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**COMPETITION AND ITS  
REGULATION: KEY ISSUES**

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## COMPETITION AND ITS REGULATION: KEY ISSUES

*‘The failure to distinguish between the idea of competition and the idea of market structure is at the root of much of the ambiguity concerning the meaning of competition’ (McNulty 1968, p641).*

*‘Today the concept of perfect competition is being pursued more widely by the profession in its theoretical work than at any time in the past. The vitality of the concept is strongly spoken for by this triumph’ (Stigler 1957, p17).*

### **1 Introduction**

The development of the private sector is viewed as a critical ingredient in poverty reduction strategies in low-income countries by international donors and policy-makers. The Asian Development Bank has recently proclaimed that support for private development is an integral part of their poverty reduction strategy (ADB 2000). Currently around two thirds of all World Bank operations include components that explicitly support private sector development. The central role accorded the private sector in the development process is seen in the UK Government’s pro-poor growth approach. ‘A successful private enterprise economy is a central building block of a successful and sustained anti-poverty policy. Efficient markets are thus central to growth and poverty reduction’ (DFID 2000, p37-38). The benefits that private sector development will bring are integrally linked to the arguments over the role that competition plays in improving allocative and productive efficiency. Over the past two decades the introduction of economic reform programmes, emphasising trade and financial liberalisation and privatisation, have been viewed by the international development agencies as the means of stimulating competition and promoting greater economic efficiency (Cook and Kirkpatrick 1988; Cook 1990; Gray 1991).

Whether it is competition or a change in ownership from public to private that matters most for improvements in economic efficiency remains an open debate, although much of the success of privatisation is premised on the existence of competition (World Bank 1983; Cook and Kirkpatrick 1988; Killick and Commander 1988; World Bank 1995; Saba and Muir 1995; Cook 1998; Shirley and Walsh 2000). Privatisation without competition, as in the case of monopoly utilities, implies that some form of surrogate competition, usually in the form of regulation, is required.

The favourable position, however, accorded to the private sector in low-income countries in relation to poverty alleviation is largely associated with the types of markets that are provided for, and the market conditions faced by, private entrepreneurs. The market is often characterised as a competitive one, with many independently operating small enterprises working in informal market conditions with relatively low entry and exit barriers. The majority of the goods and services they provide serves the needs of low-income consumers.

In reality, however, the bulk of output, measured by the contribution to GDP, often emanates from fewer and much larger enterprises who potentially wield considerable economic and political power. These larger enterprises exist for a variety of reasons. Prior to economic liberalisation in the 1980s, conglomerates were rationalised on the basis of policies to promote employment and were correspondingly provided preferential treatment in relation to credit and imported inputs. These policies applied to publicly-owned enterprises, as in Indonesia and most developing countries, or to private Chaebols, as in Korea. In relation to both, there is evidence of links between corruption, collusion, nepotism and market power.

The introduction of economic liberalisation reforms in developing countries has not necessarily reduced the economic power of large dominant enterprises. In some cases it may have increased as a direct consequence of the reforms. Studies on the impact of trade liberalisation have indicated that enterprise level concentration has often increased after the reforms. Large enterprises with considerable market power continue to be created in the aftermath of privatisation, particularly in utility and infrastructure sectors. In the past, economic protectionism often provided scope for direct foreign investment to operate on a large scale in relatively small markets. The combination of economic reforms and privatisation has provided a new impetus for large-scale foreign investment in the form of joint ventures with publicly-owned enterprises, concessions and self-standing wholly foreign-owned enterprises operating in low-income countries.

In most cases, the policy framework for competition has been weak in low-income countries. Competition policy, as distinct from competition law, has been influenced by a wide range of policy measures including policies directed towards trade and industry, employment and investment. In many instances these have developed in ways which have sought to protect domestic competition rather than to promote competition between competitors. Competition law is a subset of competition policy and seeks to establish the rules and guidelines for market power and dominance. These laws have generally considered that the exercise of market power is incompatible with notions of economic efficiency and, dominance in a market provides opportunities to erect barriers that will result in restricted competition.

By the end of the 1980s only a handful of developing countries had effective competition legislation (Gray 1991). Where rules and guidelines for competition in low-income existed, they were poorly implemented. The situation is changing, particularly among the higher

income developing countries that have recently strengthened their approach to competition policy (OECD 1999). But many countries continue with weak systems and processes for monitoring competition. Whether this is due to a lack of understanding amongst policymakers concerning the nature of competition itself, the lack of capacity to implement competition policy, the failure of ‘imported models’ to work in the local environment, or the need to maintain the status quo, is the subject matter of this paper.

The paper is divided into six sections. The next section provides a brief review of the competing concepts of competition. The third section examines the development of competition policy in relation to the theoretical analysis of competition. The fourth section discusses the various donor perspectives on the role of competition policy and its relation to other forms of regulation in low-income countries. The fifth section discusses the issues relating to competition policy in low-income countries. The final section provides a summary of the main issues and points to the gaps in our understanding of competition and its regulation in low-income countries.

## **2 Competing Notions of Competition**

The notion of competition is central to economic theory, but its meaning and the ways in which it is perceived to work and contribute to development, differ widely among theorists, policy-makers, bureaucrats and business people. Indeed the history of economic thought provides some deeply contrasting views about the meaning of competition. Amongst them, the concept of perfect competition has survived as the standard model for analysis and has had a profound influence on policy-making concerned with the regulation of competition. Yet the notion of this form of competition is very different to the concept envisaged by classical economists such as Adam Smith (McNulty 1967). When Adam Smith was writing

in 1776, the concept of competition was familiar, and was formulated in the context of independent rivalry between two or more persons. Viewed in this way competition acts as a force that would, in the long run, eliminate excessive profits and unsatisfied demand. The classical economic literature emphasised price determination through the notion of competition as replacing ethically and politically oriented price administration as the focus of economic analysis (McNulty 1967). Participants in the market would change price in response to market conditions principally through a process of rivalry. Adam Smith's major contribution to this analysis appears to have been to add systematic thinking to earlier views on the subject. Since then the development of a notion of competition gave the profession an analytical rigour akin to the character of a science (Mill 1864 I, 306). According to Edgeworth (1881, p50) without the notion of competition, economics as a discipline would be referred to as a dismal science.

By the late nineteenth century the analytical development of the concept of competition differed in many respects to that portrayed by Adam Smith. Mathematical refinement, initially by Cournot, and continued through the works of Edgeworth (1881), Clark (1915) and Knight (1946), took the concept of competition in a different direction (Stigler, 1957). In this neo-classical development, price became a parameter rather than a variable. The neo-classical economists viewed competition as a state of affairs rather than as a process as depicted by classical economists. It is built around the notion that the market is characterised by a state of equilibrium that is dependent on forces of demand and cost structure that determine who survives and who fails, and is formally presented in the idea of perfect competition. The neo-classical focus is on the effects of competition rather than a definition of the underlying behavioural process that characterises competition. As Knight states

‘perfect competition involves no presumption of psychological competition, emulation, or rivalry’ (Knight, 1946, p102).

The profit maximising behaviour based on notions of rational decision-making that underlies the neo-classical approach leads to the selection of output and choices over entry and exit in relation to observed profit opportunities. This has been subject to a barrage of criticisms. In the perfectly competitive model an enterprise seeks to maximise profits, and correspondingly selects an output where marginal costs equals the market price. As long as profit opportunities appear to exist, enterprises will continue to enter the industry. In the long run it is argued that enterprises that remain will produce at the minimum efficient scale.

Alternative maximising behaviour has been suggested by Baumol (1967) in relation to sales revenue, and Cyert and March (1963) have suggested that enterprises pursue a satisficing behaviour in an attempt to resolve a number of potentially conflicting managerial objectives. Alternative theories have viewed profits as accruing less as a result of a predictable rational process than one related to the outcome of a process of natural selection and survival (Penrose 1952).

It could be claimed that the classical and neo-classical interpretations of competition are fundamentally incompatible. Even discounting the view that the notion of perfect competition can only be used as an ideal or benchmark for analytical purposes, precisely because it is an abstract condition, does not appear to satisfy the argument that the concept is incompatible with any idea of competition. This view was stated forcibly by Hayek (1948) who claimed that perfect competition meant the absence of competitive activities.



The classical and neo-classical concepts of competition differ fundamentally, therefore, in their view of what competing means. The classical economists related the concept to business behaviour that involve organisational and technological changes. The neo-classical view is not about behaviour but is more concerned with market structure. Under neo-classical economics, the concepts of competition and the market have become merged, with competition taking a back seat. The market deals with exchange relationships as the most important notion, rather than production relationships. In this way neo-classical enterprises are viewed as differing from one another with respect to the kind of product or factor market in which they buy and sell.

The concept of workable competition also emerged from the literature in the 1930s as a concept to counteract the view that perfect competition is not a reliable basis for making normative appraisals of the working of actual markets. A set of criteria that defined workable competition was developed that reflected the demands of the public interest. The criteria related to performance, conduct and structure and drew on the works of 18 eminent writers (Sosnick 1958). Using their extended neo-classical criteria, markets could be viewed as almost workable, workable or optimum.

A variety of schools have expressed their fundamental dissatisfaction with the equilibrium concept of competition. The Austrian and Evolutionary schools view competition as a dynamic discovery process in which entrepreneurs seek new profit opportunities set in a world of constant change (Hayek 1948; Littlechild 1986; Schumpeter 1978). They are interested in change over the relatively long run. In contrast to static neo-classical theory, profits earned by successful entrepreneurs are not viewed as inefficiencies but as signals that entrepreneurs are responding to changing market conditions.

Drawing on Schumpeter's analysis these perspectives view competition less in terms of price but in terms of new technology, new sources of supply and new types of organisational development which provide cost and quality advantages. 'It is not (price) competition which counts but the competition from the new commodity, the new technology, the new source of supply, the new type of organisation ... competition which commands a decisive cost or quality advantage and which strikes not at the margin of profits and the outputs of the existing firms but at their foundations and their way of lives' (Schumpeter, 1943, p84).

This approach is rooted in the behavioural theory of the firm and emphasises learning capabilities and adaptive behaviour and the interactions between these behaviours (Metcalf 2000). This entails a shift from perceiving competition in terms of a state of equilibrium, characterised by different market structures, to competition as a process of change premised on the existence of the differential behaviour of firms and the economic arguments. In equilibrium theory, the behaviour of the firm is often depicted as a form of anti-competitive market behaviour. In this respect, the evolutionary perspective indicates that economic progress is only possible, in what is, from a neo-classical viewpoint, an inefficient world. This view was earlier shared by Adam Smith when he hinted at the importance of changes in the techniques of production and organisation when he stated that 'competition of producers who, in order to undersell one another, have recourse to new divisions of labour, and new improvements of art, which might never otherwise have been thought of' (Smith, p706 cited in McNulty 1968, p648).

As Metcalfe (1993) claims the evolutionary approaches are less developed but have clear lines of differences with the equilibrium approach to competition. The fundamental difference is the displacement of equilibrium and optimisation as the organising concepts.

Evolutionary theory is concerned with why the world changes endogenously, and with why technological competition is the driving force behind structural change and economic development. It is concerned with the process of adaptive learning and the creation of novelty<sup>1</sup>. Indeed it is by this change in approach that attention is switched to the strategic, cognitive and organisational aspects of firms which explain why they behave differently (Arthur and Lane, 1993). Nelson and Winter (1982) define this innovation process in terms of dynamic efficiency<sup>2</sup>. Decisions about technological innovation are made with great uncertainty which make it difficult to assess the results of different strategies that are adopted by enterprises. Again competition, unlike in neo-classical theory, does not only relate to prices and costs, but to a wider set of variables and welfare increases not only in response to price reductions but to improvements in quality and product variety (Jorde and Teece 1992).

The evolutionary account of the competitive process is therefore characterised by a competitive order rather than a competitive equilibrium. As Metcalfe has stated ‘competition depends upon the variety of behaviours in a population of firms. That variety is translated into differential profits in terms of differential growth and decline. Innovation processes continuously reshape the pattern of variety and provide the developmental impetus to drive the selection process’ (Metcalfe, 2000, p7). The competitive order changes with innovation and therefore is conceptually different to the idea of market structure portrayed in neo-classical economic theory and of its measurement in terms of the concentration of firms.

The evolutionary approach has been used to explain how competitive advantage, as opposed to comparative advantage, explains successful development (Teece 1987). The contrast has been made between the UK’s earlier comparative advantages in the industrial sphere which

gave way to Germany's superior competitive advantage achieved through investment in production, marketing and management.

### **3 Theory and Competition Policy**

A large number of governments have introduced national competition laws. Generally these refer to legislation, judicial decisions and regulations that relate either to agreements between firms that restrict competition or to the abuse of a dominant position by a firm or firms merging together. The rules established by these laws are intended to ensure that the competitive process is not hindered through the creation of dominance that results from forms of regulation or agreements between competitors that restrict competition (Maskus and Lahouel 2000). The term competition policy, however, has a broader meaning, and refers to a set of measures and instruments used by governments that determine the overall conditions of competition that are likely to be met in specific markets. As such, competition law is a subset of competition policy. The broader set of instruments influencing competition policy include privatisation, deregulation, foreign investment policy and subsidies. Viewed in this way domestic competition policy is also affected by regional and international agreements. Competition policy may even lead to a restriction of competition in cases where it is argued that this entails greater efficiency.

The influence of behavioural approaches to the analysis of competition, based on notions of the competitive process that rest on rivalry, undoubtedly influenced earlier anti-trust policies such as the Sherman Act of 1890 in the US. The Sherman Act applied strictly to the conduct of business and the prosecution of violations required that enforcers needed to show that a particular conduct was motivated by the restraint of competition. It was not until the Clayton Act 1914 that structural elements of anti-competitive behaviour were predominantly

introduced into US competition policy (Boner and Krueger 1991). This reflected the growing influence of neo-classical economists in this area.

The structural approach to competition policy was strengthened by the work of Mason in the 1930s, who drew on the ideas developed by the neo-classical school, that judged economic performance in terms of allocative and technical (static efficiency) and provided an abstract standard (even if unrealistic) in contrasting conditions of perfect competition and monopoly. Mason focused on the degree of concentration within an industry as a measure of market power. Differences in market structure between the extremes of perfect competition and monopoly provided implications for economic welfare using neo-classical criteria.

This work influenced the branch of economics known as industrial economics and led to the development of the structure, conduct, performance paradigm with major contributions over a period spanning thirty years or more from Bain (1951), Caves (1972) and Scherer (1980).

This literature established that the degree of competition in an industry is judged in relation to notions of perfect competition and monopoly. It was argued that the performance of an industry, largely measured in terms of profitability, varies with different degrees of market structure, conduct and performance and that there were clear causal links between them.

Later developments of the so-called structure, conduct, performance approach widened the list of features accounting for structure and performance, including consideration of X-efficiency factors and technological progress. The theoretical development of the structure, conduct, performance paradigm went in three directions. New theoretical work emerged from Harvard and MIT economists that extended the earlier approach by replacing the unidirectional link between structure, conduct and performance with a more complex set of

inter-relationships, in which elements of one factor fed back into the determination of other factors and the definition of industry structure was enlarged (Singleton, 1986).

The structure, conduct and performance approach was also extended through greater mathematical sophistication and the introduction of game-theoretic approaches based on oligopolistic models (Norman and La Manna, 1992). These developments raised fundamental questions over whether or not new insights were being gained or whether theoretical developments had obscured logic that might be derived from more empirically focused work. The result was a return to more empirical work from the 1980s onwards (Martin, 1993).

The Chicago school of antitrust, as it has become known, drawing on analysis from Alchian (1950), Demsetz (1973), Peltzman (1976), Posner (1972), and Stigler (1971), and reflecting the influence of the Austrian School, challenged the notion, central to the structure, conduct, performance approach, that market behaviour and performance are related strictly to market power. Since competition is a process, it can lead to a variety of market structures that can give efficient outcomes. It will only generate a competitive or atomistic market structure where market conditions and production processes favour the operation of very small, efficient firms (Singleton, 1986). Alternatively, production efficiency may have a scale dimension and require large firms, so that the highly concentrated industry can also be associated with efficiency.

This view rests on the belief that markets behave as if they are competitive and are in long run equilibrium. The extreme view attributes all structural monopoly to superior performance. In the long run only efficient monopolies survive and the costs of attaining monopoly will eliminate any monopoly profits. Market dominance has only limited harmful

effects and monopoly ought to be encouraged because that position is gained through superior performance. This is a clear refutation that competition policy should be solely based on notions of market share. Behind this is the idea that competition policy should promote economic efficiency and that structural approaches to competition policy, as embodied in the simple structure, conduct, performance approach, will end up penalising the successful.

While the Chicago school reflects the general antipathy to government intervention in competitive markets (Godek 1998), it does not advocate an abolition of competition or antitrust laws. It is concerned about the tendencies firms have to create mergers that would lead to inefficiencies through monopolies. These are referred to as horizontal agreements among firms. It does endorse the need for simple rules to curtail undue agglomerations of market power, but questions the level of concentration at which it is appropriate to restrict or ban mergers. A similar argument is applied to the stage at which it is appropriate to deter price fixing.

In the case of the Chicago school then, it is only horizontal agreements that come under the umbrella of competition rules. Non-horizontal arrangements are viewed as indicating the competitive market is actually working. These refer to vertical restraints, agreements between firms and its downstream distributors or upstream suppliers (price agreements, advertising, dealer territories, franchise practices) which need not be subject to competition law. These are viewed as agreements that are pro-competitive. Some may be inefficient but most are efficient.

Besides horizontal and vertical agreements, all other potentially antitrust violations are regarded by the Chicago School as forms of monopolisation. These include predatory pricing, price discrimination, and non-price predation and generally ought to be restricted, as they are viewed as efficient and pro-competitive. To this School claims against monopoly are often viewed as attempts by inefficient rivals to quell competition.

The implications of this approach for competition policy in developing countries are twofold. First, the appropriate policy would be a minimal one because it is recognised that information to regulate is costly and difficult to obtain, and political pressures can be exerted to distort competition laws. Second, policies to open up economies to international competition will alleviate many of the concerns of traditional competition policy.

Similarly the Schumpeterian and Evolutionary views of competition are broad enough to incorporate monopolistic tendencies as part of the dynamic competitive process. It is disequilibria and profit-seeking that provide the economic dynamics. The market environment, in terms of regulations and institutions, provides the conditions that ought to strengthen the competitiveness of enterprises.

The evolutionary economics position regarding competition policy that embodies the traditional industrial organisation perspective is to question both its theoretical and empirical underpinnings. The theoretical challenge to structural competition policy concerns the interpretation and meaning given to industrial concentration. Concentration is measured by indexes that capture the inequality and number of participants in the market. It is argued that this approach is flawed as high concentration cannot necessarily be associated with greater market power through price collusion. Market power is affected as much by strategic



behaviour as by structural factors. In empirical terms, questions have been raised over the direction of causality in attempting to link concentration with performance (Geroski 1988).

The implication for competition policy is that the traditional concern with market structure indicators as a guiding principle for implying something about conduct is not the right way to proceed in developing sound competition policies. Structural indicators may provide only a guide to potential market abuse.

The evolutionary perspective does see a role, however, for public intervention and institutional strengthening in order to ensure the market has the capacity to create innovative dynamic forces of competition. It also casts doubt on the market's ability to self-regulate itself to avoid economic crisis and concentration of income levels (Possas and Fagundes 1998). In terms of competition policy, the neo-Schumpeterian view cautions against presuming that all situations of market power can be interpreted as harmful to competition and welfare. This may entail a shift in approach - to recognising the importance of dynamic efficiency as an element in assessing competition. This is not easy to make. Competition agencies may be asked to permit a merger on the basis of some future efficiency gains. This judgement has to be made on the basis of current investment and innovative effort. Nelson and Winter (1982) point out that decisions about innovation occur with uncertainty, which makes it difficult to compare different strategies that have been adopted by enterprises and complicates the decisions that need to be made by competition agencies. Further, Schumpeterian analysis of competition and monopoly are no longer terms at odds with one another and attempts are made to deal with oligopolistic behaviour. Traditional competition policy is notable for its inability to incorporate notions of oligopoly because of the difficulty it has in dealing with the strategic interaction between competitors. Even game theory

approaches lead to indeterminate results and are sensitive to specific strategy and behavioural assumptions (Possas and Fagundes 1998).

A number of studies have looked at the determinants of competition policy enforcement. They explore the relative importance of politics, bureaucracy and economics in explaining government use of competition law. They question whether it shifts with changes in bureaucratic composition or results from the outcome of political elections. In economic terms public interest theories suggest competition policy operates to promote consumer welfare (Bork 1979). Private interest approaches associated with the Chicago School suggest it is there to promote the self-interest of particular participants in the regulatory process (Stigler 1971; Peltzman 1976). Most studies have dealt with the content and consequences of competition. Few investigations have focussed on the factors that have shaped the direction and scope of competition policy enforcement. Wood and Anderson (1993) found that in the US the level of competition enforcement activity is primarily a function of the executive-legislative macropolitics. The President and Congress can express their policy preferences for competition policy by proposing and approving the amount and mix of resources allocated to competition implementation. Budgets and staff allocations vary systematically with the politics of changing presidential administrations. In Mexico, the new Competition 1993 was introduced with a concern to create an independent and transparent process for assessing competition issues. While the main body of competition commissioners are insulated from the change over of presidencies, it appears sectoral agencies responsible for implementing competition policy are not (Wise 2000).

#### **4 Donor Perspectives**

In recent years the donor community has increasingly focused attention on developing a competition policy framework for developing countries. As indicated earlier, the interest in competition policy in the 1980s by the international development agencies was placed on efforts to reform the trade regime rather than explicitly through the introduction of competition policy. This was indicated by the noticeable absence of these formal competition measures as components of structural adjustment conditionality. Trade economists believed trade liberalisation was the most effective competition policy instrument available to governments with weak national competition laws and concentrated industrial structures. Competition from imports would represent the main source of market discipline for firms. Since many sectors were not tradable, then the priority was to encourage foreign multinational firms, as foreign direct investment would be a primary source of market discipline. Empirical evidence tended to support the idea that price cost margins would be reduced as trade barriers were lowered, but the effect on scale efficiency was weaker. Most of the adjustment in total domestic output came from large firms that were operating on the flat portion of their average cost curves (Roberts and Tybout 1997).

In recent years the influence of the structural approach to competition policy can be seen in most of the policy initiatives pursued by the major donors. The World Bank claimed that competition laws embodied two distinct but related concepts; market power and dominance. Market power depended upon the relative size (market share) and the structure of economic markets, thought of in terms of the number of participants, the ease of entry and barriers to trade. Dominance depended on the absolute size of the supplier and its links with customers and suppliers. There the concern was to protect competitors rather than the process of competition. According to the World Bank, the reconstructed structure, conduct,

performance paradigm maintains that economic performance flows from both conduct and market structure, with the result that competition policies can be designed to influence economic performance by intervening directly (in performance itself) or indirectly through economic conduct and/or market structure (World Bank 1991).

The Organisation for Economic Cooperation and Development (OECD) indicates that competition laws focus on problems of monopoly power in three ways: relationships and agreements between otherwise independent enterprises, actions by a single enterprise and structural combination of independent enterprises relating to mergers and concentrations. The first is considered in terms of horizontal agreements between enterprises doing the same things, covering price fixing, bid rigging, limits to output and attempts to divide the market, and vertical agreements among enterprises at different stages of production or distribution. The concern with vertical agreements also relates to price, output and questions over innovation. Actions by a single enterprise usually refers to abuse of their dominant position and involves some assessment of market power and its potential detrimental effects.

Two concerns have dominated recent thinking on competition policy within the OECD. First, the need to secure some core principles among national governments concerning competition policy. The OECD has sought to promote cooperation among national competition authorities through its council recommendations in 1995 and 1998, which built on earlier recommendations in 1967. These call for the exchange of information and the elimination of hard core controls. It also encourages governments to recognise the competition pressures of globalisation, although it recognises that the international community is unlikely to develop a set of binding rules on competition, or to develop an international dispute settlement process. It argues that the information required to review

cases is simply not available in sufficient detail to make an internationally driven system workable and such a code might end up as being set at the lowest common denominator which would make it difficult to raise standards in the future.

Second, the OECD distinguishes between different types of regulation including economic, technical and competition. Economic regulation refers to measures to control monopoly pricing and protect consumers. Technical regulation sets standards for health, safety and the environment. The OECD is currently concerned with the issue of combining competition policy and economic regulation and to the related question of how this could be achieved. The debate concerns the functions of each area of regulation and the nature of the institutions involved in implementing each aspect of regulation.

The arguments favouring amalgamation of economic and competition regulation assume there is less chance of regulatory capture by industry interests under the umbrella of a competition agency, greater scope for the coordination of regulation, and less uncertainty over the jurisdictional boundaries when offering policy under one roof. In practice, countries operate with a variety of models. In the UK the competition agency and the sector regulators have, since the introduction of the Competition Act 1998, been given concurrent powers regarding competition matters (Parker, 2000).

The OECD argues that competition agencies and regulators display important differences in their use of structural and behavioural remedies. The competition authority emphasises structural remedies, and in recommendations made by the OECD, has a narrower set of objectives built around economic efficiency. This draws on the implied link to growth through efficiency and greater competition. This narrower set of objectives does not

incorporate wider developmental goals and the structural approach appear to give little sympathy to the concepts of fairness, evident in earlier UK approaches to competition policy. Indeed, the introduction of new competition laws in Mexico, following advice from the OECD, contains no statements concerning fairness and the protection of small and medium-sized enterprises. It is recognised, on the other hand, that sector regulatory bodies operate with a wider set of policies which have distributional consequences. There may be instances in which regulators persist with a lack of competition in order to fulfil their own aims. Anti-competitive market structures may be encouraged where cross-subsidisation is used to ensure universal service obligations are met in some industries.

Competition law has emerged as an issue for the World Trade Organisation (WTO) largely because exporting firms in high-income countries argue that anti-competitive practices of competitors in foreign markets hinder their ability to penetrate those markets. Such practices may be largely private in nature and could be facilitated by the absence or weak enforcement of local competition laws. These issues have prompted a number of proposals for negotiating a limited agreement on multilateral principles and disciplines in competition law with the WTO.

A major concern of the WTO is whether national competition law should be subject to international disciplines. There has been a large push at the instigation of the US that rules are required because firms are not able to contest major markets. Market access has been denied by Japanese corporate groups buying from each other (Hoekman and Holmes, 1999). The EU has recently joined the forefront of the push for international rules with a market access driven agenda. It appears the primary interest of the US/EU is in using internationally focused competition policy to promote exports and to reduce the scope for conflict in the

approval of mergers between large firms rather than to promote efficiency or welfare, which is the preoccupation of government in formulating national competition policy. The US/EU are less interested in subjecting the behaviour of their firms operating in foreign markets to international disciplines that will end up benefiting foreign consumers.

The issue of how the protection of intellectual property rights affects competition has also arisen in response to pressures at the international level to conform to the requirements for a pro-competitive regime under TRIPs (Maskus and Lahouel 2000). Intellectual property rights can create market power by limiting competition in order to promote investment. Patents can generate market power through patent-pooling agreements among horizontal competitors. In countries without a strong tradition of competition and innovation, introducing intellectual property rights could raise market power. The tension is then between where the boundaries lie between providing incentives for innovation and some of the static concerns of competition law regarding market access.

## **5 Implications for Developing Countries?**

In many developing countries competition policy aimed explicitly at promoting competition rather than controlling prices and investment is relatively new. In the past elaborate systems of price and entry controls were established around state-owned enterprises. These were often accompanied by import protection under import substitution policies. State monopolies in some cases had been set up through nationalisation, as for instance in Pakistan in the 1970s, to counteract the perceived abuses of private market power by large family run businesses. The ultimate effect of these types of policies may have been to suppress rather than promote competition.

In the 1980s and 1990s economic liberalisation policies were introduced, often through external pressure, with the aim of increasing competition. Trade liberalisation and privatisation were central features of this reform process, although it is recognised that trade liberalisation will not ensure competition in so-called non-traded sectors and privatisation alone will not necessarily achieve greater competition. Indeed privatisation was often undertaken on the basis of its purported revenue raising contribution to government that faced large domestic and international debts rather than solely on notions linking it to efficiency and competition (Yarrow 1999). The need to maximise revenue from the sale of state-owned enterprises might even conflict with the objective of increasing competition since sales values are more likely to be higher when seeking monopoly power, particularly if regulation is weak or absent. Regulation, whether it embodies a competition component or not, was often conceived or developed after privatisation, as the example of telecommunications in Mexico in 1991 illustrates (Wise, 2000).

In relation to developing countries, the earlier protectionist and anti-competitive policies that were pursued and the narrow use of trade liberalisation to stimulate competition have left a legacy of weak and underdeveloped competition frameworks for most developing countries. Regulations are needed to safeguard and promote the competitive process. Where institutional enforcement capacity is limited, it is desirable for political structures to do all they can to make conditions as favourable as possible for pro-competitive behaviour, which includes starting free trade and avoiding the creation of monopolies through perverse regulation or ill-conceived protection (Hoekman and Holmes 1999). This had led many specialists to recommend that developing countries pursue a broad-based competition policy. Defined to include all actions government may take to promote competition, including trade liberalisation, measures to facilitate domestic entry into industry and exit, de-monopolisation



of sectors, and the imposition of hard budget constraints in the public enterprise sector. Well-managed and positive encouragement of DFI are important dimensions of competition policy.

A number of issues are raised by this brief review of some aspects of competition policy.

The first question is whether or not the introduction of competition policy in many low income countries is worth it? The introduction of effective competition policy may require new institutions, even democratic institutions and these may be costly to establish. Low income countries lack financial resources and the human skills that make the implementation of competition policy easy. As Laffont has advocated, competition is not the automatic outcome of deregulation, simply conditioning loans on the existence of competition laws will not ensure the creation of proper institutions for effective competition. Only a strong state can implement competition (Laffont 1998, p253).

The benefits from introducing competition policy may be limited, where interest groups can interfere with competition and influence the implementation of policy. Disjointed and poor communications systems can result in trading organisations being inefficient. Further, uncertainty over the economic analysis of predatory behaviour is still a major factor affecting the handling of competition issues, and competition agencies lack expertise and resources to gather the information required for effective monitoring of competition. Besides, where many newly emerging industries will be monopolistic, the remedy to some of these problems is not better competition policy but more investment (Laffont, 1998). Nevertheless, competition policy has many supporters in developing countries. It is argued that the transactions costs of collusion are lower in developing countries because monitoring technologies are less efficient and enterprises have lower implicit risk aversion and little to

lose from colluding. As a result it is argued that simple rules and measures to prevent horizontal collusion and abuse of dominant positions is required (Rey 1997).

There is a less favourable approach to the introduction of vertical restraints in developing countries. Here, there is a clear need to establish the difference between agreements among competitors that are designed to restrict competition and vertical restraints that are designed to increase efficiency (Rodriguez and Williams 1996). It is difficult to identify behaviour as monopolistic or anti-competitive given the state of theory. Predatory pricing in open, competitive markets either rarely occurs in practice or is a sign of competition working. There is a danger that regulations that are introduced to protect domestic enterprises from efficient entrants, will end up harming the competitive process. It is obviously easier to identify horizontal cartels among competitors attempting to increase their market power. But even though competition agencies can prevent these through their laws and investigative powers, caution must be exercised because not all agreements among competitors are inefficient (Graham and Richardson 1997). There are examples where joint ventures can provide cost-reducing technologies even though they have added to concentration levels.

There are cases in which vertical restraints within enterprises could increase the level of competition in developing countries. Producers can give exclusive territories to distributors in order to get them to invest in marketing products and build distribution facilities. All these are lacking in low income countries. These will contribute to an increase in the supply of goods and services and improve product quality. The danger is when vertical agreements close the door to potential domestic and foreign competitors, as illustrated by the Fuji-Kodak case.

Although the feeling is that horizontal constraints rather than vertical restraints should feature more strongly in low income developing country competition policy, vertical restraints may continue to require some monitoring. There are three main reasons for this. First, in low income countries there is limited interbrand competition so that vertical agreements can easily lead to forms of monopolistic collusion. Second, given the importance of smaller enterprises in the industrial structures of poorer countries, the scope to establish their own distribution channels or create new investment in this area is lacking. Third, governments in poorer countries may actually support controls on distribution so that vertical arrangements are viewed as anti-competitive. National laws may also give exclusive dealerships for foreign goods which may forestall interbrand competition and even facilitate rent-seeking activities.

A major difference between competition issues in industrialised and poorer countries relates to the source of the anti-competitive restriction. In low-income countries, dominant firms often result from the direct action of governments' industrial policy (Khemani and Dutz 1995). This is different to the ways in which enterprises have evolved in industrialised countries. As a result, enterprises in poorer countries may be inefficient, protected by artificial entry barriers. The implication in terms of competition policy is that a simple transfer of the lessons of competition policy from industrialised countries to lower-income countries may be inappropriate. A key element in the development of competition policy in developing countries is to remove government instigated entry barriers. These may exist in a variety of forms and be found in a wide range of policies that have implications for competition.

This inevitably leads to the important question of the role of advocacy by the competition authority in developing countries. One of the problems that has been identified with respect to competition policy in developing countries is the lack of support it receives in the wider population and through the budgetary resources allocated to it. The commitment to competition policy can be judged to some extent by the division of labour that has been assigned over competition issues. Competition policy is weakened if after reviewing the competition problems, action is handed over to other regulatory bodies that are open to capture by various interest groups. Similarly, if the ideas behind competition policy are distant from the business norms and the understanding of the concept of competition, then decisions of the competition authority may be overridden. Advocacy can have an important role, both in terms of influencing the ways in which other government agencies and their systems of regulation are likely to affect competition, and in helping local businesses familiarise themselves with competition issues, the channels for grievances and the kinds of measures that can be undertaken when competition is violated.

With the introduction of new competition laws in developing countries, around 58 countries are in the process of revising or introducing new policy frameworks for competition, the continued problem of implementation and enforcement is always beneath the surface. The introduction of new laws is likely to face considerable resistance from local business interests, particularly in countries where controls of various types had previously been quite extensive. Compliance with competition rules might be difficult and costly. There may be a sense in which the introduction of new competition rules are interpreted as a harking back to the old system of controls. The simple transfer or import of structural approaches to competition policy may also be harmful to development if countries need to restructure their industries and dominant positions are broken up in response to new laws, which places

domestic producers at a disadvantage compared to their foreign competitors. Local firms may need to improve their scale in production, sales, distribution and R&D in order to compete with foreign firms. This may be achieved through merger, acquisitions and joint ventures rather than dismantling enterprises and may be a feature of industrial policy that runs into conflict with a more structural approach to competition policy. Competition policy may also clash with industrial policy where foreign investment is involved. Competition agencies may be unwilling to confront a dominant foreign owned firm in the local market, fearing that investment plans for the economy could be adversely affected.

The argument for the strength of the private sector in the development process rests in part on the competitive case in terms of products and innovations, and in part on a competitive market for corporate control. In developing countries ownership structures are complex and in terms of the orthodox model, the market for corporate control can be described as imperfect. Large, often family-owned or foreign-owned enterprises dominate and are less vulnerable than smaller enterprises to uninvited take-overs. The threat of take-over may not be related to the way management performs in relation to profits. Many large firms are not listed on a stock market and shares may not be marketable. Since part of competition policy is to ensure that the environment for managing enterprises is conducive to providing incentives, then attention to matters relating to corporate governance, and how it works, are part of the framework for ensuring that efficiency comes with competition. If the scope for effective take-overs and bankruptcy and the legal framework to protect investors is deeply flawed, then competition policy needs to address these issues.

Indeed, incentives to manage can be stronger in publicly-owned enterprises. Public ownership can correct for market failures in goods and factor markets, and in the market for

corporate control. Information flows to monitor performance may be better than systems for private corporate governance. Giving less weight to public choice arguments concerning the imperfect nature of political control and the extent to which public ownership may transfer benefits to favoured groups at the expense of efficiency, then public ownership in low income countries may actually work best where other governance mechanisms are not functioning effectively. Whether or not this is the case, the problem facing competition authorities in developing countries is compounded by the extent to which publicly-owned enterprises are exempt from competition rules. Many state-owned enterprises or joint ventures with foreign investors in South East Asia are exempt from competition law. Indeed, privatisation may be leading to a situation in which an incumbent monopolist, especially if formed through a joint venture between an old state-owned enterprise and a foreign investor, has a distinct advantage that competition policy is helpless to manage. Monopolies of these kinds, with link-ups that allow for technological leadership, can easily lead to predatory behaviour emerging. Newcomers to enter the market would have to be highly efficient, which in the case of low-income economies, is likely to be another foreign investor. This is why it is important to develop a framework for competition policy that is able to tackle these new issues that are arising as a result of privatisation and deregulation, and to develop a behavioural as well as structural approach to competition.

## **6 Conclusion**

In developing countries regulation has been broad-based, dealing with trade and commodity production and financial policy. In the past an extensive set of regulations and controls had been established for state-owned enterprises. This took the form of internal regulation and the relationship between government and these enterprises had been fraught with difficulties over access to information for monitoring behaviour and performance. Problems of regulating

competition were also compounded by an array of administrative weaknesses and institutions with overlapping responsibilities.

The introduction of privatisation programmes has involved not only the privatisation of the so-called natural monopolies, but enterprises that are likely to have considerable monopoly power. Even enterprises that have not been privatised but have been corporatised under public ownership raise new issues for competition policy. These enterprises have been given greater autonomy to make critical strategic decisions which may or may not be subject to competition law depending upon individual country practice. In Mexico, for example, competition law does not exempt state-owned enterprises but treatment of misconduct has been lightheaded. Other social objectives to protect smaller enterprises are also absent from competition laws in Mexico. This has raised important questions over the need to develop new competition policies and reassess them in relation to other policy aims. Prior to the development of privatisation programmes, few countries had a body of competition policy aimed at addressing the adverse effects of market dominance.

Although countries have begun to introduce new competition laws, these can only be assessed through their effective monitoring, implementation and enforcement provisions rather than on the basis of the introduction of legislation. Our knowledge of how these have developed, the models used and how they are working is incomplete. Further, competition policy will need to be credible if the foreign investment flows, associated with the removal of restrictions on foreign investment, are not to lead to substantial increases in power that results in more control in domestic markets in poorer countries.

The introduction of privatisation, in particular utility privatisation, also brings with it new forms of external regulation. These will have implications for domestic competition policy, both in terms of the potential for overlap between the jurisdictions of dedicated sector regulators and competition authorities, and in terms of their overall objectives, which may conflict between the need to limit entry to maintain scale efficiencies and to be pro-competitive.

Resources allocated to regulation, and the implementation of competition policy remains low. Improving access to information is a key ingredient to better regulation of competition. Data continues to be lacking on basic information, particularly in the poorer countries, concerning markets and their structure and on the ability of competition agencies to effectively evaluate claims of market dominance and strategic behaviour. Given the lack of information and institutional weaknesses found in low-income countries, private monopolies are more likely to exploit their position by influencing the regulatory environment or by evading regulation. Weak regulation of competition is likely to undermine the potential gains to be made from privatisation and deregulation.

## **Notes**

1. The evolutionary approach differs to Alchian (1950) based on social Darwinist theory, in emphasising the importance of the internal workings of the firm. Alchian was concerned with outcomes rather than processes, in which technical change was considered to be an exogenous factor in response to market conditions rather than being a factor that affects market conditions (Auerbach, 1988).



2. Within the evolutionary school there are debates over the advantages of small firms in relation to competition and over the positive and negative effects of routine and inertia as an important asset of firms (Nelson and Winter, 1982, Teece, 1982).

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