UNCTAD/DITC/CLP/2004/1

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
Geneva

COMPETITION, COMPETITIVENESS AND DEVELOPMENT: LESSONS FROM DEVELOPING COUNTRIES

INTRODUCTION

UNITED NATIONS
New York and Geneva, 2004

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 particular 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 established 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 communications, 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 authorities 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, Ecuador, 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.

References

Boner, R. (1995). Competition Policy and Institutions in Reforming Economies. In: Fritschak, C. (ed.), *Regulatory Policies and Reform: A Comparative Analysis*, The World Bank, Washington DC.

Boner, R. and Krueger, R. (1991). The Basics of Antitrust Policy: A Review of Ten Nations and the European Communities, World Bank Technical Working Paper No. 160, Washington DC.

Caceres, A. (2000). Indecopi's First Seven Years. In: Boza, B. (ed.), *The Role of the State in Competition and IP Policy in Latin America: towards an academic audit of Indecopi*, Indecopi, Lima.

Clarke, J. and Evenett, S.J. (2003). The Deterrent Effect of National Anti-Cartel Laws: Evidence from the International Vitamins Cartel, *Antitrust Bulletin*, 2003.

Consumers Unity & Trust Society (CUTS) (2003). Pulling up our Socks: A Study of Competition Regimes of Seven Developing Countries of Africa and Asia under the 7-Up Project, CUTS, Jaipur.

Dutz, M. and Hayri, A. (1999). Does More Intense Competition Lead to Higher Growth? World Bank Working Paper No. 2320, The World Bank, Washington DC.

European Commission (2003). European Competitiveness Report 2003, Commission Staff Working Paper SEC(2003) 1299.

Evenett, S.J., Levenstein, M.C. and Suslow, V.Y. (2001). International Cartel Enforcement: Lessons from the 1990s, *The World Economy*, 24 (9): 2001, 1221–1245.

Feinberg, R.M. (1984). Strategic and deterrent pricing responses to antitrust investigations, *International Journal of Industrial Organization*, 2: 75–84.

Feinberg, R.M. (1986). The effects of European competition policy on pricing and profit margins, *Kyklos*, 39 (2): 267–287.

Hoekman, B. and Holmes, P. (1999). Competition Policy, Developing Countries, and the World Trade Organization, World Bank Working Paper No. 2211, The World Bank, Washington DC.

Holmes, P.M. (2003). Some Lessons from the CUTS 7-Up Comparative Competitive Policy Project, unpublished manuscript.

Holmes, P. and Read, R. (2001). Competition policy, agriculture and the WTO. In: McMahon, J. (ed.), *Trade & Agriculture: Negotiating a New Agreement*, Cameron May, London, Chapter 9, pp. 305-345.

Kee, H.L. and Hoekman, B. (2003). Imports, Entry and Competition Law as Market Disciplines, World Bank Working Paper No. 3031, The World Bank, Washington DC.

Khemani, R.S. and Dutz, M. (1995). The Instruments of Competition Policy and Their Relevance for Economic Development. In: Frischtak, C. (ed.), *Regulatory Policies and Reform: A Comparative Analysis*, The World Bank, Washington DC.

Krugman, P. (1987). Is Free Trade passé? *Journal of Economic Perspectives*, 1(2): 131–144.

Krugman, P. (1994). Competitiveness – a Dangerous Obsession, *Foreign Affairs,* March/April 1994, 73 (2): 28–44.

Lommerud, K.E. and Sørgard, L. (2001). Trade Liberalization and Cartel Stability, *Review of International Economics*, 9 (2): 343–355.

Macdonald, J.M. (1994). Does import competition force efficient production? *Review of Economics and Statistics*, 76: 721–727.

Nickell, S. (1996). Competition and corporate performance, *Journal of Political Economy*, 104: 724–746.

Prusa, T.J. (1992). Why are so many antidumping petitions withdrawn? *Journal of International Economics*, 33 (1/2): 1–20.

Scherer, F.M. and Ross, D. (1990). *Industrial Market Structure and Economic Performance*, 3rd ed., Houghton Mifflin Company, Boston.

Schröder, P.J.H. (2003). Cartel Stability and Economic Integration, paper presented at the Fifth Annual Conference of the European Trade Study Group, Madrid, 11–13 September 2003.

Singh, A. (2002). Competition and Competition Policy in Emerging Markets: International and Developmental Dimensions. G-24 Discussion Paper Series, UNCTAD and Center for International Development Harvard University, No. 18.

Smith, A. (1776). *The Wealth of Nations,* Penguin, London, 1999.

Tirole, J. (1999). The Institutional Infrastructure of Competition Policy, paper prepared for the World Bank-CAE Conference on Governance, Equity and Global Markets, Paris, 21 June.

Tybout, J.R. (1998). Manufacturing firms in developing countries: how well do they do, and why? World Bank Policy Research Working Paper No. 1965, World Bank, Washington DC.

UNCTAD (1997). *World Investment Report*. United Nations, New York and Geneva.

UNCTAD (2002a). *Closer Multilateral Co-Operation on Competition Policy: The Development Dimension*, Consolidated Report of the Four Regional Seminars on Post-Doha Mandate, United Nations, New York and Geneva.

UNCTAD (2002b). *Competition Policy and Law for Practitioners*, TrainForTrade Programme, United Nations, New York and Geneva.

UNCTAD (2001a). *Consumer Protection, Competition, Competitiveness and Development*, TD/B/COM.2/CLP/23, United Nations, New York and Geneva.

UNCTAD (2001b). *Model Law: The Relationship Between a Competition Authority and Regulatory Bodies, Including Sectoral Regulators*, TD/B/COM.1/EM.17/3, United Nations, New York and Geneva.

Zanardi, M. (2000). Antidumping Law as a Collusive Device, Boston College Working Papers in Economics No. 487, Boston College MA.

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).