

Designing competition policy

It is not surprising that governments in some developing countries have been sceptical about the benefits of economic competition. Many of them have spent years trying to protect their industries from external competition by restricting imports. Some have encouraged enterprises to become very large so as to benefit from economies of scale and have had little interest in encouraging new enterprises to enter the market. And for those with a tradition of state owned enterprises (SOEs) competition has been more or less irrelevant. But times have changed. In the current climate of privatisation and more open trade it is essential that developing countries compete more effectively. If they do not then their industries, and therefore their economies, will not grow. And in order to tackle their urgent economic and social problems, economic growth is essential.

At the end of the 1980s only a handful of developing countries had effective competition policies but since then many more, especially the less poor, have at least established competition laws. However many countries continue to have weak systems. The reasons for this include a reluctance to change, misunderstandings about how competition works, low capacities and the failure of 'imported models'. The fact that competition policies are often designed and implemented by the same people who previously pursued anti-competitive policies (as in Brazil for example) does not help.

Competition in context

Designing competition policy for economic growth is not a simple task. Because every economy is different, policies cannot simply be copied from others. They must be worked out in the context in which they will be applied. There is little point in

designing a sophisticated competition policy if the institutions necessary to implement it are not up to the task. Policy needs to be designed with full awareness of such constraints, as our research in Brazil demonstrates.

After a long period of import substitution and SOEs Brazil has, since the 1990s, embarked on widespread privatisation and developed a competition policy. However its implementation has been greatly hampered by Brazil's very slow legal system which has the power to overturn the competition authorities' decisions. Appeals to the judiciary are expensive and the outcome is hard to predict because judges are unfamiliar with the issues. Enterprises are further discouraged from appealing by a 30% discount on fines which are paid without appeal. Nevertheless many more are now appealing, partly because the process is so slow that it can provide

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years of useful delay and partly, no doubt, because the courts have overturned around 60% of the competition authorities' decisions, regardless of their merit.

Another capacity constraint that has hindered Brazil's attempts to make better use of the private sector in its industrial policies is the lack of a good domestic capital market. One argument for privatisation is that it will lead to more dispersed ownership through public offerings of shares in privatised companies. This in turn is expected to improve corporate governance and lead to further flows of financial capital into enterprises. However our research shows that privatisation in Brazil has not had this effect. There have been very few public share offerings and in fact most privatisation has involved sales to already existing enterprises and resulted in highly concentrated and unstable ownership – not good conditions for either corporate governance or healthy competition.

Public share offerings are difficult. They require the enterprise to be performing reasonably well (or at least to be capable of doing so quickly), the preparation and publicising of a great deal of managerial and financial information and a good domestic capital market. So a chicken and egg situation arises – privatisation will help to develop such capital markets but only if they already exist! Where they do not already exist, as in many developing countries, then privatisation may well lead, as in Brazil, to an even greater concentration of asset holding and therefore wealth.

Objectives of competition policy

It is important to recognise that competition policy is not the same as competition law. Competition policy is part of a country's broader industrial policy and relates to its policies on, for example, privatisation, financial investment and trade. Without effective competition policies, privatisation and trade policy are much less likely to benefit the economy. Powerful foreign companies may use unfair methods to crush smaller local enterprises and privatisation may lead to economic power becoming concentrated in the hands of a small elite. Competition law, to which we return below, is part of competition policy. Once the policy has been determined then the law can be drawn up so as to define, deter and punish those activities which have been deemed anti-competitive.

Any country designing a competition policy must first determine its

purpose. Some objectives of competition policy will be the same anywhere – these include promoting economic efficiency and consumer welfare by encouraging entrepreneurship and new enterprises. The general benefits of competition include making the most efficient use of resources, passing on cost savings to consumers and, over time, generating better production processes and organisational structures.

Competition is driven by innovation. It should not be made too difficult for new firms to enter markets. Many developing countries would benefit from minimising entry barriers such as unnecessary red tape and bureaucratic complications. But this must be combined with support for innovation – however much barriers are lowered there will be little effect if there are few firms ready to take advantage of this (see CRC Policy Brief No 1).

Public interest in competition policy

Competition policies can and do have broader objectives than economic efficiency alone. For example they may seek to ensure freedom of economic action or fairness, to control concentration of economic power, to promote market opportunities for small firms and to safeguard the public interest (by maximising national production or exports or providing decent employment etc). Some such development strategies may inhibit competition, at least in the short and medium term. Fine decisions have to be made as to what to prioritise in any given situation. Competition policy, therefore, should be carefully coordinated with other development policies and a wide range of stakeholders should be involved in drawing it up.

Some countries are keener than others to pursue these wider objectives through their competition policy. Public interest objectives are likely to be considered important in many developing and transitional economies for obvious reasons. South Africa is an interesting example.

Under apartheid the African National Party (ANC) had strong socialist principles. But by the time it came to power in 1994 it had been affected by international political and policy change. Instead of nationalising private enterprises the ANC looked to competition policy to regulate private enterprise and address the legacy of apartheid and economic isolation. Although South Africa's history is unique many of its problems are

common to developing countries. High levels of concentration, small markets, consumers who are not well informed about their rights, limited capacity to implement competition policy, unemployment, low levels of investment and a history of excessive government intervention – such conditions are widespread. Apartheid added severe restrictions on economic participation, especially for black South Africans.

South Africa developed its competition policy through three years of consultation, discussion and debate with competition experts and a wide range of stakeholders. Its Competition Act allows, and sometimes demands, issues such as empowerment, employment and impact on small and medium-sized enterprises (SMEs) to be taken into account. In this it is progressive – many countries with much longer experience of competition policy shy away from such contentious territory. Also, ministers do not have the power to override the competition agencies' decisions and checks and balances in the Act ensure that decisions are transparent and not politically controlled.

The focus on SMEs is because the South African economy is so concentrated that small business development is particularly challenging. The conglomerate structure and strong vertical linkages in many industries can make it very hard for small businesses to enter the market. In contrast to South Africa's measured approach, Indonesia, presumably in an attempt to support them, has exempted small-scale enterprises and cooperatives from its Competition Law. This practice would seem likely only to encourage them to engage in anti-competitive activity at each other's expense.

For many years, South Africa had one of the most unequal distributions of wealth and income in the world. Promoting a greater spread of ownership, especially for the 'historically disadvantaged' i.e. the black majority of the population, is an important part of the government's strategy.

References in the Act to adaptability and development of the economy go beyond static economic efficiency to include dynamic considerations such as market entry, firm mobility and innovation. Consumer interests are also included in a broad sense – not only in terms of prices but also product choice. Since South Africa does not yet have specific consumer protection legislation, advocacy is a key challenge for the competition authorities.

Designing Competition Law

The details of any country's competition law follow from the decisions made at the policy formulation stage. For example will state owned enterprises be covered by the law? If not this may well disadvantage competing private enterprises. Issues that will be covered under any competition law include anti-competitive practices (collusion), abuse of dominance and merger and acquisition control.

Anti-competitive practices

The five types of anti-competitive practices identified in both the World Bank-OECD and the UNCTAD model competition laws are price fixing, quantity fixing, market allocation, refusal to deal and collusive bidding/tendering. Competition laws may choose either to simply outlaw these activities or to allow exemptions if it can be shown that, on balance, they in fact benefit the public interest.

The main problem for competition agencies is discovering when such practices are occurring. Offering to be lenient with offenders if they report such activities can cut the substantial costs of detection and may be helpful if the agencies are genuinely committed to prosecuting the others involved. If the offender provides hard evidence then it can be rewarded and the information used against the others. But if the evidence is weak the investigation must continue. Its success then depends on whether the others are still able to collude. If they are, then

they can bribe whichever one of them is under scrutiny not to reveal any information. In this case the authorities may simply be unable to afford to bring the case to a successful conclusion. If the others cannot collude at this point then the threat of a fine should be enough to stop the original bad behaviour.

However, where there are only a small number of enterprises operating in a market (as is often the case in developing countries) they will tend to take each other's actions into account and copy each other's pricing strategies without ever entering into any illegal agreement. Attempts to tackle this 'joint dominance' have proved difficult even for experienced competition agencies.

It may also be hard to distinguish between anti-competitive behavior and desirable cooperation aimed at achieving economies of scale. For example bulk purchasing for importation and transportation purposes may then feed into cartelisation in distribution channels without the cost savings being passed on to consumers. Also, where there is no social consensus that cartels (groups of businesses combining to control a market) is a bad thing, business people may collude without feeling guilty, informants may be considered betrayers, and 'dawn raids' to gather evidence or the levying of substantial fines may cause too much opposition to be feasible.

Nevertheless many cases are relatively straightforward, e.g. a cartel which results in higher prices of some basic consumer necessity. Taking effective action in such easily understood cases in the early life of a competition agency can help build up the credibility and public support needed to tackle the more difficult cases later.

Abuse of dominance

This occurs when a 'dominant' enterprise in a market does something which significantly lessens competition in that market. The World Bank-OECD, in defining dominance, rules out enterprises with less than 35% of the market. In contrast UNCTAD defines it as 'a situation where an enterprise, either by itself or acting together with a few other enterprises, is in a position to control the relevant market for a particular good or service or group of goods or services'. Both definitions therefore require a judgement to be made. Where countries use a market share benchmark this varies enormously – from 20% to 75%. If this method is used then it is probably important not to set the benchmark so high as to exclude too many cases from consideration.

Both models discuss the types of behaviour that are normally associated with abuse of dominance. These include price discrimination, tie-ins, refusal to deal, predatory pricing, raising rivals' costs, vertical restraints and price fixing.

Some argue that a large market share is in itself undesirable. Indonesia's competition law, for example, states that it will routinely investigate (for either abuse of dominance or monopolistic practices) enterprises which have more than a stated share of the market. Such an approach fails to appreciate the legitimate reasons for large market share and risks wasting agency resources.

Mergers and acquisitions

Mergers, where two independent enterprises combine as one, can be horizontal, vertical or conglomerate. Horizontal mergers involve enterprises that are actual or potential competitors, vertical mergers involve enterprises at different levels in the chain of production, and conglomerate mergers involve firms that have diverse or unrelated interests. Generally speaking horizontal mergers cause the most concern for competition. However our review of the Caribbean suggests that vertical and conglomerate mergers may raise competition issues in smaller countries where highly concentrated ownership can inhibit market competition despite lack of market power. For example a conglomerate may be able to pressurise competitors in a market it does not

The Shell Tepco merger

The Shell-Tepco merger illustrates very different interpretations of what empowering historically disadvantaged people means in terms of competition policy.

South Africa's oil industry has specific goals for Black Economic Empowerment (BEE). At the time of the proposed merger, BEE in the oil industry was in its infancy and BP was the leader in this respect. Shell was therefore very interested in the merger because it would provide it with an empowerment partner. Shell is one of the major players in the oil industry whereas Tepco was one of the smallest.

The merger passed the SLC test – no decrease in competition was expected. However the Competition Commission decided that it failed the public interest test because it would remove Tepco from the market as an independent player and so inhibit its ability, as a firm owned or controlled by historically disadvantaged people, to become competitive. It therefore ruled that the merger could only go ahead if Tepco remained an independent company and maintained its brand. This pleased neither company. Tepco complained that it had structural difficulties and wanted to be taken over by Shell.

On appeal the decision was overruled and criticised as patronising. It was pointed out that empowering historically disadvantaged people did not mean obliging them to continue running unviable companies on a 'life-support machine'. The competition agencies were warned not to be over-zealous in interpreting the public interest lest they end up harming the interests of the very people they were trying to protect.

dominate because they know it can retaliate in another market which may be vertically linked or unrelated.

As already noted, where economies of scale are important, a smaller number of larger enterprises in a market is not necessarily anti-competitive. But mergers and acquisitions do need to be carefully scrutinised to see if they result in a loss of competition. Potential efficiency gains have to be weighed against potential welfare losses due to the increase in market power, including the possibility of easier collusion arising from there being fewer players in the market.

Both the World Bank-OECD and UNCTAD model competition laws require the authorities to be notified in advance of mergers. The former sets a size threshold below which this notification is not required. Pre-merger notification thresholds are used in a number of developed countries but these vary as to their size and whether they are based on assets or turnover.

Again the agencies' problem is primarily one of information. Enterprises know whether they want to merge in order to make legitimate efficiency gains or to gain market power or collude more easily. In developing countries the lack of consumer organisation makes it difficult to consult consumers and agencies are further restricted by their relative lack of resources and experience. Given this, the use of 'undertakings' might be considered. For example, if a competition agency fears that a merger will result in reduced output it can require the merged enterprise to undertake not to reduce its output for some period of time on pain of a penalty. If the enterprise agrees, this suggests that reducing output was not its motivation for merger. Any such undertaking needs to be clearly specified and enforced and may have to be altered if market conditions change substantially.

In South Africa lawyers and economists work together to carry out detailed impact assessments when mergers are examined. Public interest features strongly here too. First it must be decided whether the merger is likely to substantially lessen competition (the SLC test). If so then it must be determined whether the merger offers other benefits such as technological or efficiency gains which outweigh its anti-competitive effects. Then, regardless of the merger's expected effects on competition, a public interest test is

conducted. This involves considering the effect the merger will have on a particular sector or region; on employment; on the ability of SMEs controlled by black South Africans to become competitive, and on the ability of national industries to compete internationally. Merger decisions, therefore, do not only depend on the impact on competition. Indeed the public interest test means mergers may be allowed even if they inhibit competition (or forbidden even if they do not).

The lack of competition policy – some consequences

Malaysia does not have a national competition policy or law. The EON - Proton Edar case illustrates how Malaysia's industrial policy suffers as a result of the lack of a formal competition agency.

Cars produced by the national car company, Proton, are distributed domestically by two firms, Proton Edar and EON. EON was set up in 1984 and was originally the sole distributor. Proton Edar was established in 1985 and by 2000 it had become a wholly owned subsidiary of Proton. It then began to distribute cars that had previously been distributed by EON. In the same year the ten-year distribution agreement between Proton and EON came to an end and was not renegotiated.

In 2003 Proton, unsurprisingly, decided to distribute its new model exclusively through its subsidiary, Proton Edar. EON was told it would have to obtain its supply through Proton Edar, its competitor! Proton also told EON it should stop selling other manufacturers' cars. Anti-competitive behaviour is obvious here. It is in Proton's commercial interest to favour its own subsidiary over EON. Proton has restricted EON's access to a new product - indeed forced it to access it from its competitor - and tried to restrict competition from other manufacturers.

The government was slow to intervene but in 2004, as the dispute became more public and acrimonious, it used its power as a major shareholder in both Proton and EON to make the two parties sign a five-year dealership agreement. The agreement required EON to allocate 70% of its servicing capacity to Proton cars. This could be construed as the use of market power by a supplier to force a buyer to limit its services to other competing suppliers and would be likely to interest a Malaysian competition authority if one existed. Such an authority would also probably want to look critically at the Proton's strongly vertically integrated production and distribution structure and might even require it to divest itself of Proton Edar. At present the government is 'regulating' the industry using its power as a major shareholder – even this level of 'regulation' would not occur should the government sell its shares. It is clear that the lack of an independent competition authority is severely damaging competition in Malaysia's car industry.

This CRC Policy Brief draws heavily on the CRC Working Papers below:

No 87. De Paula, G. M. *Competition Policy and the Legal System in Brazil: the Experience of the Steel Industry*. 2005

No 75. Amann, E., De Paula, G. M. and Ferraz, J. C. *Ownership Structure in the Post-Privatized Brazilian Steel Industry: Complexity, Instability and the Lingering Role of the State* 2004

No 96. Lee, C. *Model Competition Laws: the World Bank-OECD and UNCTAD Approaches Compared*. 2004

No 79. Dhanjee, R. *The Tailoring of Competition Policy to Caribbean Circumstances – Some Suggestions* 2004

No 95. Hartzenberg, T. *Competition Policy and Enterprise Development: the Role of Public Interest Objectives in South Africa's Competition Policy*. 2004

No 68. Lee, C. *Competition Policy in Malaysia*. 2004

which are all available on the CRC web site at <http://idpm.man.ac.uk/crc/publications.htm> And on

Cook, P. *Competition Policy, Market Power and Collusion in Developing Countries* in Cook, P. *et al 2004 Leading Issues in Competition, Regulation and Development* Edward Elgar: Cheltenham

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