CHAPTER V

POLICY IMPLICATIONS

Introduction

As the analysis in the preceding chapter suggests, there is a direct, necessary and enlarging relationship between the liberalization of foreign-direct-investment (FDI) policies and the importance of competition policy: on the one hand, FDI liberalization is a means of promoting competition among firms; on the other hand, in order to benefit fully from FDI liberalization, countries need to ensure that, as statutory obstacles to contestability are reduced, these are not replaced by anticompetitive practices of firms, be they foreign or domestic. This objective was unanimously endorsed by countries members of the United Nations in 1980, when they adopted the Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices. The UNCTAD Set emphasizes the need to ensure that anticompetitive practices "do not impede or negate the realization of benefits that should arise from the liberalization of tariff and non-tariff barriers affecting international trade" (UNCTAD, 1996d, p. 134). In fact, the adoption and efficient enforcement of competition legislation, including a merger-review system, can strengthen the way in which FDI liberalization can enhance market efficiency and consumer welfare and, ultimately, promote the development of developing countries.

Building on the preceding chapter, the present chapter draws policy implications concerning the interface between FDI and competition. It begins (in section A) by looking at the implications of FDI liberalization for competition in national markets. Recognizing the benefits of FDI liberalization, governments have gone beyond liberalization by actively seeking to attract FDI in a number of ways. However, some of the methods governments utilize to attract FDI come with certain competition costs. This is particularly the case when governments use market-power inducements to promote investment. The first section of this chapter therefore also examines measures that governments can take to minimize the negative effects on competition associated with such inducements. The chapter then turns to an examination of the relationship between FDI and competition law, focusing in particular on issues relating to FDI entry and post-entry activities of TNCs (section B). Next, the discussion considers broader policy implications relating to the interface between FDI liberalization and competition policy

at the national and international levels (section C). Recognizing that contestability may not always lead to desired market outcomes, the chapter's concluding section (D) deals with the question as to whether there are limitations regarding the pursuit of competition, including through FDI-contestability, especially in the light of competing objectives pursued by governments.

A. Investment liberalization

1. Liberalization of entry and operations

As discussed in chapter IV, the liberalization of FDI policies can lead to an increase in competition in national markets. Most countries, in particular developing countries, are indeed liberalizing the entry of inward FDI and have gradually extended this process to traditionally closed industries, in particular such service industries as telecommunications, public transport and other public utilities. Previous ownership and control requirements imposed on FDI have also been considerably reduced, while general authorization requirements have tended to disappear, except in certain strategic activities or industries. Operational conditions -- such as performance requirements or those relating to hiring foreign managerial personnel -- are becoming less significant. Furthermore, it is now common practice to allow foreign investors to transfer their profits abroad freely as well as to repatriate the capital invested, subject to limited exceptions for balance-of-payments considerations.[1] Of course, the reduction of such barriers has an immediate effect in terms of reducing market-entry costs and increasing, at least in principle, the contestability of markets.

Most restrictions and controls on outward FDI have also disappeared in developed countries and are being gradually reduced in a number of developing countries (UNCTAD, 1995a), thus opening the way for local firms and foreign affiliates in traditional host countries to access international markets through outward FDI.

The gradual abandonment of many FDI restrictions has been complemented by the adoption of standards of non-discrimination, national treatment and most-favoured-nation treatment for FDI. Host countries are also granting foreign investors legal protection and guarantees against non-commercial risks. By 1997, most countries had become signatories to international instruments dealing with the treatment and protection of FDI at the bilateral, regional or multilateral levels (UNCTAD, 1996d), thereby reducing risks and enhancing the stability of FDI rules, thus further reducing the costs of FDI entry. Indeed, going beyond liberalization, virtually all countries have put in place promotion programmes designed to attract FDI.

Just like trade liberalization, the FDI liberalization process can be compared to the peeling of an onion (Feketekuty, 1994). As the process advances, non-traditional barriers to entry appear. Some of these barriers are due to government measures, such as the granting of exclusive rights (including state monopolies), privatization, technical standards, public procurement practices and licensing requirements. Others -- and these are receiving increasing attention -- concern anticompetitive private business practices (Gifford and Matsushita, 1996).

Some of these practices are prohibited *per se* for their anticompetitive effects, including various types of horizontal cartel agreements. The situation becomes more difficult when moving to practices that may have anticompetitive effects but are not considered illegal under the laws of the countries in which they occur. While such practices do not necessarily discriminate between domestic and foreign firms, they may constitute barriers to competition. Traditional vertical or reciprocal dealing arrangements, for instance, may fall into this category,[2] as do

corporate governance practices that prevent other firms from taking over corporate control, be it because only a limited number of shares are traded, or corporate by-laws inhibit foreign firms from acquiring significant equity stakes in domestic firms (Janow, 1996).[3] Such corporate governance practices are of particular relevance for foreign firms seeking entry, as mergers and acquisitions (M&As) are a principal mode of entry into markets (see chapter I).[4]

Therefore, while many governments generally seem to be becoming less tolerant of most types of anticompetitive behaviour, some such practices are tolerated, and sometimes encouraged by governments, especially if their effect is primarily felt abroad. Often, moreover, the scope for anti-competitive practices depends upon country differences in legal standards and enforcement procedures and capabilities. In terms of policy implications, transparency as regards permissible private business practices and their underlying rationale should be encouraged so that their effects -- and especially their economic development implications -- can be assessed. Indeed, to the extent that a competition culture takes hold, anticompetitive business practices should become increasingly difficult to justify.

As liberalization progresses and non-traditional barriers come within the purview of policy makers, care must be taken that, in their eagerness to attract FDI, governments do not end up in situations in which they agree to inducements which, by their very nature, restrict competition (see chapter IV). Precisely because such inducements have direct anticompetitive effects, they deserve special attention.

2. Limiting market-power inducements

(a) Assessing costs and benefits

When governments consider offering market-power inducements to attract FDI,[5] the trade-offs between the benefits associated with new or additional FDI on the one hand,[6] and the immediate costs associated with a reduction of competition as regards economic welfare due to anticompetitive effects in the markets in which exclusivity is granted, on the other hand, need to be identified as clearly as possible. Moreover, since there may be downstream markets that rely on inputs provided by upstream monopolized industries or other critical industries, including many services, they may operate in suboptimal conditions and therefore attract less FDI. Naturally, the costs and benefits of market-power inducements vary significantly across industries. Hence, individual cases need to be evaluated carefully, taking into consideration the principal elements of a specific FDI project.

Once the basic assessment is made, host countries need to be as well informed about the impact of their decisions on competition, as is the case with investors wishing to invest in exchange for dominant positions and/or protection usually are. Ideally, the level of information should be sufficient to allow the authorities to judge whether an investor would still make the investment even if not granted as much monopolistic power. In addition, it would be useful to know whether checks on market-power abuses can be established. Governments need also to engage in market analysis to determine whether other investors would consider entering the market; in many cases, countries give exclusive rights only to discover that other companies would be ready to invest with less or even with no protection from competition. National competition authorities can be of assistance in this respect, and should be consulted before such inducements are given. If the needed advice is not available from experts in the host country, or if what is available is not considered sufficient, advice may be obtained, on an *ad-hoc* basis, from international organizations.

(b) Minimizing anticompetitive effects

One of the most intractable problems associated with market-power inducements lies in evaluating how much market power needs to be given away, for how long and for what range of activities in order to attract a particular investment. Firms contemplating an investment may "shop around" for the best deal among several countries with similar characteristics. Still, a number of options exist that can be utilized to minimize negative effects on competition:

- *Pre-entry competition (auctioning).* Competitive bidding can be a tool to identify whether other firms may be interested, and how much protection from competition they require as an incentive (boxes V.1 and V.2).

Box V.1. The privatization of Manila Metropolitan Water and Sewage System

The Philippines' Manila Metropolitan Water and Sewage System (MWSS) was originally operated by a Government agency. In the early 1990s, less than 70 per cent of houses in Manila had access to piped water. Half of all water flowing in the system was either lost or stolen, water prices were high, the MWSS was losing money and to upgrade and extend the system would have entailed an expected investment of about $7.5 billion over 25 years. The Government did not have such resources and decided to privatize the water system through a bidding process to a consortia which could include foreign partners.

In broad terms, the Government proposed that it would turn over the operation of the MWSS (but not the ownership of its assets) to two private consortia, one for the Eastern and one for the Western part of Manila, for a period of 25 years; each of the consortia would have to commit to meeting specified performance criteria over time (box table) but did not have to make any specific investment commitments to meet this performance.

Summary of performance requirements [a]

(Per cent of currently prevailing water rates)

Item	1996	2001	2006	2011	2016	2021
Services						
Water [b]	67	87	98	98	98	98
Sewage [b]	8	7	15	26	38	54
Non-revenue water [c]	56	37.1	31.8	29.4	27.2	25.0
Estimated capital expenditure requirements (million pesos)	1996-2001	2002-2006	2007-2011	2012-2016	2017-2021	Total
Water	16,947	18,797	15,275	9,452	8,520	68,991
Sewage	2,618	19,861	11,889	36,304	35,970	106,633
Estimated tax revenues (million pesos)	-	5,608	24,905	33,188	43,490	107,191

a These are performance requirements that the winning firms had commited themselves to meet.
b Percentage of households that have (or will have) these services.
c Water that enters the system but is not accounted for. A loss rate of about 25 per cent is normally considered an acceptable loss rate.

/...

(Box V.1, cont'd.)

The composition of the bidding consortia was also specified. In particular, each consortium was required to have a foreign partner with a minimum of 20 per cent and a maximum of 40 per cent equity ownership. Each member of the consortia was also required to meet specified minimum criteria in terms of experience/expertise, size (revenues, capital, equity) and operating history. In particular, the foreign partner was required to have experience (on several dimensions) of constructing and operating large-scale water and sewerage systems, while the Filipino partner was not.

Four consortia that met these criteria bid on the project. Each consortium was required to bid on both the East and the West areas, but no one bidder could win the operating rights to both concessions. This method was used to try to gain some measure of competition between the two concessionaires over time and to have access to two sets of cost data on which rate increases would be granted. To reduce collusion among the bidders, there was a stipulation that the losing bidders would not be allowed to participate in the project as subcontractors for the winners.

The bidding was in terms of percentages of the current prevailing water rates. With a bid of 26 per cent, the consortium led by Ayala (including Bechtel (United States) and United Utilities (United Kingdom)) was by far the lowest bidder and won the East area. Benpres (including Lyonnaise des Eaux (France)) won the West, with a bid of 56 per cent. Even through the Ayala consortium had bid 28 per cent for the West area, it could not win both concessions under the bidding rules. The bids of the other two consortia were in the range of 55-60 per cent.

Source: UNCTAD.

- *Circumscribing exclusivity in terms of time and scope.* Once some form of exclusive position is envisaged for an investor, the exclusive rights to serve a market should only be granted for a clearly defined period of time (which should be as short as possible), subject (where possible) to periodic review, re-bidding and/or phase-out. For example, a 99-year period of exclusivity appears to be rather long (box IV.7).

- *Circumscribing exclusivity through alternative sources of competition.* Even if an enterprise obtains exclusivity over an operation or product, it might not be able to exploit market power if there was competition from alternative operations or products, i.e., if the scope of the exclusivity were as circumscribed as possible. For example, a foreign investor may obtain exclusive rights to build and operate a railway connection between two cities in a country because traffic between these two cities might not be heavy enough to allow for competition between two or among more railway networks. However, other modes of transportation -- such as road, river or maritime links -- might constitute important sources of alternative competition. Competition from these alternative connections might constrain the ability of the foreign railway affiliate to raise prices excessively. In the telecommunications industry, the monopoly power of the incumbent firm owning the public fixed network is increasingly threatened by competition from wireless networks. In these two cases, policy makers should make sure that exclusive rights on a given operation or product are not extended so as to restrict competition from alternative products or operations. In some cases, this may require procedures (such as competition-law proceedings) to decide, for example, disputes about interfaces, shared networks or predatory pricing of certain services attractive to new entrants.

Box V.2. BOT in the electricity-generating industry of the Philippines

In 1991, the Philippines faced a major crisis in its electricity-generating industry: base-load capacity was substantially below demand, resulting in eight-hour scheduled blackouts for most of the country. Power rates in the Philippines were among the highest in the world. The National Power Corporation (Napocor) was the state-owned monopoly for the generation and long-distance transmission of power. Privately-owned distribution companies, such as Meralco in Manila, then distributed the power on a regional basis.

Against this background, a build-operate-transfer (BOT) programme was initiated to encourage investment in base-load electrical generating capacity. It had two major features:

- It unbundled the electrical delivery system into its two components, generation and distribution. This procedure allowed the separation of the natural monopoly of long distance distribution from the power-generation function. Even in power generation, there are substantial economies of scale relative to market size. Hence, in order to have low-cost production of electricity, the power-generation industry would have to be very concentrated.
- It allowed individual proposals for smaller generating plants and competitive bidding for the larger plants. The essential feature of the proposals and the competitive bids was the cost of electricity delivered into the transmission system. Unlike the case of the MWSS, in which the investment amount and the costs of operating the system could not be modelled accurately, for power generation, these costs can be determined with considerable precision. Hence the Government could model the investment amount as a function of capacity, operating costs and revenues to project return on investment for these projects and as a function of the length of the "operate" phase of the BOT project. Although the BOT regulation allows up to 50 years of operation, most of the contracts that have been negotiated have been in the 25 year range.

Initially, given the time pressures for increased base-load capacity, delivered prices from the BOT were in the 1.80-1.90 pesos per-kilowatt-hour range for relatively small gas turbine projects that could be implemented quickly. More recently, a 1,200 megawatt project has been negotiated with Korea Electric Power (for $1.5 billion), with costs of .78 pesos per kilowatt hour. The relatively high costs for the initial projects were due to two factors. First, these were relatively small and the cost of gas turbine generated power is high. Second, the situation in the Philippines at that time was such that the required rate of return (based on long-term bond interest rates plus a risk factor) was high. Third, given the urgency of the situation, higher returns were allowed to these investors. Over time, however, all these factors have been reversed: the power situation has improved; the proposals were for larger, coal-fired projects; and the bond rating of the Philippines and the risk of these projects has fallen.

Source: UNCTAD.

- *Fair and non-discriminatory access to essential facilities.* Where a firm is allowed to acquire essential facilities (such as transmission and distribution grids, harbours, local telecommunications services), it should be constrained, where possible, in its potential to expand its dominant position to separate but vertically related markets, or to deny rivals access to such markets. For example, the owner of an electricity-distribution grid might negate access to competing electricity generators willing to supply the market (box V.2). Therefore, before granting exclusive rights to such facilities, non-discriminatory and cost-related access conditions should be clearly defined, or it should be possible later for excluded firms to obtain relief from the competition authority. Increasing attention is being paid to the question of access to essential facilities by competition authorities, especially in service-oriented industries.

- *Break-up of a national monopolist into regional firms*. In some cases it may be possible to break up an enterprise horizontally into local or regional monopolies and to sell them separately to independent investors. Such a break-up facilitates the task of supervision and regulation. In fact, the performance of each monopolistic company can then be compared with that of neighbouring firms ("yard-stick competition"). Also, local or regional monopolists will generally have less financial and economic power than a national monopolist. This type of solution has been adopted, for example, in the Philippines (box V.1).

- *Periodic review by competition authorities*. The competition authority could be requested to monitor periodically whether exclusivity has been abused; it could also be empowered to receive complaints about the exclusion of rivals.

- *The role of direct regulation of prices*. For products and services whose provision is supplied monopolistically to final consumers, direct regulation may be needed, although not necessarily by the competition authority. Such regulation has to take into account consumer interests, as well as investors' expectations of adequate rates of return on their investment. It may also be useful to establish certain performance criteria (box V.1), including by using comparisons with analogous industries in other countries as performance benchmarks.

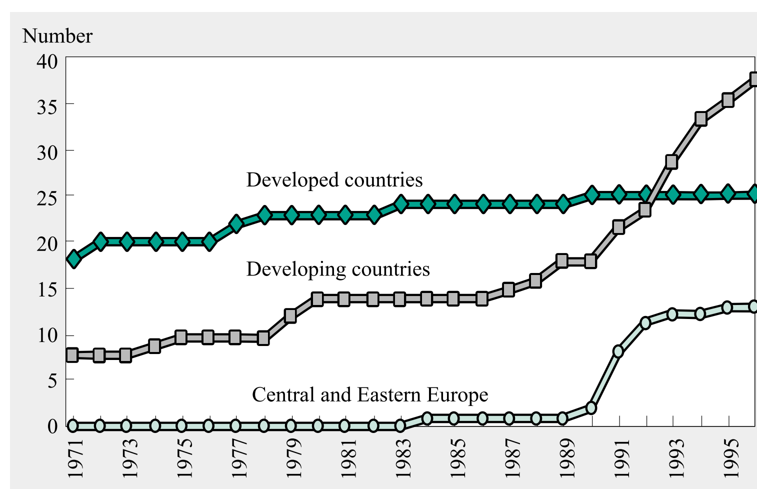
In conclusion, the inherently anti-competitive nature of market-power inducements calls for a cautious scrutiny of such deals. This scrutiny should entail two steps: first, assessing whether a market-power inducement is necessary in the first instance to attract the investment in question; second, circumscribing as much as possible the market-power inducement granted.

B. The interface of foreign direct investment and competition law

1. The growing emphasis on competition law

One of the recommendations of the UNCTAD Set was that member countries adopt, improve and effectively enforce laws for the control of restrictive business practices. In 1980, less than 40 countries had competition laws (figure V.1). The pace of adoption increased rapidly after 1989, when former centrally planned economies in Central and Eastern Europe introduced comprehensive programmes of investment liberalization, deregulation, privatization and competition-law enforcement, and a number of developing countries also adopted competition laws. Currently, over 70 countries worldwide have competition laws (figure V.1 and annex table A.22). Moreover, many of these laws have been strengthened in the past decade, in terms of stricter and broader rules and higher penalties.

Figure V.1. Number of countries with competition laws, 1971-1996



Source: UNCTAD, based on national reports and various sources.

Investment liberalization and the adoption of competition laws have received impetus from the growth of regional free trade and integration agreements. The European Union, for example, includes the institution of a system for ensuring that competition is not distorted in the internal market as one of the means of attaining the basic goals of the Union. Competition is covered in the Treaty of Rome; in addition to the traditional goal of competition policy, it aims at reinforcing the unity of the internal market by eliminating obstacles to trade resulting from the behaviour of firms or governments. When NAFTA was created, Mexico introduced important reforms in its investment legislation and adopted a competition law comparable to that of its NAFTA partners. Since then, other countries in the Western Hemisphere have concluded free-trade agreements reflecting approaches similar to NAFTA, while discussions are proceeding on the establishment of a Free Trade Agreement for the Americas, covering, among other things, FDI and competition matters. This process may receive further impetus in the future. For example, at the multilateral level, the Agreement on Trade-Related Investment Measures (TRIMs), concluded as part of the Agreement creating the World Trade Organization, provides (in its Article 9) for the possibility, as part of its five-year review, of complementing the Agreement with provisions on investment policy and competition policy.

2. Main elements of competition law

The main objective of competition laws is to preserve and promote competition as a means to ensure the efficient allocation of resources in an economy, resulting in the best possible choice of quality, the lowest prices and adequate supplies for consumers (UNCTAD, 1996f).[7] In addition to promoting efficiency, many competition laws make reference to other objectives, such as the control of concentration of economic power, promoting the competitiveness of domestic industries, encouraging innovation,[8] supporting small and medium-size enterprises and encouraging regional integration (Goldman, Kissack and Witterick, 1997).[9] Some of these additional objectives may sometimes be in conflict with the efficiency objective (see below). The manner in which efforts are made to reconcile these conflicting objectives can be relevant to the way TNCs are allowed to enter and operate in domestic markets.

Most competition laws deal with enterprise *behaviour* by prohibiting such restrictive business practices as competition-restricting horizontal agreements, acquisitions and abuses of dominant positions,[10] as well as substantially restrictive vertical distribution agreements (box V.3).[11] In addition, an increasing number of competition laws deals with alterations to the *structure* of markets, through the control of M&As, as well as joint ventures (hereinafter referred to as "merger control") aimed at avoiding the creation of dominant firms, monopolies, or even oligopolies. In some laws, the divestment of parts of monopolies is also authorized, to change the structure of markets.

Most competition laws contain exceptions (basically sectoral) and exemptions (in most cases adopted in respect to categories of practices) to the application of their provisions. These can cover, among others, labour, regulated industries (e.g., telecommunications, defence, agriculture), small and medium-size enterprises, and certain types of cooperative arrangements, including R&D joint ventures. The rationales behind exemptions vary. In some cases (market failures, for example), competition and market forces are not viewed as the best tools leading to the maximization of economic efficiency; rather, direct regulation of prices or entry is used. A number of countries, however, are reviewing the soundness and validity of those across-the board exemptions. The emphasis is increasingly on applying competition law to all business practices not explicitly imposed on firms by statutory provisions. It is then the task of the competition authority or courts to consider business practices, and focus on those that have the highest probability of anticompetitive effects and the least justification based on efficiency.

Box. V. 3. Selected restrictive business practices addressed by competition law

There are four main types of business practices that can have anticompetitive effects: practices undertaken by a single firm (when a firm enjoys a dominant position); anticompetitive mergers and acquisitions; horizontal restraints (i.e., arrangements between competitors to restrain competition) and vertical restraints (anticompetitive arrangements between firms along the production-distribution chain). Horizontal and vertical restraints include the following arrangements, which can be undertaken individually or in combination:

Horizontal restraints[a]

Price fixing	Competing suppliers enter into cooperative agreements regarding prices and sales conditions.
Restraint of output	Competing suppliers enter into agreements regarding output and product quality.
Market allocation	Competing suppliers allocate customers amongst themselves, who therefore cannot benefit from competition by other suppliers.
Exclusionary practices	Competing suppliers employ practices that inhibit or preclude the ability of other actual or potential suppliers to compete in the market for a product.
Collusive tendering (bid-rigging)	Competing suppliers exchange commercially sensitive information on bids and agree to take turns as to who will make the most competitive offer.
Conscious parallelism	Competing suppliers generally set the same prices, but without an explicit agreement.
Other restraints on competition	Generally characterized by suppliers entering into cooperative agreements not to undertake certain actions of competitive value (e.g., advertising).

Vertical restraints

Exclusive dealing	A producer supplies distributors and guarantees not to supply other distributors in a given region.
Reciprocal exclusivity	A producer supplies on the condition that the distributor does not carry anybody else's products.
Refusal to deal	A supplier refuses to sell to parties wishing to buy.
Resale price maintenance	A producer supplies distributors only on the condition that the distributor sells at a minimum price set by the supplier.
Territorial restraint	A supplier sells to distributors only on the condition that the distributor does not market the product outside a specified territory.
Discriminatory pricing	A supplier charges different parties different prices under similar circumstances.
Predatory pricing	Suppliers sell at a very low price (or supply intermediate inputs to competitors at excessive prices) in order to drive competitors out of business.
Premium offers or loyalty rebates	A dominant supplier offers discounts or other inducements only to certain parties on the condition they do not sell someone else's products.
Tied selling	Producers force purchasers to buy goods they do not want as condition to sell them those they do want, or force resalers or wholesalers to hold more goods than they wish or need.
Full-line forcing	A supplier requires distributors, for access to any product, to carry all of the supplier's products.
Transfer pricing	May involve over-invoicing or under-invoicing of intermediate inputs between foreign affiliates. Under -invoicing can be used to facilitate predatory pricing.

Sources: UNCTAD, 1996g; Boner and Krueger, 1991, pp. 50 and 56.

a These may take the form of domestic cartels, import cartels, export cartels and international cartels.

Usually, such cartel practices as price fixing, collusive tendering and market allocation are prohibited without need for market analysis, while distribution, joint ventures and merger agreements are assessed in a market context and increasingly under a rule-of-reason standard taking into account the efficiencies likely to be achieved and passed on to consumers.

At the heart of the analysis of non-cartel anticompetitive practices is the assessment of the extent of dominant position of market power held (or to be acquired) by a firm in question. "Dominant position of market power" is defined generally as the ability to affect prices and other conditions without being challenged by competitors. To determine whether a firm has dominant market power, a competition authority must first define the relevant market (i.e., the market of reasonably substitutable goods and services), both in terms of the geographical area and the product or service involved. After the relevant market is defined, the next step is to examine the relative position of the firm(s) involved in the market, using various measurements of concentration. Once the degree of market concentration is estimated,[12] another main element in competition analysis is to look at entry barriers, i.e., contestability. In the absence of significant barriers to market entry, incumbent firms are not likely to behave anti-competitively because any attempt to do so is likely to bring about supply responses, including entry into the market of new firms.

3. Competition law and foreign direct investment

Competition laws apply to all firms operating in the national territory and supplying a particular market, whether through domestic sales, imports, foreign affiliates or non-equity forms of FDI. They do not, in principle, discriminate between national and foreign firms or between foreign firms from different national or regional origins when it comes to competition analysis. Competition law therefore monitors the competitive behaviour of TNCs having effects in host countries, with a view towards ensuring that these firms (like other firms) do not abuse dominant positions of market power; it also protects TNCs from anticompetitive practices by national firms. On a wider geographical scale, competition law intends to prevent inefficiencies arising from agreements designed to lessen trade or investment.

Some of these agreements can take the form of international market-allocation investment cartels between potential rival firms in different countries. They can include promises not to invest in certain markets or not to compete when investing. For example, in the United States v. Diebold, Inc. case (United States, District Court for the Northern District of Ohio, 1976), the United States antitrust prosecutors charged that Diebold, a leading United States manufacturer of safes and bank equipment, and Chubb, the leading British firm in the same field, had agreed to stay out of each other's national markets. The case resulted in the payment of criminal fines. By their very nature, such market- allocation investment cartels restrict competition occuring through FDI, typically to the detriment of host countries, and therefore require action on the part of competition authorities (box V.4).

But such cases appear to be comparatively infrequent. Usually, the main interface between competition law and FDI occurs when a foreign affiliate is established by means of a significant merger, acquisition or joint venture.[13] This is especially the case when a large competitor acquires another. (It should be noted, however, that most of the some 40,000 TNCs in existence are small or medium-sized firms; a number of them, however, may be large in relation to the markets in which they compete.) Such transactions may be examined by competition authorities under merger-control review, especially when they occur between competing firms, such as when the acquiring foreign investor was competing through exports with the domestic firm it plans to acquire. They may also be subjected to anti-monopoly

provisions if they are viewed as a means to achieve or preserve a dominant market position. Sometimes, furthermore, joint ventures may involve a market-allocation investment cartel to restrict FDI. Countries are therefore increasingly adopting merger-control regulations. Among countries with such regulations, four broad types can be identified, based principally upon the territorial scope for review (annex table A.23):

Box V.4. Market-allocation investment cartels

The National Lead case is an instructive example of a situation in which the major worldwide competitors in titanium pigment technology formed a series of joint ventures in new markets such as Japan, and allocated those markets among themselves as exclusive territories. As part of the overall scheme, National Lead signed a contract with its principal North American competitor of the day, Canadian Industries, Ltd., under which the two companies established a Canadian joint venture, which became the beneficiary of all present and future titanium patents of both companies.

One of the most notable cases involving market-allocation investment cartels was Timken Roller Bearing Co., where United States Timken had agreed with its major international rival in the ball bearing business, a British firm also called Timken, to set up a scheme pursuant to which they entered new markets as partners (such as by creating French Timken), fixed prices in each others territories, allocated territories, cooperated to protect each other's markets, and participated in cartels to restrict exports.

Source: United States, Southern District Court of New York, 1945; United States, Supreme Court, 1951a (which contains the decision on the National Lead case), 1951b.

- *Regulations that apply only to locally registered companies*. For example, up to 1997, the competition authority of Hungary only reviewed M&As between locally registered companies.

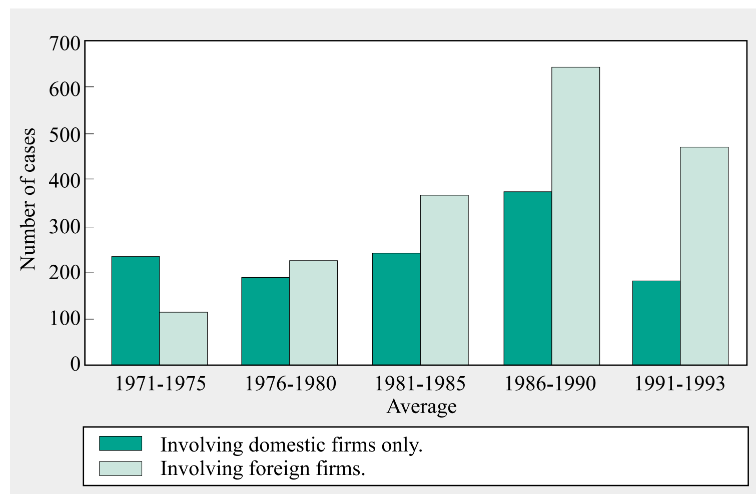
- *Regulations that cover acquisitions by foreign firms of domestic firms*. Most countries with merger regulations examine M&As between foreign and domestic firms, just as they would review purely domestic M&As. This reflects the increasingly important share of M&As that involve foreign participation. Hungary, for example, changed its merger regulations in 1997 to cover M&As involving foreign and domestic firms. The importance of such cases can be illustrated for Canada: foreign firms accounted for about a third of M&As during 1971-1975, with domestic firms accounting for the balance -- a ratio that was more than reversed by 1991-1993 (figure V.2).

- *Regulations that cover acquisitions of foreign firms by domestic firms*. This aspect of merger regulation relates to outward FDI and can be motivated by potential domestic effects.[14] For example, 6 per cent of notified mergers in Germany in 1993 were of this nature, and 19 per cent in the United Kingdom (OECD, 1997).

- *Regulations that cover M&As between foreign firms*. In this case, the examination can be motivated either by the presence of one of the merging firms in the domestic market or, through the effects doctrine, by the potential for the merger to have anti-competitive effects on local consumers. In Germany, 6 per cent of notified M&As in 1993 did not involve German firms (OECD, 1997). The recent European Union challenge to the Boeing-McDonnell merger is an example of this situation.

The following analysis of how competition law interacts with FDI distinguishes between competition rules applying to FDI at the time of entry and competition rules relating to foreign affiliates after entry. Given the multiple interactions between FDI, market structure, firm behaviour and market performance, such a classification has many limitations. It is therefore intended only for purposes of clarity and simplicity of presentation.

Figure V.2. Foreign firms in publicly reported mergers in Canada, 1971-1993



Source: UNCTAD, based on national reports and various sources.

(a) At-entry inward merger review

i. General trends

Data from enforcing countries indicate that merger control is usually not greatly restrictive of investments. For example, in 1987, United States officials conducted antitrust reviews of about 2,000 M&As in which one party had a turnover exceeding $100 million and in which more than $15 million in assets were being acquired. About 10 per cent of these transactions were subjected to a full investigation, and about 1 per cent of them were challenged, resulting in partial divestitures or abandonment. The percentage of international transactions (FDI) investigated (10 per cent) and challenged (1 per cent) was about the same as for domestic transactions (Davidow and Stevens, 1990). Similarly, the European Union has only prevented about one transaction in a 100, and has required alteration of about 5 transactions out of each 100 during the early 1990s (Fine, 1994).

Because M&As are dependent on current stock values and are difficult to unscramble once achieved, merger control requires a carefully calibrated system providing for prior notification, rapid analysis, temporary injunctions and prompt decisions.[15] Most countries use turnover or other thresholds to exempt transactions unlikely to have anticompetitive effects in order to minimize unnecessary interference and limit the number of cases screened by the competition authorities. In this respect, countries interested in introducing merger control need to select an appropriate threshold. Too low a threshold would overburden the competition authorities by forcing them to review a large number of cases; too high a threshold would allow a number of M&As with competition problems.

For these reasons, many countries with a competition-law tradition, such as the United States and Germany, have long complemented their competition rules dealing with firm behaviour with special provisions and procedures concerning M&As. In recent decades, this practice has been followed by other countries which, as they adopted or strengthened their competition laws, included merger-control regulations, sometimes under a separate statute. The list of countries which now have merger-control provisions is growing, although it is much

shorter than the list of countries with competition laws (annex table A.23). These trends underline the increasing importance of merger-control as a means of promoting competitive behaviour and efficiency in an open FDI and trade environment.

At the regional level, too, merger control is gaining increasing attention. The European Union introduced a Community-wide merger-review system in 1989 (Council of the European Communities, 1989). To qualify for Community merger review, the aggregate turnover of the companies involved in a transaction must exceed ECU 5 billion; and the turnover of at least two of the companies involved must exceed ECU 250 million in the European Union. Regional competition-law review of large concentrations has created the advantage of “one-stop shops”: although a majority of member states of the European Union have merger-control laws of their own, where the transaction has a “Community dimension”, it will only be reviewed at the Community level. If a transaction’s effects will be felt almost entirely within one member country, that country will have jurisdiction. Such a process is meant to result in there being only one authority evaluating a transaction. Similar systems could eventually be developed by other regional treaty organizations as well, although it is not an easy task.

It is a premise of most merger-control laws to be neutral about the nationality of the acquiring or acquired party. Occasionally, however, factors other than simple competition questions affect decisions on cross-border M&As. The United Kingdom statute (United Kingdom, Fair Trading Act, 1973, as amended by the Company Act, 1989), for example, lists a series of factors in addition to what would normally be regarded as competition factors, including:

- maintaining and promoting a balanced distribution of industry and employment in the United Kingdom;

- maintaining the competitiveness on foreign markets of producers and suppliers of goods and services in the United Kingdom.

The latter point has in the past given rise to some controversial rulings. For example, the proposed merger of Davy Limited, then the largest engineering contractor in the United Kingdom, with the United States-based energy group, Enserts Corporation (United Kingdom, Monopolies and Mergers Commission, 1981), was rejected by the Monopolies and Mergers Commission of the United Kingdom for three reasons (Hawk, 1995): that the Davy group would lose its character as a British bidder on foreign markets; that the merger would unproductively lengthen the chain of management command; and that the merger would expose the company to United States law, in particular the Foreign Corrupt Practices Act 1977.[16]

The United Kingdom is not the only country to have provisions in its competition law that allow for the consideration of national interest issues.[17] In Germany, for example, parties to a prohibited merger can appeal the prohibition directly to the Federal Minister of the Economy under Section 24.3 of the Act Against Restraints of Competition who may grant permission for the merger to proceed:

> "in those cases where the restraints on competition are outweighed by the overall economic advantages of the merger, or where the merger is justified by an overriding public interest; in this connection, the competitiveness of the participating enterprises in markets outside of the territory of application of this Act shall be taken into consideration... " (Rowley and Baker, 1991, p. 188).

This power was used by the Minister in permitting the merger of Daimler Benz and MBB in 1989 (Germany, Federal Cartel Office, 1989; Germany, Ministry of Economics, 1989). In this case, the Federal Cartel Office prohibited the merger; however, the Government of Germany overrode the Cartel Office's decision and permitted the merger to go forward.

ii. Typical scenarios involving mergers and acquisitions

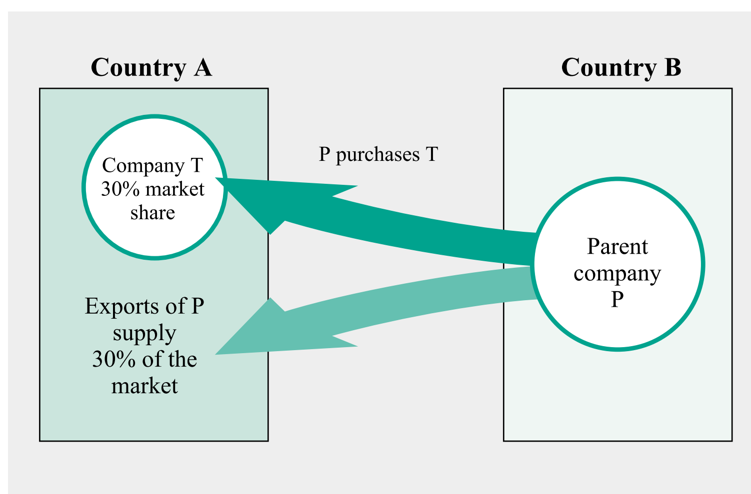
In practice, a distinction can be made between vertical and horizontal M&As. Most interventions by competition authorities occur with horizontal agreements between competitors. A new challenge in this regard are strategic alliances, i.e., cooperative ventures that do not involve equity arrangements. In rare cases, a major vertical acquisition (i.e., of a customer or supplier) may lessen competition horizontally by foreclosing outlets or sources of supply, and by raising the cost and difficulty of new entry. For instance, if a firm that has captured 40 per cent of a market by means of exports then purchases a local chain of outlets, usually accounting for 60 per cent of local sales, such acquisitions might enable the acquiring firm to raise its local market share towards 60 per cent by forcing its products through the outlets it acquired. Therefore, FDI involving the acquisition of a supplier or customer will usually be analysed in terms of the market shares involved, the likely foreclosure of rivals, and the substitute supplies or assets available to rivals.

A number of countries allow a failing firm contention to be raised as a defence to what would under normal circumstances be regarded as a M&A that leads to excessive concentration.[18] When this defence is raised in the home countries of TNCs, competition authorities in third countries need to consider whether it reasonably applies to foreign affiliates. In particular, where a foreign affiliate is capable of standing on its own, and is not failing in the same manner as the rest of the corporate system, the third country merger authority could consider whether it should force the sale of that affiliate, in particular where the merger of the affiliate with a local affiliate of the acquiring firm would be anticompetitive.

There are a number of typical scenarios of horizontal cross-border M&As. The evaluation of each case depends on whether the firms involved are competing with each other or not, and whether the guiding principles of the competition authorities concerned emphasize potential exercise of market power or dominant positions:

- Inward FDI could create competition issues when it takes the form of acquisition of a firm in a market in which that firm was competing with the acquiring firm prior to the M&A. This would occur if the acquiring firm had exported to the market before acquiring a firm in the market (figure V.3), or if a foreign firm, owning one firm in the market, acquired another firm in the

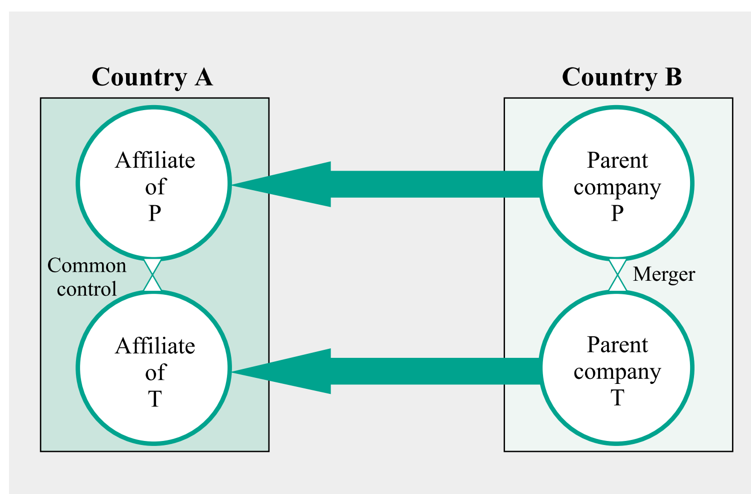
Figure V.3. Reduction of competition in country A by exporter P purchasing domestic rival T



Source: UNCTAD.

same market (figure V.4).

Figure V.4. Reduction of competition in country A by parent P of affiliate T acquiring foreign rival S

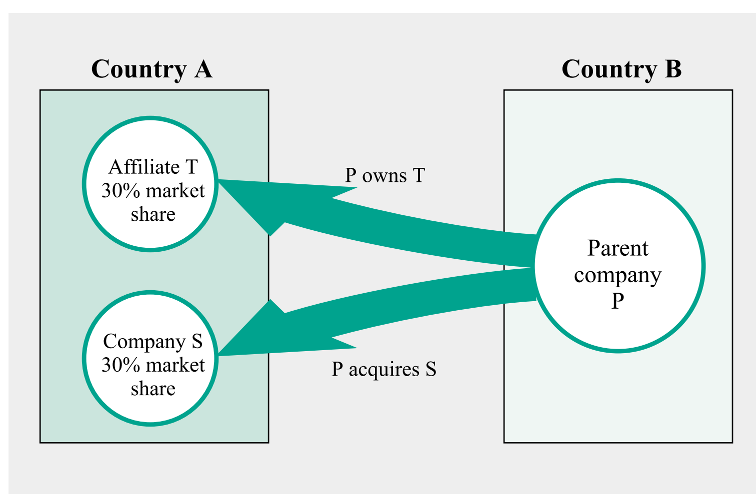


Source: UNCTAD.

- Competition problems may also occur where one foreign firm uses FDI to set up a major plant in a market, another firm does the same thing, and then the two foreign firms agree to merge (or one takes over the other), thereby eliminating local competition between their two affiliates (figure V.5). In the case of the merger of the Swiss firms Ciba and Geigy, the United States Antitrust Division initiated legal proceedings because the United States affiliates of the merging firms were substantial competitors of each other. The case was settled by means of a consent decree obligating the newly merged firm to sell off one of the two United States affiliates (United States, Northern District Court of Ohio, 1970). A similar case occurred in Mexico (box V.5).

- Sometimes joint ventures that have elements of cartel-like behaviour can be examined under merger-control law, primarily in terms of the elimination of potential competition. Thus, if a foreign firm enters a market by means of a joint venture with a local firm, the issue arises as to whether the foreign firms would have been likely to have entered the market separately and competed with the local firm in the absence of the joint venture. For instance, the United States antitrust authorities ruled that a joint venture involving FDI was illegal in the "Mobay" case (United States, District Court of Pennsylvania, 1967) in which the company Monsanto headquartered in the United States had formed a United States joint venture with the German company Bayer to manufacture plastic foam. Because Bayer was a large European competitor in this industry and had planned to enter the United States market by means of a greenfield project, the joint

Figure V.5. Reduction of competition in country A by merger of parents P and T in country B



Source: UNCTAD.

venture with Monsanto was regarded as preventing Bayer's independent competition in the United States market.

- Competition-enforcement officials have sometimes tried to encourage greenfield investment by means of merger-control prosecutions. But, as the case of the United States Federal Trade Commission v. British Oxygen Corporation shows, this is not always easy (box V.6).

- Some cases turn on whether the acquiring firm will have an incentive to suppress rather than develop the competitive potential of the firm to be acquired (box V.7).

- The merger of two foreign parent firms can sometimes create more significant competition issues in countries other than the host or home countries of the merging firms, i.e., in third countries. The merger of the leading suppliers of tea in the United Kingdom and their affiliates in Pakistan, e.g., appears to have had important implications for Kenya as a producer of tea (box V.8).

Box V.5. Merged parent firms, merged foreign affiliates

Just prior to liberalizing its investment rules under the NAFTA agreement, Mexico enacted its new competition law, including a regime for merger review. A major ruling under the new system related to the proposed acquisition of Scott Paper by Kimberly Clark. Both firms were headquartered in the United States, but each had foreign affiliates in Mexico, which had captured a significant share of the Mexican paper-products market. In particular, a combination of the affiliates would have given the merged firm 67 per cent of the paper-napkin and towel market, and 63 per cent of the feminine hygiene products (pad and tampons) market. The Mexican Federal Competition Commission ordered Kimberly Clark to divest two major brands of napkins and towels, and three major brands of feminine hygiene products, thus reducing the resulting market shares to 50 per cent or less.

Source: Mexico, Federal Competition Commission, 1996.

(b) Outward merger review

In principle, outward FDI can be expected to be competition-neutral for the home country -- since its effects would be primarily felt abroad -- or even to have pro-competitive effects, as it enhances access to foreign markets and to foreign productive resources by domestic firms, thereby making the outward investing firms stronger to compete in local and foreign markets. For countries supporting national champions, such effects are particularly desirable. However, competition authorities in some home countries will review outward M&As that can have anticompetitive effects in their domestic markets, or on their foreign trade.

The definition of "domestic effects" with respect to outward M&As needs to be seen in the context of the purposes of the competition laws in the relevant home country.[19] In essence, however, the basic concern tends to be the same for most jurisdictions, namely whether the outward investing firm acquires control of a foreign firm that otherwise would have been

Box V.6. Encouraging greenfield investment

The United States Federal Trade Commission challenged British Oxygen Corporation's (BOC) acquisition of the number three United States firm in its field, arguing that BOC had entered Canadian and South American markets by means of greenfield investment and thus had eliminated the deconcentrated effect of its probable greenfield investment in the United States by acquiring a major United States' firm. The reviewing court, however, upheld the acquisition on the grounds that, since BOC had no proved time-specific plans for greenfield investment in the United States in lieu of the acquisition, the charge against it was purely speculative.

Source: United States, Second Circuit Court, 1997.

Box.V.7. Suppressing versus encouraging competitive potential

In 1988, Irish Distillers had a monopoly of the manufacture of Irish whiskey (owning all the major brands) and was regarded as poorly performing and thus a candidate for acquisition. At the same time, the Scottish whisky (Scotch) industry was highly concentrated, its major brands being largely owned by three major companies, one of which was Grand Metropolitan. Grand Metropolitan launched a takeover bid for Irish Distillers. The bid illustrates a number of complicated problems. First, although different products, Scotch and Irish whiskey compete for the same markets, and Irish whiskey is usually regarded as the closest substitute for Scotch. Nonetheless, Grand Metropolitan promised in its bid to invest substantial sums in promoting Irish whiskey and developing the industry. However, historically the major Scotch whisky producers had bought numerous competing Scottish distillers and closed them down, eliminating brands. Ultimately, the Irish authorities blocked the merger, a decision made easier because a third company, Pernod Ricard, was waiting in the wings to purchase Irish Distillers.[a]

Prior to Grand Metropolitan's solo takeover bid for Irish Distillers, there was a hostile takeover bid by a consortium of all three of the large Scotch whisky distillers, Allied Lyons, Guinness (United Distillers) and Grand Metropolitan. After Irish Distillers complained to the European authorities, this takeover bid was the first acquisition blocked by the Commission by threat of imposing interim measures.

Sources: Rowly and Baker, 1991; Morrissey, 1989.

likely to compete in the acquirer's country (figure V.6). This is reflected, for example, in the German merger guidelines (box V.9).

Normally, a country would review an outward M&A if the acquiring firm is established in that country or is under the control of a firm established in that country and acquires control of another company abroad, provided that certain threshold tests are met. For example, in the United Kingdom for an outward merger to be reviewed, it must meet either of the following tests: the enterprise that ceases to be distinct must supply or acquire goods or services of a similar kind and must together supply or acquire at least 25 per cent of all those goods or services supplied in the United Kingdom or a substantial part of it; or the gross value of the worldwide assets been acquired must be more that £70 million (United Kingdom Office of Fair Trading, 1995).

Box V.8. Third country effects of mergers of parent firms and their foreign affiliates

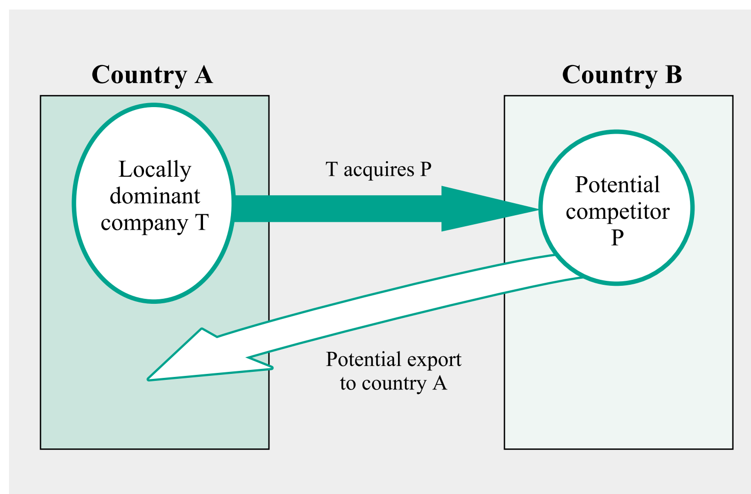
As a result of the merger of Lipton and Brooke Bond into Unilever Plc., both headquartered in the United Kingdom, two leading tea suppliers to Pakistan, Lever Brothers Limited and Brooke Bond Pakistan Limited, fell under common control, with 75 per cent and 58 per cent of their shares respectively being owned by Unilever. An investigation by the Pakistan Monopoly Control Authority found that prices for Kenyan tea paid by Lever Brothers Limited and Brooke Bond to related companies in Kenya were higher than prices paid to unrelated international buyers to those related companies. The Pakistan competition authority entered into negotiations with Unilever as a result of which Unilever agreed to withdraw one of its brands and reduce its shareholding in Brooke Bond Pakistan to 40 per cent.

What is particularly interesting about this case, however, is the effect the merger of the parent companies and consequently their affiliates in Pakistan may have on tea-growing countries from which the former separate affiliates purchased their tea. The problem, perhaps for Kenya, is that two major purchasers of Kenyan tea have merged. This could mean that Unilever had become a dominant purchaser of Kenyan tea, allowing it to a much greater degree to control the prices at which tea is sold to its various companies. It is unclear if a practical remedy would be available to such a supplier country.

Source: UNCTAD, 1995d.

Since the European Merger Regulation entered into force in 1990, outward transactions having a "Community dimension" are being reviewed by the European Commission.

Figure V.6. Reduction of potential competition in country A by locally dominant company T acquiring potential foreign competitor P



Source: UNCTAD.

Competition authorities have intervened on various occasions when outward FDI choices made by their domestic companies are likely to stifle a possible source of competition (box V.10). Countries that do are likely to face situations in which the same transaction is also reviewed by other countries -- at least by the host country in which the transaction takes place and, possibly, also other jurisdictions affected by the transaction. Of course, all affected countries would want to be sure that their interests are safeguarded. There is, therefore, a tendency for a (especially large) transaction to be reviewed by multiple jurisdictions, which involves, among other things, subjecting the parties to a transaction to increasing uncertainty (which, in turn, might deter desirable mergers from taking place). Moreover, individual national merger reviews might in some instances lead to results unacceptable to the other countries having an interest in the transaction. In such situations, the results in the first reviewing country might be met with objections from the other countries. A number of countries have tried to resolve some of these problems by increasing cooperation among their national competition authorities (see below).

Box V.9. The German Federal Cartel Office Guidelines on "domestic effects" for the review of outward mergers

The guidelines on "domestic effects" issued by the Federal Cartel Office of Germany specifically refer to outward mergers as follows:

"B. Mergers completed abroad have domestic effects if the merger affects the structural conditions for domestic competition and if a domestic enterprise (including subsidiaries and other affiliated companies) is a party to the merger.

1. As regards mergers effected abroad between two directly participating enterprises only (all merger situations except for the formation of joint ventures, e.g., acquisitions of the assets or the shares of a foreign enterprise by a domestic enterprise):

   a) there are domestic effects if both enterprises were already operating in the Federal Republic before the merger either directly or through subsidiaries, branches or importers;

   b) there may be domestic effects, if only one of the enterprises was operating in the Federal Republic before the merger but if, for instance,

/...

(Box V.9, cont'd)

aa) after the merger a foreign party to the merger is likely to deliver goods to the Federal Republic due to production links with the domestic party (preceding or subsequent production stages) or links relating to the range of products. Where such future deliveries to the Federal Republic are likely usually depends on whether goods of the same or similar kind are already covered by trade between the countries involved and whether there are no technical and administrative trade barriers to such deliveries;

bb) the know-how of a domestic enterprise is perceptibly enhanced or industrial property rights accrue to it as a result of the merger.

2. As regards the formation of joint ventures abroad, the domestic effect primarily depends on the product and geographical markets on which the joint venture operates. The question of when a joint ventures's activities have domestic effects is determined on the principles set out under B.1; in this connection the production links and /or links affecting the range of products have to be judged by the relationship between the joint venture and the domestic party.

Furthermore, the formation of a joint venture abroad may also have domestic effects, if

a) a foreign enterprise participating in the joint venture was already operating in the joint venture's field of activity with the Federal Republic before the merger or if it can be reasonably expected to enter the market without the merger (cf. B.1.aa);

b) the domestic party to the joint venture thereby obtains additional production capacity which perceptibly alters its capacity available for domestic supply (substitution or domestic production destined for exportation by production abroad). In general, it is a prerequisite for a change in capacity being perceptible that the domestic party already enjoyed a strong market position before the merger."

Source: Germany, Federal Cartel Office, 1975, p. 45.

Box V.10. Outward FDI reviewed

The United States challenged in 1968 the acquisition by its largest supplier of safety razors and blades, Gillette, of the third largest European manufacturer of electric razors, Braun, on the basis that Gillete would prevent Braun from competing vigorously in the United States market. The case was settled with a consent decree which required Gillette to divest the right to sell Braun razors in the United States to a company to be established.

The German competition authority prohibited, in 1993, the acquisition of the Allison Transmission Division of General Motors by the German company Zahnradfabrik Friedrichshafen. This latter company was the main supplier of gearboxes worldwide, whereas Allison was the second largest supplier in Germany and Europe. There were only two other competitors worldwide, both with much smaller market shares. In its decision, the Federal Cartel Office also took into account that the merged entity would have a dominant position worldwide.

In 1996, the German company Mahle took over the Brazilian firm Metal-Leve. Both firms produced automobile components. Mahle had a rather strong market position for special automobile components in Germany; but as Metal-Leve had only a very small market share in Germany (less than 2 per cent), the merger was allowed.

Sources: UNCTAD, based on OECD, 1994; United States, District Court of Massachussetts, 1968, 1975a, 1975b; Germany, Federal Cartel Office, 1993, 1996.

(c) Worldwide dominant positions

Certain cross-border M&As might have dimensions that are specifically international, i.e., that are not perceived purely from a host or home country perspective. For example, a certain merger might have the effect of facilitating global oligopolistic coordination among a limited set of producers, reducing the contestability of markets worldwide. This could be the case if global production networks were concentrated in the hands of a small number of TNCs. Such cases typically arise in situations in which a transaction affects product markets in which firms compete at the regional or global level.

There have been a few cases that illustrate competition authorities' desire to scrutinize investments that are likely to lead to, or augment, a worldwide dominant position. Such cases may involve inward FDI in one investigating jurisdiction and outward FDI in another. Each jurisdiction would typically focus its review on the competitive effects of a transaction on its national market. But, beyond that, one or more jurisdictions involved may object to the increase in worldwide concentration (box V.11).

In this respect, a distinction should be made between M&As that affect worldwide product markets discussed so far (and illustrated in the Aérospatiale-Alenia/ De Havilland case) and M&As involving firms that supply multiple but segmented regional or national markets worldwide, such as, for example, the merger between Gillette and Wilkinson Sword which was investigated in fourteen jurisdictions (European Commission, 1992).[20] In the first type of situation, the competitive effects within national jurisdictions are indistinguishable from worldwide effects because the market is global. In the second type of situation, the competitive effects differ from market to market. In either case, the task of sorting out the costs and benefits lies at present largely with national competition authorities.

Box V.11. Worldwide concentration

The merger case of the *Aérospatiale-Alenia/De Havilland* involved the proposed sale by Boeing of the United States of a Canadian company, De Havilland to a Franco-Italian consortium, Aérospatiale-Alenia (better known as ATR). De Havilland and ATR are the two most successful manufacturers in the world of mid-size regional turboprop airliners, in particular the De Havilland DASH series of aircraft and the ATR 42 and 72. In certain size categories, there were, at the time of the proposed merger, no significant competitors worldwide for the DASH and ATR 42 and 72 aircrafts. The transaction was reviewed by both the United States and European Union merger authorities. The European Commission, acting first, blocked the merger. Apart from its international implications, Aérospatiale-Alenia/De Havilland is considered significant as the first merger transaction enjoined by the European Commission.

The Canadian Competition Bureau decided not to challenge the merger because of the efficiency gains in Canada, and limited anticompetitive effects on the small Canadian market for commuter aircraft, and because of the potential that De Havilland was a failing firm.

A recent outward FDI case was the acquisition, by Gencor Limited of South Africa and Lonrho Platinum of the United Kingdom, of joint control of the whole of the company Impala Platinum Holdings Limited ("Implats"). The acquisition was blocked by the European Commission after conducting an investigation in which it concluded that the result of the operation would be the creation of a dominant duopoly position in the platinum and rhodium market worldwide between Amplats/LPD and Implats/ LPD, as a result of which effective competition would be significantly impeded in the common market within the meaning of Article 2 (3) of the Merger Regulation.

Sources: European Commission, 1991, 1996a.

(d) Post-entry competition issues

While the liberalization of FDI and trade regimes can be a means of promoting competition, the possibility of anticompetitive practices by firms requires the continuous attention of competition authorities. In fact, even in a national framework in which “trade” and investment are fully liberalized, the possibility of such practices provides one of the rationales for the existence of competition laws. In other words, the removal of international barriers to trade and investment alone would not ensure competitive behaviour in all instances. Therefore, while a FDI entry transaction may be competitively unobjectionable, or even beneficial in itself, it may raise competition issues in the longer term. These could be because of the existence of ancillary restraints or because FDI entry might be followed by practices that require the attention of competition authorities (secondary effects).[21] Cross-border corporate alliances -- especially technological alliances -- raise special issues.

(i) Ancillary agreements restraining competition

There can be instances when FDI, although approved at entry, is accompanied by ancillary agreements that may involve various restrictions of competition. For example, international franchisors establishing themselves in a country might require local franchisors to source certain inputs from specific sources they control, with the justification that this guarantees quality. Competition authorities might be persuaded that this is, indeed, necessary -- or they might insist on neutral quality standards, non-exclusive buying arrangements, or buying arrangements of relatively short duration.

In this context, the Mexican Competition Commission analyzed ancillary restraints as follows:

> Asset or stock sale agreements usually provide that the seller is under the obligation not to carry out activities or make investments in the same market in which the buyer operates. After analyzing several cases, the Commission has ruled that these covenants are not necessarily inconsistent with the provisions of the Federal Law of Economic Competition. In general terms, the conclusion is that these covenants shall be valid, from a competition point of view, provided that they are limited as to the number of parties involved, the geographic extension, the products or services to which the covenants refer to, and the period in which the obligation is in effect. These last elements are analysed on a case-by-case basis, taking into consideration the structure of each market. The Commission carefully analyses covenants not to compete for periods of more than five years, or whose purpose is not the transfer of distribution channels or similar assets, as these types of covenants may imply restrictions harmful to competition. The Commission reviews the justification or efficiency of the covenants on a case-by-case basis (Mexico, Federal Competition Commission, 1994, p. 28).

Joint ventures are particularly susceptible to the combination of a pro-competitive basic transaction and ancillary restraints raising competition issues (box V.12).

Box V.12. Ancillary constraints in joint ventures

In the Brunswick/Yamaha case, a Japanese firm entered into a joint venture in the United States with a domestic firm to develop and sell an improved outboard motor for pleasure boats. It was agreed, however, that Yamaha would not compete with Brunswick in the United States in any product, and that Brunswick would not use the new technology to compete with Yamaha in regard to land vehicles (e.g., motorcycles) propelled by such engines. The United States Federal Trade Commission invalidated the restraints and its ruling was upheld by the reviewing court.

Source: United States, Federal Trade Court, 1981.

(ii) Secondary effects

Even after the establishment of a foreign affiliate, competition authorities have a continuing role in ensuring that market situations do not develop that jeopardize competition in the economy and hinder entry by other competitors. A recent example of a post-FDI entry intervention to preserve a competitive market-place involved Mexicana and AeroMexico, two Mexican airlines (box V.13).

Box V.13. Secondary effects after FDI entry

In Mexico, a foreign TNC that owned part of a Mexican airline, chose to sell its stake in that airline to a horizontal competitor. The two airlines involved were AeroMexico, which was sold by the State to a consortium in 1988, and Mexicana, which was sold by the State to a consortium of domestic and international investors in 1989. In the period following the privatization, Mexicana integrated its operations closely with AeroMexico, until Mexicana's new owners finally sold 55 per cent of Mexicana to its larger competitor. The result was to create a conglomerate with control over 71 per cent of Mexico's domestic airline traffic, with a market share of 100 per cent on many routes. This merger occurred four months before the introduction of an antitrust law in connection with NAFTA and thus was not subject to review. However, subsequently the Mexican authorities imposed a requirement that the companies de-merge within three years as a condition of their approval of a financial restructuring plan in August of 1995.

Source: UNCTAD, based on Hanson, 1994, pp. 199-216.

A recent commentary on a present FDI situation -- the potential acquisition of the Czech Brewery, Budejovich Pivovar (brewer of the Czech beer Budweiser Budvar) by the United States company Anheuser Busch (brewer of the United States beer Budweiser) -- illustrates the need for continued monitoring of TNC operations. In this case, this was done in reference to established principles of European Union competition law in order to address the secondary problems that may result after a TNC entry:

> "[T]he application of EC law principles to cases involving acquisitions of Czech firms by foreign investors may be valuable. By modelling its economic laws so as to comply with the broad standards of EC law, the Czech legal system is creating an environment that might reassure foreign investors, while at the same time providing legal tools for the control of monopoly power that are internationally acceptable. In particular, EC legal principles can help in the process of bargaining over foreign direct investment proposals; first by indicating whether the results of the entry of a foreign investor will create a more or less competitive business environment in the market concerned; and, second, in justifying controls over the foreign investor, where needed, by reference to familiar principles of European business regulation, thereby showing that decisions are not the outcome of governmental caprice" (Muchlinski, 1996, pp. 667-668).

This advice is particularly applicable in situations where a foreign investor ends up in control of an essential facility, and the competition authority must intervene. In such circumstances, competition authorities may risk being accused of interference in the contractual and property rights if they force divestitures, or of favouritism towards competitors, particularly indigenous competitors, if they impose terms of access.

Therefore, one of the long-term issues that competition authorities must consider in dealing with FDI is preserving the competitive environment in their markets, including access to such essential facilities as energy grids and telecommunications networks. The first investor in a privatized or deregulated market may be foreign, especially if large capital sources or special expertise are needed. Such an investor -- for straightforward commercial reasons -- takes control of the best assets for a particular line of business. These assets may be, for example,

ports, networks or licences. When access to these facilities is foreclosed, new competitors may find themselves at a distinct disadvantage. In other circumstances, the first investor may, sometimes with state aid, construct essential facilities for a business, such as specialized harbour facilities at the best location, or may acquire such a facility as part of a privatization. Later, competition authorities may decide, or be asked, to order the holder of the essential facility to grant access to potential rivals in some aspect of the business (box V.14).[22]

Finally, as transfer pricing can be used for predatory purposes, i.e., to drive competitors out of business, competition authorities may have to monitor events in the area. Given the nature of this practice, international cooperation is often required.[23]

Box V.14. Access to essential facilities

An example of the type of problem that can arise from allowing an investor to take control of an essential facility is found in the privatization of the Chilean electrical power industry. The major Chilean generating utility, Endesa, was privatized in such a way as to leave it in control of almost all the best unexploited hydroelectric power water concessions. In addition, ENDESA is now controlled by ENERSIS, which owns the most important electricity distribution grid -- representing an essential facility for competing in the industry -- in the country. Competitors -- and, in particular, foreign investors who might build hydroelectric power facilities, particularly at those sites that offer low costs per kilowatt hour generated -- may therefore face difficulties in entering the market. Thus the privatization of Endesa, partly to foreign direct investors, may have the effect of blocking new investment. However, competition law might provide a remedy by compelling Endesa to deal with rivals on reasonable terms.

Source: Bitran and Serra, 1994, pp. 179-197.

(iii) Cross-border technology alliances

As noted in chapter I, intercorporate R&D alliances, which involve agreements between two unaffiliated firms, are becoming more numerous. At the same time, certain types of long-term alliances exhibit many characteristics of joint ventures (UNCTC, 1992), especially where they involve transfers of stock or interlocking directorates; thus, they may be subject to merger control. Given the many types of alliances, and the many different purposes for which they are created, they constitute a grey area of competition law (UNCTAD, 1994b).

In view of the mix of procompetitive and anti-competitive elements that might be involved in these agreements (see chapter IV), some jurisdictions (which otherwise have a strict approach to competition-law enforcement) have tended, during the past decade and a half, to narrow the range of activities that constitute violations of their competition laws in this context; in other words, the scope of *per se* violations has been reduced. Therefore, an increasing number of agreements and business practices are examined by courts under the “rule-of-reason” standard of interpretation.[24] And given the potentially positive economic implications that especially R&D alliances have, an increasing number of authorities appear to exempt them from competition regulation.[25]

In this respect it is useful to recall that R&D alliances encompass arrangements in which two or more firms provide a certain degree of technical collaboration or partial integration in R&D operations. The conclusion of a R&D alliance implies a compromise between a desire to collaborate and the underlying intention of partners to maintain as much independence as possible in order to take advantage of the potential results and new skills to be acquired through the partnership. This is particularly true where partners are required to disclose certain background information that may be necessary for the development of a given product. In the case of horizontal arrangements involving competitors engaged in the same segment of the

market, the parties may fear that their partners will considerably strengthen their competitive position at their own expense. A geographical partition of markets may therefore be considered as a solution to overcome these concerns, but such an agreement would of course restrict competition and may thus require competition-law intervention. In vertical arrangements -- where complementarities allow the benefits to be distributed according to the respective activities and products -- this kind of situation is less likely to arise. It should be added that alliances can also be a way for large or dominant firms to avoid competition through innovation, by co-opting potentially innovative rivals and by controlling and slowing down the innovation competition.

In the European Union, R&D intercorporate arrangements were first addressed in a Commission Notice of 1968 regarding agreements, decisions and concerted practices in the field of cooperation between firms (European Commission, 1968). The notice stated that cooperation agreements relating only to R&D normally do not fall under Article 85(1) of the Treaty of Rome (which prohibits, in general, agreements between firms, decisions by association of firms and concerted practices that may affect trade between member States and which have as their objective or effect the prevention, reduction or distortion of competition within the Union (box V.15)). The Notice was complemented by a block-exemption regulation that granted automatic exemption to certain categories of R&D agreements. Through this regulation, favourable treatment extends to arrangements that make provision for joint exploitation of the results. "Joint exploitation" includes joint manufacturing and joint licensing to third parties. Some conditions must be met for an agreement to receive favourable treatment. In particular, R&D must be carried out in the framework of a defined programme. In order to guarantee that several independent poles of research can exist within the European Union, the regulation excludes from its application agreements between competitors that exceed a market share threshold of 10 - 20 per cent. In any event, agreements not covered by the regulations can be notified to the Commission to obtain individual exemption (box V.16).

Under certain conditions, therefore, R&D agreements receive a favourable competition-analysis treatment. Beyond that, they also raise issues related to intellectual property rights (among them as regards ownership and the protection and the exploitation of results) and in relation to licensing

Box V.15. Exemption of R&D arrangements

In the Henkel/Colgate case, two large manufacturers of detergents operating on a worldwide scale (one a German and one a United States' firm) decided to set up a joint affiliate entrusted with the task of carrying out research relating to detergents. The agreement enabled the two parties to have access to the results of the joint R&D on the same conditions and to use them without limitations. The arrangement did not restrict the freedom of the parties to carry out individual research but provided that each one would make available to the joint affiliate the results of such research.

The European Commission considered that the agreement infringed Article 85(1) of the Treaty of Rome, mainly for two reasons: it restricted individual research since parties were bound to license the results of their own research activities related to the R&D agreement to the common entity; and the fact that parties had to communicate their results to the joint venture and that neither of them could license the results to third parties without the authorization of the partner had the effect of reverting each of the parties from securing a technological advantage over the other and thereby improving its position on the market. However, the Commission granted an individual exception on the basis that the joint research carried out by partners might make a contribution to technological progress; it contained no restrictions on either partners; and joint research was limited in time and scope.

Source: European Commission, 1972.

Box V.16. Main features of the exemption of R&D agreements in the European Union

A 1984 regulation, as amended in 1992, dealing with cooperation in R&D and the exploitation of the results of cooperative efforts, specifies the restrictions of competition that may be included in such R&D agreements in order to allow cooperating partners to concentrate their research activities, with a view towards improving their chances of success, and to facilitate the introduction of new products and services to the market. The regulation recognizes that these restrictions are generally necessary to secure the desired benefits for the partners and consumers.

Scope: The regulation covers agreements entered into between firms for the purpose of joint R&D regarding products or processes and joint exploitation of the results of that R&D; joint exploitation of the results of R&D of products or processes jointly carried out between the same firms according to prior agreement; joint R&D of products or processes excluding joint exploitation of the results.[a]

Conditions for the grant of an exemption: In order to benefit from an exemption, R&D agreements should meet the following conditions:

- the joint R&D activities to be carried out within the framework of a programme defining the objectives and the field of the work;
- all partners should have access to the results of the work;
- where the agreement is limited to just joint R&D, each partner should be free to exploit the results of the work and any pre-existing technical knowledge necessary therefore independently;
- joint exploitation should relate only to results that are protected by intellectual property rights or constitute know-how which substantially contributes to technological or economic progress and that the results should be decisive for the manufacture of the products or the application of the processes;
- firms charged with the manufacture of the products should be required to fulfil orders for supplies from all partners.

Duration of the exemption and market share limitation: There are a number of limitations with regard to the duration of R&D agreements and combined market shares of the partners:

- for non-competing firms (manufacturers of products capable of being improved or replaced by the contract products), the exemption applies for the duration of the R&D programme and, if the jointly exploitation is involved, for five years from the time the product is first put on the market within the European Union;
- for competing firms (manufacturers of products capable of being improved or replaced by the contract products), the exemption applies also for five years, but only if at the time of the agreement the partners' combined production of the products capable of being improved or replaced by the contract products does not exceed 20 per cent of the market for such products in the European Union or a substantial part thereof;
- after five years, the exemption will continue to apply as long as the production of the contract products together with the partners' combined production of other products that are considered by users to be equivalent in view of their characteristics, price and intended use does not exceed 20 per cent of the total market for such products in the European union or a substantial part thereof;
- in case an agreement covers the distribution of the products subject of the joint activities, the exemption applies only if the partners' production of the products referred to above does not exceed 10 per cent of the market for all such products in the European Union or a substantial part thereof.

Exempted restrictive practices: The list of main restrictions of competition that are allowed to be included in an R&D agreement is as follows:

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(Box V.16. Cont'd.)

- restrictions on independent R&D;
- restrictions concerning entering into agreements with third parties on R&D in the field to which the programme relates or in a closely connected field;
- restrictions on procuring the contract products exclusively from partners, joint organizations or firms or third parties, jointly charged with their manufacture;
- restrictions regarding the manufacturing of the contract products or application of the contract processes in territories reserved for other partners;
- granting one of the partners the exclusive right to distribute the contract products or granting the exclusive right to distribute the contract products to a joint firm;
- obligation imposed on partners to communicate to each other any experience they may gain in exploiting the results and to grant each other non-exclusive licences for inventions relating to improvements or new applications.

Intellectual property rights: The exemption also applies to a number of restrictive clauses involving intellectual property rights such as:

- obligation to communicate patented or non-patented technical knowledge necessary for the exploitation of its results;
- obligation not to use any know-how received from another partner for purposes other than the programme and the exploitation of its results;
- obligation to preserve the confidentiality of any know-how received or jointly developed under the programme; this obligation may be imposed even after the expiry of the agreement.

However, the exemptions do not apply to clauses that prohibit, after completion of the R&D or after the expiry of the agreement, challenging the validity of intellectual property rights which the partners hold in the European Union. Similarly, the exemptions do not cover clauses by which partners are required not to grant licences to third parties to manufacture the contract products or to apply the contract processes even though the exploitation by themselves of the results is not provided for in the agreement or could not be carried out.

Source: European Commission, 1984a and 1993.

[a] The R&D of products or processes means the acquisition of technical knowledge and the carrying out of theoretical analysis, systematic study or experimentation, including experimental production, technical testing of products or processes, the establishment of the necessary facilities and the obtaining of intellectual property rights for the results.

agreements (Ullrich, 1995). At the international level, licensing agreements, in particular, have attracted attention in the framework of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) (Roffe, forthcoming); section 8 of this Agreement contains a set of rules and standards regarding the control of anti-competitive practices in international licenses (box V.17).

* * *

Most competition laws have two basic provisions, one dealing with restrictive agreements (i.e., cartels and vertical arrangements) and one dealing with single firm conduct (i.e., monopolization or abuse of a dominant position). Increasingly, competition laws are complemented by special regulations on M&As and joint ventures. These transactions often require before-the-fact analysis and remedy, due to, among other things, the high cost of

uncertainty of ex-post facto scrutiny. Generally, the main interface between competition law and FDI occurs when TNC entry is accomplished by means of a significant M&A, or joint venture. Anti-competitive control of such transactions requires a carefully calibrated system providing for prior notification, rapid analysis, temporary injunctions and prompt decisions. In this respect, experience indicates that there are a number of typical scenarios of cross-border M&As and joint ventures that can create competition issues. An important characteristic of current merger-review analysis is that it focuses mainly on the effect of a transaction on the national market in question, not on international markets. After FDI entry, competition issues may arise in the host country that could involve TNCs. Therefore, competition authorities have a continuing role to play in ensuring that market situations do not develop that jeopardize competition in the economy and hinder entry by other competitors.

Box V.17. Anticompetitive practices and licensing arrangements concerning intellectual property rights

In connection with FDI, various licensing arrangements on the use or the exploitation of intellectual property are often concluded between firms. These arrangements may contain restrictive clauses or concerted practices that could affect competition in the relevant markets. Therefore, the use of intellectual property rights in transactions among firms could, in certain circumstances, give rise to the possibility of anticompetitive behaviour: the exclusive rights conferred by an intellectual property law may be exercised to enhance or to abuse monopoly power by extending the protection of intellectual property rights beyond its purpose.

How competition authorities deal with these issues depends in large part on their approach to vertical restraints. Thus, there are large differences in the fundamental approaches to intellectual property rights-related restrictive practices between the United States and the European Union, both with a long experience in this area. For example, the United States Antitrust Guidelines for the Licensing of Intellectual Property, issued by the Department of Justice and the Federal Trade Commission in 1995 (United States, Department of Justice and Federal Trade Commission, 1995), follow the principle of dealing with intellectual property as with any property. The competition authorities are concerned mainly with horizontal restraints, as they are in other areas. In contrast, the European Union focuses on the control of horizontal as well as vertical restraints (territorial, quantity or customer restrictions) imposed upon licensees or agreed upon between them or with the licensor, respectively. The European Union's main purpose is to control vertical agreements that may result in a partitioning of the market. The European Union is more concerned than United States authorities with maintaining consumer choice regarding suppliers of the same brand (intra-brand competition).

In this context, a trend towards a certain degree of harmonization started with the TRIPS Agreement concluded as part of the Uruguay Round of Multilateral Trade Negotiations (UNCTAD, 1996d) which also addresses anticompetitive practices in licensing arrangements. The Agreement addresses competition issues and refers to national legislation as far as it is concerned with policy determination and the implementation of specific measures. It is the first international legally binding agreement in the area of intellectual property that provides guiding principles dealing with the control of anticompetitive practices in contractual arrangements. It allows members to take, if needed, "appropriate measures, provided that they are consistent with the provisions of this Agreement, ... to prevent the abuse of intellectual property rights by right-holders or the resort to practices which unreasonably restrain trade or adversely affect the international transfer of technology" (article 40) within its main objectives, namely, the reduction of distortions and impediments to international trade and the avoidance of barriers to legitimate trade.

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(Box V.17, cont'd.)

The Agreement makes it clear (article 40) that "nothing in this Agreement shall prevent Members from specifying in their legislation licensing practices or conditions that may in particular cases constitute an abuse of intellectual property rights having an adverse effect on competition in the relevant market". It also allows (in article 40.2) member States to "adopt, consistently with the other provisions of this Agreement, appropriate measures to prevent or control such practices .... in the light of the relevant laws and regulations of that Member". It also gives examples of such practices, including exclusive grant-back conditions, conditions preventing challenges to validity, and coercive package licensing. The Agreement is limited to those licensing practices that exemplify the practices envisaged in this article. In other words, restrictive practices or practices affecting technology transfer that occur outside a licensing context, such as delimitation agreements, assignments, intellectual property clauses in R&D contracts or in cooperation agreements, joint ventures, subcontracting arrangements, etc., as well as all unilateral conduct by enterprises enjoying some sort of market power, are not subject to article 40 and, therefore, not subject to the international enforcement cooperation provided in the Agreement.

Member countries seem to be bound by an obligation to provide some minimum control over restrictive practices which, according to traditional principles, unreasonably restrain competition or adversely affect trade. The Agreement implies the gradual development and mutual understanding of at least the basic principles of what are generally unacceptable restrictive practices in the field of intellectual property.

Source: UNCTAD, 1996b.

C. Broader policy implications

The preceding section dealt with the interface between FDI and competition law and policy issues arising from it. This section examines, from a broader perspective, what governments could do to maximize pro-competitive effects of FDI and minimize anticompetitive situations.

1. The importance of competition policy

Perhaps the best starting point is to return to the opening sentence of this chapter, namely that there is a direct, necessary and enlarging relationship between the liberalization of FDI regimes and the importance of competition policy. The liberalization of FDI regimes can directly contribute to the contestability of a host country's markets. To the extent that this increases the competitiveness of domestic firms in host countries, it can also contribute to the contestability of international markets. But while FDI liberalization can help to enhance the contestability of markets by foreign firms, it is not a sufficient condition: in so far as FDI liberalization creates more space for firms to pursue their interests in markets -- as it invariably does -- it becomes necessary, as a rule, to put in place competition laws to ensure that former statutory obstacles to contestability are not replaced by anticompetitive practices of firms. This need increases as liberalization becomes more widespread and extends also to new areas.

If anything, this underlines that the three dimensions of the FDI liberalization process (UNCTAD, 1994a, chapter VII) are, indeed, inextricably linked: the reduction of barriers to FDI and the establishment of positive standards of treatment for TNCs need to go hand in hand with the adoption of measures aimed at ensuring the proper functioning of markets, including, in particular, measures to regulate and control anticompetitive practices by firms.

This also underlines something else, and something more fundamental, namely, that the culture of FDI liberalization that has grown worldwide and has become pervasive, needs to be complemented by an equally worldwide and pervasive culture of competition, which, of

course, needs to recognize competing objectives as well (see section D below). Clear competition policies and their enforcement can contribute significantly to the growth of such a competition culture. In this respect, the trend in many parts of the world towards adopting or strengthening competition laws noted earlier in this chapter (figure V.1) is important in that it suggests that a competition culture is emerging. However, many countries are new to this practice; moreover, the transition to more open, competition-oriented systems cannot be achieved overnight. This transition will, especially for many governments of developing countries and economies in transition, involve difficult political choices and the balancing of interests among many stakeholders in the process, apart from a range of practical problems. Thus, the promotion of a competition culture requires additional efforts, not only by national competition authorities themselves, but also by other administrative bodies and political and civic society groups.[26]

When one moves from the plane of competition culture to the plane of policies, this means also that, to maintain contestability and competition, increasingly, competition policy should rank alongside FDI and trade policies when it comes to relevant policy instruments. Indeed, this is part of the "necessary and enlarging" relationship between FDI liberalization and competition law. An important effect of FDI liberalization has been to reduce greatly the role of traditional tools, such as screening at the time of entry, closing activities to FDI and foreign ownership restrictions. The central presumption underlying these controls was that FDI entry should be allowed only if specifically approved by host governments. The opening of countries worldwide to FDI, and their increasing competition to attract it, has reversed that presumption and its underlying logic. In a world of liberalized investment regimes the priority becomes to ensure that inward FDI stimulates efficiency gains for the host economy and, ultimately, welfare. At the same time, countries liberalizing their investment regimes may be concerned that they may be moving, for example, from a system of screening all take-overs of national firms to screening none. They may also see risks of TNCs acquiring dominant positions. Therefore, there is a need to have tools to assess the competitive effects of FDI at the time of entry and after entry, and that function is assumed by a competition authority. Competition policy can thus play a major role in the process of liberalization, notably by ensuring that markets are kept as open as possible to new entrants, and firms do not frustrate this by engaging in anticompetitive practices. In this manner, a vigorous enforcement of competition law can provide reassurance that FDI liberalization will not leave a government powerless against anticompetitive transactions or subsequent problems. In brief, as controls on FDI are reduced, the role of competition policy for assessing the effects of FDI on a host country's economy becomes increasingly important.

When formulating their competition policies, countries need, of course, to keep in mind that competition policy is not a substitute for FDI and trade policies, but rather that all three are mutually supportive in the pursuit of efforts to ensure that markets function properly.[27] This requires appropriate coordination between these policies, at the national and international levels, e.g., in a sectoral context. (The 1997 WTO agreement on basic telecommunications services shows one way in which trade and FDI liberalization, deregulation and safeguards against anticompetitive practices can be combined -- see box V.18.) Still, to the extent that contestability and competition considerations gain in importance in shaping policies, and the more liberal trade and FDI policies become -- but at the same time do not always lead to contestable markets -- competition policy becomes *primus inter pares* among policy instruments used to maintain contestability and competition.

However, it must be recognized that there are few countries that have strong, well-functioning and well-funded competition authorities, and that even in the case of those countries that do, it took a considerable time until they had assumed an important role. It may well take other countries many years to develop appropriate policies and establish the means to implement them fairly and effectively. This means that, where contestability and competition are the objective, many countries will need to continue to rely, for the foreseeable future, primarily on FDI and trade to meet these objectives, in the context of closer integration into global markets.

Box V.18. Market structure, FDI and competition rules in the WTO negotiations on basic telecommunications services

The WTO negotiations on basic telecommunications illustrate how the General Agreement on Trade in Services (GATS) can be employed to encourage a transformation away from monopoly market structures and towards competition, the progressive elimination of restrictions on trade and FDI and the adoption of safeguards to ensure that the benefits of commitments are not undermined by anticompetitive practices.

On 15 February 1997, the WTO concluded nearly three years of negotiations on GATS schedules of commitments on liberalization for basic telecommunications.[a] Sixty-nine governments made commitments (contained in 55 schedules), which are annexed to the Fourth Protocol to the GATS. The rationale for extending the negotiations beyond the Uruguay Round was to allow negotiators to take into account the many reforms under way in national telecommunications regimes and rapid advances in technology.

The results show how dramatically views are changing about the market structure that best serves consumers and economic development imperatives. Public voice-telephone service and the national telecommunications infrastructures used to provide this service were long viewed as "natural" monopolies. In this service, however, 59 governments made commitments to allow competitive supply (defined here as two or more suppliers, including foreign suppliers), either upon entry into force of the Protocol or on a phased-in basis, in one or more market segments (i.e., local, long distance or international services). Twenty-five of the 59 governments making commitments on public voice telephone, commited to phase-in competition, meaning that liberalization would take place on the date specified in the schedule, rather than upon the formal entry into force of the Protocol in January 1998. All but one developed country agreed to create almost totally open market regimes in these areas. A substantial number of developing countries did the same. The main difference was that developing countries tended more often to commit to phase-in competition in infrastructure-based public voice telephone and were less likely than developed countries to commit to allow the service to be provided through resale.

Other basic services have often been more easily amenable (or perhaps less politically sensitive) to the introduction of competition. On these, 63 governments made commitments on competition in data-transmission services; 60 granted access to cellular/mobile telephone markets; 55 opened markets for leased circuit services (the supply of transmission capacity); and 59 committed on other types of mobile services (such as personal communication services, mobile data or paging). Regarding newer satellite-related communication services, 51 governments agreed to liberalize some or all types of mobile satellite services or transport capacity, and 50 to liberalize fixed satellite services or transport capacity.

Since GATS provisions aim at progressive liberalization, they give governments the possibility to maintain certain restrictions on their commitments, as long as these are listed in their schedules. One such limitation, particularly relevant to FDI, involves limitations on foreign equity participation.

Forty-nine governments (out of 69 taking part in the negotiations) allow majority foreign ownership of telecommunications service suppliers that may establish in their markets. Forty-three of these governments have no FDI restrictions and six maintain foreign equity limitations, which nevertheless allow foreign control (e.g., 50 per cent or higher). Limitations on foreign participation, although more

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(Box V.18 Cont'd.)

common in the economies of developing countries, are not unique to them. Six of the 23 developed countries list foreign equity limits; only three of these restrict foreign participation to a minority share, although two permit foreign control only through indirect ownership arrangements. Three of the six economies in transition that participated in the negotiations limit foreign ownership; one of these permits a majority foreign share. Fifteen of the 40 developing country participants, or less than 2 in 5, limit foreign ownership to minority share holding (49 per cent or less). Two other developing countries limiting foreign equity allow majority control.

Often, the foreign equity limits listed in the Schedules do not apply to all basic telecommunications services committed. Only one developed country and eight developing countries have inserted in their Schedules foreign equity limitations applying to all basic telecommunications services. However, two more developing countries indicated that, for the moment, the maximum level of foreign equity in all basic service suppliers is unbound, meaning that they have reserved the right to introduce limitations at a level that may be determined in the future.

One of the results of the negotiations was the elaboration of a common set of telecommunications regulatory principles, called the "Reference Paper" which participants agreed to use as a guideline in taking additional commitments. The Reference Paper deals with such matters as competition safeguards, interconnection guarantees, licensing and the independence of regulators. It was agreed that, when scheduling commitments based on the Reference Paper, participants were free to adopt it in whole, modify portions of it to fit their own regulatory structures, or to commit only on some of its elements. Nevertheless, 63 of the 69 participating governments included commitments on regulatory disciplines. Of these, 57 committed to the Reference Paper in whole or with only minor modifications. Even among the six participants that made no regulatory commitments, four undertook to introduce such commitments in the future.

The main rationale for the principles of the Reference Paper was to safeguard a competitive balance in an environment in which new market entrants would face competition with a former monopoly, one that would initially dominate existing network facilities and a large portion of the market. In some respects, it builds upon obligations already existing in Articles VIII and IX of the GATS (the first dealing with monopoly and exclusive service suppliers and the second with restrictive business practices) and in the Annex on Telecommunications (dealing with access to telecommunications for services suppliers in sectors where GATS-specific commitments have been undertaken). Also, to the extent that the GATS or the Reference Paper deal with competition-related issues, they do so more in the interest of safeguarding the integrity of GATS obligations and commitments than with the aim of establishing generalized competition rules.[b]

In order to meet the concern that the GATS obligations and the Telecommunications Annex might not provide an adequate level of discipline to prevent anticompetitive practices of monopoly and dominant operators, the Reference Paper includes a general provision on the prevention of anticompetitive practices by major suppliers (defined as telecommunications operators having control over essential facilities or market dominance). It also provides some concrete examples of such practices, including anti-competitive cross-subsidization; misusing information obtained from competitors; and withholding technical and other commercially relevant information that other suppliers need to provide their services.

Recognizing that effective interconnection is essential to successful competition in this industry, the Reference Paper also includes specific details on interconnection obligations governments could commit to impose on "major" suppliers. These provisions require that interconnection be ensured under non-discriminatory, transparent and reasonable terms, conditions and rates; of a quality no less favourable than that which a major supplier provides for its own like services, for like services of non-affiliated

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(Box V.18 Cont'd.)

service suppliers or for its subsidiaries or other affiliates; at cost-oriented rates; in a timely fashion; sufficiently unbundled so that a supplier need not pay for unnecessary network components or facilities; and at any technically feasible network-termination point. Other Reference Paper provisions on interconnection call for greater transparency and mechanisms for the resolution of disputes on interconnection with major suppliers.

Regarding universal service, the Reference Paper's principles recognize that governments have the right to define the universal service obligations they wish to maintain and that these obligations are not to be regarded as anti-competitive *per se*. However, they must be administered in a transparent, non-discriminatory and competitively neutral manner and not be more burdensome than necessary to meet the chosen universal service objectives.

The basic telecommunications commitments now included in the GATS Schedules demonstrate not only that market access for FDI and trade has been improved substantially, but also that developing countries have come to view making such commitments as complementary to their economic development strategies. Governments seeking FDI in industries such as telecommunications, which they often consider essential to development, have used the commitments to send a clear signal to potential investors of their priorities and of their resolve to maintain a stable and hospitable investment climate in which all participants, including new entrants, will have a fair chance to compete.

Source: WTO Secretariat.

[a] The definition of "basic telecommunications" developed for negotiating purposes was open-ended. It covered all telecommunications services (both public and private) that involve end-to-end transmission of customer supplied information (e.g., the relay of voice or data from sender to receiver without "adding value" or changing its form or content). It also covered these services provided over network infrastructure as well as through resale (over private leased circuits).

[b] For a more extensive discussion of the regulatory implications of the negotiations, see Tuthill, forthcoming.

To make a difference, competition policy needs to be implemented effectively (Goldman, Kissack and Witterick, 1997, pp. 22-35). This requires, first of all, a strong competition law and a competent and effective competition-enforcement agency. The agency needs broad powers to investigate enterprises' behaviour, including the authority to analyse the competitive effects of certain major types of FDI -- e.g., whether the results of the entry of a foreign investor would create a more or less competitive environment in the market concerned -- and the competition implications of market-power inducements. The agency entrusted with the enforcement of competition law ought to be obliged to put fair competition and the maximization of economic efficiency and consumer welfare above all other considerations. The rulings of competition authorities must be open to review or appeal, including by the judiciary. Once the basic political decision is made to adopt and enforce competition law, the decisions of the competition agency should not be subject to political intervention.

Such an enforcement agency requires well -trained professional staff. The agency should develop a strong analytical capability in order to be able to determine the economic consequences of alleged or potential anticompetitive practices. This, in turn, requires an appropriate budget in order to, among other things, ensure adequate staffing and to be able to meet the costs of training. This is all the more so given the speed with which competition cases -- especially M&As -- need to be dealt with in order not to block unnecessarily the flow of legitimate cross-border transactions.[28]

One important role of an effective enforcement agency is to act as a watchdog to discover potentially anticompetitive situations and to deal with them at an early stage.[29] Various

techniques can be used for this purpose. They include, most importantly, moral suasion (i.e., discussing a potential problem with the management of a firm whose practice might be anticompetitive, with a view towards reaching a mutually agreed-upon solution of the problem) and consent decrees (i.e., formal or informal agreements between an enforcement agency and a firm to the effect that, if the firm will undertake certain steps or desist from certain practices, the agency will not seek further redress through prosecution). Such "soft" approaches to competition-law enforcement can be quite effective, especially if they are buttressed by the possibility that, if a mutually satisfactory solution between the enforcement agency and the relevant firm cannot be reached, there remains the possibility of prosecution. If "soft" approaches to the enforcement of a specific case fail to work, the enforcement agency must be prepared to prosecute the case, using strong remedies for egregious and clear violations, but milder remedies, such as prohibiting future violations, in difficult, precedent-setting cases. Both the review of cases by the competition authority and prosecution of cases should be subject to some time limits, especially with respect to M&As. In many countries, moreover, firms have the right to initiate action; the threat of complaints by affected private actors could have an important dissuasive effect regarding potential anticompetitive practices.

Enforcement of competition law should therefore be vigilant but not dogmatic. Indeed, because some issues of competition policy are in "grey" areas and subject to the merits of the case involved, many areas of the law might need to be enforced on a "rule-of-reason" basis. If subject to a "rule-of-reason" standard, a particular business practice would neither be *per se* legal nor illegal but, rather, legality would be a function of its effect. Applying a rule-of-reason standard, however, increases the risk of arbitrariness in competition decisions.

Traditionally, competition laws have focused mostly on protecting competition among domestic firms within the local market. With the liberalization of international trade, attention expanded to include (foreign) competition through imports. With FDI having become more important than trade in terms of delivering goods and services to foreign markets, markets themselves becoming increasingly regionalized or globalized, and national production systems being more and more integrated through the activities of TNCs, attention now needs to expand to include the competition effects of FDI and corporate integrated international production systems, including corporate alliances. As discussed in the preceding chapter, these effects have policy implications, especially in terms of the geographical space within which certain relevant markets have to be defined, the efficiency gains that can be associated with FDI and corporate integrated international production systems, and the supply response that may be possible through FDI:

- The regionalization and globalization of markets and their underlying production structures make it increasingly difficult to define and measure market concentration and to determine the emergence of dominant positions (and the possibilities of abuse of market power inherent in this) in reference solely to *individual national* markets. This is relevant both in the context of the standards developed for the competition control of cross-border M&As and joint ventures, as well as for monitoring the subsequent competition effects after FDI entry. More broadly, the existence of larger-than-national markets and production structures can make it substantially more difficult, especially for developing countries, to obtain relevant information, to assess effects and to implement decisions. This is a consequence which, inherently, requires greater international cooperation, an issue that will be dealt with separately below.

- Closely related to this is that the efficiency gains that can be associated with corporate integrated international production systems need to be balanced against any anticompetitive effects of the relevant transactions for the markets supplied by these systems. In other words, FDI transactions involving M&As or joint ventures

increasingly need to be evaluated by taking into account well-documented efficiency gains likely to be achieved and balancing these against any lessening of competition or any increases in concentration.[30]

- When confronted with non-trivial and non-transitory price increases, competition authorities need to give more attention to a possible supply response through new FDI by foreign producers not yet servicing the market (in addition to supply responses by established domestic producers and imports). Competition authorities are only beginning to consider explicitly and systematically such new FDI as a normal possible source of supply response (box V.19). However, for the reason discussed in chapter IV, FDI can, indeed, represent, in today's world economy, a viable supply response as many producers can establish themselves in a given market within a reasonable time (e.g., less than two years). The FDI supply response is particularly important because, in terms of magnitude, world sales by foreign affiliates are larger than world imports and because, in the services sector, FDI is often the only international supply response possible, given the importance of local establishment for delivering services to foreign markets.

Box V.19. Supply response in competition analysis

As discussed above, FDI can be as important as trade in making markets more competitive. In evaluating the likely consequences of M&As or other market conduct, competition authorities would be expected to consider FDI and trade at different stages of their analysis. The United States approach to these issues is described below. The somewhat different analytical frameworks used by other competition authorities are also capable of giving full consideration to the competitive significance of FDI.

The impact of trade on competitive conditions is often an important factor in defining the relevant geographic market within which to assess the likely effects of a merger. The importance of trade to this market-definition process is obvious when one recalls that the purpose of the process is to delineate the area containing the firms or (plants) from which customers of the merging firms could obtain supplies if the merging firms attempted to restrict output and raise price. The United States and some other countries define relevant geographic markets using economic principles regardless of the size of the market; but in some other countries, the competition law is interpreted to prevent consideration of a relevant geographic market that is larger than the area circumscribed by a country's national boundaries, although imports may enter at one stage of the analysis.

Foreign direct investment entering a market (through the establishment of new production facilities) is not part of the market-definition process, but -- like imports from outside the geographic market -- it is relevant to whether a merger is likely to be anticompetitive. Under the United States system, firms not producing or selling the relevant product in the geographic market will be treated as if they were in the market if they would be likely to have a sufficient "supply response". This supply response can result from use of existing assets to produce or sell in the relevant market, or it can result from new investment: "the construction or acquisition of assets that enable production or sale in the relevant market" (United States, Department of Justice and Federal Trade Commission, 1992, at 1.32). No matter what the source of the potential supply response (trade or investment, domestic or foreign), the supply response will be considered at this stage -- as if it had already occurred -- only if it is likely to occur within one year and without the expenditure of significant sunk costs at entry and exit. In many industries, supply responses through FDI (or other investment) will not meet this requirement, because even if the supply response could in theory occur in time, the investment may be "sunk" (recoverable only through sales in the relevant market) and "significant" (not recoverable within one year). Of course, if a likely future supply is not so quick and not likely to be (treated as) already deemed part of the market, its competitive significance is fully considered at a later stage in the competition analysis -- the assessment of the ease and likelihood of entry.

Source: UNCTAD.

Competition authorities constantly need to monitor developments in the world economy to adapt to the changes that they may engender (box V.20). Increasingly, this requires that competition authorities recognize the growing importance of not only trade but also FDI for market structures and competition. When it comes to competition policy and its enforcement, moreover, this requires that competition authorities pay increasing attention to the need to cooperate among themselves.

Box V.20. Competition policy in the era of globalization

During 1996, the United States Federal Trade Commission held extensive public hearings, leading to a report entitled "Competition Policy in the New High-Tech, Global Marketplace." The Commission concluded that global competition is expanding at a rapid rate and that innovation is a crucial element of such competition. In particular, the Commission found that:

> "In general, U.S. businesses are now confronting increasingly stiff competition as a result of the "globalization" of trade. Domestic firms face a greater number of foreign competitors in their home markets and are under pressure to expand their operations abroad. In this global marketplace, U.S. businesses stress both the importance of achieving efficiencies -- that is, cost savings -- and the importance of entering new markets, whether to attract new foreign customers or to remain competitive for their U.S. customers now doing business around the world. Mergers and other collaborative ventures are sometimes the vehicles they use to achieve these goals. Given this hearings' testimony and current research on these trends, it is timely to reassess certain aspects of competition policy toward mergers and collaborative ventures to ensure that procompetitive, efficiency-enhancing transactions are permitted" (United States, Federal Trade Commission, 1996, S. 5-6).

After noting that effective, consistent, sensible competition law enforcement is a necessary and desirable framework for continuing the development of global markets, the Commission in its policy conclusions regarding competition enforcement in this new globalized era (S. 8-9) emphasized, among other things, that:

- There should be further development of an efficiencies justification for mergers or joint ventures.
- Relevant geographic markets should be defined to include foreign supply response as appropriate, giving due regard both to actual barriers to trade and to the increasing trend towards the globalization of trade and services.
- Major mergers should be examined in terms not only of whether they eliminate competition as to existing products but also to whether they will significantly lessen innovation competition for the creation of substitute products.

In April 1997, the United States amended the country's Merger Guidelines to take into account the conclusion pertaining to efficiency considerations.

Source: United States, Federal Trade Commission, 1996.

2. International cooperation

(a) The need for international cooperation

There are numerous reasons why -- in an era of globalization -- competition issues as they relate to FDI increasingly involve more than one country and, therefore, require international policy responses. Indeed, these are grounded in the very nature of the transnational character of the firms involved and relate especially to such issues as access to information and the implementation of decisions taken:

- **Information**. Even in a simple example of FDI by means of an acquisition, competition authorities in the acquired firm's country will probably need documents from the acquired firm's headquarters in order to analyse the purpose and effect of a deal. Usually, the foreign firm seeking clearance for the transaction supplies the non-local information voluntarily. But it is important that sending such information abroad be legal under the law of the country where the data are located. If foreign information is needed beyond that controlled by the firm applying for the competition-law clearance, it may become necessary for the host country to ask the home country to obtain it, even by use of compulsory means. This can be accomplished by treaty, such as the agreement between the Government of the United States of America and the Government of Canada on Mutual Legal Assistance in Criminal Matters that provides for such cooperation in criminal cases (Hachigian, 1995, p. 129), or the Agreement between the Government of the United States of America and the Commission of the European Communities Regarding the Application of Their Competition Laws.[31]

  Cooperation even with regard to public information gathering may be very helpful to competition authorities. The difficulties confronting a competition enforcer, especially in developing countries, in seeking to obtain even the most elementary public information and data in another country should not be underestimated. In some instances, information that might take one competition official weeks to obtain and collate is easily obtainable by a competition official in another country.

- **Remedies.** Competition authorities often need to take into consideration the positions of other competition authorities with respect to a proposed merger or other arrangement. Even more, if a merger or joint venture is being simultaneously investigated by two competition authorities, they will likely wish to consult about facts, theories and relief. In some instances, the companies involved waive confidentiality rules in order to allow the competition authorities in the affected countries to work from the same data and thus be more likely to receive similar conclusions. For instance, when Montedison and Shell created a worldwide joint venture (Montell) that was reviewed by United States and European Union authorities, the companies waived confidentiality as to both. Staffs of the United States and European Union competition agencies exchanged views regularly on issues relating to market definition, competitive effects and potential remedies (Starek, 1996, p. 2). Because of tighter time deadlines, the European Union had to rule first, and concluded that the transaction was acceptable, subject to certain conditions, including the transfer of particular technologies to a new subsidiary of Montedison, Technipol, which would act as a fully independent company. The United States Federal Trade Commission later concluded that the better relief was the divestiture by Shell and Shell Oil of all of its polypropylene assets. The European Union then decided to conform its remedial order to that of the United States Federal Trade Commission, since it was satisfied with the consent order issued by the latter.

(b) Obstacles

i. Impediments to information access

Several basic obstacles exist to international cooperation on the exchange of information on FDI-entry situations, and, to an even greater degree, after-FDI entry competition-law enforcement. The largest single obstacle are the confidentiality obligations that most competition authorities have -- and need to have -- regarding information submitted to them by various parties.[32] For example, European law binds the Commission to keep the information it receives in the context of a particular case confidential (Starek, 1996, p. 3). Meanwhile, competition

authorities in host countries may find it very difficult to obtain jurisdiction to compel the release of certain information. As noted before, Australia and the United States have enacted laws that allow for information sharing under certain circumstances and conditions (Varney, 1995, p. 4), but Canada recently abandoned efforts to secure such a law, and there has been very limited activity elsewhere.

ii. Limited enforcement cooperation

There are also a number of practical obstacles to closer competition-enforcement cooperation. First, agencies may not wish to cooperate because basic substantive and procedural differences exist in the competition-law regimes of different countries. An example of these differences relates to situations where one country claims extra-territorial jurisdiction under the "effects doctrine"**.** Even where there is no question about the jurisdiction of the investigating country over the allegedly illegal conduct, some countries use "blocking statutes" to preclude the disclosure of information.[33] Blocking statutes are thus the very opposite of competition-policy cooperation.

Second, the activities being investigated in one jurisdiction may have been encouraged by a government in another jurisdiction, either through advice from a competent government agency, or by explicit legal provisions. For example, many developed countries (including France, Germany, Japan and the United States) have legal provisions allowing for the creation of export cartels targeting foreign markets (OECD, 1996d). Such cartels are allowed if they have no adverse effects on the domestic economy because countries regard them as enhancing the export performance of their firms or because they may lack constitutional authority to regulate them. Many of the arrangements covered by these exemptions may, in fact, be joint ventures that would be legal in any event; but for some, the legalized activities are simply cartels. One notable case involving export-trading cartels was the European Wood Pulp in which the European Commission issued a Decision under Article 85(1) whereby 40 producers of market wood pulp located in Canada, Finland, Norway, Portugal, Spain, Sweden and the United States and three of their trade associations were found to have restricted price competition (by means of concerted practices and exchanges of information) in the European Union and had hindered trade between its member states between 1973 and 1981 (European Commission, 1984b). This case was also noted because, even though none of the producers in the wood-pulp export cartel were located within the territory of the European Union, the Commission applied something akin to the effects doctrine insofar as the cartel's restrictive effect was affecting competition in the European Union (Nicolaides, 1994, p. 20; Utton, 1995, p. 310).[34] Besides these regulatory overlaps, there are also regulatory gaps, as in the case of international cartels which may simply fall outside the scope of most competition authorities.

Finally, many governments simply may not see it in their country's interest to facilitate a foreign state's investigation of one or more of their companies. This may particularly be the case where a company is wholly or partially state-owned. However, even when a company is not state-owned, a government may be disinclined to cause problems for a major national company, especially where the activities complained of have no domestic consequences.

iii. Differences in competition laws

Difficulties can also arise from diverging national approaches with respect to what the appropriate substantive standards for competition policy are in some areas. To a large extent, this is the result of competing policy and social objectives of countries, especially where development objectives are of primary importance. For example, certain approaches to competition law could specifically aim at addressing particular development objectives, e.g., to foster enterprise development. Likewise, developed countries may take different approaches to competition to pursue their particular objectives (e.g., to promote technological innovation

by exempting R&D alliances from competition), although most developed countries now take the view that economic efficiency and consumer welfare, rather than any particular social or economic objective, is the paramount objective of competition law. Much turns therefore on the question of what is considered "anticompetitive". For example, do exclusive contracts between a supplier of intermediate goods and a manufacturer of final goods embodying these intermediate goods foreclose sales of competing suppliers in a way that could be considered "anticompetitive"? In the eyes of some countries, for example, long-run relationships between large firms and their suppliers can constitute an objectionable anticompetitive practice, because they inhibit entry into the relevant industry by alternate suppliers, including foreign firms seeking to invest in a particular country. On the other hand, the competition laws of most countries would not consider vertical agreements anticompetitive unless they created or maintained market power and the resulting anticompetitive effects were not offset by procompetitive efficiencies, e.g., allowing supplier and manufacturer to undertake complementary research that would not be economic in the absence of such a long term mutual commitment. There is no single and unequivocal approach to these issues. Indeed, under United States antitrust law, such contracts would be subject to a "rule-of-reason" standard (i.e., they would not be seen as *per se* illegal, but under certain circumstances they might be ruled illegal). On the other hand, such "vertical restraints" as exclusive dealing and tied selling have traditionally been dealt with more stringently under European Union law than under United States law (Boner and Krueger, 1991).[35] Indeed, for more than thirty years, vertical restraints have been of particular importance to the European Union's competition policy and law, but, under current economic thinking, market structure is determinant for establishing the anticompetitive effects of vertical restraints.

On matters of enforcement, competition laws likewise often differ. For example, there are a few hard core violations of competition law (e.g., certain horizontal cartels) that may be treated as criminal offenses in the United States, but only as civil-law infringements in the European Union (Boner and Krueger, 1991).[36] There are also related differences among agencies as far as powers of "discovery" are concerned (i.e., powers of competition-policy enforcement officials to obtain evidence from individuals or companies against their will). As noted before, in extreme situations, differences in jurisdictional standards have led countries to pass "blocking statutes".

As a result, efforts to harmonize competition laws have a number of difficulties to overcome. To the extent that competing objectives exist, the substantive rules of countries may differ even though many use a rule of reason. What is seen as "reasonable" under the rule of reason by one country's authorities might not be seen as reasonable by the authorities of another country. Thus, for example, if competition authorities of one country complain that exclusive dealings between a firm and its suppliers in another country constitutes an anticompetitive vertical restraint that forecloses FDI by alternate suppliers based in the first country, the authorities in the second country might investigate the complaint but find that the exclusive arrangements in fact were efficiency enhancing and hence not illegal. But this outcome might not be acceptable to officials in the first country, even though exclusive dealing is subject to the rule of reason in both countries. In such an instance, the only likely means that the differences between the two countries might be worked out would be through a process of consultation and negotiation.

(c) Existing cooperation arrangements

Precisely because of the obstacles outlined, issues relating to competition are increasingly being addressed at the international level, either in the form of separate arrangements relating to some aspects of competition policy or in the context of broader investment and trade arrangements (table V.1).

Table V.1. Selective list of bilateral and regional arrangements dealing with competition-policy issues

Name of the arrangement	Year[a]	Type	Cooperation	Common rules[b]	Common authority
MERCOSUR, Protocol on the Protection of Competition	1996	regional	yes	no	no
Agreement between the Government of the United States of America and the Government of Canada Regarding the Application of Their Deceptive Marketing Practices Laws	1995	bilateral	yes	no	no
OECD Revised Recommendation of the Council Concerning Cooperation between Member Countries on Anticompetitive Practices Affecting International Trade	1995	regional	yes	no	no
Association Agreements between the European Union and various Southern Mediterranean countries	1995-1996[c]	bilateral	no	yes	no
Cooperation and Coordination Agreement between the Australian Trade Practices Commission and New Zealand Commerce Commission	1994	bilateral	yes	no	no
European Economic Area Agreement	1994	regional	yes	yes	no
Energy Charter Treaty	1994	regional	yes	no	no
North American Free Trade Agreement	1992	regional	yes	no	no
Agreement between the United States of America and the Commission of the European Communities Regarding the Application of Their Competition Laws	1991	bilateral	yes	no	no
Cartagena Agreement Commission Decision 285: Norms to Prevent or Correct Competitive Distortions Caused by Practices that Restrict Free Trade Competition	1991	regional	yes	yes	yes
Memorandum of Understanding on the Harmonization of Busines Laws between Australia and New Zealand	1990	bilateral	yes	no	no
Agreements between the European Union and countries of Central and Eastern Europe	1991-1996[d]	bilateral	yes	yes	no
Structural Impediments Initiative between the Government of the United States of America and the Government of Japan	1990	bilateral	yes	no	no
Agreement between the Government of the Federal Republic of Germany and the Government of France on Cooperation Relating to Restrictive Business Practices	1984	bilateral	yes	no	no
Agreement between the Government of the United States of America and the Government of Australia Relating to Cooperation on Antitrust Matters	1982	bilateral	yes	no	no
OECD Guidelines for Multinational Enterprises	1976	regional	yes	no	no
Agreement between the Government of the Federal Republic of Germany and the Government of the United States of America Relating to Mutual Cooperation Regarding Restrictive Business Practices	1976	bilateral	yes	no	no
Treaty Establishing the European Community	1957	regional	yes	yes	yes

Source: UNCTAD, based on various sources.

[a] Year of signature.
[b] The extent of common rules varies considerably from instrument to instrument.
[c] Israel, Morocco, Palestine Authority (1996), and Tunisia.
[d] Six such agreements had been signed as of June 1996.

- **Bilateral level**. Bilateral cooperation among competition authorities is increasing, although formal agreements are limited to a relatively small number of countries (table V.1).[37] Most of these efforts involve cooperation on exchange of information. In addition, a number of bilateral agreements go further to establish ground rules for notification of competition investigations, consultations and cooperation on competition-law enforcement, including commitments for positive comity (e.g., the cooperation agreements between Canada and the United States and between the European Union and the United States) and negative comity (e.g., the cooperation agreements between France and Germany, Australia and the United States, Germany and the United States). Provisions for the bilateral harmonization of competition laws, on the other hand, have so far only been established in the context of bilateral agreements between countries and regional organizations that pursue broader integration objectives.

Some cooperation agreements have proved to be quite successful. In the context of the Canada-United States Mutual Legal Assistance Agreement, for example, a joint investigation led to the prosecution of New Oji Paper Ltd. and the levying of $2.6 million in fines against Oji Paper and two other companies between 1994 and 1996 in Canada (Canada, Federal Court (Trial Division), 1996). Similarly, the experience of cooperation between the European Union and the United States under their 1991 agreement has been positive. In total, from September 1991 to the end of 1996, 194 cases were notified by the European Commission, and 200 by the United States authorities.

At the same time, given the increasingly regional and global operations of firms, the question arises as to whether bilateral approaches alone can address adequately all pertinent concerns.

- **Regional level**. Cooperation efforts at the regional level often take place in the context of regional economic integration schemes, which allow approaches and trade-offs that may be more difficult to pursue in other settings. The most integrated here is the European Union. Under the Treaty of Rome, the European Commission is authorised to administer competition policy, including regulation and control of M&As throughout the Union, in matters relating to commerce among the member states. Specifically, the European Commission is entrusted with the application of Articles 85 (dealing with cartels), 86 (dealing with abuse by a firm of a dominant market position), and several other articles of the Treaty of Rome dealing with state aids to industries and regions. These powers were extended in 1989 to mergers with a Community dimension. The authority of the Commission is subject to size thresholds: it reviews only M&As involving very large firms. Naturally, a necessary condition for pursuing this approach is that national competition laws be in conformity with the regional law. In this respect, the tendency in the European Union has been for member countries to bring national laws and policies closer to European Union law and policy, although those laws still vary considerably. The norm is that Community rule takes precedence over national rulings. Finally, the decisions of the Commission are subject to appeal to the Court of First Instance of the European Court of Justice.

In addition, arrangements are also made within the European Union for agencies to share information more readily. For example, Article 10 of the European Union Council Regulation 17/62 (Council of the European Communities, 1962), the Union's basic competition procedure, establishes the rules for cooperation between the European Commission and the national competition authorities of the member states in respect of cases pending with the European Commission, while Article 20 binds both the Commission and the national authorities to keep the information secret.

The Andean group is another example of a regional organization that deals with anticompetitve business practices. Decision 285 of the Commission of the Cartagena Agreement

allows member countries, or their companies having a legitimate interest, to request the Andean Group Board to apply measures to prevent or correct damage to production or exports caused by business practices that restrict free competition within the subregion. The Decision specifies the types of business practices that are understood to restrict free competition, and spells out the procedures to be followed to address such practices or their effects (Commission of the Cartagena Agreement, 1991).

In the OECD, efforts to cooperate on restrictive business practices began in 1967. The most recent instrument (adopted in 1995) strengthens previous provisions and, in particular, calls on member countries to make best efforts in the following aspects (UNCTAD, 1996d):

- timely notification of the initiation of investigations to member countries whose interests may be affected;
- coordination of actions when two or more member countries proceed against the same anticompetitive practice;
- cooperation in developing or applying mutually-satisfactory and beneficial remedies for dealing with anticompetitive practices, and, to that effect, supplying each other with relevant information;
- consultations when a country considers that an investigation by another country may affect its important interests, or when enterprises situated in another member country have engaged in anticompetitive practices that substantially adversely affect its interests, and giving sympathetic consideration to the views expressed by the affected country; and, in this context;
- commitment to take whatever remedial action is considered appropriate.

The same Council recommendation sets out detailed guiding principles for the implementation of notifications, exchanges of information, cooperation in investigations and proceedings, consultations and conciliation of anticompetitive practices affecting international trade. Finally, it recommends that these principles be taken into account in bilateral cooperation arrangements.

In addition, the OECD Guidelines for Multinational Enterprises, adopted in 1976 as part of the Declaration on International Investment and Multinational Enterprises (UNCTAD, 1996d) recommend that enterprises refrain from abuses of market power such as anticompetitive acquisitions, predatory behaviour and anticompetitive abuse of industrial property rights, and refrain also from participating in restrictive cartels that are not in accordance with relevant laws. The OECD Recommendation of the Council for Cooperation Between Member Countries in Areas of Potential Conflict Between Competition and Trade Policies (1986) calls on OECD countries to take into account competition considerations when implementing trade policies.

Efforts are also being made in the context of other regional agreements such as the North American Free Trade Area (NAFTA) (UNCTAD, 1996d). In chapter 15, NAFTA members have agreed to maintain national measures to prohibit anticompetitive firm behaviour, but mutually agreed competition rules are not included. The same chapter commits members to establishing a working group to make recommendations on appropriate further work on the relationship between competition policy and trade in the NAFTA area, and to consult from time to time about the effectiveness of their competition policies, and cooperate on issues such as notification and exchange of information. Also, MERCOSUR envisages cooperation on competition policy, including with a view towards establishing mechanisms of consultation, information exchange and the joint investigation of anticompetitive practices (European Commission, 1996b, p. 3).[38] The Energy Charter Treaty (UNCTAD, 1996d) calls for the adoption of competition laws and policies and for cooperation on exchange of information and consultation among the signatory

countries. In the context of the Asia Pacific Economic Cooperation (APEC), a dialogue has started with a view towards developing cooperative approaches in the area of competition-policy. Most of these efforts are nascent, and only time will tell whether and what concrete developments ensue.

- **Multilateral level.** The UNCTAD Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices is so far the only multilateral instrument covering all aspects of the control of restrictive business practices (box V.21). It calls upon governments to adopt, improve and effectively enforce appropriate competition legislation and implementation of juridical and administrative procedures. Moreover, UNCTAD's continued work on the elaboration of a model law or laws on restrictive business practices -- primarily intended to assist developing countries in devising appropriate legislation -- contributes to increasing consistency in competition-law standards and procedures, as does its technical cooperation programme in this area.

The UNCTAD Set, in its section dealing with measures at the international level, provides for consultation procedures whereby a country may request a consultation with other countries in regard to issues concerning the control of such practices. These consultations are intended to prevent or avoid conflicts arising from such situations. Given the Set's non-binding nature, its institutional machinery could not act as a tribunal or pass judgement on the activities or conduct of individual governments or of individual enterprises in connection with specific consultations. An important characteristic of the Set -- in addition to its broad membership -- is that it specifically provides for preferential treatment for developing countries. This is intended to ensure that concerns of developing countries are fully taken into account.

While GATT/WTO agreements focus on governmental measures and actions, and they do not regulate anticompetitive practices by firms, a number of provisions are particularly relevant for competition policy in that they deal with practices of enterprises that may distort or impede international trade and with what governments are allowed or required to do to regulate or remedy such practices.[39]

So far, the most direct link between the provisions of GATT agreements and firm anticompetitive practices is provided by Article IV (anti-dumping and countervailing duties). Antidumping practices sanctioned under this article are inconsistent with the goals of competition policy. Other GATT provisions have relevance for competition as they affect market access (e.g., provisions on national treatment (Article III), elimination of quantitative restrictions (Article IX), state-trading enterprises (Article XVII), and nullification and impairment (Article XXIII)).[40] Furthermore, several of the most recent WTO agreements (WTO, 1995) address private practices: the Agreement on Technical Barriers to Trade (which relates not only to government rules but also to the standard-setting activities of non-governmental bodies); the Agreement on Government Procurement (which deals with practices of public enterprises); and several provisions in the General Agreement on Trade in Services (e.g., the provisions on monopolies and exclusive service suppliers which require that these suppliers not abuse their monopoly position outside the scope of their monopoly), supplemented further by relevant provisions of the agreement on basic telecommunications services completed in 1997 (box V.18). The TRIMS Agreement (UNCTAD, 1996d, Article 9) deals with investment performance requirements that restrain trade and provides that consideration be given to whether "the Agreement should be complemented with provisions on investment policy and competition policy". The TRIPS Agreement (UNCTAD, 1996d) requires members to cooperate on "control of anti-competitive practices in contractual licences". The Agreement provides

Box V.21. The UNCTAD Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices

In 1980, after almost ten years of negotiations, agreement was reached in UNCTAD on a voluntary code of conduct on competition: the Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices.

The Set's first objective is to ensure that restrictive business practices (RBPs) do not impede or negate the realization of benefits that should arise from the liberalization of tariff and non-tariff barriers affecting world trade, particularly those affecting the trade and development of developing countries. It also seeks to attain greater efficiency in international trade and development through, *inter alia*, promoting competition, control of concentration of economic power and encouragement of innovation. Moreover, it aims at protecting and promoting social welfare in general and, in particular, the interests of consumers.

Under section C of the Set, which spells out the multilaterally agreed principles for the control of RBPs, the specific needs of developing countries, and in particular the least developed, are taken into account, as it was agreed that "in order to ensure the equitable application of the Set of Principles and Rules, States, particularly developed countries, should take into account in their control of restrictive business practices the development, financial and trade needs of developing countries, in particular of the least developed countries, for the purposes especially of developing countries in:
"(a) Promoting the establishment or development of domestic industries and the economic development of other sectors in the economy, and
"(b) Encouraging their economic development through regional or global arrangements among developing countries"(para.7).

Section D of the Set (para.1) states that "enterprises should conform to the restrictive business practices laws, and the provisions concerning restrictive business practices in the laws of the countries in which they operate, and, in the event of proceedings under these laws, should be subject to the competence of the courts and relevant administrative bodies therein". Paragraphs 3 and 4 of section D deal with the main types of RBPs that enterprises should refrain from. Concerning intra-firm transactions between different entities of a TNC, while paragraph 3 excludes enterprises "when dealing with each other in the context of an economic entity wherein they are under common control, including through ownership, or otherwise not able to act independently of each other", paragraph 4 covers all enterprises which "through an abuse or acquisition and abuse of a dominant position of market power... limit access to markets or otherwise unduly restrain competition". This same paragraph goes on to list practices in this respect, which include predatory behaviour towards competitors and "discriminatory (i.e. unjustifiably differentiated) pricing or terms or conditions in the supply or purchase of goods or services, including by means of the use of pricing policies in transactions between affiliated enterprises which overcharge or undercharge for goods or services purchased or supplied as compared with prices for similar or comparable transactions outside the affiliated enterprises".

Section E, addressed to States, calls for the adoption and effective enforcement of appropriate competition legislation and implementing judicial and administrative procedures. Section E further calls for exchange of information and cooperation in proceedings, subject to confidentiality safeguards. Finally, Section F provides for consultation procedures and technical cooperation for developing countries.

An institutional machinery to monitor application of the Set was established by UNCTAD, in conformity with Section G, in the form of an Intergovernmental Group of Experts meeting annually.

Source: UNCTAD, 1996d, pp.133-144. Also reproduced in this publication is the Resolution Adopted by the Conference Strengthening the Implementation of the Set.

for consultations between members where there is reason to believe that licensing practices or conditions pertaining to intellectual property rights constitute an abuse of these rights and have an adverse effect on competition in the relevant market (Article 40). The cooperation is limited to the supply of publicly available non-confidential information of relevance to the matter in question.

As this brief review of existing cooperation arrangements shows, the need for international cooperation has been recognized, and some progress in this respect has been made at all levels. Still, more could be done.

3. Looking ahead

The most important areas in which further progress needs to be made concerns cooperation on information exchange and the enforcement of competition laws. Indeed, the UNCTAD Set calls for the institution of improved procedures for obtaining information from enterprises (including TNCs) and the establishment of appropriate mechanisms at the regional and subregional levels, to promote exchange of information on restrictive business practices and to assist each other in this area. The Review Conference of the Set provides a forum in which efforts in this respect can be pursued.

Countries that have not yet done so may need to conclude bilateral competition cooperation agreements with their major investment and trading partners. The laws of many countries prevent some kinds of information-sharing; but, even so, it could be useful for such agreements to provide for the exchange of information subject to existing laws. Regional agreements, too, could provide for exchange of information and encourage cooperation. While progress in this respect does not necessarily lead to a harmonization of competition laws, it tends to contribute to an increasing convergence of approaches to competition policy.

Cooperation efforts could also be strengthened if countries were willing to adopt "positive comity" policies towards one another. Under positive comity, the authorities of one country are sympathetic (and willing to act, where appropriate) to the concerns of the authorities of another country. For example, if a specific practice actually took place within the jurisdiction of one country but had demonstrably anticompetitive effects in a second country, the authorities of the latter country could initiate a complaint under which they would present their case before the authorities of the former country. These officials (of the country where the practice took place) may then take some form of action. This could consist, e.g., first, of investigation of the practice, and, then, of remedial action if such action was deemed appropriate.

For positive comity to work best, it would also be desirable that there be some element of mutual recognition of outcome. Thus, in the example above, the authorities of the country which initiated a complaint could consider abiding by the outcome of the investigation of the authorities of the other country and accepting the remedy arrived at by these authorities. (Of course, during the process of investigation and determination of outcome, there might be consultation between the authorities involved.) For this to be at all effective, it is clear that there must be a strong element of trust among the authorities of the relevant countries. At the same time, adopting positive comity and recognizing outcomes among countries with different levels of development may require a previous process of approximation on competition-policy stands, objectives and approaches, something that would take some time to achieve.

Even if this approach should prove to be successful, the question arises whether the international community requires more than expanded bilateral and regional cooperation to sustain the rapid regionalization and globalization of markets and production structures, especially under conditions in which the liberalization of FDI and trade policies make it all the more important that statutory obstacles are not replaced by anticompetitive practices of firms.

It is a question that, by its very nature, has broad implications, given the desirability of attributing a more prominent role to competition policy in a liberalizing and globalizing world economy. And it is a question that will most likely receive increasing attention in the future.

Indeed, recent international discussions reflect a growing recognition by the international community of the links between FDI policy, trade policy and competition policy, as means for maintaining contestable and competitive markets. This is underlined in particular by the decision taken at the December 1996 Ministerial Conference of the World Trade Organization in Singapore (WTO, 1996, para. 20) to establish one working group to examine the relationship between trade and investment, and another one to study issues raised by members relating to the interaction between trade and competition policy, including anticompetitive practices, in order to identify any areas that may merit further consideration in the WTO framework. As furthermore stated in the Ministerial Declaration, these working groups are to draw upon each other's work if necessary and also draw upon the work in UNCTAD and other appropriate intergovernmental fora.

D. Competition policy and market outcomes

The analysis in previous sections was undertaken in a framework in which FDI liberalization generally increases competition in markets. Within this framework, competitive markets are a means to achieve certain ends: economic efficiency, growth, economic development and consumer welfare. This section examines whether there are limitations as regards the effectiveness of competition (and, if so, what these are), considering that "like all instruments, markets should be evaluated by asking whether they promote our social and economic goals" (Sunstein, 1997, p. 384).[41] This is an issue of particular importance to developing countries, precisely because of the imperative of development.

Two situations generally motivate governments to take a more active role in markets: one is when markets tend naturally towards high levels of concentration; the other is when market outcomes conflict with other policy objectives. In both cases, rather than protecting the competitive process through competition law, governments usually choose to regulate markets in one form or another.

1. Naturally concentrated markets

A characteristic of virtually all economic activity is that, for entry to occur in a market, certain costs must be incurred on an "up-front" basis. These can include the costs of establishing production or distribution capabilities. They can also include, in some industries, the costs associated with establishing a reputation, including advertising and promotional expenses. To the extent that these costs are necessary and unrecoverable (should the supplier decide to exit the activity) the costs must be considered as "sunk" and,[42] as such, they affect the relative ease of entry in an activity. If the magnitude of these sunk costs is so high (relative to the size of the market) that no more than one producer can supply the relevant market and reasonably expect to amortize the costs, the activity is termed a "natural monopoly" (Boner and Krueger, 1991, p. 10).[43]

Most markets, however, operate on a continuum between natural monopoly at one extreme and contestability at the other. In addition, the conditions that sometimes give rise to natural monopolies are constantly changing over time, especially under the impact of new technologies; as a result, activities that, at one point in time are considered to be natural monopolies, may no longer have that status at another point in time, or only in a newly (and perhaps more narrowly) defined manner.[44] Sunk costs of entry in such markets yield an

advantage to incumbent suppliers, but the advantage is not so great as to preclude new entry altogether. The most likely scenario for new entry in industries with high sunk costs is that the potential new entrant has some advantage not possessed by the incumbent firms, such as a proprietary technology enabling lower production costs or superior variants of a product or service. As discussed in chapter IV, TNCs are sometimes in such a position, and may also be able to enter previously concentrated markets. However, it remains that "natural" factors can make some national markets, to a greater or lesser degree, difficult to contest. These include:

- *Economies of scale*. Certain industries possess technical characteristics that require large scale of production (and, often, high sunk costs) to be efficient. If the market is relatively small, only one or a few producers will be economically viable in such an industry. A special case of economies of scale relates to network costs. For example, markets for electricity distribution and telephone services have traditionally been treated as natural monopolies due to the high sunk costs associated with the required networks and the fact that it may be inefficient to duplicate the networks.

- *Risk costs*. Where sunk costs are particularly high and a particular economic activity is characterized by high levels of risk, a certain level of concentration in the market might be necessary for an economic activity to be viable from a business perspective. This has often been the argument put forward to competition authorities by companies seeking to cooperate more closely (or to merge), usually in areas relating to R&D, with a view towards sharing risk costs. The development of jet engines and commercial aircraft present examples of "bet-the-company" risks that owners seek to avoid by means of temporary or permanent alliances, many of which are screened by competition authorities.

One of the antidotes to markets that tend to be naturally concentrated due to the above factors involves increased entry into the relevant market for the products of these kinds of industries through market opening measures, especially investment and trade liberalization.[45] This is particularly important for countries whose internal markets are small. When a small economy (and in some instances even a large economy) is closed to international competition, the potential for natural concentration is much more significant.[46] However, in some cases, market enlargement through liberalization is politically difficult to achieve.[47]

A partial answer to the question of whether there are limitations to competition is, therefore, that there are indeed some limitations imposed by the very nature of certain economic activities. But even with respect to these activities, it may often be possible to increase competition by, for example, separating the "natural monopoly" activities from activities that are potentially competitive. Once all such possibilities have been considered, the policy question becomes how governments can minimize the negative economic effects that can be associated with limited competition.

Therefore, where markets are natural monopolies, regulation is needed to prevent abuses of dominant positions of market power by the seller, e.g., the setting of prices well above marginal costs and restricting output so as to generate higher rents. While regulation becomes important in these cases, governments need to ensure that regulation serves the purposes that it is meant to serve. One danger that they need to guard against is the possibility of "capture", i.e., regulators may come to serve the interests of the firms they are regulating instead of the interests of consumers. Another concern relates to the appropriate scope of regulation. Natural monopolies can exercise considerable market power, both upstream and downstream in their value chains. This can result in the extension of market power of a given natural monopoly into related markets which are not themselves natural monopolies (e.g., the operator of an

electricity transmission network could enter the electricity-production business and foreclose competition in this activity by not permitting competing producers access to the transmission network, which, in this case, is an essential facility). For example, some parts of telecommunications networks exhibit natural monopoly characteristics (Armstrong and Doyle, 1995, p. 2), but the selling of peripheral equipment (telephone handsets, modems, etc.) does not, nor does the selling of "value-added" services over the telecommunications network. In many such cases, competition policy can play a role, especially with respect to containing or even reducing the scope of natural monopolies, ensuring adequate access to essential facilities and generally aiming at reducing their potentially harmful effects.

2. Competing objectives

But there are also broader limitations, resulting from competing objectives, among which the development objective takes pride of place. Indeed, governments are often (if not always) faced with having to choose between competing objectives, and a number of these can conflict with the market outcomes that would be generated by reasonably competitive markets. These conflicts are more frequent in developing countries.

(a) Promoting development

Improving economic efficiency by making markets more competitive -- and thereby serving development -- is subject to the same need to make choices. Given the particular characteristics of developing countries -- low income levels, skewed distribution of wealth, lack of infrastructure, low levels of education, asymmetries in information, to mention a few -- the incidence of conflicts between market outcomes and competing objectives is often more frequent in these countries.

For example, where foreign exchange is temporarily in limited supply, certain import restrictions might be needed -- thus limiting contestability -- to ensure that critical imports are not disrupted, e.g.,
that foreign exchange reserves are used for machine parts instead of luxury goods. Or, where a country is characterized by dispersed rural communities, the market will often not provide these with certain basic services (such as roads, telecommunications services and railways); in these cases, governments might need to ensure that certain services reach segments of the national market which otherwise could not support such services. They could do so, for instance, by providing the services through state-owned enterprises or, where private operators are involved, by providing these with market power so that services in less-economically viable markets can be cross-subsidized from profits earned in larger segments of the market.[48] A policy alternative to consider in such a case would be more direct government involvement in the form of subsidized provision of the services in question. The decision in this case -- whether to allow concentration combined with cross subsidization or to provide subsidies -- would involve a careful consideration of the quite different trade-offs associated with these two options (possibly less efficiency in the market, on the one hand, versus a direct budgetary expense on the other).

It should be noted that these dilemmas -- and the need for more active government intervention in markets they might entail -- do not occur in developing countries alone. Governments of developed countries, in similar situations, also see the need to correct market outcomes through various regulatory or competitiveness-enhancing measures (table V.2). For example, recognizing the structural disadvantages faced by small and medium-sized enterprises relative to their larger counterparts, many countries exempt the former from competition rules below certain thresholds and/or provide them with special assistance.

If anything, this issue is even more relevant in developing countries, due to their particular characteristics. For example, if the competitive disadvantages of small and medium-sized enterprises are judged a reason for giving special treatment to such firms in developed countries, this may be even more so the case for many firms in developing countries, considering that most of them are small and medium-sized enterprises and that all of them face the structural disadvantages of their economies, especially in the context of liberalization and heightened international competition. This may require that firms in developing countries are given public support, e.g., to ensure that they have adequate access to finance and have opportunities for learning-by-doing, so that they are competing on a level playing field and have an opportunity to move up the learning curve of international competition.

Governments have also limited exposure to international competition in order to provide their firms the breathing space to become internationally competitive. However, when this is deemed necessary, care needs to be taken to find the proper balance between the right dose of international competition and intervention. If limits are too weak, strong international competition may force local firms to exit the market; however, unlike in the case of trade -- where import liberalization can lead to a reduction of domestic capacities -- competition through FDI does not necessarily eliminate domestic productive capacity, but rather changes it ownership and, therefore, raises other questions, namely those related to the implications of foreign ownership for economic development. If limits are too strong, domestic firms may not adjust to the international competitive environment.

Table V.2. Selected exclusions from competition laws, selected OECD countries[a]

Country	Labour	Fishing	Agriculture	Energy	Transport	Media	Medical related	Small and medium-size enterprises	Export cartels	Special-ization cartels[b]	Other cartels[c]
Canada	B	B	P	SG	P	P	No	No	P	P	P
France	B	No	P	P	No	P	No	No	n.a.	n.a.	n.a.
Germany	B	No	P	P	P	P	R	No	P	P	P
Hungary	B	No	P	R	R	P	P	P	P	P	P
Japan	B	P	P	P	P	P	P	P	P	P	P
Mexico	B	No	No	R	R	P	No	No	P	No	No
Portugal	B	No	P	R	n.a.	B	No	No	No	No	No
United Kingdom	B	No	P	R	P	P	P	P	P	No	P
United States	B	P	P	R	P	P	No	No	P	No	P
European Union	B	No	P	P	P	P	No	No	P	P	No

Source: UNCTAD, based on OECD, 1996d.

B: Broad exemptions from competition laws.
P: Partial application of competition laws.
R: Regulated sector.
SG: Safeguard related provisions.

[a] It should be noted that the classifications in this table do not reflect the different factors and conditions that apply across jurisdictions with respect to the applications of competition rules, nor do they reflect differences in approach towards enforcement, including approaches with respect to efficiency defences. As such, the table is more indicative of the flexibility that governments exercise in their application of competition laws than of actual derogations from competition laws. In particular, the classification overstate the exclusions for small and medium enterprises since many laws "exclude" only conduct that would likely be lawful in any event.

[b] Specialization cartels involve arrangements between suppliers to allocate markets according to types of products.

[c] These can include cartels relating to terms and conditions, rebates, authorizations, structural crisis, notifications on standards, exchange agreements, and various consortia.

In general, these forms of selective government intervention in the market are meant to address the particular characteristics of developing countries. They involve creating the proper policy mix aimed at defining the rules of competition, on the one hand, and undertaking measures to assist and encourage the building up of domestic capabilities, on the other hand.[49] Indeed, the key issue is to help domestic firms to participate effectively in international competition and to move up the value-added chain. Of course, finding the appropriate forms of government involvement depends, among other things, on the level of development, which varies from country to country and industry to industry; they can also change over time and in light of other competing objectives; they need to be targeted as narrowly as possible since any trade-offs in terms of economic efficiency should be minimized; and they are often difficult to implement exactly in the manner in which they are thought to bring about the desired benefits. Hence, while market intervention is needed to promote development, it is very difficult, indeed, to define general criteria for determining the type and scope of such intervention, in particular where alternative policy options exist. In any event, the main emphasis should remain on establishing, where possible, competitive and fair markets which provide a level playing field for domestic as well as foreign firms; only where this is not viable, governments need to take a more active approach vis-à-vis markets.

(b) Other objectives

Apart from development objectives, there are a number of other objectives that may not be well served by market forces and that therefore may motivate governments to play a more active role in markets. These include:

- *Safeguarding national security*. Virtually all governments intervene in markets to maintain domestic production capacity in certain industries considered essential to national security by restricting foreign (and sometimes even domestic) participation in these. They do so to minimize the risk of disruption of supply in the event of conflict and to keep certain knowledge (especially relating to high technology) from potential adversaries.

- *Protecting labour rights*. A fully market-driven national labour market would have no minimum wages, would not allow unionization or other forms of cooperative labour agreements, would not necessarily prohibit indentured servitude (a form of slavery based upon contracts) and would probably not impose regulations relating to the quality and safety of the work environment upon firms. Most societies have therefore recognized the need to regulate national labour markets because market forces would give rise to outcomes that neither governments nor societies find desirable.

- *Safeguarding culture*. Governments sometimes regulate cultural industries, with a view towards protecting and maintaining national and cultural identity.

- *Promoting positive externalities*. Positive externalities relate to activities whose net social benefit exceeds the return that a private investor could expect under normal market conditions. In other words, in cases where market signals understate the benefits to society of the activity in question and where market signals alone determine levels of investment and output, these would be less than optimal from a social perspective. Education and health care are among the most common instances of activities in which governments intervene in markets based upon the expected positive externalities associated with these services.

Another form of positive externality relates to the development and establishment of standards. For example, clear telecommunications standards imply that the market for peripheral telecommunications equipment (e.g., modems, faxes) is much larger than it would be if the market were segmented by a large number of different standards. Clear standards also increase the value of networks themselves (e.g., the utility of having a telephone is much greater if it is possible to call one million people than if it is only possible to call one hundred people due to incompatible standards between telecommunications networks).

Standards are particularly relevant in the area of professional services. For example, in the legal, accounting and medical professions, standards (in the form of accreditation by professional societies) enable consumers of the relevant services to gauge better the quality of these than would be the case in the absence of such standards.

- *Protecting property rights*. Where property rights are either not protected, or are simply not clear, competition for the property in question can give rise to inefficient outcomes. Governments therefore intervene in markets in various ways to protect property rights. A prime example concerns intellectual property rights.[50] Such rights, as embodied in patents, trademarks and copyrights, are protected because it is felt that granting such protection is needed to provide the incentives required to encourage further innovation and a high rate of commercialization of inventions.

- *Avoiding negative externalities*. Negative externalities involve costs to society that are not borne by the producers of such costs. Pollution, for example, is one of the most commonly cited negative externalities; if environmental regulations are not implemented, firms will tend to externalize the costs of operating cleanly by dumping waste. Likewise, for example, the location of airports is usually tightly regulated by governments due to the negative externalities associated with these (air and noise pollution).

- *Protecting consumers*. A number of industries have traditionally been regulated, including as regards entry by new entrants, for prudential reasons. The rationale for regulation in this case has been the asymmetric information (between producers and consumers) characterizing these industries, coupled with the high cost (in economic and social terms) of various failures associated with market forces in these industries. For example, financial industries have traditionally been regulated due to the high costs to society of exit from this industry -- in effect, exit from the financial industry is usually associated with negative externalities. It has therefore been considered inappropriate by many governments to allow market forces to hold sway in an industry where such significant exit costs are involved (e.g., the life savings of pensioners). Similarly, it has been argued by some that too much competition among airlines (or any other service provider where safety is a factor) could lead these to reduce costs at the expense of safety.

In sum, there are a number of instances in which other objectives may require careful and selective government intervention in the operation of markets. In some cases, the undesirable outcomes are due to market failures, e.g., the failure of the market to reward innovation in the absence of government intervention to protect the latter, or the failure of the market to provide adequate education or health care. Market failures, which can be encountered in all markets, are prone to exist more acutely in developing countries, and especially in the least developed countries. Indeed, many of the characteristics of underdevelopment relate in some form or another to market failures. In other cases, the undesirable outcomes are due to the failure of the market to serve particular objectives, e.g. national security. In these instances,

governments intervene in markets through various forms of regulation to ensure that competing social objectives are met.

At the same time, policies put in place for that purpose need to be formulated carefully to achieve the desired objectives,[51] and it should be recognized that such policies often come at the expense of reducing economic efficiency. Furthermore, a clear distinction needs to be drawn between undesirable market outcomes that relate to competition and those that relate to the interaction of markets and government policies. Indeed, within the context of the inextricable relationship between government policies and the functioning of markets, it becomes difficult to identify "pure" market failures. Rather, in many instances, market failures reflect a particular interaction between policies and market forces that give rise to undesirable outcomes (such as, for example, when a market that does not have natural monopoly characteristics is treated by policy makers as if it does, in which case a second best solution is adopted when the first best solution was available).

* * *

The main message of this concluding section is that there are, indeed, limitations to competition especially where market forces do not bring the desired results. This is especially the case in developing countries.

In these circumstances, there is a need to achieve the right balance in the choice of means used to pursue competing objectives. One problem for policy makers faced with competing policy choices is to distinguish between government intervention in markets that serves legitimate policy goals, and intervention which rather serves to maintain market power for particular vested interests, without contributing significantly to broader social objectives. This is a particularly important issue where government intervention in the market involves discriminatory measures between domestic and foreign firms. While many of the considerations outlined in this section have been used to justify circumscribing competition to some degree, doing so should always be tempered by the recognition that efficiency trade-offs are often involved. Moreover, when governments choose to circumscribe competition, the means by which they do so should be the least damaging from an efficiency perspective and should be transparent and subject to review in light of changes in markets and the original rationale for such policies.

Notes

1 For more details of the process of liberalization, see UNCTAD, 1994a, 1995a, 1996a.

2 An example of such practices may be keiretsus. The term "keiretsu" in Japanese is often preceded by a modifier such as kin'yu keiretsu (financial groups), kigyo keiretsu (corporate groups), kigyo groups (affiliated firm groups), or ryutsu keiretsu (distribution groups), specifying the type of relationship among the affiliated firms. However, as Matsushita (1997) observed, the term is rather vague and does not necessarily involve contractual relationships between the affiliated firms. Instead, these may be *de facto* relationships based on repeated transactions.

3 Competition authorities could nevertheless consider intervening in circumstances where shareholdings by a firm in a competitor firm are or may be used to prevent a joint venture with an investment by a new entrant.

4 In some cases, these practices appear to be anticompetitively motivated. However, they might also be explained by fiscal, social or cultural reasons. Thus, in some countries, society sees companies as having a particular responsibility for their employees, and "take-overs are socially and ethically frowned upon as akin to buying and selling people" (Lehmann, 1997, p. 98).

5 Until recently, many governments used various types of investment incentives in exchange for performance requirements, such as export performance, technology transfer, training of local personnel and local content requirements. The TRIMs agreement clarified that a number of these performance requirements are prohibited and should be phased out. These include both certain mandatory performance requirements as well as requirements linked to the granting of incentives.

6 Granting market power is most often an issue when a firm is new to the country (since such a firm usually has something new to offer to the economy where it may establish itself, and because it typically has greater leverage in terms of negotiating with different governments before committing itself to invest), or has natural monopoly characteristics.

7 Canada, Denmark, Norway, the Russian Federation and Venezuela are among the countries whose competition laws include as a main objective to promote economic efficiency (UNCTAD, 1995c).

8 For a recent study that shows that properly designed and phased-in competition policy can stimulate innovation in developing countries, see Mytelka, forthcoming.

9 For a discussion of the objectives of competition policy, see Khemani, 1993.

10 Competition laws, in general, do not consider the possession of a dominant (or monopolistic) position *per se* unlawful but, rather, the abusive exploitation of that position.

11 "Horizontal agreements" are concerted practices among enterprises competing (actually or potentially) in the same relevant market. "Vertical agreements" are agreements among firms active at different stages of the production/distribution chain (producers, distributors, wholesalers, etc.).

12 In other words, the degree of concentration is only the starting point of a competition analysis. As the Merger Enforcement Guidelines of Canada (p. ii) put it: "No inferences regarding the likely effect of a merger should be drawn from evidence that relates solely to market share or concentration. In all cases, an assessment of the market share and concentration is only the starting point of the analysis." (Canada, Director of Investigation and Research, 1991).

13 For the purpose of merger control, the term "joint venture" refers to arrangements between firms that involve acquisition of a "controlling interest" by one of the firms involved. Acquisitions involving no changes of control, such as a company acquiring more shares of a firm it already controls, are normally not reviewed by competition authorities. Foreign investment without control or voting power ("portfolio investment") does not in most instances create competition problems, or is expressly exempted. For example, Section 7 of the United States Clayton Act exempts acquisitions "solely for investment". Similarly, Article 3(5)(a) of the European Merger Regulation (4046/89) provides that holdings of credit and financial institutions who regularly deal in securities on their own or others' accounts do not fall within the merger regulation, provided the institutions do not exercise voting rights in the securities. Germany has a similar (though not identical) provision to that of the European Union (Gesetz gegen Wettbewerbschränkungen, Section 23(3)).

14 The "effects doctrine" -- which asserts jurisdiction over conduct abroad that affects domestic consumers -- is the best known approach towards dealing with domestic effects; it is not universally accepted. It was first developed in the United States. The European Union has applied something approaching the effects doctrine in a number of cases (see, e.g., the discussion of the "Wood Pulp" case below). What remains controversial is the claim that jurisdiction can be based on conduct abroad that does not affect a country's consumers but does affect its exporters.

15 For some practical suggestion in this respect, see Crampton and Carley, 1997.

16 Similar types of considerations appear to have affected the attempted acquisition of Sotheby's auctioneers in 1983. The bid was referred to the Monopolies and Mergers Commission because of the impact such a take-over might have on "the importance of London as the centre of the international art market and the importance of Sotheby's in relation to that market." (Rowley and Baker, 1991, p. 217).

17 On national interest considerations, see also Goldman, Kissack and Witterick, 1997 and Crampton and Corley, 1997.

18 The "failing firm" defence provisions in competition laws allow competition authorities to authorize or exempt certain activities that would otherwise be considered anticompetitive and, hence, illegal when such activities are deemed necessary to avoid the failure of a firm or industry and when such a failure raises significant social concerns. The failing firm defence usually consists of exemptions for various types of cartels (e.g., depression cartels, specialization cartels, rationalization cartels, structural crisis

cartels) as well as provisions that allow for a more lenient treatment of proposed mergers. Most competition laws contain some form of failing firm defence. Those that do not, nonetheless have shown prosecutorial discretion in taking into account factors similar to those that are explicitly spelled out in the competition laws of other countries (Waller, 1995).

19 For example, in the United States the ultimate concern would be the impact of an outward FDI transaction on United States consumers or on trade, including anticompetitive suppression of exporters from the United States. See the United States Foreign Antitrust Enforcement Act of 1982, enacted as Title IV of the Export Trading Act of 1982.

20 For a detailed analysis of the Gillette/Wilkinson Sword merger see OECD, 1994.

21 The UNCTAD Set has exempted, to a large extent, intra-firm transactions from the applicability of the principles and rules for the control of restrictive business practices. Section D(3) concerning horizontal arrangements states that "Enterprises, except when dealing with each other in the context of economic entity wherein they are under common control......" should refrain from practices defined as anti-competitive. At the same time, the Set covers all transactions between affiliates and third parties in host countries and, according to its Section D (4), firms should refrain from certain acts or behaviour which are considered abusive (to be examined in terms of the purpose and effects in actual situation of acts or behaviour) "in particular with reference to whether they limit access to markets or otherwise unduly restrain competition ... and to whether they are: (a) appropriate in the light of the organizational, managerial and legal relationship among enterprises concerned, such as in the context of relations within an economic entity and not having restrictions effects outside the related enterprises" (note to section D.4). For example, partial or complete refusals to deal on the basis of customary commercial terms (taking into account legitimate business practices, such as consideration of quality or safety) may amount to abuse of dominant positions. Restrictions of this type that may be included in licensing and trade arrangements can be particularly important, because they affect the developmental impact of foreign affiliates by impeding the development of downstream linkages in host county economies.

22 The issue of access to essential facilities is frequently discussed among competition authorities and commentators, and is becoming increasingly relevant given the current trend towards deregulation. The essential facilities doctrine -- which basically provides that a person who controls a facility essential to entering a market must allow others access -- has yet to be established in a number of countries. The European Commission has recognized this doctrine in the British Midland/Air Lingus case, when it took the position that companies in dominant positions have a duty to provide access to facilities when the effects on competition of a refusal to do so are significant and there is no objective commercial reason for refusal (Goldman, Kissack and Witterick, 1997).

23 On the question of transfer pricing, see Plasschaert, 1995.

24 In the United States, the trend originated in the late 1970s and was reflected in the GTE-Sylvania decision by the Supreme Court which held that vertical territorial restraints in manufacturers-dealer contracts were subject to a rule-of-reason test (United States, Bureau of National Affairs, 1990). In other cases, the Court decided not to apply the *per se* violations, but considered on a case-by-case basis according to the rule of reason, e.g., in Berkey Photo Inc. v. Eastman Kodak Company (United States, Second Circuit Court, 1979).

25 In order to encourage joint R&D, the United States enacted the National Co-operative Research Act in 1984, making joint undertakings less risky and more desirable for firms by clarifying that the rule of reason applies to such ventures and eliminating treble-damage liability for joint ventures that provide adequate notification to the Government.

26 A number of non-governmental organizations such as, for example, the International Chamber of Commerce (ICC) and Consumers International, play an active role in promoting the adoption of effective competition laws and have also stressed the need for international policy discussions in this area.

27 The need to address trade, investment and competition policy "to ensure a smoothly functioning global market place" was recognized, among others, by the International Chamber of Commerce in its submissions to the Heads of State and Government of the Group of Seven Countries attending the 1995 Halifax Summit, and the 1996 Lyon Summit (ICC, 1995, 1996a).

28 For a discussion of the difficulties and limitations often encountered in adopting and implementing competition laws, see UNCTAD, 1996c, annex 1 and 2.

29 The practice of the European Union is illustrative in this respect. Firms can formally notify their

agreements to the European Commission for assessment of their compatibility with the competition rules of the Treaty of Rome. Formal notification is a condition precedent for obtaining an exemption under Article 85(3) from the general prohibition and automatic nullity in Article 85(1) and (2). Notification grants also immunity from fines for the notifying parties from the moment of notification. Since 1962, the European Commission has received some 30,000 notifications.

30 The enhanced importance given to efficiency considerations in United States case law is reflected in the April 1997 amendments of the United States Merger Guidelines which place special emphasis on efficiency justifications, if proved, for mergers (including cross border mergers) between competitors leading to concentration well short of monopolization (United States, Federal Trade Commission, 1997). Canada's Competition Law, too, contains an efficiency exception (Canada, 1985, Section 96).

31 Also Australia and the United States have enacted legislation permitting such cooperation in civil cases pursuant to bilateral agreements, and they have recently negotiated an agreement under those laws.

32 Such obligations reflect concerns of the business community regarding the disclosure of confidential and competitively sensitive business information. See, for example, ICC, 1996b.

33 A "blocking statute" bans firms from disclosing information or authorizes a government official to direct firms not to disclose information.

34 It is also of interest to note that the United States did not interpose an objection to the European Union investigation of United States firms's involvement in the Wood Pulp case, which meant -- if not cooperation -- at least non-opposition.

35 However, in the interest of legal security and to avoid overloading the work of the European Commission, the agreements made in accordance with Regulation No. 1384/83, concerning exemptions on exclusive dealing arrangements, do not require notification.

36 In Canada, hard core cartels are also a criminal offence, while monopolization is not; rather, monopolies are addressed under the civil reviewable merger and abuse of dominance provisions of the Competition Act.

37 Another type of bilateral treaty dealing with competition issues are the bilateral treaties of friendship, commerce and navigation (FCN). These treaties were concluded in earlier decades in considerable numbers by the United States and, to a lesser extent, by Japan and a few Western European countries with other developed and developing countries, and a number of them are still in force. While intended primarily to regulate trade and investment between the two countries in the context of broader economic relations, these treaties included various provisions dealing with business practices that restrain competition, limit access to markets or foster monopolistic control. On the other hand, bilateral investment treaties for the promotion and protection of foreign investments do not include provisions dealing with anticompetitive business practices.

38 In addition, the protocol also envisages possible cooperation with other governments in the region on issues relating to competition (Article VIII(b)).

39 The Havana Charter, which was the close precedent of the General Agreement on Tariffs and Trade (GATT), did include substantive provisions on the treatment of restrictive business practices that might restrain competition in international trade (Chapter V), together with provisions on the treatment of government measures dealing with trade and investment. Only provisions dealing with trade, however, were taken it into the GATT (UNCTAD, 1996d). Instead, a Decision was adopted in 1960 on Arrangements for Consultations on Restrictive Business Practices (GATT, 1961) whereby it was recommended that, at the request of any contracting party, consultations should be held on harmful restrictive practices in international trade on a bilateral basis. Thus far, however, very few consultations have taken place pursuant to this Decision (WTO, 1997).

40 Although the "nullification and impairment" clause existed prior to WTO in GATT Art. XXIII (1)b, it was seldom used because the standards for its application were ambiguous. The new Dispute Settlement Understanding (Section 26.1) states that Article XXIII (1) b concerns measures that do not violate GATT rules. Nevertheless, member countries can appeal to a WTO panel for "mutually satisfactory adjustment" in case it is found that the measures "nullify or impair benefits" under the relevant agreement. The panel, however, cannot mandate removal of the disputed measures. A recent submission under this Article was the Kodak v. Fuji case concerning exclusive dealings for which United States and Japan

standards are markedly different (Takigawa, 1997).

41 Sunstein goes on to observe, "... markets, free or otherwise, are not a product of nature. On the contrary, markets are legally constructed instruments, created by human beings hoping to produce a successful system of social ordering...there is no opposition between 'markets' and 'government intervention'. Markets are (a particular form of) government intervention" (Sunstein, 1997, p. 384).

42 In other words, in the event of exit, the costs are forfeited.

43 It should be noted that natural monopolies can exist also where sunk costs are low. For example, airline service between two medium-sized cities (provided that new entrants have adequate access to slots, ground handling facilities, etc.) could be a market where least cost service mandates a single supplier, but the identity of that firm could change quite quickly. Sunk costs are emphasized in the discussion, however, since it is this feature of some natural monopolies that gives rise to limits to contestability.

44 For example, cellular telecommunications technology has contributed to the erosion of the natural monopoly positions of the traditional land-based networks. See in this context also the box on the WTO basic telecommunications agreement earlier in this chapter.

45 Augmenting this point is that, where such policies are likely to accelerate economic growth, growth itself can help to make markets more contestable: a new entrant is more likely to enter a market with high growth potential, even if sunk costs cannot be fully amortized in the market at its present size, if the market is expected to expand in the future.

46 For example, an isolated island economy (no FDI or trade) with fifty inhabitants will, in all likelihood, only be able to support one producer of shirts. The shirt producer is a natural monopolist. If the market expands, however, either through population growth or through the establishment of trade relations with a larger neighbouring island, the conditions for the natural monopoly disappear.

47 The debates over market enlargement in the context of the NAFTA negotiations are but one example of how politically difficult such an approach can be, even for relatively open economies.

48 In other words, the government would grant a firm market power but would also impose the condition that it must supply specific markets that would be unprofitable in addition to those that it would supply if it was guided only by market forces.

49 The UNCTAD Set provides for "preferential or differential treatment for developing countries" in section C, para. 7, especially with respect to "(a) promoting the establishment or development of domestic industries and the economic development of other sectors of the economy, and (b) encouraging ... economic development through regional or global arrangements among developing countries." (UNCTAD, 1996d, pp.133-144).

50 By way of illustration, entry into a market would be enhanced if, for example, a new entrant could enter a market by selling a product for which brand recognition was significant under the brand name of an established seller. Equally, the new entrant might try to establish a new brand name by degrading the established brand name, for example, by selling a tainted product under the established name. The problem with this from an economic efficiency perspective is that, in the absence of intellectual property protection, there would be little incentive for firms to undertake the costs of creating the brand name to begin with. A similar problem exists for proprietary technologies: if all potential new entrants into the market for a good embodying (either in product design or production process) a proprietary technology were allowed to copy the technology free of charge (that is, without having to make payments to the firm holding the technology), and assuming (as is likely) that the costs of imitation of the technology are significantly less than those associated with the innovation, there would be a major disincentive for firms to innovate in the first place. This disincentive would result from the fact that innovating firms might not reasonably expect to achieve a satisfactory return on an investment (sunk costs) in new technology creation if the successful technologies were to be rapidly imitated by competing firms. Patents, trademarks, and copyrights therefore exist in order to preserve incentives to innovate new technologies and designs, or to create brand names.

51 For example, if air pollution is a problem in a given region, authorities might choose to disallow further entry to the industry as a means of limiting further emissions. Yet, this limit to contestability would be misplaced if entry served to replace older facilities with more technologically advanced cleaner facilities. An alternative solution to the dilemma might be the creation of a market for "pollution rights", so that a new entrant could buy the rights to emit a certain amount of effluent from another firm, which would

then use the proceeds gained from selling its own rights to shut down a facility. It has been noted that such a market can promote clean air, because if the right to pollute were to become extremely costly, heavy polluters would have an incentive to sell their rights (and shut down their facilities) because the value of the right on the market might exceed the ongoing value of the facility. While the existence of such markets would limit somewhat market contestability (because a new entrant would have to buy pollution rights, adding to the costs of entry), it would do so minimally.