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Competition Policy and the WTO

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I INTRODUCTION

Joan Robinson wrote in the 1930s that " We see on every side a drift towards monopolisation under the names of restriction schemes, quota systems, rationalisation and the growth of giant companies" (1933, p.307), and suggested that the efficiency gains from the growth in size of firms or monopolisation have to be balanced against the dangers of maldistribution of wealth. These observations appear to have stood the test of time. They aptly describe the economic scene of the present day. The giant companies are now the multinational enterprises (MNEs), the principal purveyors of foreign direct investment (FDI) and it is FDI which is a prime factor in the observed growth in international trade in recent years. Whist the efficiency gains the MNEs generate, the technology and know-how they transfer to host countries are generally recognised, their operations are also viewed with suspicion. Their size, the spread of their operations and their endowments of financial and human resources are seen to thwart the growth of locally owned firms, undermine local consumer interests and indeed pose a threat to national sovereignty. Admittedly these concerns are voiced principally by the developing countries but they are by no means confined to them. The impact of cartels and mergers on consumer welfare has long been the subject of debate and investigation in the US and the EC, and increasingly investigations have taken on an international dimension, Lloyd (1998).

The challenge to competition policy then is how to preserve and promote the efficiency gains from trade and investment but at the same time limit the potential problems they pose for equity and welfare in general. This is a wide ranging brief for those implementing competition policy. They not only have to monitor and control abuses of market power, but also ensure that policies designed to limit such exploitation of monopoly power do not impair efficiency.

The complexity of the task is compounded by the fact that like pollution monopolistic and anti- competitive policies and practices can cross borders. A monopoly can sell its products produced in one location at relatively high prices in other locations through exports, especially so in the case of export cartels. Also uncoordinated national competition policies may prove to be counterproductive. International firms may opt to locate in countries with relatively less stringent or lax legislation and service other markets through exports. This problem arises not only in the case of policies designed to limit monopoly power of firms but also in the case of national rules and regulations designed to harness FDI to development objectives as in the case of Trade Related Investment Measures (TRIMS). Further, the costs of competition policy cases can be substantial both for the firm(s) involved and for the competition authorities. When potential competition policy abuses are investigated by more than one national/regional level authority, there will be a wasteful duplication of regulatory resources at least, for example, as has occurred in the recent Microsoft US and EC cases. This inefficiency will then be compounded if different competition policy bodies propose different rulings, as for example in the differing US and EC rulings on the potential General Electric and Honeywell merger.

There are thus sufficient grounds to explore the viability of a multilateral rather than a unilateral approach to competition policy under the aegis of an international institution such as the WTO. There are several papers that discuss the issue from the viewpoint of developed countries, for example recent papers include Lloyd (1998). However, very few address issues of concern to developing countries, Hoekman and Holmes (1999), Maskus and Lahouel (2000), Bercero and Amarasinha (2001), and Holmes (2002) providing notable exceptions.

The objective of this brief paper is to discuss the case for a multilateral compact on competition policy from the point of view of developing countries. Sections II and III of the paper review the main issues of relevance in the formulation of a multilateral agreement on competition policy, Section III also outlines a framework for such a compact. Section IV discusses the issue of contestability of markets in the context of a WTO compact on competition policy. Section V concludes.

II THE ISSUES

Many nation states have for long instituted policies to limit monopoly power of firms. The basic objective of such policies is often the protection of consumer welfare or consumer interests. This in fact was the brief of state established institutions such as the Monopolies and Mergers Commission of the UK (now, with a revised remit, known as the Competition Commission). Yet, in recent years most nation states have moved beyond control of monopolies to promotion of competition in the market place, as reflected in, for example, the UK 1998 Competition Act, the primary emphasis of which no longer is the protection of the 'public interest'. It is believed that competition assures promotion and protection of consumer interests. Consequently, there are two broad facets to competition policy in the globalised world of today. One is the prevention of abuse of market power by giant companies, and the other is removal of impediments to efficient operations and competition of firms that in some cases may be the consequence of competition policy itself. Allied to this are the problems posed by host country policies towards FDI designed to transfer the maximum possible rents from the foreign firms to the local economy and those designed to limit foreign control over the economy.

It is the latter which has attracted much attention in recent debates on multilateral competition policy. The essence of the problem here is the inevitable conflict between efficiency and equity. Developing countries host to FDI seek ways and means of promoting development objectives, as they see it, through controls over trade and investment, whilst foreign firms seek ways and means through which they can enhance the efficiency of their operations. Broadly put the major issue facing policy makers then is how to resolve the inherent conflict between the objectives of equity and efficiency.

Most attempts at formulating multilateral compacts on FDI have floundered because of their failure to recognise this conflict between objectives. The OECD sponsored multilateral agreement on investment (MAI) was opposed by developing countries mostly because of its emphasis on the removal of all impediments to free flows of FDI. The premise underlying the MAI was that a legal framework giving foreign investors guaranteed rights to access and strong protection of their rights in developing countries would serve to increase FDI flows and also promote its efficient utilisation. However, this was seen by the developing countries to be heavily biased in favour of foreign investors. Developing countries are unlikely to endorse a multilateral competition policy compact that is likely to give rise to increased flows of FDI to the neglect of its impact on the objectives of developing countries.

A second issue relates to the complementarity between trade and investment. FDI now accounts for a substantial proportion of world trade. Competition policy designed to limit monopoly power of firms may undermine attempts at liberalising international trade. Removal of barriers to trade may achieve little if the principal agents that promote trade are encumbered with rules and regulations governing their operations. Equally trade barriers imposed in the name of industrial policy may impede flows of FDI. There is now sufficient evidence to show that FDI and trade are complements and not substitutes for each other. Further, the social rates of returns to host countries from the tariff jumping variety of FDI may be much lower than the private rates of return accruing to foreign firms in sheltered markets. Competition policy, therefore, has to recognise these interdependencies between FDI, trade and competition.

The design of competition policy has to recognise that pursuit of competition in itself may not always promote either efficiency or equity. A case in point is FDI based on cross border mergers and acquisitions (M&As) as opposed to green field investments. Although the bulk of M&As are in the developed countries their incidence in developing countries, especially in East Asia and Latin America, has grown noticeably in recent years. At the end of the 1990s they accounted for a third of all FDI flows into developing countries, approximately $165billion in 1998, UNCTAD (2000). The quest for strategic assets, the faster route to investments which M&As as opposed to green field investments provide, access to established distribution systems and the privatisation programmes in most developing countries all account for the growth in M&As in recent years. Yet, cross border M&As are for the most part viewed with suspicion and elaborate legislation is designed to monitor and limit such acquisitions and mergers.

The issue of significance here is whether or not FDI through M&As are less effective in promoting development objectives compared with green field investments. M&As are viewed with suspicion because they extend foreign control over existing locally owned enterprises, they do not always add to existing capacity, rationalisation policies following M&As result in lay offs of workers, and may result in market dominance by large firms. Unfortunately there are few statistical studies which evaluate the relative costs and benefits of M&As and green field investments to host countries. An elaborate study by UNCTAD (2000), which is conceptual rather than statistical in its approach, concludes that many of the concerns relating to M&As may be real over the short run but are likely to fade over the long run. In the short run there may be no infusion of capital or technology, lay offs of workers are likely to occur and they may reduce or eliminate competition. These effects are more often than not embedded in the nature of M&As, especially so in developing countries where ailing firms are acquired. Infusing life into dying enterprises and restructuring them to face market competition may require drastic rationalisation of operations. The alternative to such rationalisation may be the death of the ailing firms. In any case, there is not much evidence to support the proposition that M&As are necessarily inimical to either development or competition objectives, or that they are always an inferior alternative to green field investments. It is though noteworthy that M&As have an international dimension, as the UNCTAD report puts it "the very nature of cross-border M&As - indeed the emergence of a global market for firms – puts the phenomenon into the international sphere. This means that competition authorities need to have in place, and to strengthen, cooperation mechanisms amongst themselves at the bilateral, regional and multilateral levels, in order to respond effectively to M&As and anti competitive practices that affect their countries".

The import of the foregoing is to suggest that the complex nature of the issues surrounding competition policy, especially so because of its international dimensions, calls for a multilateral compact. National, bilateral and regional policy regimes may neither be capable of coping with the intricate issues, principally because of lack of developed institutions, instruments and asymmetries in the nature of information available, nor able to implement policies that promote their development objectives. In addition, it is likely to be inefficient for competition policy cases to be investigated by multiple policy authorities simultaneously.

III TOWARDS A MULTILATERAL COMPACT

In recent years there has been greater coordination and cooperation between the competition authorities of a number of countries. Illustrative are bilateral agreements, including positive comity agreements, between the US and a number of countries, such as Germany, Australia, the EC, Israel and Canada, and regional agreements such as the competition policy provisions of the EC, NAFTA and Mercosur. Further, an increasing number of countries have adopted national competition laws, including developing countries. However, many of the bilateral agreements are between members of the OECD, such agreements are less common in the case of developing countries. In any case, bilateral agreements with developed countries may not be appropriate for developing countries given the wide differences in objectives and stage of development between the developed and developing countries. Nevertheless, many recognise the importance of issues such as international market access, international/export cartels and cross-border M&As which arguably give rise to the need for some sort of multilateral competition policy compact.

The case for a multilateral compact rests on the special needs of developing countries and the cross border nature of most of the issues associated with competition policy. Even so, it can be argued that there is no appropriate forum for the institution and operation of a multilateral compact. The WTO is often dismissed as an inappropriate forum simply because its mandate is restricted to trade and not investment, and whilst the organisation can parley with governments of member countries on trade issues, it cannot negotiate with MNEs which are privately owned. This may be a myopic view for several reasons. For the most part trade too is on account of privately owned entities, principally the MNEs. But this fact does not rule out the formulation and implementation of trade polices by governments with whom the WTO negotiates. And governments formulate and implement investment regimes too. Most opponents of a WTO regime on FDI blithely ignore the interrelationships between trade , FDI and competition. The legitimacy of the WTO to forge agreements on TRIMS and TRIPs was accepted on the grounds that these measures impacted upon trade, but these are essentially measures relating to FDI and the operations of foreign firms. There is no escaping the fact that trade, FDI and competition are intimately related to each other, and legislation governing one inevitably has impacts on the others.

Nevertheless, it can be questioned whether the WTO Dispute Settlement Panel is the most appropriate body to adjudicate on multilateral competition policy issues that may become the responsibility of the WTO. The panel or a body comparable to it may be able to adjudicate whether national governments and their competition authorities are acting appropriately, but such a body seems inadequate for passing judgement on individual competition policy offences. The emphasis of the Dispute Settlement Panel on negotiation may not be appropriate, and the length of time for cases to be decided is likely to be impractical, Kim (1999). Consequently, thought must be given to the appropriate form of adjudicative body.

Yet some essential ingredients for a multilateral competition policy are already in place in the form of rules and regulations governing TRIMS and TRIPS. The WTO, whose decisions are binding, has intervened to prohibit measures that are likely to impact on trade as in the case of the local content requirements (LCRs) imposed by the Indian automobile sector. It has effectively intervened to limit anti-competitive measures such as in the case of the recent attempts by the US to favour exports of agricultural products with the offer of export subsidies. The WTO is one of the few international institutions whose decisions are binding and can be effectively implemented.

There is though continued opposition to a multilateral compact on FDI principally from the developing countries and they are none too happy with the agreements on TRIPS and TRIMS. And with good reason. These measures are designed with the sole intent of limiting their anti-competitive effects on trade. However, ironically TRIPS may encourage monopolistic behaviour on the part of firms and prove inimical to consumer interests. In fact the need to balance considerations of efficiency against those of equity is nowhere as stark as in the case of TRIPS. The Doha Ministerial meetings of the WTO took on board this dilemma and recognised the right of nation states to deny protection of intellectual property to firms in cases where such protection was harmful to consumer interests as in the case of drugs, which were essential for public health. Similar derogation would be necessary in the case of TRIMS also. There may be cases where measures such as LCRs may be in the interests of host countries; they may promote the objectives of technology transfer and the establishment of indigenous suppliers of components. Such backward linkages between foreign firms and locally owned firms constitute one of the major benefits to host countries from FDI.

Admittedly not all LCRs promote such development objectives, they do impact on trade and adversly affect efficient operations of foreign firms. Moreover, they may result in increased costs to foreign firms that they may pass on to consumers in the host countries in the form of higher prices and hence lower consumer welfare. Foreign firms in the face of LCRs may opt to service markets through exports rather than FDI, Balasubramanyam (1991), Greenaway (1991). Paradoxically, if the supply of locally produced components is inelastic with respect to price, LCRs may place locally owned purchasers of such components at a disadvantage vi-a-vis foreign firms. This is because foreign firms have access to two sources of components-imports from their parent firms and local suppliers, where as locally owned firms have access to only local suppliers.

Nevertheless, there may be a case for selective implementation of LCRs. Most MNEs would prefer to source components from local suppliers because of savings in transport costs if nothing else. The problem though is one of identifying the presence of such suppliers and organising them, both of which entail search costs. LCRs may provide an incentive to foreign firms to bear such search costs and establish local suppliers of components. Japanese MNEs in the automobile sector in host countries such as India have successfully established local suppliers of components and provided them with the know-how to produce components. But they have also subjected the firms to the discipline of the market place, local suppliers are protected from import competition for a specified period within which they are required to meet competition from imports both with regard to quality and price. These are examples of the classic infant industry argument in practice.

It is argued that this sort of a case for LCRs is an example of the second best, they introduce a new set of distortions to overcome existing distortions and their impact on welfare can go either way. If the objective of LCRs is transfer of technology, the first best policy would be one which is geared to technology and not to purchases of components and parts, Bora *et al*. (2000). This may be so. But quite often first best policies belong to the realm of textbooks, their implementation is fraught with problems. In any case, the objective of LCRs should be to encourage the transfer of know-how from foreign firms to locally owned firms for the manufacture of components. Nevertheless, there are policies that unerringly belong to the realm of the second best, the Malaysian governments injunctions that foreign firms should actively promote the employment of Bhumiputras (sons of the soil) is one such policy. Here the foreign firms are asked to implement policies that clearly belong to the domain of public policy. Promotion of the long neglected interests and welfare of the bhumiputras calls for education and training subsidies to equip the bumiputras with the requisite skills for employment in manufacturing and other sectors. Injunctions imposed on foreign firm requiring them to employ bhumiputras may impose costs that should be borne by the public purse, foreign firms or for that matter locally owned firms can not be expected to shoulder responsibilities of the state.

In sum a compact on competition policy under the aegis of the WTO has to be pragmatic and take into consideration development objectives where relevant and feasible. It should be borne in mind that efficiency considerations should be paramount and efficiency should not be sacrificed for the sake of short term gains. Policies governing M&As are a case in point. As said earlier acquisitions do impose short term costs on the host countries such as loss of jobs and they may not result in an immediate transfer of know-how. But such job losses in the short term may be inevitable given the alternative of bankruptcies and closure of firms.

Admittedly the formulation of a pragmatic competition policy that is universally acceptable is no easy task. Inevitably compromises have to be forged, concessions made and the policy framework should be incremental with a gradualist approach. The WTO principles of non-discrimination, national treatment and transparency of policies should form the building blocks for a multilateral compact. In addition, the principle of subsidiarity should be adopted, as in the EC.

National treatment implies not only non-discrimination in policies between locally owned and foreign firms but also market access. In fact national treatment is coterminous with market access. Yet here again, because of considerations of national sovereignty exceptions may have to be allowed as in the case of the agreement on trade in services (GATS). GATS, in fact, provides an ideal framework for a compact on competition policy, especially so as most trade in services entails the presence and establishment of foreign firms or FDI. Arguably the GATS framework in place constitutes a multilateral compact on competition policy. All that is required is the addition of the agreements on TRIPS and TRIMS with due recognition of development objectives, and provisos relating to M&As.

The WTO with its existing accords on trade and promotion of rules based trade, which for the large part are designed to promote non-discrimination or market access to both domestic and foreign firms may be ideally placed to promote market access in the wider sense of the term now known as contestable markets. In addition, it may also be capable of promoting market outcomes more in line with those emerging in competitive markets without actually intervening but with credible threats of intervention. Section IV addresses these issues.

SECTION IV MULTILATERAL COMPETITION POLICY AND CONTESTABILITY

Following the introduction of the notion of contestable markets in the Industrial Organisation literature by Baumol amongst others,[1] Zampetti and Sauvé (1996) defined a market to be internationally contestable when "…the rivalrous relationship between firms is not unduly distorted by anticompetitive governmental or private action." (1996, p.337) Both Zampetti and Sauvé (1996) and Lloyd (1998) discuss the conditions required for international contestability to be achieved, arguing that market access for foreign firms is insufficient. Freedom of foreign investment, national treatment of foreign firms, and the absence of 'unfair' advantages to domestic firms, as may emerge through, for example, government or regulatory policy, are all essential. These principles encapsulate a broad range of policies, although it is clear that national and multilateral competition policies can enhance the contestability of international, as well as, domestic markets. However, Zampetti and Sauvé (1996) suggest that domestic competition policies do not necessarily always work to guarantee international contestability as well as national level contestable markets. This is another justification for a multilateral competition body. Consequently, a primary goal of such an institution should be to develop policies to boost the international contestability of markets, for example, assisting national competition authorities to ensure that their policies promote internationally contestable markets.

However, further links between trade, competition and the contestability of markets can be made. Acutt and Elliott (2001) have suggested that (national level) competition authorities can take on a role analogous to that of the 'hit and run entrant' in the contestable markets literature, to create more desirable market outcomes in terms of economic efficiency. Incumbent firms' behaviour may be constrained by the fear of intervention by the competition authorities, as well as by intervention itself.[2]

[1] See, for example, Baumol *et al.* (1982).
[2] See Appendix 1 for a simple, broadly applicable, model of how this may be achieved when a firm abuses its market power.

The conditions required for the threats to intervene to be credible include the following. The competition authorities must be able to detect abuses of market power; intervention must entail an expected punishment larger, when discounted, than the expected benefits derived from the abuse, and crucially the threat of intervention must be credible. Hence, the authorities need to develop a reputation for intervening in response to abuses of market power.

These desirable, if elementary, characteristics of competition policy should influence decisions on the future role for the WTO in , formulating and enforcing a multilateral competition policy compact. If the WTO is to adjudicate in international competition policy cases it would need sufficient resources to be able to identify and fully investigate the potentially large number of ensuing cases. This is an important issue as the difficulties faced by existing competition authorities in collecting information pertaining to foreign firms has been highlighted,(see for example Lloyd (1998), Tarullo (1999).) Smith (1999) also suggests that if competition policy became a responsibility of an expanded WTO dispute settlement panel, then the issue of protection for confidential and proprietary information would have to be reassessed. Alternatively, if the WTO were to have a greater coordinating role in multilateral competition policy, it would need to promote non-confidential information sharing agreements between national competition authorities. This might ensure that competition policy abuses with international dimensions could be properly investigated by the relevant national and regional competition bodies.

If the WTO's competition policy role were to be extended beyond a coordinating and advisory role, its ability to decide and enforce punishments would also need to be considered carefully. An extension of its dispute settlement mechanism has been considered as a potential way of extending the WTO's role, for example by Smith (1999), Jung (2000) and Bercero and Amarasinha (2001). However, it has been argued that the dispute settlement mechanism is ill-equipped to deal with deciding and enforcing competition policy abuse punishments given that currently its principal role is to adjudicate in disputes between competition authorities rather than individual firms,(Tarullo (1999), Bercero and Amarasinha (2001).) Hence, maybe more radical proposals for the form of any greater WTO multilateral competition policy intervention need to be investigated as previously highlighted. Such proposals should ensure that the WTO has sufficient power and resources to be able to impose appropriate punishments. Further, threats that it could make to intervene in an international competition policy dispute should be credible. The current prominent role of the WTO in multilateral trade suggests that it is likely to be an appropriate body to take responsibility for future multilateral competition policy developments. In comparison with a newly created independent body with responsibility for multilateral competition policy issues, such as the International Competition Policy Office as proposed by Scherer (1994), the WTO may find it easier to develop a reputation for appropriate policing of competition policy. As such, it is possible that any such credible threat to intervene may in fact deter firms from acting anticompetitively in the international arena, so making the need for actual intervention redundant.

SECTION V CONCLUSIONS

In a world in which investment and competition increasingly take on an international dimension this paper re-examines the possibility of developing a multilateral competition policy compact under the auspices of the WTO, extending current provisions within the WTO with respect to, for example trade, TRIMS and TRIPS. Explicit account is taken of the significant concerns of developing countries, and it is argued that as with other elements of international investment policy, these concerns often relate to trade-offs between efficiency and equity.

Multilateral competition policy has a role in promoting greater international contestability of markets. However, any body with responsibility for multilateral competition policy should be able to influence market outcomes through regulatory threats, as well as through direct intervention itselfFinally, it is suggested that given its existing multilateral trade role, the WTO is well placed to extend its remit to the development of a multilateral competition policy compact.

APPENDIX 1[3]

Assume that a firm with sufficient power to be considered a monopolist (or joint profit maximising oligopolists) sets price and wishes to maximise profits in a one

[3] This section relies heavily on ongoing work by Acutt and Elliott.

period model. However, suppose a competition authority can monitor the price charged and can choose to impose a punishment if the firm's chosen price is deemed to be unacceptably high.[4] The punishment is assumed to be enforceable and takes the form of a penalty on revenue. Partly to reflect the imperfect and costly nature of regulation and regulatory monitoring, intervention by the competition authority may not necessarily be certain, even when price is high. Rather, it is positively related to the price charged. It is assumed that:

$\gamma = f(P) \in [0,1]$

$\gamma(P) \geq 0 \qquad \gamma'(P) > 0 \qquad \gamma''(P) \lesseqgtr 0$

where:

γ = probability of regulatory intervention;

P = price charged by the firm.

A potential penalty (fine) on revenue is denoted $R(P)$, it being assumed that:

$R(P) \geq 0 \qquad R'(P) > 0 \qquad R''(P) \lesseqgtr 0$

Fixed costs of production are assumed to equal zero, whilst variable costs, c, are assumed to be constant and may be positive. The demand function is assumed to be linear and of the following form:

$P = a - bQ$

where:

Q = firm output;

$P = \left(\dfrac{a+c}{2}\right)$ = a firm's profit maximising price in the absence of potential penalties.

A firm maximises the following expected profit function:

$$E(\Pi) = [1-\gamma(P)][PQ - cQ] + \gamma(P)[PQ - R(P) - cQ] \qquad (1)$$

where:

Π = firm profits.

Although not required below, a range of constraints on the upper limit of $R(P)$ can be envisaged, for example, to ensure that a firm at least makes non-negative profits.

[4] The criteria for deciding what constitutes an unacceptable high price are to be established by the

Equation (1) will be maximised when price is:

$$P = \frac{a + c - b[\gamma(P)R'(P) + \gamma'(P)R(P)]}{2} \qquad (2)$$

with the second order condition for profit maximisation satisfied if:

$$\frac{d^2\Pi}{dP^2} = -2 - b[2\gamma'(P)R'(P) + \gamma(P)R''(P) + \gamma''(P)R(P)] < 0 \qquad (3)$$

Further, price will be less than a firm would charge in the absence of possible regulatory intervention iff:

$$-b[\gamma(P)R'(P) + \gamma'(P)R(P)] < 0 \qquad (4)$$

which can be reasonably expected to hold.

Consequently, it has been shown that the threat of intervention by a competition authority can impact upon price charged. The extent to which price will be lowered depends on the precise form of the $\gamma(P)$ and $R(P)$ functions. Further, the model does not make any assumptions about the price under consideration being charged in the home country market of the firm. Hence, the model can be applied by a national, regional or a multilateral competition policy body.

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