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SMALL ECONOMIES AND COMPETITION POLICY: A BACKGROUND PAPER

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“SMALL ECONOMIES” AND COMPETITION POLICY

1. Introduction and Summary

1. This paper has been prepared as background for a discussion of “small economy” issues at the February 2003 OECD Global Forum on Competition.* It focuses on whether the size of an economy has implications concerning the desirability and substance of a competition law or the design of institutional aspects of the law enforcement process.

2. The idea that small economies are “different” for competition law and policy purposes has been expressed in a number of different ways. Sometimes, articulated without any apparent rationale, the argument that “small economies are different” has seemed to be merely a way to oppose competition law without explicitly denying its general benefits – a political variation on the perennial argument that “our industry is different.”

3. The serious consideration of small economy issues took a significant step forward in a submission by Trinidad and Tobago to the WTO’s Working Group on the Interaction of Trade and Competition. (WT/WGTCP/W/143, 2 August 2000). The submission raised basic questions, though it also merged discussion of factors characteristic of small economies (*e.g.*, export-oriented, import-dependent) with factors that are equally applicable to large economies (*e.g.*, “the need to protect high employment sectors in the interest of socio-economic security.”) As has become clearer over time, analysis of whether, how, and to what extent small economies are different for competition law purposes requires separating out both the concerns they share fully with all or all but the largest economies (*e.g.*, concern about the “denationalisation” that occurs when domestic firms are acquired by foreigners), and concerns that relate to the increased competition brought about by trade and investment liberalisation rather than to anything related to competition law (*e.g.*, “increased market access by foreign firms, to the detriment of local firms.”)¹

4. Building on the Trinidad and Tobago paper and other recent work, this paper examines how economies’ small size may affect the optimal design and implementation of a competition law enforcement regime. Before proceeding, however, several preliminary observations are necessary.

5. First, except where specifically noted, the paper focuses on competition **law** rather than competition policy in general or particular regulatory policies that are usually considered “procompetitive,

* The principal author of this paper is Beatriz Boza, the former President of Indecopi, the Peruvian agency responsible for competition law enforcement (and other fields). In particular, she is responsible for Part III and prepared a first draft of most of the rest. Matti Purasjoki, the head of the Finnish Competition Authority, authored Part II.B of the paper and provided comments on an early draft. OECD consultant Terry Winslow also provided comments, prepared Parts I, II.A, and IV in their current form, and accepts responsibility for any errors resulting from his final edits of the paper. Professor Michal S. Gal of the Haifa University School of Law shared the page proofs of her forthcoming book on competition policy in small economies, drafted the annexed summary of most important literature in the field, and patiently provided explanations of the definitional and other aspects of her work.

“such as structural separation of vertically integrated natural monopolies. Specific regulatory policies are by definition economy-specific, even though some generalisations are possible. And competition policy in its broadest sense does not call for uniform or particular regulatory policies, but rather is a general approach to regulation (now often called “regulatory reform”) in which governments include in their assessment of existing and proposed laws and regulations an analysis of whether they contain restrictions on competition and consumer choice that are unnecessary to achieve regulatory goals. The value of competition policy in this general sense does not vary with the size of an economy (or other reasons); indeed, it is a tool by which economies with differing characteristics can develop regulatory policies that take those differences into account.

6. Second, in accordance with common usage at international events, this paper uses “economy” as a substitute for “country” in order to emphasise that it takes no position concerning the sovereignty of any governments. Moreover, use of the term *economy* to describe a political unit does not imply that its political borders constitute a competitively significant *market*.

7. Third, the paper concludes that the “size” of an economy may affect its optimal enforcement priorities, the nature and content of legal presumptions, and/or the institutional design of a competition regime. The nature and extent of the possible differences, however, are very dependent on how one defines “smallness.” This paper addresses alternative definitions, sometimes explicitly but sometimes implicitly and interwoven into the substantive analysis. The Secretariat’s note for the Forum will seek to make these distinctions clearer and to discuss which definitions are relevant for which purposes. It will also offer observations on a number of other topics, including the increasingly rare argument that small, open economies do not need a competition law and the more common (but far from universal) view that small economies need not have a system of merger control.

8. This paper is organised as follows:

- Part II.A examines two specifically size-related issues. First, it considers whether and to what extent small economies have unique economic attributes that call for a different approach to competition law. This analysis focuses on the argument that a small economy should be defined in terms of its high concentration levels and entry barriers, and that these characteristics call for variations in the substance or scope of competition law. It consists primarily of an analysis of the work of Professor Gal of Haifa University.
- Based on the experience of Matti Purasjoki, the head of the Finnish Competition Authority, Part II.B then identifies political and cultural features of small economies that may affect competition law enforcement. In general, these features seem to relate to how competition law is enforced, not to possible differences in competition law’s substance or scope.
- Thereafter, based on Beatriz Boza’s experiences as head of Peru’s competition authority and her recent research, Part III broadens the inquiry to include developmental issues, because small economies are often developing economies with special institutional and cultural conditions that may, at least during the early years of a competition regime, call for special “competition rules”² or enforcement means.
- Part IV’s conclusions seek identify certain points of consensus and certain areas where further analysis is needed, with the hope that this background will help provide a useful focus for the discussion at the Forum meeting.

2. What implications, if any, does an economy's small size have on the usefulness and content of a competition law?

2.1 *Special attributes of small economies due to economic factors*

2.1.1 *General considerations*

9. The "economic" argument for small economies' having some differences in their approaches to competition law has been based essentially on the proposition that, other things being equal, small economies can support fewer firms.³ Domestic demand may be small compared to minimum efficient scale ("MES," the scale at which average cost is minimised); thus, *measured in terms of the political boundaries that surround small economies*, concentration levels tend to be relatively high in small economies. It is concluded that small economies have less competitive markets and risk more, as well as different kinds of, anticompetitive conduct.

10. This underlying proposition about MES is sound, but the conclusion does not necessarily follow, unless one assumes that the political boundaries constitute a properly defined market, because concentration ratios have no value as an indicator of competition problems unless concentration has been measured in such a market. Considerations such as high trade barriers, other legal restrictions, the coincidence of political borders with geographic barriers such as mountains or oceans, and language and other differences sometimes give competitive significance to the political boundaries that surround small economies,⁴ though such significance has diminished as a result of trade and investment liberalisation and of modern distribution methods. Today, markets for tradable goods are often international. Moreover, markets for non-tradable goods and services may often be smaller than the borders of even a small economy.

11. In the past, particularly in economies without a competition culture, many claims about the alleged uniqueness of small (and other) economies were rooted in a failure to recognise that economy-wide concentration levels often have little or no economic significance because political borders often have no relationship to boundaries of markets. Such thinking has not been limited to small economies. For example, the China Chapter of the OECD's 2002 China Study noted that some Chinese leaders viewed China's economy as competitive based on concentration levels in China as a whole, despite the fact that China's markets are often regional and dominated by one or a few firms.⁵ Globally, officials with competition-related responsibilities are increasingly aware of the need to define competitively significant markets before assessing the state of competition, but in both OECD and non-Member economies this is often not at all clear to other officials, the government, or the public. This lack of knowledge is a real barrier to pro-competitive reform and is a challenge to "competition advocates" world-wide.

12. On the other hand, even though political borders may not tend to define competitively significant markets, they may sometimes do so. Just as competition analysis generally rejects the notion that by lowering entry barriers free trade is sometimes sufficient to ensure competition, it should be alert to the possibility that the forces which make free trade insufficient also mean that economies may constitute competitively significant markets even for tradable goods in some circumstances. And for non-tradable goods and services, it is even clearer that small economies may constitute or contain such markets.

2.1.2 *Concentration levels and other factors*

13. Professor Michal Gal has recently published a book entitled *Competition Policy for Small Market Economies* (Harvard University Press, 2003). Based on that book and considerable e-mail correspondence

with Professor Gal, this section of the paper summarises the book's approach and raises some questions for possible discussion at the Forum meeting.

14. One of the main contributions of the book relates to creating a definition of "small economy" that is sound for purposes of competition analysis. The book begins by stating that a small economy is one that "can support only a small number of competitors in most of its industries." Although the term "industries" has no necessary relevance in competition analysis, Professor Gal has clarified that the definition is intended to incorporate a full process of product and geographic market analysis (including supply-side substitution) done from the perspective of buyers within the political borders of the economy. Thus, one would begin deciding whether an economy is small by defining all of the relevant product and geographic markets within its political borders and then determining, for each such market, how many business entities compete to serve domestic consumers.

15. Before concluding that those product and geographic markets served by only a few competitors were concentrated, however, one would apparently apply a second, "negative" element of the small economy definition (implied in the book's second paragraph references to entry conditions and international trade). This second step means that even if a market that is being served by only a small number of firms, it will not be considered concentrated if trade and other entry barriers are low enough that a small but significant price increase would induce entry. Stated differently, it means that an economy will be considered small only if a majority of its markets are concentrated and have high entry barriers.

16. One goal of this second part is to exclude economies – such as Lichtenstein, Andorra, and Monaco – that are so economically integrated with their neighbours that they can be economically regarded as part of their markets. It also excludes all economies that can support more than "a small number of competitors," *i.e.*, those in which the majority of markets do not have high concentration and entry barriers. In sum, as stated at p. 15, small economies include "jurisdictions with absolutely small population and high natural and artificial barriers to foreign trade (*e.g.*, Israel) or jurisdictions with dispersed populations and high entry barriers to foreign trade (*e.g.*, Australia)."

17. Thus, all of the economies the book considers small share a "basic handicap"⁶ of achieving efficient scales of production, and also face a higher probability of competition problems in most markets.⁷ Thus, although all economies face a "basic conflict"⁸ between efficiency and the vigour of competition, economies meeting the book's definition of small encounter this conflict much more frequently.

The marginal cases of large economies constitute, however, the mainstream cases for small economies. The effect of small size is similar to that of a magnifying glass: special market phenomena become more significant as extremes become the rule. This requires small economies to change the focus of their competition laws to regulate their markets efficiently.⁹

18. In sum, "In a small economy, it is vital that . . . that economic efficiency be given primacy over other goals."¹⁰ The reason, essentially, is that a small economy cannot afford the deviations from efficiency that a large economy could absorb. In particular, small economies should to avoid the "undeviating pursuit of wealth dispersion and small size of firms at the expense of efficiency" because doing so will preserve inefficient firms and inefficient operation of the market.¹¹ Therefore, competition law should avoid such elusive concepts as "the public interest," which may be interpreted as giving legitimacy to deviations from the efficiency goal. Ultimately,

Competition policy should strive to strike an optimal balance between structural efficiency and competitive vigour so that firms can operate at efficient scales and pass at least some of the benefits of greater efficiency on to consumers.¹²

19. For the foregoing reasons, the book concludes that the competition laws of small economies should contain the same elements as those of large economies – notably, including a ban on anticompetitive mergers and acquisitions – but they should not adopt all of the presumptions, rules of thumb, and “per se” rules used by large economies (except with respect to clearly illegal conduct, such as cartels). In particular, they should adopt a case-by-case approach and not follow rules of thumb that do not give enough weight to efficiency considerations. In discussing the review of horizontal mergers, for example, the book states that many large economies have adopted legal presumptions under which a market share above a certain percentage establishes *prima facie* illegality. This approach could be harmful in small economies by implying that efficiency-enhancing mergers should never be allowed if a party has a certain market share. Therefore, the book proposes that merger policy in small economies be based on a balancing approach, weighing potential efficiency gains with negative effects of reduced competition. A corollary of this argument is that structural remedies – like splitting up a conglomerate in order to introduce competition – may have large costs in terms of efficiency and should therefore be analysed with special caution.

20. Similarly, the book recommends that competition policy in small economies be flexible with respect to co-operative agreements among rivals whenever such agreements contribute to overcome the difficulties of achieving efficiency. It also suggests that small economies should give special weight to efficiency motives when considering price and non-price discrimination.¹³

21. Before turning to aspects of this book’s analysis that may merit discussion at the Forum, it is important to emphasise that the book does not purport to address many of the issues that the Forum will consider. One of the book’s main contributions is its proffered economically meaningful definition of small economy. However, precisely because it makes high concentration levels and entry barriers the focus of its definition, the book does not address whether there are also reasons for special competition rules or institutions in economies that are or might be small in some other sense. For that reason, Part II.B of this paper assesses the importance of more conventional measures of size, such as population and GDP. Moreover, Part III considers whether and to what extent the institutional and other aspects of developing economies may, at least during a transition period, make it more important for them to focus on creating a competitive market structure than on efficiencies.

22. Moreover, it appears that China would meet the book’s definition of small economy because the local self-sufficiency principle that long governed its development has led to local markets dominated by enterprises that are smaller than MES, and competition among enterprises in these areas is undermined by transportation problems and by administrative barriers created by local governments. The definition may also apply to Indonesia, whose many islands hold a widely dispersed population. It is clear, however, that the book was intended to address economies that are “smaller” in the conventional sense than China or Indonesia.

23. In reality, then, this book is not about “small” economies in any normal sense of the word; rather, it concerns *all – and only* – those economies within whose political borders a majority of the relevant product and geographic markets have high concentration levels and entry barriers. The question arises whether all such economies in fact have enough in common to warrant inclusion in a single definition and single set of recommendations.

24. Moreover, assuming that the book in fact means to address competition-relevant markets rather than “industries,” an economy wanting to know whether the book’s recommendations apply to it would need to assess concentration levels and entry barriers in thousands of relevant markets. This could take a very long time and massive resources if the analysis is going to be rigorous. Since the book concludes that Australia, for example, meets its definition without conducting or referring to any such analysis, Professor Gal may contemplate the use of some proxies or simplifying assumptions, but is unclear whether or how

the analysis could be simplified without while still being grounded in real competition law market principles.

25. Whether it would make sense for an economy to go through the process of determining whether it is small in this book's terms would also depend on how and how much the approaches advocated in the book differ from those that are generally used by "large" economies and/or advocated by the Competition Committee or other expert organisations. Generalisations about such matters are difficult, especially without knowing which economies are considered large, but it appears that the book may overstate these differences. To be sure, small economies should not "transplant simplistic competition policies applied in large economies," but how often are large economies' rules of thumb "simplistic rules that tend to deny categorically that real benefits can come from concentration-increasing measures?"¹⁴ And with the general trend towards greater consideration of efficiencies, how different are the book's recommendations for small economies from the usual advice to large or small economies that have reached a certain level of development?

26. Moreover, although the book concludes by arguing in favour of a rule-of-reason, case-by-case approach in order to avoid the errors that rules of thumb may impose, it can also be argued that in economies with severe resource constraints and a lack of relevant expertise and documentation, competition law should make liberal use of rules of thumb. Insisting on rigorous rule-of-reason analysis could paralyse law enforcement, which could be more harmful to an economy than having rules of thumb generate some errors at the margin. However, there may be value in discussing whether there should be systematic differences in rules of thumb between large and small economies.

27. In sum Professor Gal's book and previous work are important contributions to the analysis of an important issue. The book does not purport to be the final word on the subject, and some aspects of its analysis stand out as calling for further examination. However, it is notable that the analysis finds that even small economies benefit from laws banning abuse of dominance, anticompetitive agreements, and potentially anticompetitive mergers. Also notable is the conclusion that small economies should focus more than others on economic efficiency as the goal for competition law. In this regard, it is interesting to note that during the February 2002 meeting of the Forum, a representative from Brazil argued that such a focus on efficiency is vital for all developing economies. At least one basis for the argument was similar to that made by Professor Gal – that if competition law does not restrict the consideration of factors other than efficiency, those factors will become a "loophole" permitting a wide variety of anticompetitive arrangements. There will not be time at the upcoming Forum meeting to discuss all of the analysis and implications of Professor Gal's work, but it provides important background for that discussion and for further analysis.

2.2 *Special attributes of small economies due to "political" and cultural factors*

2.2.1 *General considerations*

28. As noted above, the WTO submission by Trinidad and Tobago noted some points that related to the size of an economy, but it also calls attention to points – such as a lack of "culture of competition" that is reflected in a lack of knowledge and interest in the competition regime and a scarcity of skilled professionals. This section provides the perspective of Matti Purasjoki, head of the Finnish Competition Authority, on how such political and cultural factors affect competition law enforcement.

29. **Political environment.** In a small economy, not only entrepreneurship is concentrated. The same can often be said of political activity. A small economy cannot contain sustain a great number of

political operators or a political agenda many issues at a time. In a small economy, a successful political concept is often extremely pragmatically designed.

30. To competition policy, its creation and implementation, these traits are both harmful and beneficial. It can be typical of a small economy that, at the early stages of development, politicians easily believe in market failure explanations and maintain regulatory systems that unnecessarily distort competition. In such conditions, it is not easy to find room for vigorous competition law enforcement or for use of a competition policy approach to regulatory systems. The possibility of reform is contained in two phenomena: on the other hand, the motivation to use regulatory controls even in potentially competitive markets may die out if it can be shown to produce bad results. The best possible example of this is the gradual waning of price regulation in the Nordic economies. In this context, it should be pointed out for clarity's sake that the regulatory authorities themselves "exposed" the disastrous nature of regulatory policy. Another line of reform is the wish of the political elite to "keep up with the Joneses", i.e. we cannot do any worse than the neighbouring economies as regards certain social policy development trends, for example competition policy. The expansion of the EU would seem to be a good example: even those economies where regulation has had a crushing power over the markets are now rushing to develop new institutions in the field of competition.

31. It is customary for the political elite of a small economy to lean on national champions to a larger extent than do politicians of big economies for the obvious reason that there are fewer such champions in small economy and they are exceptionally important for its identity. The temptation may arise to award special treatment to these champions: to protect them from foreign competition, to secure to them oversized development benefits etc. The political elite may also try to protect the national champions from the competition authorities either openly, through legislative means, or indirectly, by affecting the activities of the authorities.

32. **Organisations and institutions in small economies.** In a small economy, everybody knows each other: everybody has been to the same school, studied in the same universities and obtained further vocational training in the same elite courses. Hobbies may take you to the same golf courses or yacht clubs. It is clear that these conditions have an effect on the formation and implementation of competition policy. In an economy where everybody knows each other, news travels fast and it may be said that the latest information always reaches the same relevant parties at the same time— business management, politicians, leading officials and the press. If it is possible to introduce an opinion of the importance of competition policy in this environment you can be sure that soon the whole elite will share the opinion. The opposite spiral is equally likely: the negative attitude of the nation toward a "circle shocking" competition policy spreads fast and becomes cemented. In an economy characterised by the power of small circles, it is obviously easy to maintain cartels and other collusive arrangements because when "everybody knows everybody else" there is no need for detailed and difficult-to-manage (vulnerable) contractual arrangements.

33. **Lack of educated resources.** A small economy must make difficult decisions concerning the allocation of limited human resources. The authorities responsible for the system of higher education maximise short-term benefits in education and research. "Important" fields are techno-scientific, administrative-legal and those qualifying for the administration of social policy. The needs of competition policy easily remain secondary. Competition authorities, which have a need to recruit well-educated lawyers and economists, are forced to take their turn in the allocation of society's resources.

34. Measured in conventional terms, such as population and GDP, small size does not appear to call for substantive differences in competition laws, though it is associated with some problems that may affect the mix of cases, the difficulty of proving collusion, and the ability to remedy conduct that occurs abroad. Economies that are small in this sense may find that competition law enforcement is relatively more costly,

which may call for assigning competition enforcement to an agency that also has related functions, such as consumer protection and some forms of sectoral regulation. Another potentially useful remedy for problems associated with this measure of size is the creation of a regional enforcement agency.

3. Competition policy in developing market economies – institutional issues

3.1 *Development and institutions*

35. In order to analyse the prescriptions for competition policy in different stages of development, it is useful to think of development as defined by Stiglitz:

Development represents a transformation of society, a movement from traditional relations, traditional ways of thinking, traditional ways of dealing with health and education, traditional methods of production, to more ‘modern’ ways.¹⁵

36. This definition is useful because it implies that stages of development should not be characterised by socio-economic indicators – like GDP per capita, poverty indices or literacy rates – but should rather be defined by the capability of an economy’s institutional apparatus to generate wealth and well being for its citizens. That is, the stage of development indicates how far an economy has advanced in generating the institutions necessary for a well functioning market economy. It is then possible to apply the tools of new institutional economics, and especially the theories on institutional change, to analyse if a specific policy – in this case competition policy – is optimal within a given institutional framework.

3.1.1 *Institutions, economic policy and economic performance*

37. The theories of Douglass North¹⁶ are crucial to an understanding of how economic institutions influence economic performance and why specific policies may be successful or fail in different institutional contexts. Institutions are defined as the rules that determine the behaviour of individuals and organisations. It is very important to distinguish between two types of behaviour-shaping institutions: the formal rules – laws and regulations – and informal rules - constraints on behaviour derived from culture, tradition, custom and attitudes.

38. A quote by North serves best to explain the complex relationship between formal rules, informal constraints, and actual behaviour:

While formal rules can be changed overnight by the polity, informal constraints change very slowly. Both are ultimately shaped by the subjective perceptions people possess to explain the world around them which in turn determine explicit choices of formal rules and evolving informal constraints.¹⁷

39. For economic policy this implies that the effect of any measure to be taken on economic performance will depend crucially on the reactions of individuals and organisations, which in turn are influenced by informal constraints.¹⁸ Therefore, if policy measures do not take into account these informal constraints, the actual outcomes may differ hugely from the expected ones. It also implies that similar measures adopted in different economies with different informal constraints may generate totally different outcomes.

40. Institutional economics has been very helpful in explaining the puzzling experience of the transition process from central planning to a market economy undergone by the formerly communist economies of Eastern Europe.¹⁹ Indeed, there is a broad consensus that the failure to take institutions into account when designing reform policies has generated extreme difficulties in the process and in some cases led to disastrous results.²⁰

41. Reform policies in Eastern Europe and Latin America were based on the so-called Washington consensus,²¹ the broad coincidence among technocrats from the multilateral financial agencies and Western economists that a combination of macroeconomic stabilisation, privatisation and liberalisation would suffice to bring about an efficient allocation of resources and generate a dynamic private sector that would ultimately lead to rapid economic growth. The results, however, were disappointing in many cases,²² and it is important to note that they had very different consequences on the economies' macroeconomic performance.²³

42. Though an analysis of the transition process is beyond the scope of this paper, it may be nevertheless useful to mention some examples of how the lack of appropriate institutions led to failure or varying results of reform measures. Privatisation and liberalisation of prices were expected to lead firms to react to price signals and allocate resources properly. However, the absence of minimum corporate governance arrangements and of broad profit seeking culture in some economies led to a lack of incentives for managers to behave in a profit maximising way. Not only did many of the newly privatised companies remain hugely inefficient; in many cases, fast privatisation led to massive plundering of assets by managers.²⁴

43. Where property rights weren't adequately defined or enforced by the State, the risk of business activity rose enormously and investment suffered large contractions. In Russia, for example, a virtual absence of public mechanisms to enforce contracts and property rights led to the creation of a private "alternative" – mafia-like organised crime structures which now are crippling for private entrepreneurial initiative. A first lesson from the transition experience is therefore that specific policies that are adequate in one institutional setting may be bound for failure in another. Therefore, competition policy must be analysed not only as one complementary element of a whole set of economic policies, but also in the context of the institutional framework in which it operates.

3.1.2 *Institutions and the dynamics of reform policy*

44. A second reason why the same policy design may not be appropriate for all economies at all times is that formal rules and informal constraints are in permanent interaction. Institutional change is a complex dynamic process that is very difficult to predict. This process is subject to path dependencies: every institutional framework embodies institutional downstream choices.²⁵ Any policy measure will not only lead to immediate reactions of economic agents and organisations which will depend on actual informal constraints. It may also induce a modification of informal constraints themselves. Though such changes will usually develop at a rather slow pace, they will produce a feedback and have a heavy influence on future choices of formal rules.²⁶

45. Special attention should be paid to the dynamic interaction between reform policy and the political system.²⁷ It depends crucially on the effects of every stage of a reform process if the political system will support further reform – that is, demand more institutional change – or if opposition builds up that may eventually bring the process of transition to a halt or even reverse it. Reform policy will necessarily generate winners and losers within society. It may also strengthen some interest groups and weaken others. Reform policy itself may therefore generate new political constellations that may be favourable or obstructive for further reform.²⁸ In the latter case, time consistency problems may occur.²⁹ It

is possible, for example, that price liberalisation and privatisation increases the economic and political power of certain sectors of the business community that may later oppose and prevent trade liberalisation.

46. If reform policy is to be successful, it must therefore take these problems into account. From the beginning, the reform process must be designed in such a manner that complementarities are respected and time consistencies are avoided.

3.2 *Institutional framework, institutional dynamics and competition policy*

47. The importance of institutions for economic development and success of reforms has been established in several empirical studies in recent years.³⁰ Unfortunately, convincing models that may explain institutional change and allow predictions of the political process are not yet available. However, several authors have proposed certain guidelines that may be useful when designing reform processes. Some of these ideas and prescriptions may also be useful for a diagnosis of which kind of competition policy may be adequate for a specific economy in a determined institutional framework.

- a. *Be aware of incompatibilities of policy measures with institutional framework.* Though it should be one of the explicit goals of reform policy to transform and improve the institutional framework, this will certainly be a very slow process. It is important that policies be implemented that are compatible with the institutional framework that is actually in place.³¹
- b. *Respecting complementarities of reform elements.* Some reform elements may not render the desired results if they are not implemented jointly with other elements. For example, newly introduced profit incentives in markets that are distorted because price controls are still in place will lead to misallocation, while price liberalisation without privatisation doesn't lead to the profit maximising behaviour needed for efficient market outcomes.³² The case of Peru's Export Association ADEX against the Ministry of Labour provides a good example of such inconsistencies. On one hand, the Government pushed for streamlining government services and doing away with unnecessary red tape and bureaucratic procedures, while on the other hand, it allowed government ministries (in this case, the Department of Employment) to finance their budgets through unnecessary red tape.³³
- c. *Creating constituencies that are supportive of reform.* Because at every step of the reform process there may be winners and losers, it is important to mobilise potential winners before and during the introduction of the actual measures, for example via public information campaigns that inform about the potential gains and identify winners as well as losers. Similarly, it may help to compensate potential losers, ideally through the creation of adequate bundles of reforms.³⁴ Indecopi, Peru's competition authority, for example, proactively sought to empower consumers by providing timely critical market information.³⁵
- d. *Sequencing of the reform process.* The sequence of the different reform stages should be such that the reform process is ex-ante acceptable; on the other hand, it should also be aimed at building constituencies and momentum for further reform. However, there may be a trade-off between these two goals.³⁶

48. At the time of writing of this paper, no comprehensive analysis of the working of competition policy in different institutional frameworks, and especially in institutional frameworks in transformation, has been identified. In what follows, some ideas are presented on how in early stages of the transition

process prescriptions for competition policy might deviate from an approach that focuses on economic efficiency. These ideas should be taken as an orientation to further discussion and possibly research.

3.2.1 *Some institutional problems in developing market economies*

49. Institutional economics tries to go beyond neo-classical welfare analysis by taking into account the non-price incentives behind the actions of individuals, and it does not take efficient markets for granted, but rather tries to explain under what circumstances they may exist. When these theories are applied, optimal competition policy in economies at an early stage of transition may not be the same as in developed market economies.

50. There are several features of the institutional frameworks of economies with incipient market economies that may complicate a mere transplantation of competition policy regimes that work well in highly developed economies. To mention just three of them:

51. **Lack of “market culture.”** It has often been observed that economies in transition lack a “culture” of capitalism that facilitates the working of the market system in developed economies. In the words of Kolodko:

Transition calls not only for a new legal system, but also for learning a new type of behaviour. Enterprises, banks, the civil service and state bureaucracy, even households – all must quickly learn how to perform under the circumstances of new reality: the emerging market system.³⁷

52. The economic agents need time to digest and adjust to the new rules. Enterprises and consumers may not even be aware of the existence of the new competition policy, less of its implications. Business practices that have come to be commonly accepted and even regarded as socially beneficial under the previous system may suddenly be ruled out by the new competition law, without the agents being conscious of some of their actions being illicit. This lack of culture may also affect senior civil servants of other ministries and agencies who may even encourage illicit behaviour or try to obstruct the implementation of competition law.

53. Consumers International estimates that a process of three or more years is necessary to raise a sufficient public awareness of a new competition system: “Industry, the legal community and consumers must all be brought into the process in order to validate the objectives of the law and to insure that there is a meaningful domestic participation in complaint and enforcement”³⁸. In that line it is revealing to note that when Peru’s Indecopi brought in late 1995 (more than 3 years since the competition law had been enacted and the competition agency open its doors to the public) action against the flour mill cartel, it was the Minister of Economy who called Indecopi’s head alleging “that he was meeting with all the flour mill industry CEOs, who had just explained to him their cost structure, based upon which any allegation of price fixing was unwarranted!”

54. **Scarcity of human capital.** If competition policy is to be implemented properly, which means for example that cases are brought forward correctly and evaluated thoroughly so that resolutions are of high standards, a great amount of human capital must be created. Kolodko again:

Key organisations and institutional links must be developed gradually. Considering the point of departure, this also calls for a process of retraining many professionals to enable them to work in a market environment. This takes years, and thus it would be much wiser to manage the processes of liberalisation and privatisation at a pace compatible with the speed of human capital development.³⁹

55. More than the competition agency, of course, must find well-educated, highly specialised lawyers and economists. There must be a sufficient amount of such human resources available in the private sector for companies to draw on, either through direct employment or through consulting services. In developing economies, human capital is usually especially scarce, so that the necessary human resources simply don't exist. It can also often be observed that a very small pool of specialised professionals "rotate" between the public and private sector, thus generating obvious conflicts of interest.

56. **Powerful pressure groups.** Economic power in developing economies is often concentrated in a small number of business groups, which in turn tend to be controlled by families that also form part of the political and intellectual elites. These corporations therefore exert enormous political influence and may achieve to capture the political apparatus. This allows them to influence not only the course of the reform process and policy design, but also policy implementation.⁴⁰

57. **Lack of stakeholders.** While powerful pressure groups will often be easily organised against effective efficiency-oriented competition policy, the broad and disperse base of beneficiaries of such policies will hardly gather to support them. A lack of stakeholders is often a structural problem for the design and implementation of competition policy.

58. **Corruption and extra-legal arrangements.** In the early reform stages, a vicious circle can easily form that is later very difficult to break. If trust in the market system, and in competition policy in particular, is not generated early on, economic agents may seek "private" conflict solution and enforcement systems. This will result in corruption, the formation of mafia structures, and the operation of a system in which private parties make decisions based entirely on their own discretion

3.2.2 *Consequences for competition law*

59. Where the institutional characteristics described in the previous paragraph are in place, competition policy must deal with them if it is to be successful. This may lead to specific policy prescriptions that may be different from the ones that apply to developed economies. In some cases, these differences may simply be a matter of emphasising certain aspects of competition policy; in others, there may be outright deviations from the approach used in large, developed economies.

60. **The importance of sequencing and competition constituency building through competition advocacy and other means.** In many of the reform processes of the last decade competition law and some other aspects of competition policy have been introduced at the very early stage.⁴¹ There are good reasons for this. Competition law and policy can be important complements to price liberalisation and privatisation, helping avoiding that privatisation simply leads to substitution of public monopolies by private ones, and preventing the potential efficiency gains from privatisation and liberalisation from being undermined by anticompetitive behaviour of dominant firms. It therefore makes the reform process more tractable to consumers and small business, which favours its political viability.

61. Introducing competition policy early also avoids a time consistency problem. Large business groups may benefit from privatisation and liberalisation and grow more powerful economically and politically once these reforms are implemented. However, they may also be the group that is most likely to oppose the installation of a competition policy regime, as this may limit their strategic options. It is therefore important that competition policies be implemented in a bundle with privatisation and liberalisation, so those pressure groups won't have an opportunity to obstruct them.

62. Furthermore, it is important to build constituencies that support both competition law enforcement and procompetitive market reform in general. A strict efficiency orientation will generally

favour higher market concentration, which may strengthen the position of those pressure groups who might be interested in reducing the effectiveness of the competition regime. A policy that sacrifices some efficiency in favour of a more competitive market structure may benefit small and medium sized enterprises, which then might be a constituency that supports competition policy and, if they are able to form well-organised lobby groups, might be a good counterweight to the interests of large businesses. For example, whereas Professor Gal encourages small economies to be more tolerant of mergers that may increase efficiency by permitting the realisation of economies of scale, small developing economies may find it preferable, at least during a transition period, to use relatively low merger thresholds.

63. **The importance of communication and training.** In the early stages of a market reform process, it is extremely important that the competition authority assume, additionally to its enforcement role, very effective communication and training policies. The functions of this policy have to be educational and informative. It is very important that the content and the implications of the competition regime be properly explained to the business community and to consumers. Similarly, a special effort should be assigned to exploiting important cases for didactic purposes. The media should be used to give understandable explanations on why a case is relevant, how the behaviour under examination affects different groups of the society, and why any sanctions that are imposed are therefore justified. This will not only contribute to the generation of a “market culture”, but also helps to build constituencies, as it will become apparent which groups of the society are potential winners, and which are potential losers, of the competition regime.

64. **Increased autonomy.** If all three of the above mentioned institutional settings – “lack of market culture”, scarcity of qualified staff, and existence of powerful pressure groups – are present, the competition agency is not only likely to suffer from enormous pressure from large business groups and other government agencies, but their staff will also be ill equipped to resist this pressure. Institutional arrangements should therefore be established to reduce these problems to a minimum.

65. The competition agency should be protected from outside pressure, especially from the rest of the government, by giving it a large degree of autonomy. This autonomy should comprise suitable appointment rules, financial independence and legal independence.

66. **Reduced discretion.** At the same time, however, it is necessary to reduce the flexibility of the competition agency itself when interpreting and implementing the law. The less room there is for discretion, the fewer the options for competition officers to respond to external pressures. There are definite benefits to having the law be very clear and simple, and having a transparent process so that the public will be able to observe how it is implemented.⁴²

67. **Promote private entrepreneurship.** In many developing countries, government more than private agents pose the more significant threat to competition and private entrepreneurship. Competition policy should take account of this and direct effort and resources to tackle State-created obstacles to entrepreneurship and the development of a market culture. Problems may certainly vary very much between countries, but the following examples from Peru, where Ms. Boza headed the competition authority, illustrate the problems that can arise. The State may be engaged in numerous entrepreneurial activities, sometimes in formally constituted State enterprises, sometimes through hidden activities on behalf of government bodies. Such activity may benefit from substantial explicit and implicit subsidies and soft budget constraints, which form significant barriers to entry for private operators. The generation of private entrepreneurship is blocked. In general, competition policy (and economic policy in general) must give private entrepreneurship opportunities to develop.

68. In these circumstances, in the case of doubt, decisions should be taken in favour of private enterprise. One point to consider, for example, is whether merger control should be introduced at the very

beginning of the policy reform, or if some phase-in period should be introduced in order for government to gain relevant expertise and for private entities to have time to adapt to the new regulations. In Peru, as in Jamaica, it was decided not to introduce merger control; on the other hand, South Africa has found merger enforcement to be its most effective means of establishing the credibility needed by its even more recently enacted competition law.

69. According to Ms. Boza, the primary author of this section, several of these points are particularly important. She believes that the need to build constituencies – and the fact that a natural constituency is small and medium sized business – generally calls for a regime that grants the competition agency great autonomy with minimum discretion, permits the agency to favour a competitive market structure over a strict efficiency-oriented approach, and makes liberal use of presumptions and other simplifying formulas. Professor Gal also recognises the political risks to giving too much discretion, and agrees that presumptions that err on the margin may improve competition enforcement overall, but she argues in favour of an approach that recognises the primacy of efficiency. This difference in approach is among the topics discussed in this paper’s conclusions.

4. Conclusions

70. Market boundaries, which are determined by topographical, cultural and political factors as well as transportation costs, consumer preferences, etc., often do not coincide with political frontiers. Therefore, many markets are international, transcending political borders, while others are smaller than an economy’s borders, and the high concentration levels found in small economies cannot be assumed to indicate the presence of market power.

71. Defining small economies as those in which most relevant product and geographic markets are highly concentrated and have high entry barriers gives the term economic significance, but does not address the concerns of economies whose economies may be “small” in other senses, such as (a) population and GDP, and (b) level of development. Moreover, it is questionable whether all of the economies meeting this definition have enough in common to benefit from recommendations derived from their concentration levels and entry barriers. Application of this definition would be difficult and costly, and the policy recommendations derived from this approach do not appear to differ markedly from what is generally considered best practice in developed economies.

72. Measured in more conventional terms, such as population and GDP, small size does not appear to call for substantive differences in competition laws, though it is associated with some problems that may affect the mix of cases, the difficulty of proving collusion, and the ability to remedy conduct that occurs abroad. Economies that are small in this sense may find that competition law enforcement is relatively more costly, which may call for assigning competition enforcement to an agency that also has related functions, such as consumer protection and some forms of sectoral regulation. Another potentially useful remedy for problems associated with this measure of size is the creation of a regional enforcement agency.

73. Although developing economies are not necessarily small in conventional terms, there is some relation between the two, and the experience of OECD “outreach” and other forms of capacity building and technical assistance has shown that economic and institutional factors in “transition” and developing economies are vitally important determinants of the successful introduction of a competition regime. Therefore, it makes sense to consider what whether and to what extent these factors imply the value of “different” approaches to competition law. And in fact, the analysis in Part III suggests that the policy implications of development levels may be much more important than those of the levels of concentration and entry barriers or of size as measured by population or GDP. It is impossible to making across-the-

board recommendations for such a diverse group of economies, but the following suggestions are offered as means of contributing to the discussion and pointing the way for further analysis.

74. First, developing economies should carefully weigh the merits of a regime that uses a case-by-case approach focusing on economic efficiency against the merits of a more simplified approach that employs more presumptions and that gives more weight to maintaining or creating a competitive market structure. Without explicit focus on the development levels, Professor Gal advocates the former approach, whereas Ms. Boza advocates the latter specifically for developing economies.

75. Each of these approaches may be preferable in particular circumstances, but developing economies seeking to introduce competition law enforcement as part of a general reform in the direction of a market economy face a transition process that is institutionally similar to – though structurally different from – that faced in the 1990's by all Central European economies. During such a transition, political and economic reality, including the lack of a competition cultural and the institutions necessary to sustain it, sometimes calls for “transition” policies that are different from the policies of competition authorities in OECD (large and small) economies. An early, public expression of this reality was the position of Anna Fornalczyk, the first President of the Polish Antimonopoly Office, that transition economies should be prepared to break up enterprises being privatised – even at the cost of some efficiency loss – in order to create more firms and more entrepreneurs and managers.⁴³

76. Second, competition policy in emerging market economies should place a strong emphasis on competitive advocacy, including use of communication strategies that help educate economic agents and help them act within the new regime. These strategies will also help to identify and formulate ways of dealing with winners and losers of the regime, which may help to build constituencies.

77. Finally, in an environment where a lack of market culture, scarcity of specialised professionals, and strong pressure groups are present, measures must be taken to reduce strong external influences on an agency that does not yet have the type of professionals who are able to deal with them. It is recommended that the agency be equipped with a strong autonomy from the rest of the government sector, but that discretion of implementation be kept to a minimum. It is also important, however, to ensure that limitations on discretion do not waste the agency's resources (*e.g.*, requiring investigation of frivolous complaints) or the economies' overall resources (*e.g.*, establishing overly broad rules of thumb under which seriously anticompetitive, inefficient conduct cannot be halted or transactions with major efficiencies cannot be allowed).

ENDNOTES

- ¹ Taimoon Stewart, Challenges of Developing a Competition Regime in CARICOM, March 2001.
- ² Alan E. Bollard (1994), "The Role of Antitrust in a Small Open Economy: The Commerce Act in New Zealand", in: *Review of Industrial Organization* Vol. 9, No. 5: 671-694; World Trade Organization / Working Group on the Interaction between Trade and Competition Policy (2000), "Communication from Trinidad", Aug. 2.
- ³ For a detailed summary on the determinants of optimal firm size and market structure, see John C. Panzar (1989), "Technological Determinants of Firm and Market Structure", in: Richard Schmalensee and Robert Willig (eds.), *Handbook of Industrial Economics*, Vol. I, Elsevier, Amsterdam, 3 - 59.
- ⁴ Indeed, it is because of political and cultural barriers nations deserve special attention in economic analysis. In the words of Perkins and Syraquin:

Economic analysis is best understood as a process that involves the interaction of millions of households and firms within a framework determined to a large degree by the sovereign governments that rule those households and firms Thus, the discontinuities between states due to differences in language and culture are reinforced by trade policies. And trade barriers are only one subset of tools among many available to governments in shaping their domestic economies.

Perkins and Syraquin (1996), p. 1698). There is empirical evidence supporting this theory. Pryor shows that, while concentration levels of given industries don't differ systematically among large industrial economies; size has an influence if smaller economies are analyzed. F.L. Pryor (1972), "An international comparison of concentration ratios", in: *Review of Economics and Statistics*, Vol. 54, 130 – 140. A study by Scherer et.al. on a sample of differently sized economies, including the US and Sweden, shows that the number of firms that operate in manufacturing markets is positively correlated with the population size. See Scherer et al. (1972). A summary table is reproduced in Gal (2000). Other studies support this finding. Joe S. Bain (1966), *International Differences in Industrial Structure*, New Haven: Yale University Press; P.L. Pryor (1972), "An International Comparison of Concentration Ratios," *Review of Economics and Statistics* 130. It is noteworthy, however, that many of these studies were done at a time when tariff and non-tariff trade barriers were higher than they are today and before the current globalisation of the economy.
- ⁵ OECD, *China and the Global Economy: The Domestic Policy Challenges*, April 2002
- ⁶ Gal (2003) p. 15-18, (2000), p. 1444.
- ⁷ Gal (2003) p. 1-2.
- ⁸ Gal (2003) p. 42; (2000), p. 1448.
- ⁹ Gal (2003), p. vii-viii and 5.
- ¹⁰ Gal (2003), p. 47; Gal (2000), p. 1450.
- ¹¹ Gal (2003) p. 48.
- ¹² Gal (2003), p. 52; Gal (2000), p. 1454.
- ¹³ Gal (2003) p. 101; Gal (2000), 1466.

- 14 Gal (2003), p.55.
- 15 Joseph Stiglitz (2002), "Participation and Development: Perspectives from the Comprehensive Development Paradigm", in: *Review of Development Economics*, Vol. 6, 2, June, Special Issue on Democracy, Participation and Development, pp. 163-182, p. 164.
- 16 The following paragraphs draw on Douglass C. North (1997), *The Contribution of the New Institutional Economics to an Understanding of the Transition Problem*, *WIDER Annual Lectures*, Helsinki, March 1997. This paper summarizes the main findings of earlier work on this issue and applies them to the problem of the transition from central planning to a market economy. See also Douglass North (1990), *Institutions, Institutional Change and Economic Performance*, Cambridge University Press.
- 17 North (1997).
- 18 It is important not to confound institutions and organizations: institutions are the rules that shape behaviour. Organizations are groups of individuals with a common objective function; see North (1997), p. 1.
- 19 Kolodko defines "transition" as follows: "Transition is the historical process of complex changes leading from the centrally planned economy based upon the dominance of bureaucratic coordination and state property to an open economy based upon market coordination and dominance of private property." See Grzegorz Kolodko (2000), "Transition to a market and entrepreneurship: the systemic factors and policy options", in: *Communist and Post-Communist Studies*, Vol. 33. p. 5. Kolodko states that the necessity of a complete institutional overhaul is historically a unique experience of the former communist nations. However, in our opinion the concept of transition is of relevance for other emerging markets as well. The Latin American economies of the "lost decade", for example, were also characterized by a State with huge entrepreneurial activity, widespread price regulation and curtailing of the private sector, while many of the institutions that are necessary for a well-functioning market economy didn't exist and had to be created from scratch.
- 20 Kolodko (2000); Peter Murrell (1996), "How Far has the Transition Progressed?", in: *Journal of Economic Perspectives*, Vol. 10,2; Mario Blejer and Marko Skreb (2001), *Transition: The First Decade*, Cambridge MA; Gerard Roland (2000), *Transition and Economics: Politics, Markets and Firms*, Cambridge MA; Joseph Stiglitz (1999), "Wither Reform?", Paper presented at the World Bank ABCDE Conference 1999. It is especially noteworthy that even the International Monetary Fund, who had great influence in the design of transition policies, has cautiously recognized the shortcomings of the proposed strategies, see International Monetary Fund (2000), *World Economic Outlook: Focus on Transition Economies*, Chapter III: "Transition: Experience and Policy Issues", Washington D.C, 84 – 137.
- 21 Williamson, John (1990), "What Washington Means by Policy Reform", in J. Williamson (ed.), *Latin American Adjustment: How Much Has Happened?*, Washington: Institute for International Economics.
- 22 Johannes F. Linn, "Ten Years of Transition in Central Europe and the FUS: The Good News and the Not-So-Good News", in: Blejer and Skreb (2001).
- 23 Roland (2000).
- 24 Roland (2000).
- 25 See North (1997), p. 15.
- 26 Several authors have therefore recognized that institutional change can be looked at as a repeated game. See Roland (2000); Paul G. Hare (2001), "Institutional Change and Economic Performance in the Transition Economies", in: UN Economic Commission for Europe (2001), *Economic Survey of Europe*, No.2, Geneva, 77-99.

Shahid Javed Burki and Guillermo Perry (1998), *Beyond the Washington Consensus: Institutions Matter*, Washington; Roland (2000).

Peter Evans describes an interesting example of unforeseen interaction between policy and behaviour of agents. He tells the story of the Korean governments' efforts to promote a domestic IT industry. It first set fiscal and other incentives to promote the emergence of new entrepreneurial groups or induce established firms to start ventures in the IT-sector. After initial success the government also assisted firms that engaged in global projects. However, when international firms started to be interested in the Korean market, they tried to protect their "national champions" against foreign competition by generating heavy regulation against market entry. However, this then constituted an incentive for Korean firms to engage in joint ventures with multinational firms: unexpectedly for the policy makers, they had emancipated from protectionist policy. See *Peter Evans, Embedded Autonomy, Princeton*.

Burki and Perry (1998).

See review on empirical literature in Burky and Perry (1998).

G. Kolodko (2001), "Globalization and catching-up: from recession to growth in transition economies", in: *Communist and Post-Communist Studies* 34.

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The case was centred on the Department of Labour demanding a fee payment for the processing of certain limited term employment contracts. For further detail see S. Espinoza, "The Importance of the Elimination of Bureaucratic Barriers" in B. Boza (2000), at 250 et seq.

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See, for example, the case study of Judith Teichmann on the Argentine and Mexican reform processes. Judith Teichmann (2002), "Private Sector Power and Market Reform: Exploring the Domestic Origins of Argentina's Meltdown and Mexico's Policy Failures", in: *Third World Quarterly*, Vol. 23, No. 3, pp. 491-512.

Roland (2000).

Professor Gal has made similar recommendation small economies because they tend to display very powerful large corporations and intertwined political and economic elites. See Michal S. Gal (2002), "Reality Bits (or Bites): The Political Economy of Antitrust Enforcement", in: Barry Hawk (ed.), *International Antitrust Law and Policy*, New York: Juris Publishing, Chapter 23

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Main Literature Sources on Competition Policy in Small Economies

For those interested in doing follow-up work in this area, Professor has prepared the following summary of the most important literature, including her own.

Sources are cited alphabetically

General Literature

Michal S. Gal *Competition Policy for Small Market Economies* (Harvard University Press, 2003). A comprehensive guide to the implications of small size on competition policy. The book includes a discussion of the unique characteristics of small economies, the basic dilemmas for competition policy raised by such dilemmas, and separate chapters on the implications of these characteristics on different market structures and types of conduct (e.g. monopoly, oligopoly, merger). It also discusses the implications of small size for current attempts to harmonize competition laws.

Michal S. Gal, "Size Does Matter: The Effects of Market Size on Optimal Competition Policy" 74 *Southern California Law Review* 1437 (2001) discusses the unique characteristics of small economies and the basic dilemmas for competition policy raised by such dilemmas.

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Economic characteristics of small economies

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wholesaling and retailing sectors due to small size; and imperfect competition among firms due to concentrated market structures protected by entry barriers. This research implies that simply increasing trade will not be sufficient to improve efficiency.

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Oligopoly

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