforcement has significantly increased since the mid-1990s. First of all, though the KFTC holds the power to authorize cartels that are planned to rationalize the industry or to overcome the economic slump, this has not happened. If we look at the corrective measures imposed on cartels by monopolistic corporations, except for the corrective measures on prohibited activities of business associations, there were 215 cases that the KFTC imposed more than corrective orders (including surcharges and prosecution) and 44 corrective recommendations since the 1981 enforcement of the MRFTA up to 2001. Since 1988 when the surcharges for cartels were first adopted, 314.4 billion won in total were imposed, about 93 per cent of this since 1998. If we add the 155 warnings, 374 cartels identified in total. This shows how widespread cartels were among corporations in Korea. To look at it differently, we can assess that the KFTC had a positive influence on the national economy as it succeeded in regulating cartels to a considerable degree by enforcement of antitrust policies. The continuous rise in numbers of disclosed cases and the increases in sanctions since the 1990s appear to be having preventive effects on cartels. Meanwhile, to regulate effectively cartels that are operating in very shrewd and covert ways, the KFTC adopted

the Leniency Program for those who cooperate with the investigation by offering evidence. In addition, starting from 2002, the reward system of up to 20 million won was introduced for third-party reports on cartel activities.

Below are examples of typical cartels to demonstrate how cartel regulations had practical impacts on consumer economic welfare.

a. Correction of student uniform manufacturers' cartel (May 2001)

Three major student uniform manufacturers with around a 50 per cent share of the market collaborated to fix consumer prices for student uniforms. In this cartel case, the KFTC took strong measures that included an injunction order, an imposition of 11.5 billion won surcharges in total and they reported the case to the prosecutor's office. The estimated annual reduction of consumer burden by the disclosure of this cartel is about 60 billion won.[20] The case is a good example of how cartels can have negative effects on consumer welfare and how antitrust policies correct the distortion of resource allocation and increase consumer welfare by preventing and disclosing cartel activities.

b. Correction of bid riggings for public construction projects

The KFTC imposed strict sanctions by investigating three public construction projects bidding cases, one on the Baekje bridge construction in 1994, another on rolling stock purchase in 1996 and the other on the West-Coast Expressway construction in 1999. This worked as an impetus to end this long-lived practice of the industry. Also since 1998, it reinforced the supervision of public constructions by building and managing a permanent information collection system on public biddings. Consequently, competition is taking root in those public constructions that have a total value of 20–30 trillion won each year. Also, retrenchment of the annual government budget is estimated at around 4 trillion won as the average contract-awarding rate decreased from 87 per cent in 1997 to 75 per cent in the mid-2000s. This shows how cartels aggravate burdens and reduce efficiency in the economy.

c. Correction of the international cartel of graphite electrodes (March 2002)

On March 20, 2002, the KFTC decided to impose a surcharge of 11.2 billion won (US$ 8,532 thousand) on six graphite electrode manufacturers from the US, Germany and Japan which participated in an international cartel of graphite electrodes. The six companies comprised approximately 80 per cent of the worldwide market share of graphite electrodes. The participants held meetings in London and Tokyo to fix prices and allocate markets among themselves during the 1992–1998 period. Korea is 100 per cent dependent on imports for graphite electrodes, and during the 1992–1998 period, the import price increased by 48.9 per cent. In contrast, the price of imports from non-cartel members only rose by 9.1 per cent during the 1992–1997 period. The damages incurred from the cartel were estimated at about US$ 139 million.

This case is significant in the sense that it was the first case of the MRFTA being applied to an anti-competitive action committed by foreign companies located outside Korean territory. The decision demonstrates the KFTC's determination to apply competition laws when Korean companies and consumers are subject to damages due to anti-competitive actions committed by foreign companies. The decision will also serve as a strong deterrent against international cartels that heavily affect the developing countries. Korea is the first Asian country to join the worldwide efforts in controlling and rooting out international cartels. The case has a strong implication for the developing countries as well. This is because the developing countries have long suffered damages by international cartels and only advanced economies such as the US, EU and Canada had made efforts to sanction such cartels.

As we've seen from the examples above, cartels do immense economic harm to consumers by setting higher prices than the normal prices with competition. Thus, preventing cartels and insuring market competition have direct effects that increase consumer benefit. In this sense it is worthwhile to estimate the size of economic benefit to consumers due to the KFTC's achievements in repealing cartels in Korea. For convenience' sake, let's assume that 10 per cent of the total sales amount is the extent of consumer damage[21] caused by cartels and that the KFTC's surcharges amount to 1 per cent of total sales of the relevant market during the period when the cartel existed (average one year). Until 2001, the surcharges the KFTC imposed on cartels add up to 314.4 billion won, so while cartels existed, the total sales of the market is 31.44 trillion won. With this we can estimate around 3 trillion won as additional burdens on consumers by the cartels. So if it is assumed that cartels would have lasted for one extra year on average if they had not been revealed, that amount (3 trillion won) has returned for the benefit of consumers through cartel regulations by the KFTC. The numerical value of this estimate is much lower than the actual effects considering that the KFTC imposed surcharges on only 84 cases among the 374 cases where the KFTC imposed measures stronger than warnings until 2001. Still, if we take into consideration that 93 per cent of the surcharges have been imposed in the last 4 years since 1998, it sounds more reasonable to estimate consumer benefit at 3 trillion won, which is gained by the KFTC's regulations on cartels during the period.

3.2. Regulatory reforms and increase of economic efficiency and welfare

3.2.1. Regulatory reforms and competition advocacy of the competition authorities

The competition advocacy role refers to all those activities of competition authorities that advise and influence government statute revisions and regulations in order to promote a more competitive industrial structure and corporate behaviour by creating a pro-competition environment. In developing countries such as Korea where a competition culture is not established, competition advocacy is regarded as an indispensable element in antitrust policies. This is because getting rid of anti-competitive

institutions and practices that had become widespread during the government-led economic management era is the core task necessary to complete the transition to a market economy and to prepare for steady economic development.

Regulatory reform is one of the fundamental functions of the competition authorities and the most important means of competition advocacy. The purpose of regulatory reform is to promote market competition, technological innovation and creative activities of corporations and to raise economic efficiency by reforming anti-competitive government regulations.[22] Regulations often act as an artificial barrier that blocks entry. Thus, deregulation aims to put pressure on existing corporations to raise competitiveness by improving productivity and innovating technologies. In addition, it has positive effects on consumer welfare in that it promotes development of new goods or services, broadens the consumer's options and influences price and quality. Regulatory reform, as described above, has common effects and purposes with antitrust policy because it also has a positive influence on long-term economic growth and development.

3.2.2. The KFTC's efforts in regulatory reforms and accomplishments

Ever since the enactment of the MRFTA, the KFTC has contributed to promote economic development by preventing the diffusion of public restrictions on market competition, i.e. anti-competitive government regulations, and by expanding the arena of the market economy while steadily assuming the competition advocacy role inside the government. It has stopped the formation of anti-competitive regulations using the Prior Statute Consultation System and achieved considerable abolitions of existing regulations and practices as a leader of the deregulating operation at government level. Meanwhile, the Omnibus Cartel Repeal Act was one of the accomplishments of the competition advocacy in the dimension of regulatory reform.

3.2.2.1. Prevention of anti-competitive regulations

To prevent anti-competitive regulations in advance, Article 63 of the MRFTA prescribes prior consultation with the KFTC when government bodies plan to establish or revise anti-competitive legislations or impose administrative measures of a similar nature. This is a competition advocacy system quite unique to Korea. The system was adopted at the time of the MRFTA enactment in 1981 and has had considerable achievements in preventing new adoptions of anti-competitive regulations or policies. During the consultation process, the KFTC mainly deals with market entry restrictions, price maintenance, restrictions on business territories, cartel activities, awarding monopolist rights of import and prohibited activities of business associations and suggests its opinions with regards to the issues. From 1991 to 2001, the total number of consultations was 3,654. The KFTC recommended removal or revision in 654 cases, which is 12.4 per cent of the total and in 581 cases (72 per cent of the total number of recommendations), its opinions were accepted. In particular, as

the KFTC's independence and status strengthened, its acceptance by other authorities increased.

3.2.2.2. Reforms in the existing government regulations

Meanwhile, the KFTC recognized regulatory reforms as the main responsibility of the competition authorities from early on and has been leading government efforts to reform various anti-competitive statutes and policies since its establishment. In 1987, it spearheaded the use of the term "deregulation" and began to pursue regulatory reforms actively to reinforce competitiveness in each industry. It was then that the KFTC performed deregulations in 18 industries selected after industrial research. Coming into the 1990s, it took the lead in government efforts to reform regulations, participating in the Economic and Administration Deregulation Committee (1993) and in the Economic Administration Regulatory Reform Committee (1996).

The KFTC was in complete charge of economic regulatory reforms, operating the Economic Regulatory Reform Committee from 1997 to 1998. During this period the Economic Regulatory Reform Committee selected 11 core sectors, such as information and telecommunication, industrial location and factory construction, distribution, transport, construction and so on, that have great influence on the national economy yet are burdened with many regulations. It completely reformed the relevant regulations such as market entry barriers, price regulations or business activities regulations. During that period of regulatory reform, the KFTC was regarded as having been a success as a neutral third party overcoming protests from vested interest groups. Most of all, under critical monitoring by the IMF, successful reforms contributed much to the Korean economy as it developed into a pro-competitive market economy.

Since regulatory reform works were integrated into the Regulatory Reform Committee in 1998, the KFTC Chairman has participated in the Committee as a member and steadily influenced the regulatory reform process to reflect the competition policy perspective. Since then, the KFTC has been pursuing regulatory reforms by way of preparing improvement plans on anti-competitive regulations and presenting them to the Regulatory Reform Committee.

3.2.2.3. Examples of regulatory reforms and their economic effects

(i) Examples of regulatory reforms led by the KFTC

(a). Abolition of service fee regulations in certified professions

The legislation and enactment of the Omnibus Cartel Repeal Act[23] in early 1999 is noted as one of the most unique and remarkable achievements among the KFTC's regulatory reforms. Due to the Act, 20 different cartels were eliminated or improved, causing immediate modifications of price, production quantity and division of sales areas. These cartels had been granted government authorization. The reforms elimi-

nated price fixing for service fees in nine certified professions such as lawyers and accountants. Since the Act took effect, the KFTC has reported the variations in fees for those professional services on a regular basis to assist consumers in making a rational choice of service. According to reported figures, the elimination of price regulations has generated greater variation between the maximum and minimum fees. This variation can be attributed to price differentiation according to the quality of service. Initially, levels of service rates in some certified professions rose, but in the second year of service rate liberalization, average service rates began to decrease or stabilize. Service fees for patent lawyers, for example, rose until the second half of 2000. However, according to research conducted in December 2001 on fees in professions concerned with patent applications, fees dropped 10.2 per cent since the latter half of 2000. In the case of lawyers' fees, rates have been dropping steadily since the market was liberalized. From 4.56 million won in the second half of 1999, the total average of lawyer's fees dropped to 4.35 million won in the first half of 2000, 4.07 million won in late 2001 and 3.85 million won as the annual average for 2001. Fees for certified accountants have also fallen steadily since fee regulations were abolished. Auditing service fees dropped an average 9.9 per cent between 1998 and the second half of 2001. Analysis suggests that these changes are the effects of price competition and new optimal prices being reached in the market. It is also evidence that effective competition is taking root within the certified professions with the expansion of consumer information that is provided through frequent investigation of changes in service fees.

(b). Relaxation of entry and price regulation in the telecommunication market

Since 1990, in consultation with the relevant government bodies, the KFTC had been trying to make the telecommunications market more competitive by deregulating market entry and price control. Consequently, in the Korean telecommunications industry since the late 1990s, competition has increased in each service sector as new corporations enter the market. In 1998, the KFTC induced active competition among companies by changing the billing system of telephone charges from the authorization to the report system. This change had positive effects on both telephone rates and quality of service. General telecommunications rates decreased steadily since 1995 resulting in more than 50 per cent cuts in long-distance and international rates. Taking into account the influence the telecommunications industry exerts on the overall increase of industrial competitiveness, the economic effects of regulatory reforms in this sector are regarded as very important.

(c). Abolition of entry regulations on gas station and beer brewery market

The KFTC abolished market-entry barriers on gas stations in consultation with the Ministry of Commerce, Industry and Energy in 1995, and they started competing on price and services. Before this, every station had more or less the same price and the numbers of stations were so few that consumers were not well catered for. Similarly, in August 2001, in consultation with the Ministry of Finance and Economy, the

KFTC deregulated controls that prescribed brewery facilities above a certain size. As a result, small brewers are now able to sell their beer and consumers have greater choice, making competition in the beer market more intense.

(ii) Analysis of the economic effect of regulatory reforms

As previously mentioned, it is not too difficult to estimate how regulatory reforms would facilitate economic activity and have positive influences on various economic growth indices, in theory. However, empirical analysis on the economic effects of regulation or deregulation is rare. Thus, I will refer to the research data on the effects on the Korean economy's macro-variants of the successful regulatory reforms since 1998 to support the argument of this article.

Ha (1999) investigated the benefits of the government's main regulatory reform measures in 1998, classifying their effects into three areas: increase in employment, reduction of public burdens and curtailment of the government cost. The measures analysed here are the reform policies on 324 main regulations that 30 different government bodies were in charge of. In numbers, it amounted to 4.1 per cent of the total 7,841 regulation adjustment cases in 1998. According to estimations, the main regulatory reform measures were expected to create a maximum of roughly one million job opportunities from 1999 to 2003, equivalent to 4.9 per cent of the 1997 population in terms of economic activity. During the same period, the opportunity and actual cost to be paid by the private sector to uphold the regulations were to be reduced by 18,600 billion won, about 4.4 per cent of 1997 total GDP. If the amount of cost reduction were to be used for economic activities, it would make a great contribution to the development of the Korean economy. However, this analysis has certain limitations in that it started with the pre-condition that all the decisions on regulatory reforms at that point would be executed efficiently without failure.

In addition, this study tried to analyse regulatory reform's macroeconomic effects with regard to five service industries, electricity, telecommunications, construction, distribution and transport, that play important parts in the national economy. As a result, if regulatory reforms in the five industries are successful, labour and capital productivity will increase by 4.3 per cent and 4.8 per cent, respectively, in the general Korean economy. Particularly in the telecommunications industry, labour productivity is estimated to increase by 15 per cent. With the fall of cost in the target industries of the study as well as in other industries, producer price will also decrease by 2.21 per cent. As we look at the general effect of all the impacts caused by regulatory reforms, in 10 years, actual GDP increase is estimated to be 8.57 per cent. This amounts to a 0.64 per cent rise in annual growth rate and indicates that, in Korea, regulatory reforms have very extensive effects on economic growth and development.

4. Conclusion

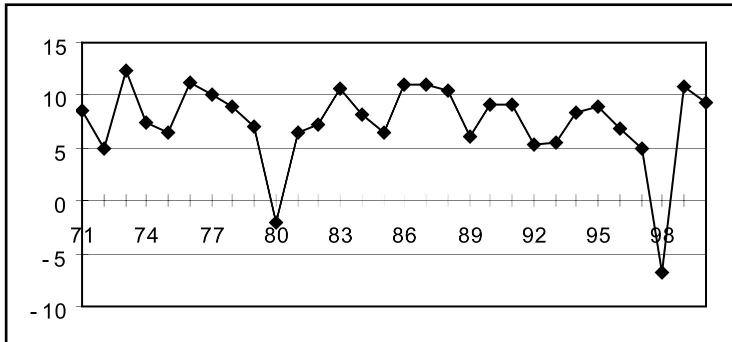
In the 1960s and 1970s, Korea promoted a government-led export-oriented growth strategy that distributed resources directly through protection and regulation result-

ing in remarkably rapid growth that surprised the world. In this period, however, the market economy was distorted and the resulting monopolistic market and structural inefficiency started to disturb the economy. To respond to these problems, antitrust policy was adopted in 1981. Since then, the KFTC has tried to diffuse competition principles into the economy and it has achieved some positive results. The Korean government and corporations, however, refused to face the necessity to restructure based on the principles of the market economy and, consequently, Korea had to undergo a harsh time in restructuring the economy after the 1997 financial crisis. As a result of the aforementioned efforts, Korea quickly overcame the crisis and is recovering economic vitality.

As we have seen, Korean antitrust policies have achieved certain accomplishments in introducing the competition principles into the economy and promoting competition by monopoly regulation, cartel repeal and competition advocacy that is manifested as regulatory reforms. As a consequence, they have made significant contributions to improve social welfare and develop the economy steadily. In particular, technological innovation and increase in productivity coming from competition and regulatory reform aided the growth of the Korean economy by improving economic efficiency. These are substantially different from the growth effects that arise from increases in production factors or in demand. Increases in these factors do not guarantee continuous economic growth. However, policies that provide a microeconomic environment where corporations can freely compete with one another enable the economy to grow steadily by improving productivity and increasing economic efficiency. In this respect, the impact of the antitrust policy on Korean economic growth and development is remarkable.

Korean competition policies have evolved to the present intertwined with the process of rapid economic growth that adopted the market economy system to overcome domestic structural problems as a response to changes in the external environment. Graph 1 shows the shift in Korea's annual GDP growth rate for 30 years since the 1970s. This shows that while Korea continued to maintain over 10 per cent growth every year on the whole, it had two clearly critical periods. The first is 1980, when the government adopted the MRFTA as it changed the economic policy fundamentals to attach importance to the market. The second period began with the financial crisis at the end of 1997. The government admitted that the causes of the crisis were the structural defects resulting from the immature market system. It executed extensive restructuring measures and spread the principles of the market economy. Enforcement of antitrust policies and laws was also greatly emphasized.

Graph 1. Changes in annual GDP growth rate.



As we've observed so far, Korea has constantly pursued reforms to reinforce the market system and antitrust policies each time it faced a crisis without taking a step backwards. Therefore, it can be said that the antitrust policy provided a means of recovering from economic depression in a short period of time and served as a driving force in continuing the path of high economic growth and development.

Nevertheless, many developing and less developed countries are worried that adopting antitrust policies will not be conducive to the country's economic development. Considering the Korean experience, however, for a country to develop steadily, it is advantageous in the long run to rely on the principles of competition from the early stages of economic development based on a strong belief in market efficiency. Developing countries should not argue that countries like Korea have succeeded in developing their economies without antitrust policies. However, it should be noted that the global economic environment today is changing so much compared with the past. With the stabilization of the WTO system, government protection can no longer be tolerated under the GATT system. Progress in liberalization of trade and investment and globalization of the corporations also intensify the trend that world markets are integrating into the one "level playing field". At an early stage of economic development, government intervention seems to be inevitable to a certain degree and it is not mandatory for developing or less developed countries to be equipped with the same level of antitrust policy system as that of the developed countries. It should be noted, however, that competition policies successfully took root in Korea because they evolved while trying to meet the needs of the economic situation of Korea. What is most important is that, in the long run, the earlier the adoption of antitrust policies the better, and it is imperative that the policies be constantly expanded and reinforced for countries to achieve continuous economic development.

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Notes

* The author would like to acknowledge assistance from Mr. Jong Bae Park.

[1] The Seoul Competition Forum 2002 (2002.11.6).

[2] Economic development refers to the process of economic progress that improves the quality of life of the people, as the domestic potential reveals itself gradually. Narrowly defined, it could mean an increase in the GDP or the GDP *per capita*, i.e. a quantitative increase in people's economic ability. However, it can be also broadly defined as an overall improvement in the quality of life.

[3] Art. 1 in the Korean MRFTA describes its purpose as "… to promote fair and free competition, to encourage creative enterprising activities, to protect consumers and to strive for balanced development of the national economy by preventing any abuse of market-dominating position by enterprises and any excessive concentration of economic power, and regulating unreasonable joint acts and unfair trade practices".

[4] Porter's empirical analysis (Porter, 2000) is a unique example which had remarkable results. In his research presentation in the World Competitiveness Report, Professor Michael Porter proved the strong positive correlation between the effectiveness of antitrust policy and national GDP *per capita* regardless of the country's stage of development. He used regression analysis on the relationship between many microeconomic variants and economic development.

[5] We can think about the number of times that the competition authority enforced the law, the amount of surcharges, the number of personnel and the size of the budget as the

variants that could indicate the intensity of antitrust policies. However, these are not enough. Dutz and Hayri (1999) attempted inter-state transaction analysis using the numerical value of responses from entrepreneurs as the variant indicating the effectiveness of antitrust policy. This shows the difficulty of finding objective variants. In Porter's analysis mentioned in footnote 3 (Porter, 2000), this method was used to measure the effectiveness of antitrust policy.

[6] In the early 1960s when supply was short, monopolist and oligopolist companies that produced flour, sugar and cement derived excessive profits by adjusting prices three to four times higher than official prices and evading taxes as they took advantage of the chronic supply shortage.

[7] GDP growth rate in 1980 is recorded as being -2.1 per cent.

[8] First established as an office inside the Economic Planning Board with the personnel of 75 at the time of the MRFTA legislation, the KFTC has grown steadily and its authority has been reinforced through several subsequent law amendments. In 1990, the KFTC was re-established as an independent administrative organization under a commission system (221 staff members). The power to enforce the MRFTA was transferred from the Minister of Finance and Economy to the KFTC chairman. Regional offices were also opened at this period. In 1995 at the dissolution of the Economic Planning Board, the KFTC became a totally independent administrative body. In 1996, it was elevated to Ministry status and its role was once again reinforced (381 staff).

[9] Control system on debt guarantees was introduced in the 3rd revision of the MRFTA in 1992. It was limited to less than 200 per cent of owned capital in 1992 to be re-adjusted to 100 per cent during the 5th revision in 1996. The problem of debt guarantees among *chaebol* affiliates was resolved belatedly after the practice was completely banned with the help of the IMF, along with the economic crisis.

[10] In 1998, the KFTC eliminated all mutual debt guarantees among *chaebol* affiliates with assets or sales totalling 34 trillion won or more and banned the practice in order to prevent the possibility of collective insolvency among affiliates. In addition, it focused on disclosing insider trading among affiliates and imposed surcharges of over 3000 billion won to promote the establishment of independent management in each affiliated company.

[11] General prohibition of cartels and surcharge imposition were adopted at the revision in 1986, still 62 per cent of all correction orders (128 out of 204) on cartels till 2001 and 93 per cent of the total amount of the surcharges (3,144 billion won) were imposed after the crisis. On prohibited activities of corporate organizations, too, corrections orders, which had been under 20 cases annually increased to be more than 70 cases since 1998. Imposition of the surcharges once rare is becoming more frequent. Meanwhile, looking at the general trend of the MRFTA enforcement – though in the early stages it was weak - we can see that it was reinforced since the early 1990s and it is increasingly so after the economic crisis in 1997. Since the beginning of the 1990s, correction measures, surcharge imposition and reports increased dramatically and since 1998, especially, correction orders and surcharges have multiplied. Before the economic crisis the maximum annual correction measures and total amount of surcharges were, respectively, 250 cases and 162 billion won in 1996. In 1998, however, correction measures have more than doubled to 533 cases and surcharges amounted to 1350 billion won. In 2001, the biggest amount in surcharges was imposed (2,234 billion won).

(In 2002, the amount was down to 1,632 billion won.)

[12] Moody's upgraded Korea's international credit rating by two steps (Baa2 ? A3) last March and Fitch did the same in June (BBB+ ? A).

[13] I will not deal with the effects of the economic power concentration control on *chaebols* that the KFTC has been implementing since 1987. There is divergence on its effectiveness and influences. In principle, it is more desirable to let the market deal with the inefficiency problems of the *chaebol* system than to have government intervention. In reality, however, as the financial system, management market and capital market are not mature enough, government intervention is necessary for the time being to improve the management structure and behaviour of *chaebols*. It is hard to say that the economic power concentration control system in the MRFTA, which is represented by total shareholding and loan security regulations and prohibitions of mutual shareholding, would be the policy that raises corporate efficiency in a direct manner. However, the important point is that if insider trading among affiliates or cross-support exists, it will lower the national economic competitiveness and increase the possibility that the whole Korean economy will suffer a mortal blow in times of crisis. In this respect, policies on *chaebols*, such as prohibition of mutual loan security, total (shareholding) regulations and investigation on insider trading have the effect of stabilizing the economy and raising the long-term potential for growth by contributing to stop the *chaebols'* irrational expansionist administration from worsening. To support this argument we can look at the current situation. Recently, the tendency to have independent administration in *chaebol*) affiliates is gaining ground as giving debt security is abolished and unfair insider trading is suppressed.

[14] It would be difficult to say that the KFTC's M&A regulations had an impact on monopoly prevention by looking at the KFTC performance in the past 20 years. However, it can be said that certain contributions were made by saving the social costs of monopoly since the mere existence of preliminary structural regulations such as M&A reviews have the effect of preventing M&A attempts that could bring monopolization.

[15] That the worsening industrial concentration will have negative effects on social welfare and effectiveness is similarly explained by the empirical example mentioned below.

[16] Of course, there are many factors other than antitrust policy that can be identified as a determinant of market structure. Still, it is reasonable to think that antitrust policy is the factor that has the most direct influence on the market structure because it has as its primary goal, promotion of competition through the market structure reform.

[17] Competition influences economic development in quantitative terms, i.e. economic growth can be classified in two ways. First is the static effect. This refers to the effect of price nearing marginal production cost as the market approaches full competition. The production and consumption is likely to meet at a level where social welfare is maximized. Second is the dynamic effect. Here, competition increases economic wealth steadily by inducing industrial technology innovation and ensuring the survival of only the most efficient corporations. Thus, the effect of improving social welfare refers to the former explanation. It means that market structure reform and the resulting competition will, in a static sense, decrease the social cost caused by the monopolistic structure and expand the economic wealth.

[18] The Lerner Index is the most conventional means to estimate the monopolist power and social welfare effect. It shows how far price is fixed from marginal production cost. Lerner Index ranges from 0 to 1. The higher the index the stronger monopoly is and the lower the index the closer to full competition.

[19] Between 1981 and 2000, the KFTC took 3013 corrective measures in total regarding MRFTA violations. But only 23 cases were concerned with the abuse of market dominance. During the same period, the amount of the imposed surcharges on market dominance was around 35 billion won which accounted for only 0.6 per cent of the total surcharges

(Sung and Shin, 2001).

[20] A market survey, after the correction measures were imposed, showed that the prices for winter uniforms have decreased from 175,000 won to 145,000 won for the three major cartel participants and from 155,000 won to 125, 000 won for other SMEs. In the case of summer uniforms, the price decreased from 50,000 won to 40,000 won. According to this survey, we can calculate the annual benefit transfer effect for consumers by the dissolution of the cartel. Adding benefits for both winter (30,000*1.5 million students = 450 billion won) and summer uniforms (10,000*1.5 million students = 150 billion won), the total reaches 600 billion won.

[21] When estimating the size of the surcharges on cartels in the US, generally 10 per cent of the total sales amount is regarded as the industry's unjust profit surplus by forming a cartel. In addition, actual consumer damage is believed to be even bigger considering the consumers who give up purchasing at all upon price increase. Thus, here the size of consumer damage is at 10 per cent of the total sales amount, but the actual size is likely to be considerably higher than that.

[22] Anti-competitive regulations refer to regulations that hinder competition by direct government intervention on variants such as number of suppliers, products, price of service and production scale that should be decided by market functions. They include various authorization/permission systems, certificate systems, price regulations and regulations on business areas. Those regulations dispersed in the overall industry weaken the constitution of individual corporations and cause social inefficiency and a decrease in consumer welfare by giving rise to high costs, low production phenomenon in the general industry. They also encourage corruption since privileges and interests are incorporated into the regulations.

[23] The official title is "Act on Regulating Undue Concerted Activities Exempt from the Application of the Monopoly Regulation and MRFTA" (No. 5815, promulgated Feb. 5th, 1999).

IV

Competition policy, supply capacity and export competitiveness

IV.1. COMPETITION AND PRODUCTIVITY GROWTH: EVIDENCE FROM KOREAN MANUFACTURING FIRMS

Mikyung Yun

1. The relationship between competition, productivity and development: a selective literature review

Authors have been prolific in exploring the connection between competition and economic growth but theoretical treatment does not offer any ready conclusions. For example, although competition induces productivity gains, this might be outweighed by the monopolist's advantage for innovation. The theoretical ambiguity has rendered empirical analysis of greater importance. There are many dimensions to the connection between competition and economic growth, but an important area of empirical research has focused on analysing the impact of product market competition on productivity growth. Ahn (2002) reports, in a recent survey of the literature, that a large number of empirical studies seem to confirm that product market competition encourages productivity growth. Nickell (1996) is representative of such a study. He finds that for a sample of 676 UK firms over the period 1975–1986, competition was associated with both higher productivity levels and productivity growth. Disney, Haskel and Heden (2000) extend this study to a larger data set of around 143,000 UK establishments over the period 1980–1992 and find similar results. Using a different methodology, Klette (1999)[1] finds that, for 14 manufacturing industries in Norway, plants with higher market power tend to be less productive.

However, most of the current studies are based on experiences in developed country, especially in North America and Europe. Despite mounting empirical evidence coming from the developed countries, it is often argued that, during the early stages of development, too much competition would inhibit economic growth. The proponents of this argument typically refer to the Korean experience. It is widely believed that Korea's economic development is based on nurturing national champions by suppressing competition at firm level and protecting the domestic market.

This suggests that the appropriate level of competition differs for different stages of economic development. Indeed, some argue that there is an optimal level of competition, given the economic circumstances, and that maximum competition is not always better (Singh, 2002). With respect to Korea, Amsden and Singh (1994) show that, given the

market size of Korea, there was actually more competition than is widely perceived and not all of the growth is due to government protection and subsidies. Further, they argue that there are different kinds of competition – for example competition *for* the market as opposed to competition *in* the market. Competition among a small number of large conglomerates is representative of the former kind of competition, and such competition can be as fierce as competition within a market.

Competition for the market has been usually applied to analyse standards competition and network effects, but viewing competition as the selection process that weeds out the less efficient from the more efficient is in line with the "competition for the market" type of competition. There is empirical support for the active role of selection in promoting competition and productivity for Korea. Using plant-level data for the period 1990–1998, Hahn (2000) shows that plant entry and exit rates in the manufacturing sector are high (higher than in the US and several developing countries), and that entry and exit account for as much as 45 per cent and 65 per cent of productivity growth during cyclical upturn and downturn, respectively. This suggests that at least in the post-liberalization Korean economy, selection has been an important element of product market competition, and a dynamic source of productivity growth. On the other hand, the study also shows that market share reallocation between continuing plants (i.e. competition *in* the market) plays only a minor role in productivity growth.

Glen, Lee and Singh (2001) also show that competition in many developing countries has been higher than is usually thought. Their study finds that the persistence of profits in selected emerging markets[2] is less than that reported for developed economy markets. This indicates that developing country product markets are at least as competitive as those in advanced countries and imply that competition by itself is not necessarily the most important ingredient for economic growth. This conclusion also implies that adopting a stringent competition policy is not a priority in developing economies. However, Glen and colleagues do not directly explore what the source of such competition is, or what impact such an unexpectedly high level of competition has had on productivity growth.

Transition economies, which have switched over from the planned economic system to a market-based system in the 1990s, have become an excellent subject to study the impact of competition as an external shock on productivity and existing evidence supports the "optimal competition" theory. A good example of such a study is that of Carlin *et al*. (2001), which shows that competition has a positive effect on firm performance, but that the relationship is not a simple one. Firms that had fewer than three competitors were more productive than either firms that had more than three competitors or monopolies. At the same time, market dominance (measured by price elasticity) was shown to have a positive impact on sales growth.

In a cross-country study (100 countries over the period 1986–1995), using the presence of an antitrust policy as the main proxy for intensity of competition, Dutz and Hayri (1999) show that competition has a positive impact on growth, both in developed

and developing countries. An interesting finding in their study is that, unlike their Latin American and European counterparts, a group of Asian countries[3] did not show any correlation between competition and growth. This result, if correct, implies that while competition might encourage growth, there are other factors that can also do so.

The foregoing literature review shows that evidence from developing economies on the impact of competition on productivity growth at firm level is rather thin. The remainder of this paper addresses the debate of whether or not competition has contributed to productivity gains in Korea, by focusing on the impact of product market competition on productivity using firm-level panel data. The next section presents the empirical work. Although this paper does not directly deal with competition policy *per se*, a number of policy implications are drawn in the concluding section, based on the empirical results.

2. Competition and productivity growth: empirical analysis

2.1. Theoretical background

This study explores the impact of competition on productivity and productivity growth by estimating a production function. A simple Cobb–Douglass production function with two factors of production, labour and capital, can be expressed as in equation (1).

$$Y_t = f(K_t, L_t) = A_t L_t^{\alpha} K_t^{\alpha} \quad (1)$$

$$Y_t / L_t^{\alpha} = A_t K_t^{\alpha} \quad (2)$$

$$A_t = Y_t / L_t^{\alpha} K_t^{\alpha} \quad (3)$$

where Y is output, K is capital stock, and L is labour. Labour productivity is given by dividing output by labour as in equation (2). The constant term *A*, or total factor productivity, represents the shift in the production function at given levels of labour and capital, and is given by equation (3). It is the unexplained source of productivity growth, and is generally identified with technical change.[4] As the literature review in Section 1 shows, product market competition is increasingly viewed as an important source of productivity and productivity growth (i.e. as a significant constituent of the shift parameter). However, whether or not this applies to the developing economies is still open to debate.

This paper explores the impact of competition on productivity by estimating a simple production function at firm level. Taking logs on both sides, adding competition variables and incorporating industry and time dummies to the labour productivity equation (i.e. equation 2) yields equation (4).

$$\ln(Y_{it}/L_{it}) = \alpha_1 \ln K_{it} + \alpha_2 c_{it} + \alpha_3 c_{it} t + Z_i + Z_j + Z_t + \varepsilon_{it} \quad (4)$$

In this equation, Y_{it} represents the output of firm i at time t, K_{it} is the capital stock of firm i at time t, and L_{it} is hours worked at firm i at time t. Therefore, Y_{it}/L_{it} is the labour productivity. The third term, c_{it}, represents the degree of competition and its coefficient measures how much impact competition has on the level of productivity of the firm. On the other hand, the fourth term, $c_{it}t$, represents the impact of competition on productivity growth, with *t* being the time trend. The coefficient of this term measures how much competition affects changes in productivity over time. Following Nickell (1996) and Disney, Haskel and Heden (2000), this formulation allows one to distinguish the effect of competition on the *level* of productivity from its effect on the *growth* of productivity. The term Z_i captures all unobserved firm-specific factors influencing the level of productivity that does not change over time, while Z_t captures shocks common to all firms over time. The error term e_{it} captures all other shocks to company productivity, including technological change (i.e. A_t). The term Z_j captures industry-specific characteristics, with the subscript *j* representing industry.

Equation (4) is not easy to estimate because the firm-specific factors are unobservable and make it difficult to construct a proxy for this variable. However, if these factors are stable over time, it can be eliminated by first differencing. Four proxies are used to represent competition (or lack thereof): number of firms (NUM), firm's market share (MKS), industry concentration (CR3), and rent (RENT). Firm's market share or industry concentration are probably not reliable cross-section measures of market power because collusion depends not only on the size of the firms relative to the market, but also on other factors such as the ability of firms to hide price changes, which are hard to observe. However, these factors are not likely to change much over time, and it is possible to expect that changes in the measure of market share be correlated with changes in the true measure of market power. Thus, market share or industry concentration is a reasonably good time-series measure of market power (Nickell, 1996; Disney, Haskel and Heden, 2000).

Further, these variables can be affected by technological or cost differences between firms. Indeed, a reverse causality may exist. While a firm's market dominance may lead to slack and result in a loss of productivity (competitiveness), it is possible that firms with high productivity gain a high market share, leading to positive correlation between market power and productivity. Industry concentration may make collusion easier, lowering competition and thus the effort to increase productivity, but it is also possible that a high level of concentration is a result of competition, which weeds out the less productive firms. This would again lead to positive correlation between the inverse measure of competition and productivity. The reverse causality problem also exists for rent. A high level of monopoly rent leads to slack and thus a decrease in productivity, but it is also possible that a firm enjoys a high level of profits due to its high productivity. Therefore, these variables are lagged by one period to fix the direction of causality being estimated.

However, there does not seem to be any obvious problem of reverse causality for number of firms. A high number of firms would indicate a high level of competitive pressure, and lead to higher productivity. However, higher productivity does not necessarily

mean a high or low number of firms, unless there are economies of scale. To pick up the effect of economies of scale, the variable SIZE is added to the estimation. In addition, as noted by Nickell, Nicolitsas and Dryden (1997), competition comes not only from the product market but also from the financial market, and this is represented by the variable FP, financial pressure. Therefore, the final equation estimated is equation (5).

$$\Delta \ln(Y_{it}/L_{it}) = \alpha_1 \Delta \ln K_{it} + \alpha_2 \Delta MKS_{it-1} + \alpha_3 \Delta CR3_{it-1} + \alpha_4 \Delta NUM_{it} + \alpha_5 NUM_{it} + \alpha_6 \Delta RENT_{it-1} + \alpha_7 RENT_{it-1} + \alpha_8 \Delta FP_{it} + \alpha_9 FP_{it} + \alpha_{10} SIZE_{it} + \alpha_{11} Z_j + \alpha_{12} Z_t + \varepsilon_{it} \quad (5)$$

2.2. The data and variables

This study uses an unbalanced panel data set of manufacturing firms for the period 1990–2002. All firm-level data are provided by the Korea Information Service Inc., a proprietary credit-rating agency. Industry-level data, such as industry concentration and shipment at the five-digit level, are published by the Korea Development Institute. This

Table 1. The variables

The variable	Measurement	Predicted sign
Real output, Y	Value added/producer price index (before-tax profit + tax + labour cost + financial charges + lease charges + deficit)	Dependent variable, labour productivity: Y/L
Labour input, L	Number of employees	
Real capital input, K	Fixed asset/capital deflator	Positive
Market share, MKS	Firm sales/industry shipment	Negative
Industry concentration, CR3	Combined market share of top three firms in the 5-digit industry	Negative
Number of firms, NUM	Number of firms in the 5-digit industry	Positive
Above-normal profit, RENT	Before-tax profit/sales	Negative
Financial pressure, FP	Financial charges/sales	Positive
Firm size, SIZE	Dummy variable = 1 for large enterprises, = 0 for SMEs.	Positive

data series exists only up to 2000. Table 1 shows the measurements used to proxy the variables in equation (5). A firm's output is represented by value added, and is normalized by the producer price index published by the National Statistical Office. The amount of labour is measured by number of employees, and capital input by fixed asset. Fixed asset is normalized by the capital deflator calculated from the real and nominal capital stock published by the National Statistical Office.

The variable RENT represents price cost margin, or above-normal profit and is proxied by before-tax profit divided by sales. Financial pressure, FP, is measured by financial expenses divided by sales. SIZE is a dummy variable, taking on the value of 1 for large firms, and 0 for small and medium firms. Industry dummies group the firms into 23 industries (three-digit level). The time dummy takes on a value of 1 for 1990–1997, and 0 for 1998–2002. Therefore, the time dummy should be able to pick up the effect of any structural changes due to the financial crisis.

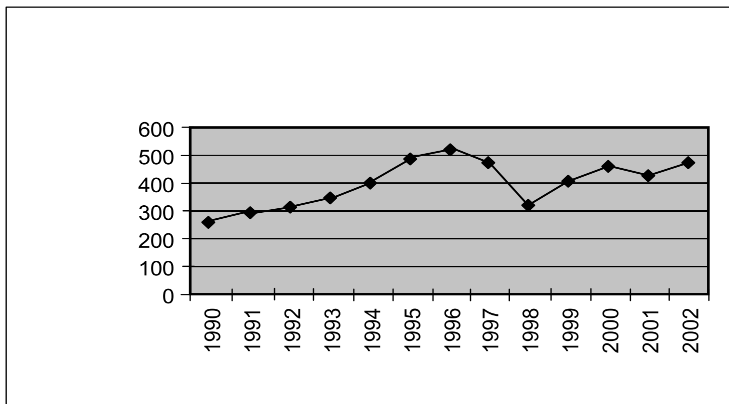
The summary statistics in Table 2 and the following graphs show the general trend of the important variables and the economic environment in Korea during the period 1990–2002. The GDP increases until 1996 and then plummets during the crisis years of 1997–1998. It has rapidly recovered since then. The annual average of percentage growth in

Table 2. Summar y statistics

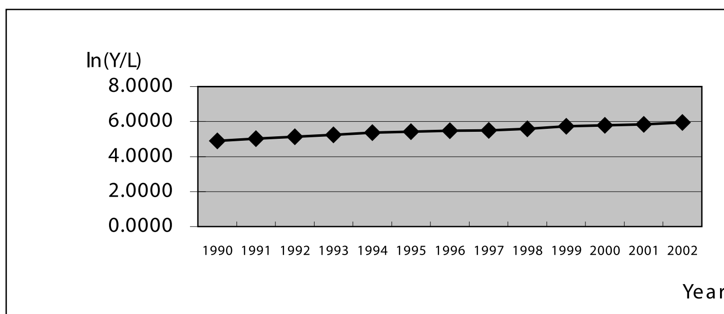
Variable (unit)	No. of Obs.	Mean	Std. Dev.	Min.	Max.
Real value added (1000 won)	11,786	327,680.80	2,445,550	20.13	1.74×10^8
Capital input (1000 won)	16,986	1,147,477	6,322,581	2.12	1.91×10^8
Labour input (no. persons)	16,597	659.43	2449.72	1	59,019
Market share	7,802	0.0963	0.1736	2.99e-08	0.99994
CR_3	8,453	46.30	23.59	3.5	100
Number of firms	8,453	328.91	455.45	1	3,166
Rent	16,810	-0.1371	5.63	-580.59	175.25
Financial pressure	16,404	0.0820	2.04	-0.5145	244.23

labour productivity at firm level does not show much dramatic movement during 1990–2002, showing a very slow but increasing trend. Korean firms suffered from very low profitability, with the annual average being in the negative for the entire period under study. However, the difference between the minimum and the maximum is quite large. Profitability increases significantly from 1996 to 1997, perhaps due to large-scale bankruptcies of insolvent firms, which are no longer in the sample to pull down the averages. But if this is the case, profitability should recover somewhat after 1997. Consistent with the profitability series, industry concentration steadily decreases until 1997, when it shoots up, again possibly due to the large number of bankruptcies at the time of the crisis. Concentration seems to level off after 1998. It is quite evident that 1997 is a watershed in many respects and there is a structural break before and after the financial crisis.

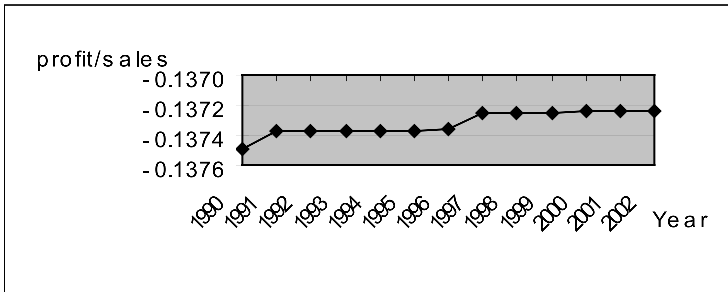
Graph 1. Trend in real GDP: 1990–2002 annual averages. Unit: billion US$



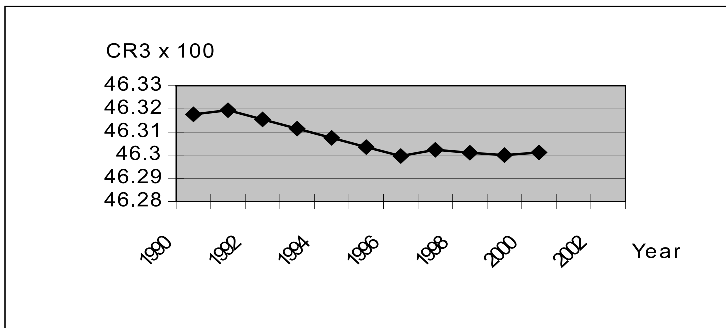
Graph 2. Trend in labour productivity growth: 1990–2002 annual averages Unit: 1000won/person



Graph 3. Trend in annual average rent



Graph 4. Trend in annual average CR_3



2.3. Estimation results

The results are shown in Table 3. Column 1 gives the regression result for all the variables included, whereas column 2 reports the more parsimonious specification, dropping variables that are not significant. As predicted, capital input (K) is positive and significant. Market share (MKS) and industry concentration (CR3) are not significant, indicating that changes in these variables do not affect changes in productivity in any significant way. It is interesting to note that market share is unexpectedly signed positively, but industry concentration is negatively signed as predicted.

Changes in the number of firms (NUM) positively affect changes in productivity, and this is significant at the 10 per cent level. On the other hand, the number of firms is negatively correlated with change in productivity, but this effect is not significant. Similarly, change in rent (RENT) is positively correlated with productivity change, but this effect is not significant. Rent itself is negatively correlated with productivity change, and this effect

is highly significant. This suggests that while enjoyment of monopoly rent may boost productivity, it is not conducive to long-term, cumulative growth in productivity, and that the latter effect is likely to be more significant. Finally, financial pressure has the greatest impact on productivity, but a negative one. The competitive pressure coming from the financial market raises neither productivity nor productivity growth. Why this is so, is difficult to explain but it may reflect the heavy financial burden borne by Korean firms both before and after the financial crisis. The dummy variable SIZE is not significant, indicating that economies of scale (i.e. bigger firms were not necessarily the more efficient) may not be important. This is difficult to believe for most manufacturing economies, and it is possible that the SIZE variable is not picking up the economies of scale effect very well.

Table 3. Impact of competition on productivity and productivity growth

	1	2
$\Delta \ln K_{it}$	0.1169** (0.0513)	0.1023** (0.0392)
ΔMKS_{it-1}	0.0659 (0.0962)	
$\Delta CR3_{it-1}$	-3×10^{-4} (0.0012)	
ΔNUM_{it}	2.5×10^{-3}* (1.399×10^{-5})	2.231×10^{-4}* (1.273×10^{-4})
NUM_{it}	-3.22×10^{-5} (3.96×10^{-5})	-6.45×10^{-5}* (3.05×10^{-5})
$\Delta RENT_{it-1}$	0.2 (0.0137)	0.0313 (.0668)
$RENT_{it-1}$	-2.611** (0.3305)	-2.6340** (0.2491)
ΔFP_{it}	-1.999** (0.6289)	-1.7963** (0.5817)
FP_{it}	-0.9709** (0.3747)	-0.5925* (0.3391)
SIZE	0.0182 (0.0189)	
Constant	0.8205** (0.1262)	0.2522 (0.3733)
No. of Obs.	2846	3672
R^2 (F statistic)	0.18 (5.28)	0.1914 (8.21)

Note: Standard errors are given in brackets.
**Significant at 1 per cent, *significant at 10 per cent.

When the insignificant variables, market share, industry concentration and firm size are dropped in column 2, the results remain much the same, except that now both the level and the change effect of number of firms become significant.

These results are, however, provisional. Import competition has not been included among the explanatory variables, due to the difficulty in matching product classification used for trade data and industry data. This procedure is difficult and tedious at the highly disaggregated level (for example, below the three-digit level). Further, a more precise measure of market power (such as price cost margin) would be preferred. Firms in the service sector were excluded from this sample, but as this sector takes up a large portion of the economy, it would be important to include the services sector. Furthermore, measuring productivity with only the surviving firms may result in sample selection bias (see Disney, Haskel and Heden, 2000). A methodology has been developed to deal with this problem, and it would be worth extending this analysis to correct for sample selection bias, if any.

Summing up, the regression results seem to suggest the following:

Industry dynamics such as changes in number of firms (i.e. entry and exit of firms) could be a more significant index of competition than individual or combined market shares of the top few firms. Further, change in number of firms is an important source of competition and productivity growth while a high number of firms in the market itself is not conducive to productivity growth. This supports Hahn's study (Hahn, 2000), which shows that the selection effect is much greater than competition within the market in explaining productivity growth.

Rent is positively correlated with productivity but negatively correlated with productivity growth, and only the latter effect is significant. When this is interpreted for the long-term horizon, it may mean that increased monopoly rent may boost productivity growth now, but will hinder economic development in the long run, and that the latter effect is the significant one.

Competitive pressure coming from the financial market is not helpful to either productivity or productivity growth. But this may reflect the particular circumstances arising from the financial crisis rather than through any linkages between competitive pressures from the financial market affecting corporate governance and managerial effort in the firm.

3. Conclusion

This paper did not directly deal with competition policy and its application to developing economies but rather focused on empirical analysis of the impact of competition on firm-level productivity. Nevertheless, a number of policy implications can be drawn based on the Korean experience analysed above. First, competition policy should not narrowly focus on curbing the market dominance of the few firms already in the market but rather employ a broad approach that keeps entry and exit barriers low. This means adopting a broad-based deregulatory framework to eliminate as much red tape on entry and exit of firms into the overall economy as possible. This is probably better done through compe-

tition advocacy, cultivating entrepreneurial culture, and providing functional support on the supply side (e.g. infrastructure, setting up market institutions) to assist newcomers and directing exiting firms to new opportunities, rather than through case by case investigations of violations of competition law.

An interesting avenue for future analysis would be to compare the application of competition policy in developing countries to that of high-tech industries in developed countries. One can find an uncertain analogy between applying competition policy to developing economies, where most of the production technology introduced is new, and the application of competition policies to high-tech industries in developed countries, where technology is rapidly developing in an emerging market structure. The competition for the markets, characteristic of competition among Korean firms, is akin to the competition for the markets found in network industries. Seemingly anti-competitive behaviour may hide intense levels of underlying competition, and too much intervention on competition-policy grounds (or on the basis of industry structure such as concentration levels) in the early period of the industry's development may inhibit the fully fledged growth of the industry. It is important to note that such an analogy is applicable only if the technology being adopted is new to the developing country, and the industry is taking off with participants and industry structure unfolding over time. The analogy would not be appropriate where there is no dynamics in the industry, and if the industry incumbents are obviously abusing their monopoly power, without any incentive to adopt new ways of doing things.

Second, whether it is simple competitive advocacy or setting up highly sophisticated court procedures, it is important to have competition policy in whatever form, as persistent monopoly rents are not conducive for long-term, cumulative productivity growth. It would therefore be important to have an authority in charge of promoting and implementing competition law and competition advocacy.

Third, the financial market needs to be well developed before it can have a positive effect on productivity through sharpening competition for managers who will then struggle to raise the effort to survive and stay in the market. Otherwise, financial pressure may only act as too heavy a burden on firms. In this sense, product market competition may be a much more important source of keeping managerial effort on alert than the financial market, which is likely to be inadequate in monitoring firm performance in developing economies. Therefore, the role of competition policy would be much more important in developing economies than in developed economies where there are many other channels (such as the well-developed financial market and markets for mangers) through which firm performance can be monitored.

For more general conclusions regarding the application of competition policy for developing economies, it would be important to directly test for hypotheses found in the literature, such as the stages theory (or optimal competition theory) and comparing the relative importance between competition through selection effect and competition within the market. The former hypothesis would require a longer time series, or pooling of firm-

level data of countries at different levels of economic development. Further, this would require assuming a particular shape of the production function. This is beyond the scope of the current paper, and is left for future studies.

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Notes

1 Klette (1999) extends Hall's approach (Hall 1988) of estimating market power which accounts for economies of scale and quasi-fixity of capital.

2 Korea, Brazil, India, Jordan, Malaysia, Mexico and Zimbabwe. The data set employed uses the largest 100 corporations quoted on the stock market with 10 or more years of unbroken time-series data. Profit is measured by return on assets (ratio of after-tax earnings to total assets).

3 Korea, China, Thailand, Indonesia, Malaysia, Hong Kong, Singapore and the Philippines.

4 Hulten (2000: 9) emphasizes that this is not always an appropriate interpretation. The shift parameter captures costless improvements in the way an economy's resources of labour and capital are transformed into real GDP. For example, technical change due to R&D spending will not be captured by *A* if R&D is not excluded from K_t, and L_t. Further, institutional organization of production will also shift the function, as will systematic changes in worker effort.

IV.2. COMPETITION POLICY, MANUFACTURING EXPORTS, INVESTMENT AND PRODUCTIVITY: FIRM-LEVEL EVIDENCE FROM TANZANIA MANUFACTURING ENTERPRISES

Godius Kahyarara

Executive Summary

The major objective of this study is to answer the question: to what extent is firm-level performance measured by investment, productivity and export influenced by government measures aiming to stimulate competition and protect consumers against monopoly? To analyse this influence, the study assesses the effect of control of dominant firms through institutions, the effect of mergers to prevent industries becoming monopolized and the effect of control of anti-competitive behaviour. The analysis focuses on assessing firm-level effects due to existing government efforts to regulate business activity in order to ensure that it operates in the public interest. In particular, the study analyses the role of competition policy in influencing productivity, investment and export performance of Tanzanian manufacturing enterprises. The study focuses on the hypothesis that fair competition has a causal impact on the quality and quantity of manufactured exports, productivity and investment.

In fulfilling the study objective, the following issues are covered: a thorough literature review that provides, among other things, the theoretical framework on which the empirical analysis of the study is based. Previous findings and conclusions regarding the topic under investigation are also presented. The other issue covered by the study is an empirical study of the Tanzanian case. This section provides direct evidence based on microeconomic data of how the existing government policy and institutions charged with overseeing fair competition have succeeded in ensuring competitive production that is fair and in line with the public interest. The empirical approach of this case study focuses on identifying, describing and measuring variables that link competition policy and firm performance, and assessing the impact of legal and institutional structures of competition policy and the related policies on domestic firm performance. Specifically, the study estimates the probability functions for investment, productivity and exports and the production functions in which competition policy and competition variables are among the independent variables. The final issue covered in the study is the question: what are the prerequisites for the successful implementation of competition policy in developing countries and the mechanisms through which this may operate? The study findings are used to provide this perspective.

The study argues that, prior to the 1980s, competition policy played little role in most developing countries. It was contended that free trade did not allow a true comparative advantage situation to develop due to differences between marginal social and marginal private costs. Based on this argument, industrialization in most of the developing countries was undertaken through highly protective industrial and

trade policies particularly through the infant industry argument for protection. The presence of a large state sector partly explained why many developing countries did not find it necessary to have a competition policy. While there were some gains in industrialization, the general performance of inward-looking protected industrialization programmes was not very successful. High effective rates of protection resulted in monopolistic enterprises which were characterized by high investments but with low rates of capacity utilization, falling value added and total factor productivity, over-reliance on government subsidies and generally inefficient industrial bases in most developing countries.

Nonetheless, the 1990s have seen a reversal of trade and industrial policies in developing countries. This decade was marked by comprehensive economic reforms, aimed at moving away from state control towards a market economy. After the introduction of the reforms, it is not difficult to see why the need for competition policy becomes crucial in developing countries. The basic assumption of the market-based economy is that the competitive process will ensure the efficient allocation of resources which is essentially a self-correcting mechanism, and that intervention will be required only occasionally to correct temporary imperfection. However, in practice, markets exhibit some form of imperfect or monopolistic competition even in the absence of a state monopoly. Sometimes reform measures such as privatization can simply involve replacing the public monopoly with a private one.

To account for the limitations of the market economy, many governments in developing countries have established laws and institutions to regulate economic activities. The introduction of competition policy and the creation of antitrust authorities are some of the steps taken to facilitate such regulation. The specific areas targeted by the competition policies and antitrust authorities include (i) control of dominant firms by regulation, (ii) control of mergers to prevent industries becoming monopolized, and (iii) control of anti-competitive acts, such as predatory pricing. The main goal of competition policy is to facilitate competition that brings economic benefits through greater efficiency, lower prices, greater choice and higher product quality. The interaction of competition and long-term firm performance in terms of such aspects as exports, investment and productivity movements is less well understood. The analysis of this study is thus a contribution to this area. Our data set permits us to investigate various measures of competition and competition policy. We first test for the possibility that competition policy can be one of the determinants of firm performance, and then assess how the introduction of competition into production has influenced performance at firm level.

Our empirical results given in this chapter do not indicate that firm performance has been adversely affected by competition policy. Distinctively, we find a positive relationship between competition policy with productivity, investment and export. For the export and investment performances, the results are stable even when we consider unobserved firm-specific attributes. For the productivity effect of competition policy, the results are influenced by firm-specific attributes suggesting that the posi-

tive relationship between competition policy and firm productivity is highly dependent on firm-specific characteristics. The other findings of the study are that there is a negative impact of competition on certain firms. In particular, firms that regard competition as one of the three biggest production problems have more difficulty in enhancing exports, maintaining productivity and investing. We point out that such findings form a basis for the need to adopt competition policy as an intervention mechanism, to minimize the adverse effect of competition.

The analysis of aggregate manufacturing sector statistics undertaken in this chapter also do not show any clear evidence that sector performance measured by export and investment has been affected adversely by the introduction of competition policy – indeed all these variables at some point have shown an up-and-down trend that might be due to factors that have less to do with competition policy. We have evidence of high concentrations in Tanzanian manufacturing and the existence of anti-competitive behaviour, which have been reported to the fair competition department. It is true that the policy may have affected the specific firms that were reported to the commission. However, based on the information about investment and export behaviour of some of the firms, we find no major effect, and our data do not provide support for the view that anti-competitive behaviour through a means such as false advertisement are helpful to their performance. In fact, such companies have retained their position and some have their performance improved even after being dealt with by the competition laws.

To address the question on what are the prerequisites for the successful implementation of competition policy in developing countries, we first argue that there are specific characteristics in developing countries which pose a great challenge for policy makers when designing an appropriate competition policy that will bring about economic development, restrain anti-competitive behaviour, limit abuses of monopoly power, and promote industrial development. For instance, whereas market entry and access are the key elements of market economies that many developing countries are currently striving to achieve, in practice, promoting the conditions for wider market access and efficiency through competition has been a difficult challenge. In most developing countries, the market or indivisible hand does not always operate very smoothly and indeed instances of market failure are rather frequent. The other limits to competition policy design in developing countries are the existence of large informal activities, lack of well-defined property rights, limited environmental, safety and health standards, underdeveloped consumer protection institutions and laws, limited capability to verify and check standards, lack of technical expertise and experience in competition policy and limited institutional capability in areas of competition and antitrust. The prerequisites for the successful implementation of competition policy in developing countries are therefore: a sound competitive environment in other economic sectors and policies that are directly or indirectly linked to competition policy, establishment of production standards, defined property rights, consumer protection agencies organized as an efficient institutional framework with adequate human,

technical and financial resources, harmonization of competition policy with those of countries with similar characteristics and/or economic partners, establishment of procedures and methods that can allow the monitoring of competition, ensuring that competition is legally protected and provides settlement for disputes through appropriate institutions with adequate knowledge of competition matters, improving the system of data collection and reporting on competition matters, e.g. changes in industrial concentration, changes in market power, investment behaviour of the producing firms, and other possible measures of competition, encouragement, and facilitating training in disciplines necessary for the competition policy implementation such as competition law, and an economics field that has a strong emphasis on competition aspects and the related fields.

1. Introduction

This study assesses the role of competition policy in influencing productivity, investment and export performance of Tanzanian manufacturing enterprises. We focus on the hypothesis that fair competition has a causal impact on the quality and quantity of manufactured exports, productivity and investment. The study's main argument is that the presence of a competitive environment motivates firms to consistently make different decisions regarding investment, training, technology and the selection of inputs, and thus raises their productivity. However, in the absence of fair competition, the quality and quantity of investment and productivity, along with the extent of export performance, might be impaired. It is only through fair competition that domestic firms, which target global markets, can be assured of future certainty, which gives them substantial incentives to invest in improving the efficiency of their operations to support technology transfer through a variety of means to economies with favourable factor endowments – including direct investment. By examining the patterns of manufacturing productivity, investment and export across Tanzanian manufacturing firms, we will attempt to show how the extent of openness and the competitiveness of markets affect the relative performance of manufacturing firms.

The major study objective is thus to investigate the extent to which firm-level performance measured by investment, productivity and export are influenced by government measures aiming to stimulate competition and protect consumers against monopoly. To analyse this influence, the study assesses the effect of control of dominant firms through institutions, the effect of mergers to prevent industries becoming monopolized and the effect of control of anti-competitive behaviour such as full-line forcing and predatory commission. In particular, the study assesses the existing government efforts to regulate business activity in order to ensure that it operates in the public interest. The study asserts that, whereas there are advantages of competition policy, its adverse effects cannot be ruled out. Firms facing actual or potential competitors will, in theory, concentrate on improving their products and lowering production costs. However, the threat poised by competition may be so severe that it leads to closure of weak incumbent firms. This explains why governments would wish to regulate business activity in order to ensure that it operates in the public interest.

The motivation of the study is that about a decade ago competition policy played little role in most developing countries. It was contended that free trade did not allow a true comparative advantage situation to develop due to differences between marginal social and marginal private costs; hence, there was a need to temporarily protect trade during its initial high-cost period until the correct pattern of international specialization is established. Based on this argument industrialization in most developing countries was marked by highly protective industrial and trade policies, especially under the infant industry argument for protection. While there were some gains in industrialization, the general performance of inward-looking protected industrialization programmes was not very successful. High effective rates of protection resulted in monopolistic industrial enterprises which were characterized by high investments but with low rates of capacity utilization, falling value added and total factor productivity and over-reliance on government subsidies, hence leading to an inefficient industrial base.

It was during that era that Tanzania strived to achieve state-led development. To facilitate development, the government controlled all markets and directed various projects. Investment was targeted as the government tried to allocate resources directly through systems of control such as business licenses. Through the infant industry argument, Tanzanian manufacturing firms were highly protected against foreign producers through a restrictive trade policy, an imposition of local content requirement, a technological transfer requirement and a ceiling on profit repatriation. Initially, the manufacturing sector generated significant growth, especially in the 1970s, but from the late 1970s this growth halted. The sector faced high rates of effective protection, an absence of competition and decreasing capacity utilization factors that resulted in decreasing efficiency and increasing costs (Ndulu, 1986).

The economic reforms adopted in the mid-1980s have shown some signs of recovery, such as a positive real growth rate and increased participation of the private sector in production. Nevertheless, as in many other developing countries, competition in broad international markets has not resulted in significant responses in elastic demand-induced improvements in productivity, investment and exports. The manufacturing exports are still a small proportion of the total country exports. Even in the domestic market, Tanzanian manufacturers have been facing stiff competition from imported cheap manufactured products. After the collapse of the state-controlled economy, Tanzania has shown considerable efforts to attain the competition policy that is relevant to its own local environment, which will regulate economic activities in line with public interest and discourage anti-competitive behaviour. This study is thus particularly relevant currently where Tanzania's stage of industrialization is associated with substantial changes in manufacturing organization and technology and poorly integrated markets.

Despite major changes regarding the competitive environment in which the manufacturing sector operates, the interaction of competition and long-term firm performance in terms of such things as exports, investment and productivity movements is

less well understood. For instance, the move from the state monopoly towards a market-oriented system involves both the elimination of protections and the introduction of competition. On the other hand, competition subjects firms to continuous threats from new suppliers, products or processes. The potential role of competition policy after liberalization is to enhance the effectiveness of competition in reallocating market shares between firms, inducing improved performance in existing firms, inducing entry by more, rather than less, efficient firms and expediting the exit of inefficient firms. Recent empirical works that establish the significance of within-firm impacts of competition on performance highlight the fact that there are welfare gains available from heightened competition. The antitrust authority has to find out whether the competition enhances firm performance.

In this chapter, we therefore use firm-level information to investigate whether the competitive environment in which the manufacturing firms of Tanzania operate increases productivity growth, investment and exports, along with an investigation into any anti-competitive behaviour and its effect on firm performance. We provide direct evidence based on microeconomic data of how the existing government policy and institutions charged with overseeing fair competition have succeeded in ensuring competitive production that is fair and in line with the public interest. The study further identifies gaps and the need for policy changes and/or institutional restructuring to cater for the new production environment within which the Tanzanian manufacturing sector operates. The data used are the employer-employee matched firm-level data obtained from Tanzanian Manufacturing/RPED surveys which contain detailed information on company-level performance and other firm characteristics. The data used contain information on the extent to which firm managers rank competition from both local and foreign firms among the three biggest problems facing their companies. With regard to this, managers are asked how often they had any dispute with their competitors and how such disputes were resolved. Finally, there are questions aimed at assessing the effectiveness of the existing institutions and regulations in enhancing fair competition in Tanzanian manufacturing.

The structure of the chapter is as follows. In section 2, we provide the link between competition policy, competition and firm performance and review the literature that analyses the impact of competition policy on firm performance. The discussion in this second section provides guidance as to the relative importance of competition policy for firm performance. In particular, it provides, among other things, the theoretical framework on which the empirical analysis of this chapter is based. Previous findings and conclusions on the related analysis are also provided in this section. The third section uses aggregate statistics from the Tanzanian manufacturing sector to evaluate export performance, investment and competition in Tanzanian manufacturing. The discussion considers changes in industrial performance along with industrial and trade polices of Tanzania over the 1960–2003 period. The fourth section discusses the theoretical framework of the study, data and models estimated. The fifth section describes the impact of competition policy on firm firm-level performance

while the sixth section discusses the empirical estimates of the productivity effects of competition and the impact of competition policy on firm-level performance based on the Tanzanian case. The emphasis in section seven is on an examination of the effect of competition policy on investment and export performance of a firm. Section eight examines market power concentration and competition policy in the Tanzanian manufacturing sector. The summary and conclusions are given in section nine. In particular, this section outlines the prerequisites for the successful implementation of competition policy in developing countries and the mechanisms through which it may operate, based on the study findings and experience from related works.

2. Competition policy, competition, firm performance and some empirical evidence

This section examines the links between firm performance, competition policies and competition. First we provide a definition and justification of competition policies and then we review the empirical and theoretical literature concerning competition policy and firm performance. Specifically, we undertake a thorough literature review that provides, *inter alia*, the theoretical framework on which the empirical analysis of the study is based. Previous findings and conclusions regarding the topic under investigation are also summarized in this section. In the previous section, we pointed out that, before the 1980s, competition policy did not exist in many developing countries. In particular, we showed that there was an infant industry argument that justified industrialization under highly protective industrial and trade policies in many developing countries. But since the introduction of the comprehensive economic reforms of the 1980s, it is not difficult to see why the need for competition policy becomes crucial in developing countries. Prior to the 1980s, many manufacturing firms in developing countries were natural monopolies under state ownership. The presence of a large state sector partly explained why many developing countries did not find it necessary to have a competition policy. However, the need for competition policy is called for in the new liberal market-based “outward-looking” economy. The basic assumption of the market reforms introduced after the economic reforms is that the competitive process will ensure the efficient allocation of resources, that it is essentially a self-correcting mechanism, and that intervention will be required only occasionally to correct temporary imperfection.

To facilitate competition, many developing countries have privatized the former state-owned firms. However, privatization and liberalization are necessary, but not sufficient, conditions for eliminating monopoly and market imperfections. In practice, markets exhibit some form of imperfect or monopolistic competition even in the absence of a state monopoly; hence, privatization as a process can simply involve replacing the public monopoly with a private one. If there are fewer firms then they can have scope to exercise their market power to manipulate the market in favour of firm-specific interests. In fact, some authors in this area argue that the creation of artificial barriers, for example, can allow such firms to earn excess profits without new entrants being able to compete to bring prices down. There are many other

forms through which manufacturing activities can be subjected to the adverse effects of competition.

To account for the limitations of the market economy, many governments in developing countries have established laws and institutions to regulate economic activities (including manufacturing-related activities) so that they operate in the public interest. The specific areas targeted by the competition policies and antitrust authorities include (i) control of dominant firms by regulation, (ii) control of mergers to prevent industries becoming monopolized, and (iii) control of anti-competitive acts, such as predatory pricing. In the manufacturing sector, competition policy aims at preventing restrictive practices, such as manufacturers insisting on a minimum retail price. Cartels and agreements prevent, restrict, or distort competition. The idea behind the introduction of competition policy is to ensure that competition brings economic benefits: it leads to greater efficiency, lower prices, greater choice and higher product quality.

There are other justifications for the competition policy in the manufacturing sector. The sunk cost argument for regulation, whereby there might be barriers to entry into markets stemming from the high sunk costs of establishment is one such justification. The competition policy is expected to ensure that the behaviour of the incumbent, i.e. the already established firm, does not contribute to artificial sunk costs. In the same way, the competition policy should protect the incumbent against entry that can lead to unexpected losses such as an inability to recover the sunk costs, e.g. technological duplication. It has been emphasized that the need to sink costs is not a barrier to entry if the entrant can invest in new technology with a performance advantage over obsolescent technology. There are also wider benefits of competition in that if firms are efficient, their international competitiveness will improve and the economy will see higher exports, lower imports and more employment.

The literature examining the effect of competition on firm performance is diverse. There have been numerous studies linking competition policy and competition with various firm performance indicators such as productivity, exports, investment, growth and profitability. The literature classifies the analysis of the relationship between competition and productivity into three sources from which the link between competition and productivity can arise. Firstly, following the observation of Hicks (1935), increased productivity under competition could arise from better incentives for workers and managers, and hence a reduction in slack and inefficiencies, in a competitive environment. Secondly, competition could improve productivity by providing better incentives for innovation. This is illustrated in endogenous growth frameworks where competition provides stronger incentives to adopt new technologies (Aghion, Harris and Vickers, 1995; Aghion and Howitt, 1996; Aghion, Dewatripont and Rey, 1999). A third strand of theories stresses the role of competition in weeding out inefficient firms through a dynamic process of entry of new firms, exit of unproductive firms and reallocation of output from less productive to more productive firms. The Melitz model also predicts increased productivity following trade liberalization.

There have been studies linking competition and productivity. Evidence of the effect of competition on the level of productivity is provided in studies by Nickell, Wadhwani and Wall (1992) and by Hay and Liu (1994). In these studies, a positive correlation between competition and productivity is reported. A contrasting, positive effect of high concentration (reflected in a positive correlation between market share and productivity growth) on productivity growth was found by Nickell (1992), whose later study (Nickell, 1996) suggests a positive effect of competition (measured by increasing number of competitors or lower rents) on productivity growth. The literature examining the effect of competition on technical efficiency is summarized in Nickell (1996). Studies by Caves and Barton (1990), Green and Mayes (1991) and Caves *et al*. (1992) suggest that an increase in market concentration tends to reduce technical efficiency.

In several studies, it has been theoretically modelled and empirically verified that increased import competition tends to reduce domestic cost-price margins in concentrated industries. Scherer and Huh (1992) note that some US firms react aggressively to increased import competition by increasing their R&D expenditure, while other firms react submissively. Bernard and Wagner (1997) found that, in Germany, exporters were more productive than their non-exporting counterparts. Bernard and Jensen (1999) made a similar observation regarding US manufacturers. Helpman and Krugman (1989) give an exposition of a wide range of models incorporating different modes of imperfect competition that share the common feature that abolition of institutional trade barriers reduces the mark-up.

There are studies which have assessed the effect of investment on local firms. Liu and colleagues (Wei *et al.*, 2000) consider productivity effects of foreign investment in the UK. For the 1991–1995 period, they found that foreign investment has been beneficial for the productivity of UK-owned firms in the same industry. Instead of the anticipated convergence of productivity levels between domestic and foreign firms, which means that domestic firms would need higher productivity growth rates than foreign ones to catch up, they found evidence to the contrary, indicating that the gap between foreign and domestic firms is widening.

Blomström and Sjöholm (1998) found that foreign establishments have a relatively higher level of labour productivity, but that domestic firms benefit from spillover effects (also in terms of labour productivity). Anderson (2001), using panel data on Indonesian manufacturing establishments for the 1980–1995 period, also found productivity spillovers from foreign to purely domestic enterprises. Kokko (1994) established similar positive effects for labour productivity in Mexico. Blomström and Wolff (1994) also concluded that, during the 1965–1982 period, foreign presence significantly influenced the rates of growth of productivity of local Mexican firms. Positive results are also found by Kokko *et al.* (1996) for the Uruguayan manufacturing industry.

Several other studies have also found negative effects of foreign investment on the productivity of local firms. The overall effect of foreign participation on the productivity of the entire industry was weakly positive. Studies by Haddad and Harrison (1993) for Morocco and Aitken *et al.* (1996) for Venezuela and Mexico also showed no positive spillovers in productivity and wages, respectively. A study by Kawai (1994), using a set of Asian and Latin-American countries, indicated that an increase in foreign investment had a generally negative effect on productivity, though positive results could be established for some countries.

There is limited empirical evidence concerning the impact of competition policy on firm performance. A few authors who have analysed this aspect have based their studies either on advanced countries or transition economies mainly in eastern Europe. Gonenc, Maher and Nicoletti (2000) surveyed the effect of regulatory reform in OECD countries. They focused on previously regulated industries – both competitive and non-competitive. Their studies provide evidence that competition policy results in improved static and dynamic efficiency, enhanced quality and lower prices to consumers. Dutz and Vagliasindi (2000a,b) measured the effect of competition policy rules and implementation on competition in a transition context. In the first study (Dutz and Vagliasindi, 2000a), they measured competition by enterprise mobility: an economy-wide indicator that captures the frequency with which private enterprises expanded employment over the 1997–1999 period, weighted by the corresponding proportion of expanding firms that increase labour productivity. They explained this enterprise mobility measure by average market concentration, average pressure of foreign competition, competition policy rules (constructed as explained in the previous subsection), competition policy implementation (see above) and corporate governance in 18 transition countries. They found that both rules and implementation improve enterprise mobility and that the effect of implementation is more important. They also found that more adequate corporate governance and stronger foreign competition increase economy-wide enterprise mobility, while the greater the average market concentration the smaller the measured enterprise mobility. In the second study (Dutz and Vagliasindi 2000b), their dependent variable is the average frequency with which enterprises faced a more competitive environment (the proportion of firms facing at least one competitor in the domestic market) in 1999. They constructed this variable for 20 transition countries and explain it with twice-lagged competition policy implementation and the change of the implementation over the previous 2 years. They also use the overall state of privatization and variables assessing the hardening of the budget constraint as explanatory variables.

Despite the differences in empirical approach, methods and variables used in the studies reviewed in this section, it is possible to draw some general conclusions. First of all, estimating the effect of competition and competition policy on firm performance in most of the studies presented generates positive effects. However, there are problems in estimating the effect of competition and competition policy on firm performance particularly endogeneity, specification of production function and input

measurement. There is a potential simultaneity problem when estimating production function especially when firm performance is correlated with firm-specific characteristics. Estimates that do not control for these effects may be thus biased. In this study, we control for this bias by estimating the firm fixed-effects estimates. We have seen, for instance, that studies that control for such heterogeneity find significant influence of the fixed effects on estimated coefficients.

The other important issue from the literature presented above is that the inclusion of a broad variety of additional firm characteristics improves the estimation and reduces the measured competition impact. Estimations excluding such variables may therefore be biased. It may also be the case that competition measures may pick up the performance effects of other variables that are frequently closely correlated with market and overall macroeconomic conditions. For instance, the Tanzanian manufacturing sector experienced huge investment growth during initial efforts to establish large state-owned firms, a factor that is not correlated with the existence of competition. In this study, we present panel data from the Tanzanian Manufacturing Enterprise surveys. We are thus able to use the panel dimension of the data to control for the unobserved time-invariant firm characteristics when estimating the impact of competition on firm performance. We estimate a production function with labour and capital inputs, and augmented by competition policy and competition variables. To account for the problems arising due to type, specification of production functions will estimate both the value added and the gross output production functions.

3. Export performance, investment and competition in Tanzanian manufacturing

In this section, we discuss the relationship between competition policy export performance and competition policy in Tanzania based on the manufacturing sector performance. The analysis is based on the aggregate statistics of the manufacturing sector. The data used are the annual surveys of industrial production, the industrial census over the 1966–2002 period. The time series trend enables an assessment of the changes in the exports and investment performance before and after the competition policy was introduced. Given that the competition policy was introduced in 1994, our competition variable takes the value of 1 for the post-1994 years and 0 for the years before that. The investment trends, total factor productivity, exports and investment are presented in Table 1.

The investment of a manufacturing firm is an important aspect of competition. This partly stems from the fact that barriers to entry are considered an important structural characteristic of an industry that can be inferred through investment. Bain's pioneering work (1956) specified three sources of entry barriers: absolute cost advantages of incumbent firms, economies of scale and product-differentiation advantages of incumbent firms, such as reputation and goodwill. Other reasons include the learning experience possessed by the existing firms, consumer loyalty to brands already used, and availability of financing (banks are less eager to lend to new inves-

tors) (see also Geroski, Gilbert and Jacquemin, 1990). Whereas there can be many reasons why entry may not occur, the investment performance of an industry is generally assumed to strongly influence the entry conditions. The primary explanation for entry barriers is the existence of entry cost. When the investment costs of establishing a new firm are high, the establishment of new firms will be difficult. To some extent, firms that are already in business, i.e. incumbent firms, can have an incentive to deter entry through creating artificially high investment costs. One aspect of the argument for infant protection was that opening up the domestic market would lead to a decline in local production due to competition from imported finished products. The trends in investment after liberalization and the introduction of competition policy could thus shed light on this issue.

In Figure 1, we present trends in investment in the Tanzanian manufacturing sector, and assess how the introduction of competition policy has influenced its trend. The data are from the aggregate statistics of the Tanzanian manufacturing sector from the 1960s to 2000. The time series trend of the data enables us to divide the data set into the pre-competition and post-competition period. The competition policy variables take the value of 1 in the post-competition policy and 0 for the pre-competition policy era. As we showed earlier, the competition policy in Tanzania did not exist until 1994. We therefore compare the behaviour in sector investment during the time when there was no competition policy with the post-competition policy period.

The estimated investment shown in Figure 1 indicates that investment accumulation increased steadily from 1966 up to 1974. Further, we note that there was substantial growth in investment in the sector from 1974 through 1982. The increases during that period partly reflect the response to rapid import substitution industrialization that Tanzania introduced during the 1970s. It was in this period that the manufacturing sector of Tanzania experienced rapid expansion enhanced by the Import Substitution Industrialization strategy of 1968 and Basic Industrial Strategies (1974). To implement these strategies, a rapid expansion of the manufacturing sector's capacity was pursued. Ndulu and Semboja (1986) indicated that production capacity increased by 77 per cent between 1967 and 1975, and doubled between 1975 and 1981. The declining trend especially after 1979 might be due to the economic crisis marked by a foreign exchange crisis and input constraints. The sector faced high rates of effective protection, an absence of competition and decreasing capacity utilization factors that resulted in decreasing efficiency and increasing costs (Ndulu, 1986). Due to the economic crisis, by 1986 output was at only 30 per cent of its 1979 level, with the share of GDP falling from 12 per cent in the 1970s to 8 percent in the 1980s (Mans, 1994). This was the period when major state-owned monopolistic firms were established. The figure also shows that from the late 1970s to the mid-1980s, investment in the sector fell markedly. This trend coincides with the economic crisis of the early 1980s. The recovery in investment is noticeable, especially from the late 1980s, when Tanzania embarked on major economic restructuring. The trend

in investment from 1994, when competition policy was introduced, indicates that sector investment is relatively higher than the pre-1970s level.

Figure 1. Trends in manufacturing investment.

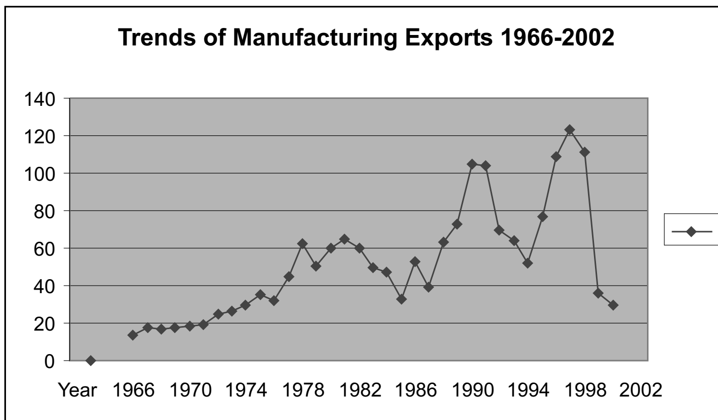
Source: Computed from the Economic Surveys, Statistical Abstracts and National Accounts (various issues).

The estimated total factor productivity (TFP) series of the Tanzanian manufacturing sector is shown in column 1 of Table 1. Based on the results in this first column, the estimates of TFP from 1966 to 1969 were negative and ranged between –12 and –52. The TFP improved from 1969 to 1979, and was positive throughout this period. From 1980 to 1985, total factor productivity fell significantly. Declining trends of total factor productivity associated with increased capital stock can be due to the effect of industrial expansion marked by under-utilization of capacity. The reforms introduced in the 1980s were intended to restore performance in the manufacturing sector through increased capacity utilization, export promotion, attraction of private sector (both foreign and domestic), investment increased competitiveness and overall efficiency (Maliyamkono, 1985). During this period, inefficient companies closed down as the government role in direct production substantially decreased. However, the post-1994 period does not reflect a significant improvement in total factor productivity. Based on such an observation, we have little evidence of the link between total factor productivity and competition policy. However, one limitation of analysis based on these aggregate statistics is the extent to which they can represent the entire sector, as they cover only medium and large enterprises. We will exploit this issue more using firm-level statistics.

In columns 2 and 3 of Table 1, we show the role of manufactured exports over time before and after the introduction of the competition policy. The trend is also displayed in Figure 2. It is apparent that Tanzania's share in the world market is

negligible and has been declining in real terms. One objective of the trade and financial sector liberalization, which has been implemented since the 1980s, is to encourage manufacturing firms to operate in a more competitive environment so as to enhance their efficiency and productivity. There was certainly an expectation that, after the reforms, local firms would hold their market share and increase exports. On the basis of the official statistics there is no basis to believe that this expectation has been met. The other aspect is whether and to what extent the export trend observed here is linked to competition policy. When we consider the early 1990s as the cut-off point for competition, we find that there is no systematic pattern in changes in export and changes in policy. The export figures for example were higher in 1990–1991, fell dramatically between 1991 and 1995, and then peaked in 1996–1998. Further, the exports fell significantly between 1999 and 2001.

Figure 2. Trends of manufacturing exports 1996–2002.



Source: *Computed from the Economic Surveys, Statistical Abstracts and National Accounts (various issues).*

However, the analysis of firm performance presented in this section is limited by the extent to which the aggregate statistics can be representative of the entire sector. The figures reported in all aggregate sources are based on the large and medium-sized firms, hence excluding micro and small firms. Given that firm size can influence firm-specific characteristics, there is a question as to how representative they are of the entire sector. The other limitation of the aggregate statistics of Tanzanian manufacturing is that, prior to 1988, the sector was protected through tariffs, subsidization and other forms of protection. This could lead to over-valuation of the output figures prior to 1988 as reported in official sources. For instance, Bukuku (1993) argued that some manufacturing enterprises were financially profitable ventures only because of high protection of domestic production, but at world prices their contribution was not significant. In this study, we present firm-level statistics that contain information for all firm sizes, i.e. micro, small, medium and large firms from

Table 1. Total factor productivity, investment, export and competition policy in Tanzanian manufacturing.

Year	TFP	Exports (US$)	Log export	Real investment
1966	-52	13	18	382.50
1967	-47	18	19	354.80
1968	-27	17	19	437.00
1969	-12	18	19	323.00
1970	5	19	19	621.40
1971	9	19	19	509.83
1972	26	25	19	335.14
1973	37	26	19	405.00
1974	50	30	19	719.00
1975	40	35	19	785.50
1976	19	32	19	1555.27
1977	54	45	20	2202.50
1978	51	62	20	1906.06
1979	39	50	20	2401.78
1980	0	60	20	2189.17
1981	-20	65	20	1282.21
1982	-22	60	20	877.70
1983	-19	50	20	484.50
1984	-15	47	20	552.55
1985	-10	33	20	588.56
1986	5	53	22	729.13
1987	35	39	22	1319.09
1988	1	63	23	1496.86
1989	30	73	23	1523.88
1990	6	105	24	1152.06
1991	-19	104	24	1658.42
1992	-64	70	24	1161.65
1993	-81	64	24	1295.75
1994	5	52	24	1120.08
1995	1	77	24	1065.79
1996	-1	109	25	813.10
1997	2	123	25	887.62
1998	3	111	25	800.77
1999	-4	36	24	918.69
2000	-2	30	24	866.33
2001	-6	56	25	1058.23
2002	-17	66	25	1002.15

***Note:** TFP is total factor productivity. The total factor productivity is directly estimated from the production function. Data on investment are from the Economic Surveys, Statistical Abstracts and National Accounts (various issues). The export figures are in millions of US dollars. The investment data are real values of gross fixed investment deflated using the 1994 CPI =100 and are in millions of Tanzanian shillings. The competition variable is a dummy for whether or not the period was affected by competition policy. Specifically, the dummy is equal to 1 if the year was influenced by competition policy and 0 if otherwise.*

1993 to 2002. This information will be used to compare productivity trends for 1993–2002 based on both firm-level and aggregate-sector statistics. In this study, we use a firm-level data set that contains firms of all sizes, i.e. micro, small, medium and large firms. The data also provide detailed information concerning aspects of firm-level performance, competition and regulations. We will therefore use this information to provide a more rigorous firm-level assessment of the relationship between competition policy and firm performance.

4. Methods and approach for assessing the impact of competition policy on manufacturing performance

In this section, we provide the methodology and approach for assessing the impact of competition policy and competition on firm performance. We also discuss the limitations of the approach and possible solution(s) for such problems. In addition, we discuss ways of tackling estimation problems employed in this study. We also specify the model to be estimated and the data available for our study. The discussion on data includes a description of the type of data used, their source and the creation of variables to be estimated. The empirical approach of this chapter focuses on identifying, describing and measuring variables that link competition policy and firm performance and assessing the impact of the legal and institutional structures of competition policy and the related policies on domestic firm performance. In particular, the methodology used develops measurement criteria that can be tested over time in the same sector or replicated in other countries with similar characteristics. Recently, we have seen an increase in the availability of firm-level micro-data in developing countries, primarily through the regional Programme of Enterprise Development (RPED) surveys organized by the World Bank. This chapter uses an existing data source from Tanzanian manufacturing firm surveys that are part of the RPED surveys. The independent variables in our analysis are variables that proxy for the set of measures and instruments used by government that determine the conditions of competition. In view of the possible overlap between competition policy and competition, the chapter attempts to include some variables that proxy for competition such as the existence of five competitors in the production sector and the condition of competition.

The dependent variables in our estimates are the investment, export and productivity variables. The fact that panel data are used enables us to provide an empirical analysis that controls for unobserved characteristics that affect the measurement of causal effects of competition policy on our firm performance variables. The RPED surveys data used in this chapter collect information on competition from imports, competition from local firms, the effect of government industrial policies on firm performance, the effect of government restrictions on various aspects related to industrial activities, and the way taxation policy affects company performance.

4.1. Estimating the productivity effect of competition

To assess the productivity effect of competition policy on the manufacturing sector, we estimate the production function as follows:

$$Q_t = A_t K^{\beta 1}_t L_t^{\beta 2} COM_t^{\beta 3} \quad [1]$$

where Q_t is the value of manufacturing output in year t, A_t is an index of total factor productivity or a coefficient that denotes the level of technology, and K_t and L_t are the stocks of physical capital and labour for year t, respectively, and COM is a dummy for competition policy. In order to estimate our production function [1], we introduce log variables that give us the following equation:

$$\text{Log } Q_t = \log A_t + \beta_1 \log K_t + \beta_2 \log L_t + \beta_3 \log C_t + \beta_4 COM_t + \varepsilon \quad [2]$$

where Q_t is the log of output, $\log K_t$, $\log L_t$ and $\log C_t$ are logs of capital stock, labour and indirect costs, respectively, COM is as defined in equation [1] and e is the error term. Value added production function output is measured as value added hence the dependent variable in equation [2] is the log of value added. The value added production function is specified in equation [3] below.

$$\text{Log } V_t = \log A_t + \beta_1 \log K_t + \beta_2 \log L_t + \varepsilon \quad [3]$$

However, there are problems in estimating the effect of competition on firm performance productivity, particularly endogeneity, and specification of production function and input measurement. There is a potential simultaneity problem when estimating production function especially when firm usage of inputs is correlated with firm-specific characteristics, e.g. a strategy to adjust for unforeseen upsets during transition. In addition, firm-specific effects are correlated with the competition variables; hence, estimates that do not control for these effects may be biased. In this study, we control for this bias by estimating the differenced production function estimates.

The other estimation problem arises from specification of production function (i.e. whether the value added or gross output production function is specified). The previous studies that have estimated production function argue that the choice between using the gross output or value added production function is important because each specification leads to different results. Basu and Fernald (1997), for example, indicated that estimates of the increasing returns to scale measured by the value added production function do not imply increasing returns to scale in the gross output production function. The problems of estimating gross output production function are also highlighted in Griliches and Klette (1996), who argued that when sales are used instead of output in production function analysis, and if the prices are correlated with included variables in the model, an omitted variable bias will arise. The authors also argued that in the presence of imperfect competition, value added suffers from an omitted variable bias and aggregation bias. Allied with that, the value

added production function, is said to impose weak separability on technology unless the sample used satisfies the condition that the ratio of price of materials to the price of output is constant (Ferguson, 1965). Data availability and the market conditions are therefore important determinants of the choice between the two specifications. To address the weakness of alternative specifications, we estimate production functions that analyse the impact of output on factor productivity and human capital characteristics of learning by comparing the value added with the gross output production functions.

4.2. Estimating the competition and competition policy effects on firm performance

To estimate the possible influence of competition and competition policy on firm performance indicators of investment, exports and productivity, we specify a probability or likelihood model, i.e. a probit function. Such a model is an appropriate tool for fitting a situation with a binary outcome. In our situation, we assume that the presence of competition policy and/or competition *per se* will result in two possible outcomes: (1) enhance firm performance through increased productivity, export and investment, or (2) limit firm performance by eliminating its likelihood to export or invest and reducing its productivity. To investigate the way competition policy and/or competition might have affected firm performance the model groups firms into those that increased performance after the competition policy and/competition was introduced and those that experienced reduced performance after the introduction of competition policy and/or competition. To be able to examine the effect of competition policy on investment and export, we estimate a probit model. The binary outcome is characterized as changes in export/investment due to changes in competition policy. The probit model estimate is defined as follows:

$$Y^*ijt = \beta_0 + \beta_1 X_{ijt} + \delta_{ijt} \quad [4]$$

where Y*ijt is the unobserved “latent” variable determining the levels of investment and/or firm-level exports of firm j during time t. X_{ijt} is a set of observable determinants of investments and exports. To facilitate our analysis we include the competition variable COM, among the possible determinants of investment and exports. β_i denotes parameter estimates and δ is the disturbance term. Although Y*ijt is not observed, we can observe Y, a dummy variable that we characterized above for binary outcomes.

$$Y^*ijt = 1 \text{ if } Y^*ijt > 0$$

$$0 \text{ otherwise} \quad [5]$$

4.3. Measuring changes in market power and concentration

In order to investigate changes in market power or concentration, we specify a concentration measure. There are a variety of indices that can be used. Most concentration measures are based on the shares of an individual firm. If we denote the number of firms in the sector as n and q_{it} represents the share of sales of an ith firm at time t, then the sum of q_{it} from 1 to n will be q_t and the share of each firm in the market for a specified time period, say year t, would be expressed as:

$$p_{it} = \frac{q_{it}}{q_t} \quad i = 1,...,n \text{ and } t = 1,...,T$$

[6]

The Concentration Ratio (CR) can be calculated as the total share of firms which have the largest shares in the market. It is denoted by CR(k) and is calculated as:

$$CR(k)_t = \sum_{i=1}^{k} p_{it}, \qquad k < m$$

[7]

In most applications CR(4), CR(8) or CR(16) are used; the selection of k is arbitrary. The other measure is the Hirschman-Herfindahl Index (HH). This measure can be described as the sum of p_{it}s weighted by themselves:

$$HH_t = \sum_{i=1}^{m} p_{it}^2$$

[8]

The HH index lies between 1/n, where all p_{it} values are equal, and 1, where there is only one p_{it}, implying that $q_{it} = q_t$.

Theoretical support for the HH index is provided by Cowling and Waterson (1976) but many studies use the concentration ratios as they are often supplied by the official statistics. Various authors have argued that for an economy with high concentration, the use of the HH index is more revealing, as the changes taking place at the top end of the size distribution can be obscured by the measures such as CR(4).

5. The effect of competition policy on firm performance

This section analyses the effect of competition policy on firm performance. In particular, we assess the role of competition policy in influencing a firm's propensity to export or invest and its productivity. In the introduction section of this chapter, we

argued that, in order to promote desirable economic performance, competition policy may strategically subject firms to rules that safeguard anti-competitive behaviour, such as collusive tendering and bidding, and price-fixing arrangements. To achieve the intended objectives, competition polices can aim at limiting the economic power of some firms and abuses of the economic and political system. However, there is limited evidence that competition policy will at all times lead to all these advantages. In a study by Brien, Howe and Wright (1979), it was highlighted that clearly there is a belief that competition policy has harmful effects upon the development of firms. The authors further indicate how, in their earlier study, it came to light that competition policy had been responsible for the lack of prosperity of firms; what they called 'the anti-competitive tide', the rise of restrictive practices to protect profit margins in the face of the emergence of mass trade-unionism, which meant that downward wage stickiness will greatly increase in times of recession.

Therefore, the major question that surfaces from implementing competition policy is whether and to what extent is firm-level performance influenced by competition policy? It is anticipated that a well-designed and effective competition policy enhances the international competitiveness of efficient firms and improves the economy in ways such as higher exports, the attraction of new investments, lower imports and more employment. Whether or not this is the case is the subject of empirical investigation in this area. To address this question, we estimate the firm-level production function, the export propensity function and the investment propensity function, in which the proxy for competition policy is one of the variables that determine firm productivity, export and investment. We look at the investment, export and productivity of firms in an attempt to see whether the competition policy has any effect on firm-level performance. In addition to these functions, we compare trends in selected firm-level performance indicators of profit rates, exports, investment and value added of firms that have indeed been affected by the competition policy, before and after the competition measures were introduced.

We begin by presenting the descriptive statistics of the key variables used in our estimations, namely gross output, raw materials, exports, capital stock and the human capital variables of schooling, tenure and work experience. The data show that in 1993 the gross real output was US$ 1,034,332, and increased gradually over the 1990–2000 period. By the year 2000, the gross output had reached US$ 1,887,968. The observed changes are a reflection of substantial reforms in the sector, especially privatization of many stagnant state firms and encouragement of investment in the sector during the period. The substantial rise in gross output is supported by a rise in value added. The figure shows that value added was US$ 392,069 in 1993, but reached US$ 1,498,333 in 2000. It is evident that both net output and gross output have shown an increasing trend during the period.

The other variable presented is export. The trend in this variable shows that export performance has not significantly changed over the entire 1990–2000 period. The average total exports have stagnated at about US$ 4.5 million.

The data show that, prior to the mid-1990s, the average tenure was 7 years, and during the late 1990s and 2000 it increased slightly to about 8 years. In theory, this short tenure cannot be expected to result in significant firm-specific skill acquisition. Therefore, firms might experience less positive gains in productivity due to firm-specific skills. The data also show that between 1993 and 2000, the average years of education of a member of a firm's workforce in our surveyed firm-level data was about 8 years. The results suggest that the majority of the workers have less than secondary school education and very few have post-secondary education, which requires about 16 years of education in total.

Table 3. Regression estimates of the effect of competition policy on manufacturing productivity.

Variables	OLS1	OLS2	OLS3	FEM1	FEM2	FEM3
Dependent	Value added	Investment	Export	Value added	Investment	Export
Com-policy	0.412	0.821	0.133	-0.246	1.410	0.422
	(2.33)**	(2.47)**	(0.53)	(0.62)**	(2.57)**	(1.74)*
Com1		-0.586	-0.291		-2.045	
		(1.00)	(0.81)		(1.44)*	
Log capital	0.349	0.881	0.217	-0.026	1.35	0.005
	(9.63)***	(6.87)***	(3.53)	(0.10)	(6.43)***	(0.03)
Log labour	0.702	0.200	0.142	0.622	-0.567	0.22
	(10.27)***	(0.66)	(1.46)*	(3.18)***	(1.48)	(1.62)*
Log value added			0.774		-0.066	0.373
			(9.34)***		(0.39)	(6.58)***
Job training	-0.789			-0.536		
	(1.61)			(0.43)		
Other training	0.363			-0.011		
	(1.30)			(0.01)		
Experience	0.033			-0.013		
	(2.03)**			(0.89)		
Tenure	-0.021			0.074		
	(1.37)			(2.28)		
Schooling	0.552			0.100		
	(1.65)			(1.73)*		
Constant	3.501	7.30	1.763	7.92	3.63	5.37
	(8.29)**	(7.54)***	(16.78)**	(2.58)**	(2.48)**	(2.63)**
Observations	421	421	421	421	421421	
R-squared	0.73	0.73	0.92	0.30	0.78	0.900
F	74	22	102	4	149	
Prob > F	0.000	0.000	0.000	0.000	0.000	0.000

Notes: Absolute value of t-statistics in parentheses; *significant at 1 per cent level; **significant at 5 per cent level; ***significant at 10 per cent level.

The results reported in the first column of Table 3 are for estimating the effect of competition policy on firm-level productivity. The measure of firm-level productivity or "the dependent variable" is the log of value added. The competition policy variable is measured as a dummy that takes the value of 0 for the period before the competition

policy was introduced and 1 after the competition policy was introduced. The productivity effect of the competition policy variable is estimated directly from the production function. Other determinants of productivity considered in this first column are log of capital stock, log of labour and human capital. The real value added is the deflated value of the difference of total manufactured output minus indirect costs and minus raw materials used in producing the output. The capital stock is a real capital stock series based upon an initial observation of the firm's replacement value of plant and machinery, which is augmented with subsequent investments in plant and machinery made by the firm. The weighted average of schooling, tenure, age and training are derived from firm-level information for each individual concerning the highest level of education completed, the occupational specialization, work tenure and age. Each value is weighted by the proportion of workers in a given occupational category in each firm to obtain a weighted average for each firm.

As shown in Table 3, competition policy is an important determinant of establishment productivity. In particular, it is shown that competition policy has a positive and significant effect on firm-level productivity. The estimated coefficient reported in the first column implies that firm-level productivity in the post-competition policy era is about 50 per cent higher than the productivity effect in the pre-competition policy period. The other results in the first column suggest that capital stock, stock of labour and human capital also influence firm-level productivity.

The results presented in the second column are for testing whether competition policy has any effect on investment in our data. The results are obtained from estimating an investment equation in which competition policy is one of the variables that determine the level of firm-level investment. The other determinants of investment are the stock of capital, firm size (measured by log of labour), firm performance (measured by log of value added) and the general competition environment measured by the situation where competition is one of the three major problems that face a particular firm. The results in the second column are that the implied competition policy coefficient would suggest that investment is higher in the post-competition period than in the pre-competition policy period. The results indicate that firm-level investment in the post-competition policy period is over one-fold higher than firm-level investment prior to the establishment of the competition policy. The other important determinant of firm-level investment according to the results is the stock of capital. It is indicated that a 1 per cent rise in the stock of capital results in a 0.8 per cent increase in investment. Further results indicate that competition *per se* is negatively related to investment. In particular, it is indicated that firms that regard competition as one of the three biggest problems for production have less investment than those that do not regard competition as one of the three production problems.

The third column presents estimates of the export function. As for the other firm performance measures (value added and investment), we include the proxy for competition policy measure among the determinants of exports. The other determinants of exports included in this column are competitive environment, log of capital, log of

labour, and log of value added. The results indicate that there is no significant correlation between competition policy and export. The variables that appear to have strong effect on export are firm size, measured by the log of labour, and the log of value added.

While the results in columns 1–3 highlight the importance of competition policy for firm-level performance, particularly productivity and investment, there are several limitations to these findings. First and foremost is the problem of endogeneity. The presence of unobserved establishment characteristics that are time invariant is likely to bias our estimated coefficients. We mitigate this effect by estimating fixed-effect models of all the three models and report their results in columns 4–6. The results in columns 4–6 indicate that when we control for unobserved firm-specific characteristics, competition policy appears to have significant effects on all firm performance indicators presented in this section (i.e. value added, investment and export performance of a firm). The results suggest that the causal relationship between competition policy and firm performance indicators discussed in this section is not negatively affected by firm-specific characteristics. In fact, there appears to be a positive correlation between firm fixed effects and performance effects of competition policy. In all cases, the estimated coefficient size of competition is substantially increased after the control of firm fixed effects.

Table 4. Summary statistics of firm performance before and after the introduction of competition policy.

	Before introduction of competition policy	After introduction of competition policy
Export US$	8,092,303	4,405,767
(SD)	(39,400,000)	(10,100,000)
Value added US$	664,953	710,059
(SD)	(6,260,554)	(5,735,618)
Investment	1,160,672	8,081,651
(SD)	(9,152,969)	(12,300,000)
Profit rate	-0.92	0.809
(SD)	(29.2)	(1.347)

Source: Tanzanian Manufacturing Surveys – part of Regional Enterprise Development Surveys (1994–2001).

Table 4 shows the average total exports, value added, investment and the rate of profit before and after the introduction of competition policy. This sort of presentation allows us to compare the changes in magnitude of the performance variables after the competition policy is introduced. The results indicate that the mean exports after

the introduction of competition policy are half those before the policy was introduced. The other observation is that in both cases, there is high variability in export from the mean (as the standard deviations in both cases are more than twice the mean). But given such an observation, it may be necessary to isolate the effect of competition policy from other possible influences of export performance. As we mentioned in the Introduction, the Tanzanian manufacturing sector has been subjected to a series of reforms particularly privatization. The performance of the sector has not been very satisfactory and in some cases the performance is below the pre-reform levels. A detailed account of the factors behind such performance is beyond the scope of this study, but it is apparent that there are other factors influencing the observed trends in exports.

The other mean displayed in the table is that for value added. The results for this variable indicate that the value added after the introduction of competition policy is higher than the average value added before the competition policy was introduced. Just like the export figures, they appear to have higher variation from the mean (higher standard deviations). The investment figures are much higher in the post-competition policy period than in the pre-competition policy period. Similarly, the profit rates are higher in the post-competition policy period than in the pre-competition policy era. But, as we mentioned above, our results are subject to data problems and other limitations. Despite these limitations, it is evident from the data that there is no evidence that competition policy has adversely affected any of the performance variables described here. In general, competition policy does not appear to have clear adverse effects on firm performance.

6. The empirical estimates of the productivity effects of competition

In this section, we estimate the link between competition and firm performance. In particular, we estimate the gross output and value added production functions in which competition variables are included among the determinants of firm-level productivity. Two measures of competition are available from the survey data. The first is a measure of the existence of competition within the line of production of a firm. This sort of competition is measured by the existence of at least five major competitors. The second measure of competition is based on whether competition is one of the three biggest problems affecting the firm. In this way we are able to differentiate between the effect of the existence of competition and the effect of competition itself.

Table 6. Regression estimates of the effect of competition on manufacturing productivity.

Variables	OLS1	OLS2	OLS3	OLS4
Dependent	Value added	Value added	Gross output	Gross output
com1	-0.350		-0.074	
	(1.73)*		(1.49)	
comf1		0.247	0.041	
		(1.62)	(1.09)	
lkus	0.329	0.343	-0.006	-0.009
	(9.53)***	(9.84)***	(0.59)	(0.86)
ll	0.760	0.750	0.103	0.104
	(11.82)***	(11.67)***	(5.51)***	(5.58)***
lmus		0.549	0.549	
		(29.35)**	(29.37)**	
lous		0.366	0.367	
		(15.96)**	(16.03)**	
onjwgs	-0.676	-0.563	-0.293	-0.312
	(1.38)	(1.14)	(2.37)**	(2.56)**
jotwgs	0.298	0.270	-0.040	-0.036
	(1.13)	(1.02)	(0.61)	(0.56)
pexwgs	0.033	0.029	0.006	0.007
	(2.05)**	(1.75)*	(1.59)*	(1.82)*
tenwgt	-0.015	-0.014	0.004	0.004
	(1.23)	(1.14)	(1.25)	(1.19)
eduwgted	0.008	0.014	0.001	-0.000
	(0.27)	(0.48)	(0.12)	(0.05)
round1	-0.009	-0.001		
	(0.04)	(0.00)		
round2	0.011	0.012	-0.025	-0.023
	(0.05)	(0.05)	(0.53)	(0.49)
round3	0.000	0.000	0.002	0.004
	(0.061)	(0.071)	(0.032)	(0.07)
round5	0.464	0.309	0.067	0.097
	(2.06)**	(1.33)	(1.42)	(2.12)*
round6	0.580	0.432	0.086	0.115
	(2.66)**	(1.91)*	(1.89)*	(2.61)**
round7	0.000	0.000	0.000	0.000
	(0.06)	(0.02)	(0.05)	(0.03)
Constant	3.501	3.319	1.763	1.794
	(8.29)**	(7.91)**	(16.78)**	(17.05)**
Observations	421	421	426	426
R-squared	0.73	0.73	0.98	0.98

*Notes: Absolute value of t-statistics in parentheses; *significant at 5 per cent level; **significant at 1 per cent level. Tzwn, Tanzanian private ownership; statec, state ownership; vadus, value added in US dollars; inplan, investment plan; fmage, firm age; ll, log of labour; lmus, log of raw materials; lous, log of other inputs. Round1 is the year 1993, round2 1994, round3 1995, round5 1997, round6 1998 and round7 1999. The omitted variable is for round8 which is the year 2000.*

The results reported in column 1 indicate that for a firm that ranks competition among the three biggest problems, there is a substantial negative effect of productivity due to competition. In particular, the results show that a competition problem

reduces productivity by 35 per cent. The other results in this column indicate that the estimated coefficient on capital stock is 0.28 and highly significant at the 1 per cent level. It has a positive sign implying that a 1 per cent increase in capital stock will lead to an increase in value added by 0.32 per cent while the labour coefficient is 0.76 and both are significant at the 1 per cent level with a positive sign, implying that a 1 per cent increase in the labour force increases value added by 0.76 percent and a 1 percent rise in capital stock increases productivity by 0.32 percent. The estimated total effect of change in inputs is roughly 1 (summing to 1.08) per cent hence displaying a constant returns to scale.

In column 2, we report the results that models the value added as a function of the existence of competition measured by the existence of at least five competitors. Other production inputs appear in column 2. The results show that the existence of competitors is positively correlated with productivity. Specifically, we find that the existence of at least five competitors is associated with a 24 per cent increase in productivity. These results suggest that there is a positive correlation between productivity and the competition environment, which is consistent with the economic liberalization objectives. Other results are that the estimated coefficient on capital stock is 0.34 and highly significant at the 1 per cent level. It has a positive sign implying that a 1 per cent increase in capital stock will lead to an increase in value added by 0.34 per cent. The labour coefficient is 0.75 and is significant at the 1 per cent level with a positive sign, implying that a 1 per cent increase in labour force increases value added by 0.75 per cent.

But, as previously noted, different specifications of production function lead to estimates that are radically different. We therefore estimate the gross output production function as a supplement to our value added production function estimations. The results in the third column confirm a negative correlation with competition being one of the major production problems facing a firm and productivity. Although the results are weakly statistically significant, they still show that there is a fall in productivity of about 7 per cent for firms that consider competition as a major problem in production. Further, we note that other production inputs such as raw materials, labour and human capital characteristics, such as education, are positively correlated with gross output. In the fourth column, we estimate the gross output production function where the measure of existence of competition is included among the determinants of productivity. The results still confirm a positive correlation between productivity and the existence of competition. However, the estimated coefficient is lower than reported in the second column.

The results presented in Table 6 suggest that the existence of competition and the competition problem comprise one of the major production problems that affect a firm's productivity differently. It is evident that the existence of competition has a positive effect on firm productivity, and when competition is ranked among the three major production problems, a negative effect on firm's productivity is observed. Nonetheless, there are limitations to the OLS approach used in the table, especially re-

garding the failure to address the problem of unobserved characteristics mentioned earlier. To account for this problem, we estimate the differenced production functions that exploit the time variation to difference out the unobserved time-invariant aspects that are the source of this estimation problem. The results are reported in Table 7.

Table 7. Regression estimates of the effect of competition on manufacturing productivity.

Variables	OLS1	OLS2	OLS3	OLS4
Dependent	Value added	Value added	Gross output	Gross output
com1		-0.058		0.023
		(1.39)		(0.15)
comf1	0.135		-0.284	
	(2.49)**		(1.33)	
ddlkus	-0.011	-0.012	0.374	0.377
	(0.92)	(0.96)	(10.67)***	(10.71)***
ddll	0.103	0.101	0.716	0.714
	(5.22)***	(5.07)***	(10.80)***	(10.74)***
ddlmus	0.543	0.544		
	(27.37)***	(27.24)***		
ddlous	0.373	0.375		
	(15.07)***	(15.04)***		
onjwgs	-0.056	-0.084	0.317	0.322
	(0.42)	(0.61)	(0.62)	(0.62)
jotwgs	-0.123	-0.097	0.049	0.070
	(1.76)*	(1.36)	(0.18)	(0.26)
pexwgs	0.006	0.007	0.032	0.031
	(1.45)	(1.48)	(1.88)*	(1.80)*
tenwgt	0.004	0.004	-0.012	-0.012
	(1.11)	(1.05)	(0.91)	(0.89)
eduwgted	-0.014	-0.011	-0.035	-0.029
	(1.74)*	(1.42)	(1.17)	(0.96)
round2	-0.008	-0.006	-0.032	-0.024
	(0.15)	(0.12)	(0.13)	(0.10)
round3	-0.033	-0.042	0.000	0.000
	(0.55)	(0.69)	(0.80)	(0.61)
round5	0.143	0.140	0.715	0.657
	(2.84)***	(2.67)***	(3.01)***	(2.69)***
round6	0.104	0.105	0.598	0.548
	(2.18)**	(2.09)**	(2.60)***	(2.30)**
round7	0.000	0.000	0.000	0.000
	(0.05)	(0.01)	(0.02)	(0.04)
round1		0.268	0.277	
		(1.16)	(1.20)	
Constant	1.946	1.924	3.427	3.333
	(17.11)**	(16.91)**	(7.65)**	(7.48)**
Observations	425	425	420	420
R-squared	0.98	0.98	0.72	0.72

*Absolute value of t-statistics in parentheses; *significant at 5 per cent level; **significant at 1 per cent level. Variables are as defined in Table 5, except that dd refers to a*

differenced variable. Eduwgted is the weighted variable of schooling, tenwgt is the weighted average of tenure, and pextwgt is the weighed average of work experience. Jotwgts is the weighed average of job training attended in the past and onjotwgs is the weighted average of job training attended recently.

The results in the first column suggest that even when we control for firm fixed effects, the impact of the existence of competition on productivity is positive. It is observed that controlling for firm fixed effects, the existence of at least five competitors raises the productivity of a firm by 13 per cent. The results on the other hand are less than those obtained using OLS, suggesting that the OLS results were biased upwards. In the second column, we consider the effect of competition problem on firm productivity once we control for firm fixed effects. The results reveal that there is still a negative correlation between competition problem and firm productivity, although the results are not statically significant. In columns 3 and 4, we estimate the differenced gross output production function. In the third column, a positive correlation between existence of competition and productivity is confirmed. In column 4, a negative correlation between competition problem and firm-level productivity is observed, but the results are not statistically significant.

7. Determinants of competition investment plans and exports

In this section, we examine the effect of competition policy on investment and export behaviour of a firm by assessing the extent to which one variable is a determinant of the other. Specifically we estimate the extent that either of the determinants of investment plan and export behaviour could be affected by competition and *vice versa*. In column 1, we present a probability equation for the existence of competition. The independent variable estimated in this probit equation is for whether a firm has at least five competitors. The determinants of competition existence considered in this equation are firm ownership, productivity (measured as value added), investment plan, export behaviour, firm size and sector. The results show that an increase in value added reduces the existence of competition for a firm. It is also observed that the probability of the firm-level plans to invest increases with the existence of competition. This is consistent with the predictions that competition may induce investment as a tool to maintain production in the face of increased competition. The other results in column 1 indicate that the likelihood of the existence of competition is influenced by sector, firm age and export behaviour. The exporters are less likely to have more competitors than non-exporters. Also, the existence of competition is negatively correlated with firm age implying that old firms are less likely to have more competitors than new ones.

In column 2, we report estimates of a probit equation for estimating the determinants of the competition problem in the surveyed firms. Similar determinants considered in the first column are presented. The value added is negatively related to the competition problem implying that the higher the value added, the less the likelihood of facing competition among the biggest production problems. The results also show

Table 5. Determinants of competition investment plans and exports.

	Competition problem	Competition existence	Export sales	Investment plans
plans				
tzwn	0.058	0.678	-0.041	0.078
	(0.25)	(3.96)***	(0.18)	(0.34)
Statec	0.900	0.251	0.637	
	(2.26)**	(0.50)	(1.17)	
vadus	-0.001	-0.001	0.0001	0.000
	(1.25.)	(2.16)**	(1.61)*	(0.92)
inplan	-0.001	-0.001		
	(1.64)*	(4.51)*		
micro	-0.527	0.154	-1.217	-1.271
	(1.92)	(0.79)	(3.79)***	(3.72)**
small	-0.266	0.093	-0.756	-0.656
	(1.44)	(0.62)	(4.76)***	(4.04)**
medium	-0.50	-0.619	-0.416	-0.334
	(2.07)	(3.13)**	(2.29)**	(1.83)
fmage	0.001	-0.010	-0.014	0.012
	(1.24)	(1.96)*	(2.08)	(2.33)*
exports	-0.983	-0.325		
	(2.72)**	(1.72)*		
comp	-0.621		-0.386	-0.377
	(4.04)***		(2.66)**	(2.35)**
com1			-1.088	-1.12
			(2.90)**	(3.87)**
comf1			-0.144	1.551
			(0.85)	(9.22)
lkus				-0.201
				(2.89)**
ll				0.013
				(0.12)
lmus				-0.037
				(0.37)
lous				0.181
				(1.32)
Chi2	53.1	131	70.86	156
Pseudo R^2	0.2199	0.17	0.135	0.314
Prob > chi^2	0.0000	0.000	0.000	0.000
Log likelihood	-177	-318	-227	-169
Observations	648	648	648	648

*Absolute value of z-statistics in parentheses; *significant at 5 per cent level; **significant at 1 per cent level.*

a negative relationship between the possibility of mentioning competition among the three biggest production problems and the investment plans. This suggests that firms that rank competition among the top production problems are less likely to invest in the future. Further, we observe that competition problems are more common to smaller firms than large firms, non-exporters than exporters, and are sector specific. In particular, we find that the likelihood of ranking competition among the three biggest production problems is higher in the textile sector than in the wood sector. In columns 3 and 4, we present the probability models for estimating the determinants of investment plans and exports. In both estimates, competition variables are included among the determinants of investment plans and exports. The results in column 3 indicate that the likelihood of investing in the future is positively related to the existence of competition, but negatively correlated to the competition problem. In the fourth column, we do not find significant correlation between the likelihood of export and competition.

8. Market power concentration and competition policy in the Tanzanian manufacturing sector

This section reviews the implementation of Tanzanian Competition Law. The enactment of the law and the establishment of the Competition Authority have largely been due to Tanzania's obligation under regional and international agreements along with the comprehensive economic reforms adopted in the mid-1980s. After a prolonged period of economic problems especially in the first half of the 1980s, Tanzania embarked on a course of market-oriented reforms at the end of the second half of the 1980s. Reform of the trade regime stood at the core of the reform programme. This involved commitment to a more flexible exchange rate policy and abandoning of import substitution policies through promotion of exports as well as liberalization of imports. Another main objective of the 1980s reform was privatization of state-owned enterprises and liberalization of financial markets. The reforms brought about profound changes in the incentive structure economic actors faced and in the way they did business. This was the case especially for the Tanzanian manufacturing industry, which had to go through a fundamental reorientation after decades of protection under import substitution policies. Cushioned by import restrictions and high tariff barriers, many sectors of the manufacturing industry had been highly concentrated, and state-owned enterprises had dominated many important sectors. Export promotion policies created a new set of incentives for the manufacturing industry.

We first assess the trends in market power or concentration after the reforms and provide some cases illustrating to what extent competition policy has been a key influence on the observed trends. The market power considered here is the degree to which a firm exercises influence over price and output. When firms have market power, they can use this power to raise the price above the going rate. The degree of dominance in market share is one form of market power acquisition. When the sales of a firm as a proportion of the product traded in the market form a significant portion of sales, a firm will then have market power. The reform measures aimed at chang-

ing the market structure, in particular the nature of competition and pricing. Specifically, we discuss the trends in concentration estimated from the survey data.

Table 8. Measures of concentration of the manufacturing firms from Tanzanian manufacturing surveys (1993–2001).

Year	1993	1994	1996	1998	1999	2000	2001
Firm1	0.29	0.34	0.41	0.50	0.49	0.45	0.41
Firm2	0.28	0.23	0.06	0.07	0.07	0.06	0.06
Firm3	0.06	0.06	0.05	0.06	0.06	0.06	0.05
Firm4	0.05	0.06	0.01	0.02	0.01	0.02	0.02
Firm5	0.03	0.05	0.01	0.01	0.01	0.01	0.01
Others	0.29	0.26	0.46	0.34	0.36	0.40	
Concentration Ratio:							
CR3	0.63	0.63	0.52	0.63	0.62	0.57	0.52
CR4	0.68	0.69	0.53	0.65	0.63	0.59	0.54
CR5	0.71	0.74	0.54	0.66	0.64	0.60	0.55
Herfindahl	0.24	0.38	0.47	0.37	0.37	0.38	
1/H	3.84	4.16	2.63	2.13	2.70	2.70	2.63

Source: Computed using firm survey data from the Tanzanian manufacturing surveys (1993–2001).

Table 8 gives average concentrations for all manufacturing industries that are included in the Tanzanian manufacturing surveys over the period 1993–2001. The concentration ratio that concerns us here is the ratio that shows the degree to which an industry is dominated by a small number of large firms or is made up of many small firms. This ratio is calculated based on the concentration ratios specified in section 3. The concentration ratios CR3, CR4 and CR5, as well as the HH index are reported. The firm share is measured in terms of their contribution to sales during the year of survey. In view of the fact that the competition law in Tanzania was introduced in 1994, the year 1993 represents the pre-competition policy era. Based on the concentration results reported in Table 8, the concentration ratios of CR3, CR4 and CR5 reveal that a reduction in concentration occurred after 1993. This is the period when the manufacturing sector went through restructuring and privatization phases and in which privately owned firms entered the market. However, the decrease in concentration appears to be moderate over the period. The decline in concentration ratio indices is notable in firms that are not among the top three dominants. In fact, the concentration of the largest firm remains higher and well above its 1993 level. The

concentration behaviour of the largest firm partly influences the trends in concentration ratios presented in the table. For instance, a substantial fall in concentration of firm2 in 1996 was obscured by an accompanied significant rise in concentration of the largest firm, firm1.

One would have expected that the more liberal import policies and the export orientation of the 1980s would also transform the structure of the Tanzanian manufacturing industry and lead to less market concentration. One objective of the economic liberalization was to reduce monopolization. However, the evidence available on the evolution of market concentration in Tanzanian manufacturing industries since 1993 presented in Table 8 point to the persistence of monopolization and high concentration in some specific activities of the Tanzanian manufacturing industry during the post-reform era. The experience from previous studies in this area shows that cement production, cigarettes, beer and textiles are good examples of where a few large firms dominate the market share in Tanzania.

Given the persistence of high concentration ratios in the manufacturing industry, the importance of instituting and implementing antitrust mechanisms in Tanzania becomes more apparent. The absence of well-articulated competition policy and law would create a breeding ground for all sorts of anti-competitive practices. In 1994, Tanzania adopted the Fair Trade Practices Act (1994) which exhaustively prescribes rules for the protection of the interests of consumers. The law prohibits misleading or deceptive conduct. It requires that in determining whether a person has contravened the law, the Commissioner may have regard to the strength of the bargaining positions of the parties, the validity of conditions, the consumer's understanding of the documents and the circumstances (e.g. use of force or unfair tactics). In addition to other unfair practices, the Fair Trade Practices Act prohibits misrepresentations, misleading advertising and conduct, bait supply, harassment and coercion.

The requirement to comply with prescribed consumer product safety standards and the requirements of the Act relating to consumer protection are obligatory on penalty of prescribed fines and/or imprisonment. Fines imposed are stated in the Act. Some recent cases are summarized in Table 9 below. There is clear evidence of the anti-competitive practice of the monopolistic companies as well as of less concentrated ones. However, as it is noted, most of the cases are based on narrowly defined competition parameters. Institutional, legal and human resource constraints are among the factors behind the limited enforcement of competition law in Tanzania (ESRF, 2002).

9. Summary conclusion and policy recommendations

In this chapter, we set out to answer the question: to what extent firm-level performance measured by investment, productivity and export are influenced by government measures aiming to stimulate competition and protect consumers against monopolization? Our empirical results in this chapter do not indicate that firm performance has been adversely affected by competition policy. On the contrary, we find a

Table 9. Cases dealt with by the Trade Practices Commissioner.

Year	Parties involved	Bone of contention	Action/Decision
8/6/1998	Cooper and Lybrand and Waterhouse	Request for merger approval of two multi-nationals; accounts and business consulting firms	Request granted on 27/6/98
13/8/1998	Trade Practices Commissioner *vs.* Tanzania Communication Commission	Query on allowing Mobile and Tritel (cell phone companies) dominance in the economy. Letter MITC/E.10/45 of 13/8/1998	Other cell phone providers were registered, e.g. Vodafone in 2000
August 1998	Permanent Secretary Ministry of Industry and Trade *vs.* Associated Breweries (Tanzania) Ltd.	False advertisement and unfair representation complaint that Associated Breweries advertisement of "Guaranteeing no hangover" from their alcoholic beer "no sugar added" were false and misleading especially the latter to diabetics	The use of such an advertisement was barred.
22/9/1998	Kibo Breweries *vs.* Tanzania Breweries Limited	Tanzania Breweries with a monopolistic market share in Tanzania of over 80 per cent was barring independent agents, mini-wholesalers from stocking competitors' beer brands and threatening to punish by not selling beers to those who did not obey, on similar terms with those who obeyed	The regulations on how to carry out the Act are not in place, and therefore no case/mandate has been decided upon.
5/5/1999	Urafiki Textile Mills *vs.* Karibu Textile Mills	Urafiki Textile Mills complained against Karibu Textile Mills about fast copying machines which copy Urafiki designs and sell them at a lower price than the original prints by Urafiki Textile Mills.	Regarded as a copyright issue, which should be dealt with by the Commercial Court in the High Court.

5/6/1999	United Lumber and Forest Products Co. Ltd. *vs.* Sao Hill Timber Ltd.	The Government of Tanzania had leased a previously run Parastatal to a Norwegian firm at terms below the normal commercial rates, and also it appeared that the Norwegian Company was subsidizing the operations of this firm. Both dispensations were enabling Sao Hill Timber Ltd. to outbid all others on tenders and price offers.	The government is conducting an outright sale through open tender instead of leasing. The tender is out but it took a long time.
1/6/1999	Ministry of Industry and Trade *vs.* Bonite Bottlers Ltd.	Bonite Bottler bottles drinking water under the Kilimanjaro brand. In their advertisement, they claimed the water to be bottled from a "Natural Spring" when actually the water was from a deep well, purified and then bottled.	The advertisement was changed to "Pure Drinking Water" with neither an argument nor a notification of compliance.
Recent Case1	Coca-Cola *vs.* Pepsi-Cola	Coca-Cola provides refrigerators and chairs to suppliers and restricts them from selling other products such as Pepsi-Cola.	
Recent Case2	Traders of Imported Wine *vs.* TBL	TBL restrict sellers of its products from selling imported beer.	

Source: ESRF, 2003, Wanga (2001) and interview with Trade Practices Commission, Ministry of Trade and Industry 2001.

positive relationship between competition policy and productivity, investment and export performances. For the export and investment performances, the results are stable even when we consider unobserved firm-specific attributes. Regarding the productivity effect of competition policy, the results are influenced by firm-specific attributes suggesting that the positive relationship between competition policy and firm productivity is highly dependent on firm-specific characteristics. But we certainly have evidence that if competition is one of the three major problems facing an enterprise, the enterprise-level performance measured by the productivity will be seriously impaired. This, therefore, calls for some sort of intervention through such measures as competition policy, to minimize the adverse effect of competition. The analysis of aggregate manufacturing sector statistics undertaken in this chapter does not show any clear evidence that sector performance measured by export and invest-

ment has been affected adversely by competition policy – indeed all these variables at some point have shown an up-and-down trend. We have evidence of high concentration in Tanzanian manufacturing and the existence of anti-competitive behaviour, which have been reported to the fair competition department. It is true that the policy may have affected the specific firms that were reported to the commission. However, based on the information about the investment and export behaviour of some of the firms, we find no major effect, and our data do not provide support for the view that anti-competitive behaviour, e.g. through false advertisement, is helpful to their performance. In fact, such companies have retained their position and some have had their performance improved even after being dealt with by the competition laws.

The other important task of the study has been to address the question: what are the prerequisites for the successful implementation of competition policy in developing countries and the mechanism through which this may operate? This study points out that policy makers in developing countries face the challenging task of designing appropriate competition policies that will bring about economic development in these countries. In the light of the previous discussion, such a policy must at least be able to (a) restrain anti-competitive behaviour by domestic privatized large firms, (b) limit abuses of monopoly power by mega-corporations created by the international merger movement, and (c) promote development. There are several characteristics in developing countries that certainly can make the task of competition policy design difficult. For instance, while market entry and access are the key elements of the market economies that many developing countries are currently striving to achieve, in practice, promoting the conditions for wider market access and efficiency through competition has been a difficult challenge. In most developing countries, the market or invisible hand does not always operate very smoothly and indeed the instances of market failures are rather frequent. A clear understanding of the sources of the market failure is crucial for developing an effective competition policy for developing countries. The theoretical explanation for market failure in developing countries is that the high transaction costs and asymmetric information in these countries limit the occurrence of some transactions which would occur for the sake of economic efficiency. The other limits to competition policy design in developing countries are the existence of large informal activities, lack of well-defined property rights, limited environmental, safety and health standards, underdeveloped consumer protection institutions and laws, limited capability to verify and check standards, lack of technical expertise and experience in competition policy and limited institutional capability in areas of competition and antitrust.

While the optimal competition policy will differ between countries depending on their stage of development and the effectiveness of their governments, as well as the supporting institutional framework, there are some prerequisites for the successful implementation of competition policy in developing countries that can be uniformly relevant. First, a country implementing a competition policy needs an enforcement agency with properly trained employees and adequate resources to enforce the policy.

This, thus, calls for the developing countries to maintain a well-organized and efficient institutional framework with adequate human, technical and financial resources. Connected to this point, the institution(s) in charge of competition policy should be politically independent, and transparent to avoid pressure from possible conflict of interest and acts such as corruption. It has also been the case that some countries have developed competition policies in parallel with other existing public policies. But a well-functioning competition policy needs to be linked with other rules and regulations in the economy. In this case, the design of competition policy must be accompanied by efforts to ensure that there is a sound competitive environment in other economic sectors, and policies that are directly or indirectly linked to competition policy. A related point is that competition policy should look beyond the domestic situation. There should be harmonization of the competition policy with those of countries with similar characteristics,

The proper enforcement of competition policy requires knowledge about competition policy, and the capacity to investigate and interpret cases related to competition. Developing countries should, therefore, improve the system of data collection and reporting on competition matters, e.g. concentration, change in market power, investment behaviour of the producing firms, and other possible measures of competition, and encourage and facilitate training in disciplines necessary for the competition policy implementation such as competition law, and economics which has a strong emphasis on aspects of competition and the related fields. But given limited financial and technical capabilities, many developing countries left on their own can hardly afford to establish new institutions equipped with the required expertise and to institute a well-functioning competition policy. There needs to be technical and financial assistance to assist developing countries in the design of optimal competition

To sum up, the prerequisites for the successful implementation of competition policy in developing countries are: a sound competitive environment in other economic sectors and policies that are directly or indirectly linked to competition policy; establishment of production standards; defined property rights; consumer protection agencies; an organized and efficient institutional framework with adequate human, technical and financial resources; harmonization of competition policy with those of countries with similar characteristics and/or economic partners; establishment of procedures and methods that allow the monitoring of competition; ensuring that competition is legally protected and the provision of settlement procedures for disputes through appropriate institutions with adequate knowledge of competition matters; improving the system of data collection and reporting on competition matters, e.g. changes in industrial concentration, changes in market power, investment behaviour of the producing firms and other possible measures of competition; encouragement and facilitation of training in disciplines necessary for competition policy implementation such as competition law, and economics with a strong emphasis on aspects of competition and its related fields.

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IV.3. PRIVATIZATION, COMPETITION POLICY, ECONOMIC DEREGULATION AND THEIR IMPACT ON COMPETITIVENESS: THE CASE OF THE ELECTRIC POWER MARKET IN PERU

Gonzalo Ruíz[1]

1. Introduction

After a decade of increasing fiscal problems and macroeconomic instability, the Peruvian Government initiated a broad set of economic reforms. Among these, the reforms in infrastructural industries, especially in the telecommunications and energy sectors, were particularly important in terms of their scope and economic impact. In the electrical power sector, consistent with widespread structural reform around the world, the reform emphasized three aspects: private participation, industry restructuring and competition promotion. On the one hand, the government promoted a broad privatization program, the vertical and horizontal divestiture of previous state monopolies, and a combination of regulatory schemes and competition mechanisms. On the other hand, however, the government created an institutional framework aimed at minimizing the lack of credibility generated by Peru's weak institutional framework.

Under the new institutional setting for reform in the electricity sector, different roles were defined for public institutions. The main normative tasks were assigned to the Energy Ministry (MEM[2]) and the competition policy task to the competition agency (Indecopi[3]), the supervision and administration of tariff regulatory schemes and quality to the energy regulatory agency (initially the Electric Tariffs Commission and later Osinerg[4]), and the privatization process to the privatization agency (initially COPRI and later ProInversion).

In this context, the reform established at least three dynamic transmission channels to economic competitiveness: the design of a credible institutional framework and, consequently, the promotion of private investment at a lower capital cost, the ability to adequately manage the cost-based regulatory schemes (with some incentive components), and the ability to promote competition among generators on the supply side and among the unregulated big customers on the demand side.

One main question regarding the above is the overall effect of the electricity industry reform on the competitiveness of the economy. The economic literature shows that competition policy is a key factor in price convergence, which is better obtained in economies where competition policies have been successfully applied.[5]

During the 1990s, some developed countries implemented new regulations in the electricity sector in order to stimulate competition in activities that do not possess the technological characteristics of a natural monopoly. There is strong evidence that the general results of these attempts to introduce competition have been positive in terms of lower prices and use of capacity in generation. Indeed, Steiner (2000) has shown, for a sample of 19 OECD countries over the 1986–1996 period, that unbundling

generation and transmission activities, promotion of access to the grid and the introduction of electricity markets have reduced both industrial end-user electricity prices and the ratio of industrial to residential prices.[6] Additionally, Steiner (2000) shows that the reforms in these countries contributed to improve reserve margins and utilization of capacity in the electricity generation market. This general conclusion is also supported by specific country studies.[7]

Compared with the literature regarding reform and promotion of competition in the electricity sector, research about the impact of performance in the electricity market on the competitiveness of other economic sectors of the economy is relatively scarce. However, recent studies applied to Latin American countries have shown that reforms in utilities had a positive impact on welfare and competitiveness. UADE (2003), for example, using a general equilibrium model for Argentina, demonstrated that reforms in electric energy among other services[8] implemented in this country had a positive impact on consumers, on GDP and on exports.

In the case of Peru, an empirical evaluation on the effects of reforms in utilities on the competitiveness of other economic sectors is certainly lacking. In this chapter, we estimate the effects of competition policy on economy competitiveness. Our research strategy is to estimate a supply function for a number of industries, using an input-output matrix in order to quantify the effects of changes in prices of electric power on the prices of other industries, including those which produce tradable and non-tradable goods and services.

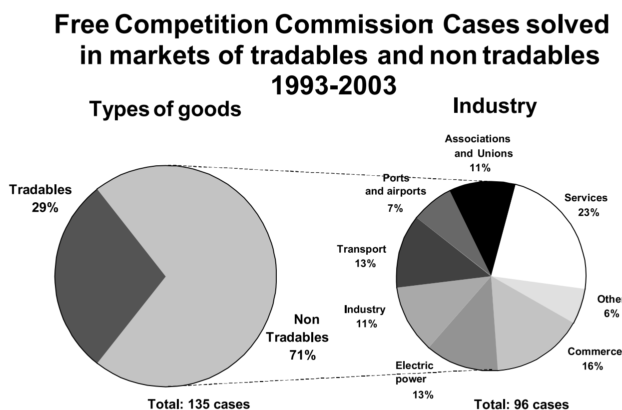
The chapter is divided into six sections. The first section describes the process of reforms introduced in the electric power market in Peru, since 1994. The second section introduces the discussion about the effects of competition in the markets of non-tradable inputs on the competitiveness of the economy and illustrates this relationship in the context of a simple model. The third section presents the general methodology for assessing the impact of increased competition in a non-tradable input on the competitiveness of the economy. The fourth section explains the results obtained by the estimation. Finally, this chapter includes some final remarks with comments on possible extensions to other markets and countries and the complementary roles played by the competition agency, the sectoral regulator and the privatization agency in the case of Peru.

2. The process of reforms in Peru and the deregulation and promotion of competition in the electricity sector

One of the main effects of the foreign trade reform implemented in Peru during the last decade was the increase of competition in domestic markets through the reduction of entry barriers (especially tariff and non-tariff measures[9]) to such markets. This process led to a substantial change in domestic markets structure and the delimitation of domestic markets. As a result, some goods or services, which were considered as non-tradables[10] before the reforms, began to face strong competition from imported goods and services.

Despite the above-mentioned reforms, the technological characteristics of some economic activities, or the nature of certain goods and services, still remain factors that limit the entry to domestic markets. This situation may be one of the reasons why a higher proportion of cases solved by the competition authorities in transition economies refer to non-tradable goods or services. Indeed, Figure 1 shows that in Peru, during the last decade, the proportion of cases solved by the Free Competition Commission in markets of non-tradables was 71 per cent of the total. This reflects the importance of enforcement activities in such markets, as part of the competition policy agenda.

Figure 1. Free Competition Commission: cases solved in markets of tradables and non-tradables (1993–2003).



Source: Free Competition Commission, Indecopi.

In the case of the electricity sector, which represented 13 per cent of the cases solved by the Free Competition Commission mentioned above, since 1992, the Peruvian Government initiated a process of reform in the electric power market. Between 1972 and 1992, the electricity sector had been managed exclusively by Electroperu, a state-owned enterprise which integrated vertically the generation, transmission and distribution activities.

Consistent with the widespread international experience, in the case of Peru, one of the key objectives of the reform was to introduce competition in potentially competitive markets and to ensure the access of competitors to transmission and distribution networks. In order to achieve these objectives, in 1992, through the

Concessions Law in Electricity,[11] the Government proposed the splitting up of the industry into four activities: generation, transmission, distribution and energy trading.

As mentioned above, the decision and strategy of privatization was in the charge of the Commission for the Promotion of Private Investment (COPRI).[12] In the case of the electric energy sector, the privatization process was initiated in 1994, with the auction of 60 per cent of shares from Edelnor and Edelsur, the two electricity distribution firms located in the north and south of Lima, respectively. In 1995, two generation firms (Cahua and Edegel) and another distribution company (Edechancay) were privatized. The process continued during 1996 and 1997, with the transfer of Etevensa and Eepsa, two generation companies, and other distribution firms, located in the north of the country.[13] During 2001, the transmission net was transferred by concession (see Table 1).

Since 2001, the privatization process in the electric energy sector has stagnated. Thus, one of the most important generation companies (Electroperú) still remains in the ownership of the state. However, the general balance of the privatization process is positive: privatization not only allowed new investments to be attracted to the sector (which, only considering the amount obtained through sales, equalled US$ 1.6 billion between 1994 and 2001) but also increased competition in generation, through the entry of new private players into the market.

Table 1. Privatization in the electric energy sector.

Privatization in Electric Energy Sector

Closing date 1/	Firm	Buyer/ concessioner	Amount (US$ thousand)
18-Ago-94	Edelnor	Inversiones Distrilima	176,490
18-Ago-94	Luz del Sur	Ontario Quinta	212,100
30-May-95	Cahua	Sipesa	41,810
30-Nov-95	Edegel	Generandes	524,400
15-Dic-95	EdeChancay	Inversiones Distrilima	10,360
22-Ene-96	Etevensa	Consorcio Generalima	
09-Ago-96	Egenor	Inversiones Dominion	228,200
27-Jun-95	EdeCañete	Luz del Sur	8,620
20-Nov-96	EEPSA	Consorcio Elect. Cabo Blanco	19,660
25-Mar-97	Electro Sur Medio	Consorcio Hica Inversiones	25,640
15-Ene-98	TransMantaro	Hydro Quebec - G y M	Concesión
22-Dic-98	Electro Norte	Grupo Gloria (JORBSA)	22,120
	Electro Nor Oeste		22,890
	Electro Centro		32,690
	Hidrandina		67,880
29-Ene-99	Redesur	Red Eléctrica de España	Concession
26-Abr-01	BOOT LL.TT. Oroya-Carhuamayo-Paragsha-Derivación Antamina y Aguaytia- Pucallpa	Interconex . Eléctrica ISA	Concession
11-Dic-01	Electro Andes	Inversiones Elegia S.R.L 2/	226,360
TOTAL			1,619,220

~~Note:~~
1/ Closing date: Date of subsciption of the contract.
2/ PSEG Global INC was declared winer of the Public International Contest PRI-64-2001.
However, PSEG Global INC transfer its rights to Inversiones Elegia S.R.L.

~~Source~~
Osinerg: Reporte de Privatización
http://www.osinerg.org.pe/osinerg/privatizacion/post_privatiza.jsp
Fuente: Osinerg (www.osinerg.org.pe), Proinversión

As mentioned above, regulatory functions in the electricity market were assigned to the Electric Tariff Commission (CTE), an institution that years later (1996) was incorporated into Osinerg. Osinerg has the role of setting prices in regulated markets, based on the marginal cost of energy production (generation) and the value added of distribution (VAD). The Concessions Law in Electricity also established the functions of the System's Economic Operations Committee (COES), which is composed of all the generators in the system. One of the main functions of COES is to determine the order of dispatch of generation plants taking into account the respective marginal cost of energy production.

Table Nº2 Free Competition Commission: Merger Authorizations

Year of Notification	Authorization Request	Type of Transaction	Date of Resolution	Number of Resolution Free Competition Commission	Decission First Instance	Decission Second Instance
1998	ETECEN - Constitución del Consorcio Transmantaro	Merger	26/02/98	002-98-INDECOPI-CLC	Out of scope of the Law	-
1998	Generandes Perú S.A - Compañía Electrica Cono Sur S.A.	Buy of Shares	23/12/98	015-98-INDECOPI-CLC	Out of scope of the Law	-
1999	Endesa (España) - Enersis (Chile)	Buy of Shares	03/12/99	012-99-INDECOPI/CLC	Authorization subject to conditions	-
1999	Enersis S.A. - Endesa Chile	Buy of Shares	03/12/99	012-99-INDECOPI/CLC	Authorization subject to conditions	-
2001	Tractebel - Electroandes	Previous request of authorization	22/10/01	030-2001-INDECOPI/CLC	Authorization without conditions	-
2001	Tractebel - PSEG Global Inc.	Previous request of authorization	22/10/01	031-2001-INDECOPI/CLC	Authorization without conditions	Confirm
2002	Interconexión Eléctrica ISA - ETECEN ETESUR	Previous request of authorization	29/08/02	016-2002-INDECOPI/CLC	Authorization without conditions	-
2002	Tractebel - EGASA EGESUR	Previous request of authorization	07/11/02	020-2002-INDECOPI/CLC	Authorization without conditions	-
2002	Electroandes-Yuncán	Previous request of authorization	04/12/02	N°022-2002-INDECOPI/CLC	Not funded	-

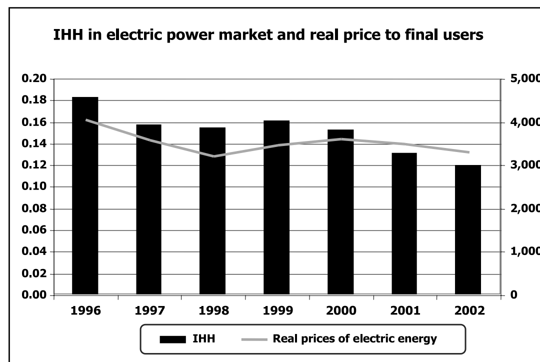
Source: Free Competition Commission, Indecopi

Regarding competition policy, in September 1997, Law 26876 was enacted which established a merger review system in the electric power sector. According to this Law, any concentration transaction made by companies whose market share exceed 15 per cent, in the case of horizontal mergers, or 5 per cent, in the case of vertical mergers, must be notified to Indecopi. Indecopi's role in this procedure is to evaluate the impact of the transaction on competition conditions in relevant markets and to decide either the approval, conditioning, or prohibition of the operation. From

November 1997[14] to December 2002, only nine authorization requests were approved by Indecopi (Table 2). In almost all cases, the transactions were authorized without conditions. There were only two cases in which the authorization was subject to conditions.[15]

Despite the fact that no operation was prohibited since the start of this merger review system, the concentration indexes in the electric power markets have declined. Indeed, Figure 2 shows that the Hirschman–Herfindhal Index (IHH) in the electric power generation market declined by 25 per cent between 1997 and 2002.[16]

Figure 2. IHH in the electric power market and the real price to end-users.



Source: Osinerg

The competition analysis in the Peruvian electric power market includes at least three relevant markets. The first one is the market of non-regulated users, which includes clients whose energy consumption exceeds 1 MW. Prices in this market are not regulated. A second market is composed of regulated users and includes transactions between generators and distributors or distributors and regulated clients. In both cases, prices are regulated by Osinerg. A third relevant market includes spot transfers of energy and power between generators. This market is governed by regulatory rules that establish the merit order dispatch to supply energy.[17] In this spot market, prices are set by COES, which is composed of all the generators, according to the parameters established by the Concessions Law in Electricity.

Figure 2 shows the evolution of average annual real prices of energy to end-users during the 1996–2002 period. The cumulative reduction of these prices during the period has been 18.2 per cent.

Other performance indicators of the industry show significant improvements during the period.[18] For example, regarding the quality of the service, in 1993 total energy losses of distributors was 22 per cent of the total amount of energy received by distribution systems. This percentage declined to 9.1 per cent in 2002. The coverage

of the electricity system increased substantially, which has been reflected in the increase in the number of users. While in 1994 the number of users was of the order of 2,309 thousands, in 2002 it was 3,621 thousands.[19] Moreover, as a consequence of a broad program of electrification implemented during the period,[20] per capita electrification coefficients were reduced from 52.3 per cent (one of the lowest in Latin America) to around 75 per cent in 2000.[21]

Given the results outlined above, the overall balance of the reform implemented in the Peruvian electricity market during the 1994–2002 period is positive. Even though levels of concentration in generation in absolute terms still remain relatively high, prices have been reduced, and quality and coverage have been improved. In contrast with the deficit in generation capacity faced in the early 1990s, nowadays the system exhibits excess capacity as a consequence of the increase of new investments in the sector.

Even though is not our intention to undertake an exhaustive analysis of the reform, the figures and indicators shown above, give us a general overview of the most important results of this process.[22] In the next section, we will address the methodology for measuring the impact of one of the variables analysed above (real prices) on the competitiveness of the economy.

3. A simple model of fixed coefficients for a small economy

Promoting competition in markets of non-tradables may have positive effects from the perspective of both final and intermediate consumers. From the final consumer perspective, reducing market power in those markets will be reflected not only in lower prices of these goods but also in lower prices of other goods and services which are included in its consumption basket (which uses the non-tradable product as an input).

From the intermediate consumer perspective, a reduction in market power in the non-tradable market could also have direct and indirect effects on its competitiveness. The direct effect is related to the reduction of the price of the non-tradable input itself and the indirect effect to the reduction of the price of other inputs which also consume the non-tradable good.

These effects could be easily illustrated through a simple model. Let's assume an economy in which the production vector includes a non-tradable product (N) and other products (Y).[23] These products are used in turn as an input for producing N and Y. Accordingly, a fraction of Y is used as an input for producing the same good (Y_Y) and the other fraction for producing N (Y_N). The same assumptions could be made for the non-tradable good (N):

We can express (1) as the sum of the technical coefficients associated with the production of Y and N:

$$a_{YN} + a_{YY} = 1$$

(1')

$$a_{NN} + a_{NY} = 1$$

In (1') the coefficient a_{ij} is the technical coefficient corresponding to the input i used for producing output j. Let's consider a Leontief technology so that these technical coefficients may be assumed to be constant. Additionally, if we assume that the production function exhibits constant scale returns, we can express the production of Y and N as follows:

$$Y = PMg\,Y\ Y_Y + PMgN\ N_Y$$

(2)

$$N = PMg\,N\ N_N + PMgY\ Y_Y$$

where PMg indicates the marginal productivity of each input. If there is equilibrium in the market of inputs, the real price of any input must equal its marginal productivity. Therefore, replacing in (2) the technical coefficients defined in (1') and the equilibrium condition in input markets we get:

$$P = P\ a_{YY} + w_n\ a_{NY}$$

(3)

$$w_N = P\,a_{YN} + w_N\,a_{NN}$$

The system of equations described in (3), where P is the price of Y, could be used to assess the impact of a change in prices of the non-tradable input (w_N) on P. In order to include in this evaluation both direct and indirect effects of changes in w_N, we must solve the second equation of (3) for P and replace the solution in the first equation. Then we get that any change in w_N has the following impact on P:

$$(4)\quad \Delta P = \left[\frac{a_{YY}}{a_{YN}} + 1\right] a_{NY}\ \Delta w_N$$

where the first part in parentheses reflects the indirect effect of a change on the price of the non-tradable input, while the second indicates the direct effect (which only depends on technical coefficient a_{NY}). Notice that the lower the fraction of input Y used to produce N (and therefore the higher the proportion of this input used to produce Y), the higher is the indirect effect of a change in price in non-tradables.

According to this simple model, the impact of a change in non-tradable input could have multiplicative effects on the prices of other products in the economy, especially when such products consume a significant proportion of inputs from other sectors of the economy (which is related to a_{YY}). This multiplicative effect is associated with the indirect effects of reduction of prices on the non-tradable inputs on other sectors.

It is important to stress that a price reduction in the non-tradable input will not always be a consequence of the improvement in competition in that market. Indeed, a reduction in prices of non-tradables could reflect productivity improvements in its production or an increase in some resource endowments, among several other factors.

One method for isolating the impact of competition on Dw_N could consist of the construction of an indicator of market power in the non-tradable market. For example, by using a definition of the Lerner Index[24] we can estimate the difference between the actual prices of the non-tradable input and a hypothetical price that would maintain market power (on average) constant during the period of analysis. The reduction in the difference between the price of non-tradables and that of constructed prices could be attributable to the improvement in competition conditions in that market.

A final remark related to the concept of competitiveness used in this chapter – in the context of this chapter, we will use the concept of competitiveness as the capacity of firms to gain access to markets through reducing production costs (among other factors). This could be achieved by means of internal or external economies. Hence, a reduction in the prices of non-tradables helps domestic firms to achieve external economies contributing to strengthen their ability to compete in domestic and external markets.

4. Methodology

Based on the theoretical framework described in the last section, we can develop a general methodology in order to assess the impact of increased competition in electric power markets on competitiveness in other sectors of the economy. Generalizing the expression (3) to an economy with M inputs and N products, we get:

$$(5)\ \left[P_j\right]_{N\times 1} = \sum_{i=1}^{M} a_{ij} P_i + a_{ej}\, P_e$$

where $[P_j]$ depicts the vector of prices of products and a_{ij} is the technical coefficient which relates the input i to the output j. Accordingly, P_e is the price of the electricity and a_{ej} is the technical coefficient which relates the input e (electricity) to the output j.

The indirect effects of a change in the price of electricity must be analysed in another equation, incorporating the impact of changes in the electricity price on the prices of other inputs.[25] Replacing these results in (5) we get:

$$(6)\ \left[P_j\right]_{N\times 1} = \frac{\sum_{i=1}^{M} a_{ei} P_e a_{i\ j}}{(1-\sum_{k=1}^{M} a_{ki})} + a_{ej}\ P_e$$

This equation could be used to quantify the effects of a change in the price of electricity on the prices of other sectors of the economy. Indeed, the first part of the right-hand expression in (6) describes the indirect effects and the second the direct effects of changes in the price of electricity for N different sectors of the economy. In sectors in which electricity is relatively important as an input, the direct effects will dominate the indirect effects. The opposite occurs in sectors which consume a high proportion of inputs other than electricity.

Equation (7), which is a generalization of expression (4), could be used to predict the impact of changes in the price of energy on the prices of the products of the economy:

$$(7)\ \left[\Delta P_j\right]_{N\times 1} = \left[\frac{\sum_{i=1}^{M} a_{ei} a_{i\ j}}{(1-\sum_{k=1}^{M} a_{ki})} + a_{ej}\right]\Delta P_e$$

Given that generation is subject to a cost-based regulation, in the case of the Peruvian market, it is difficult to construct market power indicators for generation firms based on Lerner Indexes.[26] Moreover, in the case of the price of electricity paid by end-users, in the regulated market, there are components of the end-user price that are determined exclusively by regulation, such as tariffs for transmission and distribution.[27] For these reasons, instead of using a pure competition indicator (as a Lerner Index) we will use an indicator of competition and regulation performance. This indicator will be the real price of electricity sold to final consumers.[28]

Another important reason for using a “competition and regulation” performance indicator is the complementary and interdependent role that economic regulation and competition has played during the process of reform. Economic regulation was in charge not only of setting transmission and distribution fees (which represent a

component of final price) but also of guaranteeing the access of competitors to distribution and transmission networks. Distribution and transmission fees represent a significant fraction of the end-user price (which is the actual price paid by customers). During the last years, for example, the value added of distribution represented around 35 per cent of the end-user prices. Access policies are also crucial for promoting entry to markets of final customers. A poor performance of these policies could limit or restrain the effectiveness of deregulation and competition.

In order to address the total potential savings caused by a reduction in energy prices, we multiply price variations obtained in (7) by Q_j (total production of sector j). On the right-hand side, we can do the same using the ratio (Q_j/Q_{ej}, where Q_{ej} is the production of electricity sold to sector j), which is a proxy of productivity of electricity in this sector.

$$(8)\ Q_j\left[\Delta P_j\right]_{N\times 1}=\left[\frac{\sum_{i=1}^{M} a_{ei}a_{ij}}{(1-\sum_{k=1}^{M} a_{ki})}+a_{ej}\right]\Delta P_e\,\frac{Q_j}{Q_{ej}}\,Q_{ej}$$

The input-output matrix, which consists of a double entry table that relates supply of inputs to demand from each sector of the economy, used for this calculation is the 1994 matrix, source INEI.[29] The dimensions of the matrix are 287 rows of inputs and 45 columns of products. One advantageous characteristic of this matrix is that the electric sector is included separately in one of the rows. However, for calculating the indirect effects, it was necessary to use some ad hoc assumptions to split the 45 columns into 287 sectors[30] in order to work with a squared matrix.

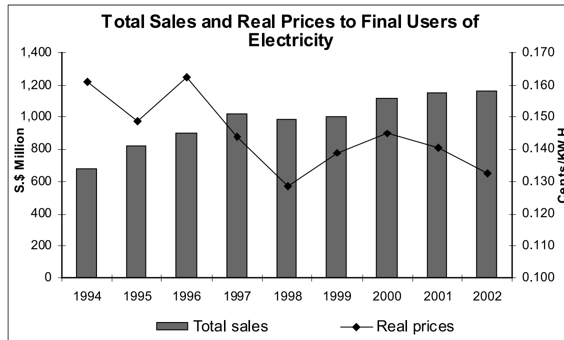
5. Results

In this section, we estimate the impact of the reduction in electricity prices during the 1994–2002 period on the competitiveness of the economy. Figure 3 shows the decreasing trend in the real prices[31] of electricity and the growth of energy sales during this period. The accumulated percentage of reduction of this price between 1994 and 2002 is 17.6 per cent. Based on this figure, is possible to estimate the amount saved by consumers as a result of reduction in the real prices of energy.[32] Indeed, multiplying the total consumption of energy by the difference between yearly real prices and the 1994 prices, we get US$ 530.8 million. This amount equals 6.5 per cent of the total sales of electricity during the 1995–2002 period.

Table 3 shows how this reduction in real prices could be divided between sectors which consume electric energy as an input, according to the input-output matrix of 1994. Around 45 per cent of the benefits of the reduction in prices of energy during the 1994–2002 period were directed to households. If total benefit from price reduction was US$ 530.8 million, the savings for households, during the period, could be

estimated as US$ 239.1 million. Other sectors that benefited from reduction in energy prices were commerce (7.8 per cent), metal mining manufacturers (4.9 per cent), services to companies (3.9 per cent), mineral extraction (3.4 per cent) and government services (3.3 per cent).

Figure 3. Total sales and real prices of electricity to end-users.



Source: Osinerg, INEI

Table 4 shows the estimates of direct and indirect effects of reduction in prices of electricity, using the technical coefficients included between the parentheses of expression (7) obtained from the input-output matrix. The total effect varies between nearly 0 per cent and 5 per cent. The sectors in which this percentage is most important are paper manufacturing (5.0 per cent), chemical basic products (4.8 per cent), mining manufacturing products (4.8 per cent) and rubber and plastic manufacturing (nearly 4.0 per cent). Notice that for the final demand of electricity the total estimated effect is 2.7 per cent.[33]

As was argued through our simple model presented in section 3, in those sectors where consumption of inputs other than electricity represents a relatively high share of the total inputs consumed, the direct effects are higher than the indirect ones. Indeed, in sectors such as textiles, clothing, pharmaceuticals, inter alia, indirect effects are higher than direct effects. The number of sectors in which indirect effects dominate is 26 (nearly 60 per cent of the total). Notice that in the case of final demand for electricity, the indirect effects (1.4 per cent) also dominate the direct effects (1.29 per cent).

In sectors in which consumption of electric power is relatively important, direct effects are higher than indirect effects. For example, this is the case for mineral extraction and production, paper manufacturing and chemical basic products.

In order to address the impact of a reduction in prices of electric energy on the competitiveness of industry, we need to estimate the effects of this reduction on prices of goods and services. The annual price changes are small. However, when the latest figures are taken into account, results are quite significant.

6. Final remarks

The lack of competition in the markets of non-tradable goods is a factor that may limit substantially the competitiveness of industries intensive in the use of non-tradable inputs. The recent experience of privatization, deregulation and competition promotion applied to the electric power sector in Peru provides an interesting example of how a combination of these policies can be reflected in a better performance of the industry, more competition in the electricity generation market (of non-tradable inputs), reduced prices of energy, and improved quality conditions for intermediate and final consumers (including industries of tradable goods and services). The actual and potential benefits associated with the promotion of competition in electric power, can be measured through its impact on the competitiveness of other industries. Indeed, electric energy constitutes an important input for many economic activities in Peru (representing around 2 per cent of Peruvian GDP), including the production of tradable goods arising from mining industries.

The main goal of this chapter was two-fold. In the first place, it aimed to develop a general framework, based on the use of the input-product matrix, in order to evaluate the impact of competition and market power in non-tradable markets on other industries' competitiveness. The second objective is to apply this methodology to the electric power market in order to quantify the actual and potential impact of increased competition and reduced market power on other industries during the 1994–2002 period.

The main results can be summarized as follows:

- From 1994 to 2002, the real prices of energy sold to end-users showed a cumulative reduction of 17.6 per cent. Assuming a Leontief technology, total savings to electricity consumers associated with reduction in real prices during the 1994–2002 period were US$ 530 million. This amount equals 6.5 per cent of the total sales of electricity during the 1995–2002 period. The sectors which benefited most from this reduction were households, commerce, metal mining manufacturers, services to companies, minerals extraction and government services.
- Regarding the impact on competitiveness from reduction in prices of electricity, the sectors in which the effects were most significant were manufacturing, chemical basic products, mining manufacturing products, and rubber and plastic manufacturing.
- One of the most important lessons from the reform implemented in the electric energy sector in Peru, during the last decade, is that the success of a process doesn't depend exclusively on the individual performance of the competition agency, the sectoral regulator or the privatization agency. The success of the

reform will also depend on a combination of antitrust, privatization and regulatory policies and on the internal consistency and coherence between them. Additionally, the coherence and consistency of the institutional framework will depend critically on the political commitment of the Government to the process.

For the above-mentioned reasons, the empirical evaluation of the results of the reform and its impact on consumers, in this chapter, was based on a "regulation and competition" indicator (real prices of energy sold to consumers), in order to reflect also the degree of complementarity and consistency between different policies.

The methodology developed in this chapter could be easily extended to other non-tradable sectors and industries (such as infrastructure, ports, rails, telecom), in which competition is technically and economically feasible. Indeed, the promotion of competition on non-tradable markets in developing countries constitutes a priority of any government engaged in a competitiveness strategy. A foregone conclusion is that trade and financial liberalization in these countries exposed tradable goods and services to foreign competition and, consequently, the benefits of competition were easier to achieve in these markets; non-tradable goods, in contrast, would be subject to a more stringent scrutiny by the competition authority.

Another important lesson from the reform implemented in the electric energy sector in Peru, during the last decade, is that the success of a process of competition promotion doesn't depend exclusively on the individual performance of the competition agency, the sectoral regulator or the privatization agency. The success of the reform will also depend on the combination of antitrust, privatization and regulatory policies and on the internal consistency and coherence between them. This doesn't means that individual performance of public agencies is not an important factor in determining the success of the reform. Indeed, in the case of the Peruvian electricity market, for example, the benefits of competition promotion through antitrust policies and privatization (for example in terms of lower prices of generation) could have been offset by a poor performance of the sectoral regulator (in terms of high prices in transmission and distribution). The opposite could also occur: the benefits of an efficient price and quality regulation could have been obscured without an effective antitrust or privatization policy.

However, the evaluation of the individual performance of the antitrust agency, the regulatory body or the privatization organization, will depend crucially on their institutional objectives and goals. In order to guarantee consistency between antitrust policy, regulation and privatization, is important not only that functions assigned to these institutions be clearly defined but also that their goals and objectives be complementary to the objective of competition promotion.

The coherence and consistency of the institutional framework will depend critically on the political commitment of the government to the process. In the design of the institutional setting and the division of powers between different agencies and public organizations, the government certainly plays a central role. The successful

Peruvian experience in the electricity market reform would not be possible without government support in the approval of the Concessions Law in Electricity, Law 26876 or COPRI's decision to privatize electric public companies. Conceiving a long-term vision of the process of reforms and the inclusion of competition policy as a tool that could contribute to achieving some of its objectives (attracting new investment, increasing welfare, among others) are among the main tasks that government faces in order to guarantee the success of the reform.

Once the institutional setting is created, a close coordination between the different organizations involved in the process must be ensured. The coordination channels could be formal or informal. In the case of the Peruvian experience in the electricity sector, for example, during the process of merger reviews Indecopi invited the regulator (Osinerg), among other entities, to present an opinion about the case. In other cases, COPRI requested Indecopi's opinion informally about certain clauses included in concession contracts. Even though these informal mechanisms have been used during these years, it would be desirable to strengthen them, establishing formal procedures for requesting opinions about the privatization process, concession contracts, etc. These formal mechanisms will contribute not only to improving the transparency of the process but also to promote consensus about the goals and objectives pursued by the authority.

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Table 3. Participation in benefits of the reduction of price of electricity.

Sector	Participation	US$ millon
Households consumption	45.1%	239,178,419
Commerce	7.8%	41,174,344
Metal Mining Manufactures	4.9%	25,893,002
Services to Companies	3.9%	20,584,801
Minerals extraction	3.4%	17,854,347
Government services	3.3%	17,342,793
Restaurants and Hotels	2.6%	13,960,002
Non-Ferrous Metals Transformation	2.2%	11,832,649
Manufacturing of Basic Chemicals	1.9%	10,302,575
Transport and Communications	1.9%	9,939,659
Electricity and water	1.9%	9,893,488
Textile	1.8%	9,633,256
Private Education	1.6%	8,742,213
Paper Manufacturing	1.2%	6,536,230
Other Food	1.2%	6,500,168
Financial Services	1.2%	6,350,504
Milling and Pastry	1.2%	6,313,132
Iron and steel industry	1.1%	6,042,939
Private Health	1.1%	5,635,117
Metal and wood furniture	0.9%	4,875,379
Other manufactured products	0.9%	4,616,861
Printing and edition	0.8%	4,317,436
Rubber and plastic manufacturing	0.8%	4,230,124
Beverage and tobacco	0.8%	4,056,340
Commercial services to households	0.7%	3,677,204
Other Chemical Products	0.6%	3,387,752
Non-Commercial services to households	0.6%	3,385,697
Manufacturing of Metallic Products	0.6%	3,037,131
Fish flour and oil	0.5%	2,867,556
Clothes	0.5%	2,703,476
Transport materials manufacturing	0.5%	2,467,056
Electric Machinery construction	0.4%	2,351,032
Construction	0.4%	2,101,908
Oil Refining	0.3%	1,563,439
Non-electric machinery manufacturing	0.2%	1,063,338
Exports	0.2%	1,053,779
Production, Agriculture and farming	0.2%	1,024,215
Leather manufacturing	0.2%	912,130
Oil extraction	0.2%	826,897
Pharmaceutical production	0.1%	692,483
Footwear manufacturing	0.1%	544,345
Fish production and preservation	0.1%	523,606
Milk and others	0.1%	366,968
Sugar production and refining	0.0%	217,449
Insurances	0.0%	193,946
Fishing	0.0%	2,955
Hose renting	0.0%	0
Total demand	**100%**	**530,770,143**

Source: INEI; Elaboration: Own calculations. Note: In the first column the formula used was e_i/E, where E is total electricity production and e_i is the share of the demand of electricity corresponding to sector i. The second column includes the result of multiplying total savings in energy (US$ 530 million) by e_i/E.

Table 4. Indirect and direct effects of changes in electric power prices.

Sector	Indirect effect	Direct effect	Total effect
Production, Agriculture and farming	0.48%	0.03%	0.51%
Fishing	0.49%	0.00%	0.49%
Oil extraction	0.00%	0.00%	0.00%
Minerals extraction	0.47%	1.06%	1.53%
Dairy products manufacturing	0.55%	0.15%	0.70%
Fish production and preservation	0.00%	0.00%	0.00%
Fish flour and oil production	0.00%	0.00%	0.00%
Milling and Pastry	0.60%	0.60%	1.20%
Sugar production and refining	0.35%	0.11%	0.47%
Other foods	0.39%	0.32%	0.70%
Beverage and tobacco manufacturing	0.88%	0.66%	1.54%
Textiles manufacturing	1.68%	0.94%	2.62%
Clothes manufacturing	1.49%	0.26%	1.75%
Leather manufacturing	2.21%	0.72%	2.93%
Footwear manufacturing	1.79%	0.24%	2.03%
Furniture manufacturing	1.66%	0.82%	2.47%
Paper manufacturing	2.18%	2.81%	5.00%
Print and edition	2.69%	1.27%	3.96%
Chemical basic products manufacturing	1.60%	3.24%	4.84%
Pharmaceutical manufacturing	1.26%	0.24%	1.50%
Other chemical products manufacturing	2.06%	0.73%	2.79%
Oil refining	0.14%	0.16%	0.31%
Rubber and plastic manufacturing	2.68%	1.32%	3.99%
Mining metallic products manufacturing	1.11%	3.72%	4.83%
Non-ferrous metals transformation	1.29%	0.95%	2.25%
Diverse metallic manufacturing	2.16%	0.80%	2.96%
Non-electric machinery	1.29%	0.54%	1.83%
Machinery and electrical equipment	1.80%	0.82%	2.62%
Transport materials construction	1.86%	0.79%	2.65%
Other manufactured products	1.15%	0.99%	2.14%
Electricity and water production and distribution	0.33%	1.25%	1.58%
Construction	0.90%	0.06%	0.96%
Trade	0.00%	0.00%	0.00%
Transport and Communications	0.42%	0.23%	0.65%
Financial Service producers	0.40%	0.85%	1.25%
Insurance Services	0.41%	0.13%	0.54%
House renting	0.00%	0.00%	0.00%
Other Services	0.48%	0.60%	1.08%
Restaurants and hotels	0.43%	0.60%	1.03%
Services for households	0.31%	0.21%	0.53%
Non-Commercial Services for households	0.00%	0.00%	0.00%
Private health	0.56%	0.73%	1.30%
Private education	0.44%	0.60%	1.04%
Governmental Services	0.00%	0.00%	0.00%
Final demand	1.44%	1.29%	2.73%

Source: INEI; Elaboration: Own calculations. The first column indicates the indirect effects according to the following formula, taken from the first part of the parentheses of the left-hand side of equation (6)

$$\left[\frac{\sum_{i=1}^{M} a_{ei} a_{ij}}{(1 - \sum_{k=1}^{M} a_{ki})} \right]$$

The second column corresponds to coefficient $a_{e.j}$ *.The third column includes the sum of both effects.*

Notes

[1] Economic Studies Manager of Indecopi. The opinion of the author doesn't necessarily reflect the institutional opinion of Indecopi. I would like to thank the criticisms and suggestions from Jose Gallardo. Also, I want to acknowledge the support and help received from Julio Aguirre and Fedor Molina. Any error is entirely the responsibility of the author.

[2] Ministerio de Energía y Minas.

[3] Instituto Nacional de Defensa de la Competencia y Protección de la Propiedad Intelectual.

[4] Organismo Supervisor de la Inversión en Energía.

[5] For the British telecom and energy industries, see Newbery (2002), for recent experience in the US, see Joskow (2003), and for a cross-sectional analysis applied to developed countries see Steiner (2000).

[6] However, Steiner (2000) states that a high degree of private ownership and imminence of both privatization and liberalization tend to increase industrial end-user prices.

[7] Individual country studies also support the conclusion that restructuring of the industry and promotion of competition could improve the performance of the electricity sector. Newbery (2002) through review of the UK experience, states that increased competition in electricity generation is necessary in order to reduce prices, emphasizing that this objective could only be achieved through separation of generation, transmission and distribution activities. This author also describes the process of reforms in Chile, Argentina and Mexico, among other developing countries.
In the case of the United States, Joskow (2003) states that competition in well-functioning wholesale and retail markets in this country is "work in progress". As a result of the process of deregulation initiated during the late 1990s, private investment in generation has grown, competitive markets have developed and access to transmission networks and associated support services has increased, among other positive outcomes. However, the reform in the United States has faced many imperfections associated with over-investment in generation and the persistence of market power in wholesale power markets, among others. Despite these poor results, there is a wide consensus around the importance of increasing competition in generation, wholesale and retailing markets as a means of improving the performance of the industry.

[8] Includes also telecom, gas, rail transport and water.

[9] For a general analysis of reforms implemented in Peru during the 1990s and their impact on competition in domestic markets see Cáceres and Ruiz (1998) and UNCTAD (2004).

[10] Goods or services which cannot be exported or imported because of tariff or non-tariff measures, and transport costs, among other factors. In such cases, the geographic configuration of markets may be restricted to the country territory or even smaller regions.

[11] Law Decree Nº25844.

[12] Created through Legislative Decree 674, published in September 1991.

[13] See Proyecto BID-CAF-Indecopi (1999).

[14] In November 1997 Supreme Decree Nº017-97-ITINCI was enacted, which regulates and implements the provisions contained in Law Nº26876.

[15] These cases correspond to a simultaneous vertical and horizontal concentration caused in the Peruvian market as a consequence of an international acquisition by the Endesa Group, from Spain. Indecopi's Free Competition Commission decided to approve the transaction subject to two conditions: (i) One of the generation companies of the Endesa Group should resign to participate in decisions of the Board of the System Operator (COES)

corresponding to the Central-North Interconnected System (Comité de Operación Económica del Sistema Eléctrico del Sistema Interconectado Centro Norte), until this system was integrated into the South transmission net; (ii) Edelnor, a distribution firm from the Endesa Group, must organize public auctions in order to encourage the participation of generators in areas in which that distribution company operates.

[16] According to the methodology used by Indecopi, both state-owned and private companies are included in calculations of the IHH. Notice that despite the sharp reduction in the IHH during the period, in absolute terms, this index is relatively high compared with international standards. One factor that could explain this level of concentration, among others, is the relatively small size of the Peruvian market.

[17] Different studies had reviewed the competition conditions in both the generator merit order dispatch (Indecopi; 1999), and the unregulated market (Indecopi; 2000).

[18] See, for example, Campodónico (2002).

[19] It includes 253 non-regulated users.

[20] One of the main programmes of electrification implemented was the National Electrification Program (PEN).

[21] See Campodónico (2002: 42).

[22] For a more detailed and exhaustive analysis, see Proyecto BID-CAF-Indecopi (1999) *Op. Cit*. or Campodónico (2000).

[23] These products may be tradable or non-tradable.

[24] The Lerner Index (LI) is one of the most frequently used indicators to measure market power. It consists of the difference between price and marginal cost of production divided by the marginal cost of production. When this index grows, market power is higher, and *vice versa*. It is supposed that when competition in the market is weak this index tends to be higher and when competition is intense the LI tends to decrease.

[25] The equation for other input prices is:

$$P_i = \sum_{k=1}^{M} a_{ki} P_k + a_{ei} P_e$$

We can iterate over the same expression replacing P_k and getting the following result:

$$P_i = \frac{a_{ei} P_e}{\left(1 - \sum_{k=1}^{M} a_{ki}\right)}$$

Replacing this result in (5) we get equation (6).

[26] For a discussion about the concept of market power in the electricity generation market see Borenstein (1999).

[27] Competition certainly has been one of the key factors that influenced the reduction in prices to end-users. Indeed, between 1995 and 2002, according to information from Osiner, the real prices of generation and energy sold to non-regulated users, declined by 17.8 per cent and 20.8 per cent, respectively.

[28] There are other factors that can influence the price of energy. On the supply side, in the case of Peru, climatic conditions may influence price through their effects on capacity and water availability for hydroelectric plants. In the case of thermal electricity, the price of petroleum is a key variable that influences the costs of generation. On the demand side, economic activity, especially the evolution of industrial output and the international prices of some products related to the production of raw materials, such as the mining sector or mineral refining, among others, could be identified as key variables that influence electric

energy prices.

[29] Instituto Nacional de Estadísticas.

[30] To split the columns into 287 sub-sectors, the corresponding technical coefficients of each product were multiplied by the share of the sub-sector production on total production of the sector. The assumption behind this transformation is that inside each product sector, the relative importance of inputs is proportional to the sum of total production of inputs.

[31] Calculated as the ratio of the price of electric energy sold to end-users divided by the Consumer Price Index (IPC). See Anuario Estadístico 1994, 1995, 1996, 1997, 1998, 1999, 2000, 2001, 2002, Osinerg: www.osinerg.gob.pe.

[32] Under the assumption of a Leontief technology, the demand for inputs is completely inelastic. Thus, any increase or decrease in the price of the input will generate an increase in total excedent of firms and consumers.

[33] Final demand includes demand for electricity from both final consumers and firms. Regarding final consumers, it is important to consider that participation of electricity in the Consumer Price Index is 2.234 per cent for Lima and 2.255 per cent at national level.

V

Conclusions

COMPETITION, COMPETITIVENESS AND DEVELOPMENT: RE-STATING THE CASE

Philippe Brusick, Lucian Cernat, Ana Maria Alvarez

Throughout this book, it has been argued that competition laws and policies in their various forms can be used as a tool for enhancing competitiveness and development. The book offers a number of suggestions to developing countries on how to maximize the benefits stemming from well-implemented competition laws and policies. Based on a selection of country case studies, ranging from larger more advanced developing countries such as Brazil, Peru, Republic of Korea, Thailand and South Africa, to least developed countries (Nepal, United Republic of Tanzania, and Zambia), this book offers clear arguments about the development-related aspects of competition and the pre-requisite institutional environment necessary for effective competition policy implementation.

In this concluding chapter we summarize some of the major findings and point out some challenges facing developing countries in adopting and implementing competition laws and policies.

That all countries, including developing countries and LDCs, are adversely affected by anticompetitive practices is unquestionable. Similarly, there is a widespread belief that the creation of competitive markets empowers the poor, provides them with employment opportunities, and increases their access to cheaper and better quality products. Competition policy is therefore an important institutional pillar for a thriving market economy wherein competitive pressures hone production efficiency and stimulate product and process innovation fundamental to international competitiveness and economic growth.

While recognizing that globalization and liberalization of goods and services markets had the potential to improve national welfare, the studies included in the book show that market failures, especially in developing countries, can pose major challenges to their competitiveness. As governments increasingly become cognisant of the fact that international markets are characterised by imperfect competition rather than the ideal competition of liberal economic theory, the role of competition law and policy becomes fundamental in ensuring a “level playing field”. In such a complex

and dynamic economic environment, competition, competitiveness and overall economic performance are closely intertwined.

Competition policy and economic performance

A major contribution of the book is to fill some of the gaps in the existing literature of *ex-post* studies quantifying the effects of competition policies in developing and least developed countries. As the various chapters suggest, competition, competitiveness, and development are intrinsically linked. This is not merely a conceptually attractive theoretical proposition but also a basis for clear policy recommendations.

For instance, as the analysis of the Tanzanian experience clearly showed, various aspects of competition policy played an important role in spurring international competitiveness. The evidence provided by firm-level performance indicators (such as investment, productivity and export performance) suggests a robust positive relationship between government measures aiming to stimulate competition and protect consumers against anti-competitive practices. As international competitiveness depends on a country's ability to consolidate, upgrade and diversify its productive capacity, a well-implemented competition policy may act as a crucial ingredient in a successful development strategy.

Moreover, as several contributors have convincingly argued (the Korean experience is a *locus classicus* in this regard), in the long run full confrontation with competition has been essential to ensuring the continuing development of industries, at all stages of development. In order for protected industries to gain significant economies of scale and become globally competitive in the true sense of the term, "infant industry" protection should be applied selectively, made conditional upon meeting performance standards, transparent, time-limited, involve minimum discrimination, and, above all, be constantly reviewed. It has to be also recognised that providing protection to the domestic sector, particularly to infant industries, is the second best option. For instance, Amsden and Singh (1994) shows that even in Korea, a typical example for the infant industry argument, there existed more competition than is often thought, and not all of the growth was due to government protection and subsidies. Moreover, the chapter by Yun in this book convincingly argues that although increased monopoly rent may boost up productivity growth on the short term, it may hinder economic development in the long run, and that the latter effect is prevalent.

Further, it is not only the degree of competition that matters, but also the nature of competition that stimulates growth. As developing nations implement structural reforms designed to stimulate economic growth through greater reliance on the market system, concerns regarding competition policy naturally arise. These nations have a unique opportunity to create new conceptions of competition policy designed to promote the competitive process and foster development.

Several contributors (see in particular the chapters by Hartzenberg and Lipimile) have shown that enterprise development has been successfully transformed into a

major "public interest" policy objective with the introduction and enforcement of competition laws in South Africa and Zambia. Such policies not only complemented the existing development-related policies, but also specifically benefit SMEs and increase the competitive edge of larger firms. A large body of literature suggests that SMEs from developing countries face significant constraints. In particular, SMEs are most likely to face imperfect financial markets where transaction costs preclude their growth. Thus, given these market imperfections, SMEs may require public funding to achieve socially desirable goals. An effective competition policy focused on enterprise development in a dynamic market may also encourage innovative behaviour, given the knowledge that innovation encourages technological advance and technological advance stimulates economic growth and the competitiveness of firms. Large firms with market power may be able to realize advantages of firm size, and their market power may stimulate R&D investment, but the potential source of innovation and rapid adaptation to market changes provided by SMEs should not be neglected.

Competition policy and sound institutional environment

One central argument in the current development debate is that good governance has become the key variable in explaining the economic performance of successful developing countries over the last few decades. As part of good governance and institution building, an increasing number of developing and least developed countries have adopted competition policies at national level, as part of a coherent set of policies to create comparative advantage and internationally competitive industries. As the contributors to this book tried to demonstrate, there are various mechanisms through which competition policy can positively impact on a number of key macro- and micro-economic ingredients for competitiveness and development. In short, competition policy is needed by all countries, but it should be accompanied by the right pre-conditions and measures.

Good governance of regulatory agencies is also a major factor that can improve sector performance. For instance, the empirical evidence included in this volume based on the Brazilian experience suggested a positive relationship between the level of independence of Brazilian regulatory agencies and the performance and effectiveness of their respective regulated sectors. Similarly, one of the most important lessons from the reform implemented in the electric energy sector in Peru, during the last decade, is that the success of a process of competition promotion does not depend exclusively of the individual performance of the competition agency, the sectoral regulator or the privatization agency. In the case of the Peruvian electric market, the book shows that the benefits of competition promotion through competition policies and privatization (for example in terms of lower prices of generation) could have been offset by incoherent policies. The contributors of the book also argue the importance of a cautious policy on the adoption of exemptions and exceptions. Exemptions for state-owned enterprises and exceptions provided for regulated private companies have certain justification, but proved to be costly to the economy when effective regulatory regimes are not yet in place (see for instance the chapter

on Thailand). The impact of these exemptions and exceptions vary, depending on the scope and scale of the alleged restrictive practices and the nature of players in the market.

However, several contributors cautioned that merely adopting a competition law is no panacea. Instead, what really makes a key contribution to competitiveness and development is properly implemented competition policies. Moreover, favouring a competitive environment in other economic sectors through other policies that are directly or indirectly linked to competition policy, (e.g. establishing production standards, defined property rights, consumer protection agencies, efficient institutional frameworks with adequate human, technical and financial resources) would also have a 'multiplier effect' on the overall benefits expected from competition policy implementation. As Michal Gal argued, any successful unfolding of these processes will depend on the "ecology of antitrust". If not part of a well-coordinated set of legal and economic institutions, the impact of competition policy on productive capacities and in favour of more competitive economies is likely to remain minimal. The existence of large informal activities (in some developing countries the informal sector is thought to account for as much as 60% of their GDP), the lack of well defined property rights, limited environmental, safety and health standards, underdeveloped consumer protection institutions and laws, limited capability to verify and check standards, lack of technical expertise and experience, may all limit the potential benefits stemming from an effective competition policy implementation.

This points out that policy-makers in developing countries face the challenging task of designing appropriate competition policies that will bring about economic development in these countries. As discussed earlier in this book (see for instance the chapters by Gal, Adhikari, and Nkikomborirak), there are several characteristics in developing countries that certainly can make the task of competition policy design and implementation difficult. For instance, while market entry and access are the key elements of market economies that many developing countries are currently striving to achieve, in practice, in most developing countries the "invisible hand" of the market does not always operate very smoothly and indeed the instance of market failures are rather frequent.

The theoretical explanation for market failure in developing countries is that the high transaction costs and asymmetric information in these countries limit economic efficiency. Competition authorities should therefore perform two most important functions: eliminating *private* and *governmental* barriers to entry.

When dealing with *private barriers to entry*, the authority must have sufficient economic expertise to assess the business practices of dominant firms in order to challenge only those practices that impede the competitive process by erecting artificial barriers to entry. In addition, as several contributors suggested, to ensure that these benefits are materialized, competition authorities should be insulated from the rent-seeking activities of business and political interest groups. The task of identify-

ing and challenging the entry-deterring business practices of dominant firms requires sophisticated and discerning competition authorities that can distinguish between pro and anticompetitive business practices, implement a workable definition of dominance, count on efficient procedures for examining defences of challenged business practices, and apply suitable penalties or other remedies to eliminate the use of practices deemed anticompetitive. Developing countries need to improve the system of data collection and reporting on the competition matters e.g. concentration, determination of market power, investment behaviour of the producing firms, and other possible measures of competition and encouragement and facilitating training in disciplines necessary for the competition policy implementation such as competition law, economics that has strong emphasis on competition aspects and the related fields. However, conditions prevailing in most developing countries and uncertainties regarding existing rules make this objective extremely problematic. For instance, the process of determining dominance, as the case of Thailand suggests, is complex, controversial, and critical to effective competition policy implementation. Without clearly defined, simple operational rules, competition authorities can hardly discourage dominant firms from using anti-competitive practices (e.g. exclusive dealing arrangements, refusal to deal, predation, exclusive access to essential facilities, mergers aimed at increasing market power) designed to deter entry and stifle competition. Furthermore, as the case study of Nepal has shown, given limited financial and technical capabilities many developing countries can hardly afford to establish new institutions manned by required expertise and institute a well-functioning competition policy without appropriate technical cooperation. Hence, the need to provide technical and financial assistance to developing countries engaged in the design and implementation of national competition legislation cannot be stressed enough.

Not only private barriers but also governmental barriers can impose major restrictions to competition and competitiveness. A competition authority may identify and amend public policies, rules, and laws that restrict competition. The competition authority should therefore be a senior partner in developing countries that are attempting to reform their economic systems and incorporate more market-oriented reforms. Privatisation and deregulation strategies, as well as trade reform plans (to name just a few) should include key inputs and guidance from competition authorities. Ultimately, the success of the reform process will also depend of the combination of competition policies, privatization and regulatory policies and of the internal consistency and coherence between them. Given these reasons, the competition authority’s role is broader and even more fundamental than that normally associated with competition authorities in developed countries.

The competition authority also could play an important role in eliminating or reducing other barriers to entry. Given the conditions that characterize most developing countries, natural barriers to entry significantly deter competition. Through competition advocacy, an active competition authority could coordinate with other state agencies in promoting more favourable business conditions. For instance, Baumol

(1992) suggests adopting public policies that encourage the exchange of technology, including incentives for licensing, and signal a clear commitment not to penalize technological joint ventures in order to promote inter-firm cooperation in producing and disseminating technology. However, effectively tackling natural barriers to entry is a difficult challenge (particularly in many developing countries with shallow financial sectors, limited educational and training opportunities, and limited technological capacities) and having too high expectations from competition authorities in these areas would be unrealistic.

Directions for further research

So far we have seen that a clear understanding of the sources of the market failure is a useful step in trying to design an effective competition policy that could enhance the competitiveness of developing countries. In practice, a well functioning competition policy needs to be linked with other rules and regulations in a particular economy. It is important to understand how competition, and competition law and policies work in different economic and institutional settings. This means that one needs to look at both general and specific settings in which competition policy needs to operate. This was precisely the major attempt throughout all chapters included in this volume, be they qualitative or quantitative in their methodological approach. By locating the firm at the centre of the analysis, the country cases included in the book tried to build bridges between general analyses on the benefits of competition policy and microeconomic studies, two approaches that are all too often disconnected.

Given the complexity of the task at hand, some caveats are in order. Some of the effects of competition are not easily measurable, or there may be little available empirical evidence thereon, while some evidence may be inconclusive or ambiguous. Furthermore, it may be difficult to isolate the effects of more competition from other domestic reforms. For instance, liberalization and the elimination of distortions within an economy do not automatically lead to growth in the absence of the supply capabilities to take advantage of new opportunities, and the prevalence of competition is only one factor determining countries' growth rates. It should also be mentioned that the findings of the chapters discussed above often do not take into account all adjustment losses, which one may reasonably suppose to occur in countries where competition policies are adopted as part of a broader reform process.

One way in which some of these shortcomings have been dealt with in the book, was to adopt complementary methodologies. Qualitative analyses look at the more general pre-conditions that competition policy needs in order to fulfil its objectives. Quantitative methods take a narrower approach and investigate the impact of specific features of competition and competition policy on several economic variables, thus making the overall argument more convincing. The quantitative chapters suggest that when well-implemented competition policies fulfil their objectives (such as lower prices and higher quality for consumers, and enhanced efficiency across all sectors) competition authorities will have acquired their own "legitimacy by results".

Even if quantitative tools do not give us precisely measurable data, they provide the confidence that making the necessary political and economic reforms related to the introduction and enforcement of competition law and policy will necessarily improve the developments prospects of developing countries and LDCs.

Despite these difficulties, the main argument coming across the country cases included in this volume is that competition policies implemented in a coherent manner, not only with regard to their own objectives but also vis-à-vis the broad development objectives at national level, usually lead to better policy decisions and efficient use of society's resources. The chapters included in the volume therefore offer important insights about the benefits of competition policy for competitiveness of developing and least-developed countries. It is likely that the above estimates understate the benefits of reform, as several mechanisms through which competition contributes to improved welfare (e.g. qualitative assessments in terms of better service quality or pressures to innovate) are not taken into account.

For more general conclusions regarding application of competition policy for developing economies, it would be important to directly test other hypotheses found in the literature, such as the optimal competition theory. Similarly, it would be interesting to further investigate the linkages between increased competition, corporate governance and social corporate responsibility in developing countries. Additional research may also shed light on specific developing countries and economic sectors where scale economies are significant and where the blind pursuit of a policy designed to provide for 'maximum competition' will merely lead to low capacity utilisation and will diminish both economic growth and international competitiveness. For these and other reasons not fully explored in this book, policymakers should conceive appropriate tailor-made competition policies that take into account the specificities of developing countries.

Competition policy and development: a stake in the future

While some aspects related to the design and implementation of competition policy may still deserve further investigation, the discussion in the previous chapters brought out one clear conclusion: mainstreaming a certain degree of competition into a successful policy framework is fundamentally pro-development. Ensuring that competition policy contributes to enhancing the development prospects of developing and least developed countries has been a longstanding preoccupation in UNCTAD (Brusick and Cernat 2004). Over almost four decades, UNCTAD's work in this area proved that the case for national competition policies can hardly be overstated. As noted in the introduction to this volume, Adam Smith clearly understood the significance of competition and market entry over 200 years ago. This widely held notion remained perennial in economic thinking and there is now widespread recognition of the need to adopt national competition policies, both for reasons of equity and on grounds of economic efficiency. Joseph Stiglitz, the 2001 Nobel Prize winner, makes the argument forcefully:

"Strong competition policy is not just a luxury to be enjoyed by rich countries, but a real necessity for those striving to create democratic market economies." (Stiglitz, 2001)

Therefore, the economic rationale for competition policy remains of paramount importance. This is particularly so for those developing and least developed countries moving towards market-oriented reforms. Several specific reasons call for adoption of competition law sooner rather than later. Firstly, the adoption of liberalisation policies, the rise in privatisations, and the fact that most privatised entities in the utilities sector are natural monopolies underscore the importance of a solid competition regime to elicit the most favourable efficiency and welfare effects of liberalisation and privatisation. In some cases, privatisation and deregulation have taken place with scant regard for, and often in the absence of legal and institutional frameworks for competition policy. In a period of extensive deregulation, the adoption of competition law and policy represents a complementary measure that would "bring the state back" in ways that support and reinforce recent market-oriented reforms, while limiting the scope for unnecessary regulation. During such an adjustment process, one challenge ahead is to infuse competition principles with sound economic analysis that reflect the special characteristics in which firms and policy-makers operate when "rebuilding the ship at sea".

Secondly, the recent proliferation of massive international mergers, the existence of international cartels and their potentially negative impact on consumers (Evenett, 2003) puts forward a case for competition policy to equip developing countries with the tools to deal with the increased market power of multinational companies and their anti-competitive practices. Such evidence suggests that, once the "deep waters" of government-imposed trade barriers are gradually removed, the "mountain peaks" of trade-related private anti-competitive practices become even more apparent.

Even though national competition policies may be poorly equipped to deal with such potential negative external influences, the importance of domestic competition policies stems also from the differential impact that domestic and competition from abroad may have during adjustment periods. In certain cases, competition among domestic firms may have a relatively more beneficial effect than foreign competition, not only because it increases rivalry with known competitors but also because it provides a 'level playing field' among similar competitors and a gradual exposure to competitive forces, before engaging in full-fledged competition on world markets.

Although national competitiveness means different things to different people, it basically involves building public-private partnerships for the purpose of promoting exports and economic development. As several contributors argued in this book, a development-friendly competition policy is best suited to promote competitiveness, while maintaining the right balance between the interests of all stakeholders. In this regard, the experiences of the countries included in this book contain key elements

for the design and implementation of tailor-made competition policies in developing countries and LDCs.

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