

DPRU CONFERENCE ON REGULATION

COMPETITION LAW AND POLICY IN BAD TIMES

Macro-economists often stand accused – with good reason – of treating firms as black boxes whose diverse features are not acknowledged, or even understood, when responses to fiscal and monetary policy decisions are considered. But by the same token, much of micro-economics treats the broader economic and political context as a black box, as a mere neutral stage on which firms and individuals interact. Competition and regulatory economics, in all its stimulating, mind-bending, complexity is the province of very clever micro-economists who endlessly model and theorise the strategic interactions of firms and the behaviour of consumers without giving much thought to the context in which this behaviour occurs. However, broader contextual issues set the stage for those interactions and when that set changes, the parameters and possibilities, the outcomes and the public expectations, of regulatory interventions shift, sometimes markedly. We are currently experiencing such a change in the stage set, and I want to look at the immediate prospects for competition law and policy in this changed context.

In summary I will argue that competition law and policy has, over the past 15 years experienced something of a golden age. But this was a period of high global growth rates when policymakers were prepared to endorse market friendly economic policies, in part, because some of the more severe dislocations of economic reform were cushioned by high growth. However the worm has turned. We are now entering a period of low growth, even recession. This will throw up significant new challenges for competition law enforcement and for competition policy. I will identify the features of the era of pro-market competition law and policies and outline the challenges that these approaches will face in the current period of economic difficulties.

US Supreme Court Justice Thurgood Marshall once famously described the Sherman Act, the US anti-trust statute, as

‘...the Magna Carta of free enterprise...as important to the preservation of economic freedom and our free-enterprise system as the Bill of Rights is to the protection of our fundamental personal freedoms’?

In recent years this ‘magna carta’ has come to constitute the fundamental economic law of most national economies. At any of the numerous international conferences on competition law someone, sooner rather than later, will observe that whereas in about 1990 there were of the order of 14 functioning competition authorities in the world, by the end of that decade the number had grown to little under 100 and this pattern has continued to the present day. A high point in the global acceptance of the centrality of competition law was achieved this year when both India and China passed anti-trust statutes.

This has predictably coincided with the mushrooming of regulatory authorities in those markets – for example, telecommunications, energy, etc - where competitive outcomes are, for a variety of reasons, not always possible and with a significant development of regulatory techniques and instruments.

The reason for the massive up-take of competition law and policy is not difficult to identify: it follows the spread of what Justice Marshall refers to as ‘free enterprise’ and what this conference would term ‘liberalisation’, a characteristic feature of both developed and developing countries in the 80’s and 90’s and this on two fronts: firstly by way of a significant reduction in barriers to cross-border flows of goods and services and capital. Secondly via domestic market reforms that, through privatisation, significantly reduced the direct role of the state in production and, through deregulation, purported to lower what were widely construed as domestic regulatory barriers that impeded business entry and growth.

These days one hears much – and rightly so - about market failure, but it is often forgotten that the underlying reasons for the widespread acceptance of liberal economic policies reside mostly in state failure. In developing countries, this was manifest in the shockingly poor service delivered by corrupt and incompetent states and state owned enterprises. There is, of course, a significant body of opinion that understands liberalisation in developing countries as the product of the dominance of institutions like the IMF and the World Bank. There is undoubtedly a strong measure of truth in this but it’s equally true that the multilateral institutions were, in significant part, able to achieve policy influence in many developing countries precisely because the statism that characterised post-Second World War development economics and policy had run into the sand.

In the transition economies of the former Soviet bloc, the conditions for the introduction of liberal economic policies are self-evident. Not only were the economic shortcomings of statism particularly evident in these countries, but the political underpinnings of centralised economic management were, largely in consequence of their economic failings, abruptly removed, leaving a vacuum into which market forces poured.

In the European Union whose member states have a strong history of state participation in the economy, both as a provider of basic public goods and, through trade and industrial policies, an instrument of growth, liberalisation was the critical instrument for eliminating barriers between the various national markets of the member states, for, in other words, creating the common market and so, from inception, competition law was at the centre of the European project.

In the US reform appears to have taken the shape of lighter modes of regulation than were previously employed. One particularly pertinent example: banking regulations were substantially relaxed in this period. Also in the latter part of this period US approaches to anti-trust enforcement were markedly less interventionist than had been the case in earlier periods. While the US anti-trust authorities remained as vigilant as ever where cartel conduct was concerned, they eased up significantly in their approach to mergers and to dominant firm conduct.

As the state retrenched in each of these widely divergent sets of national economies, a common theme began to emerge and that is that while market liberalisation did indeed prove capable of enhancing economic performance, experience starkly demonstrated, yet again, that markets, like all other institutions, require, a framework of rules governing the conduct of participants in their activities. The core element of these rules – those dubbed by Marshall the ‘magna carta’ or constitutional law of the market economy – are those rules governing the process of

competition. The proponents of liberalisation appear to have forgotten that 'free' markets – even those whose structures are actually or potentially competitive – are only able to fulfil their considerable promise in the context of a regulatory framework that would blunt the immensely powerful incentives to collude in a competitive structure or to abuse a monopolistic structure.

Inevitably the most dramatic evidence of the effects of this regulatory lacuna was found in those economies where markets had been most comprehensively repressed. Hence following the 'big bang' liberalisation of the Russian economy, the development of a capitalist class was marked by the rapid rise of the politically well-connected and immensely wealthy oligarchs who grabbed control of what had previously belonged to the state, a process which inured to the everlasting benefit of the supporters of the Chelsea football club if not ordinary Russians. And you will recall how the first decade – indeed until the commodities boom – of post-Soviet capitalism was equally characterised by the sudden withdrawal of public goods and a massive surge in prices of most goods and services.

These dislocations were experienced in developing countries as well, most of which contain salutary lessons of botched privatisations and of regulatory frameworks that, where they existed at all, were simply not up to enforcing the required rules of conduct on participants in these newly created markets. In similar fashion to the experience of Russia it was often a small group, generally allied to the ruling party, who reaped the benefits from liberalisation.

Nor did the most advanced economies escape the consequences of ill-considered deregulation, or, rather the consequences of removing defective regulatory frameworks without replacing them with a more appropriate set of rules. I've already noted that liberalisation in the US proceeded by way of the deregulation of important markets and the weakening of anti-trust enforcement. There can be little doubt that severe failures in important energy markets in the US at the turn of this century and contemporary problems experienced in financial markets owe much to incomplete deregulation, incomplete in the sense that the removal of old, and conceivably, inappropriate regulatory frameworks, were not replaced by a new, more efficient regulatory framework. And when the US emerges from this current crisis with significantly more concentrated financial markets it will not be well served by the more permissive approach of its anti-trust authorities to dominant firms. Europe arguably escaped some of these dislocating consequences of liberalisation because the major thrust of its liberalisation consisted of the establishment of precisely those rules – community-wide anti-trust rules and, to a lesser degree, sectoral regulation – that underpin the effective functioning of a common market.

So there you have a very high level potted recent economic history of the world: a world of widespread liberalisation accompanied by unusually high levels of growth threatened by massive inequalities and by conduct by market participants that, in turn, threatened to undermine the very gains achieved by liberalisation. It was precisely these outcomes of liberalisation that led to the widespread adoption of anti-trust rules and the proliferation of sector regulators that I referred to at the outset. These were intended to restore order to the market system precisely so as to ensure, in the words of Thurgood Marshall, the '*preservation of economic freedom and our free-enterprise system*'.

But these new regulatory institutions and mechanisms encountered significant obstacles. For one thing, were always playing catch-up, they were always having to deal with firms – publically and privately owned – that were not only immensely powerful in their markets, but which enjoyed privileged access to information and political power. For example, while Russia has made a significant commitment to competition enforcement it is difficult to see it operating independently of a political authority so deeply intertwined with immensely powerful business interests. Similar doubts must apply to India and China where the prospect of competition enforcement being used as a protectionist device rather than a supportive framework of rules for a liberal economic order is strong.

South Africa reflects much of this experience. The passing of our new Act – which represented a comprehensive break with previous experience of competition enforcement – also follows a period of significant liberalization. We too have had to contend with dominant firms, often recently privatized, in key markets. It is no coincidence that we count firms like Sasol, Mittal and SAA – and were jurisdictional uncertainties to be sorted out no doubt also Telkom, Escom and Transnet - as amongst our most regular customers. In regulated sectors there is little doubt that resource constraints, informational asymmetries and an uneven distribution of political power have significantly favoured the incumbent operators over the beleaguered regulators.

However there are peculiar factors that have assisted competition enforcement in South Africa. While many of our markets are characterized by high levels of concentration and by exclusionary and co-operative conduct that has furthered concentration, we, in contrast with the transition economies and many developing economies, do have significant experience of competitive markets. But more than this, the prospect of robust anti-trust enforcement enjoyed considerable popular and official endorsement. All the major policy pronouncements of the ANC – both as a liberation movement and then as the ruling party – make this explicit. Even the venerable Freedom Charter inveighs against monopolies. And this support is manifest in the Competition Act that came into effect in 1999. The Act extended to the newly created competition authorities extensive investigative and remedial powers and an unusual degree of independence from executive intervention. The reasons for this level of popular and official support are fairly obvious: the existence of ‘monopolies’ – which often seemed to focus on concentrated ownership structures rather than concentrated market structures – was a longstanding grievance, particularly given their association with racial exclusion. The weakness of small business – itself a reflection of concentrated market structures and racial exclusion – bolstered support for a policy intervention explicitly concerned with lowering entry barriers. In short, while the strengthening of South African competition law coincided with economic reform, it was legitimized by a deep seated popular sentiment similar to that which characterized the introduction of US anti-trust at the turn of the last century. That is to say, South African competition law was as much, if not more, driven by the imperative to confront long standing concentrations of economic power, as it was to support liberalization.

All the difficulties notwithstanding, global anti-trust enforcement proceeded apace, with considerable popular support. Markets were delivering on their promise as manifest in high economic growth rates. Although liberalisation generated substantial adjustment costs, high growth rates served to cushion some of these costs. In the meantime, anti-trust enforcers were

supporting markets in achieving their best outcomes and doing so in a manner that confirmed anti-trust's promise to confront concentrations of economic power. They were apprehending important international and domestic cartels and imposing record fines and, in the US, considerable jail time. High profile cross-border and domestic mergers that threatened competition were being blocked although, on occasion, merger review revealed significant differences in approach between the US and an increasingly aggressive EU. Although the enforcement of rules against monopolistic conduct continued to generate significant controversy, the 'nineties saw the beginning of the Microsoft cases first prosecuted by the Clinton administration, later soft-pedalled by the Bush administration and then pursued with greater vigour by the EU. Nor was this upsurge in enforcement activity confined to the developed country enforcers. For example countries like Brazil, Mexico, Korea, several of the transition economies and South Africa notched up significant successes in merger review as well as cartel and unilateral conduct enforcement and commanded considerable respect both in their own countries and in the international business and enforcement world.

Nor did the competition enforcers necessarily confine their attentions to the private sector. The European competition directorate, driven as it is by the imperative to create and maintain a single European market, enjoys jurisdiction over national state aid and frequently took on the nationalistic industrial policies of powerful national European government. Other competition authorities are empowered to veto local government legislation and many, including the South African competition authorities, are consulted as a matter of course by national government departments on the competition implications of intended legislation and policy. Where jurisdictional considerations permitted it, SOEs also found themselves in the cross-fire – here the finding against SAA in a restrictive practices case and the prohibition of a merger involving Telkom are clear examples. A culture of respect for competition had taken hold in a manner and to a degree that would have not been contemplated when countries embarked on the various programmes of market oriented reforms.

But that was then. We have now entered a period of low economic growth, even crisis, with full-blooded global recession a real prospect. And it seems increasingly likely that this stagnation will once again be accompanied by significant inflation. This is inevitably a period where resonant demands will be made by citizens and producers for protection from market forces, where, in other words, it will be demanded of policy-makers that they subordinate pro-market competition policies to state-centred social and industrial policies, demands that will be bolstered by dramatic evidence of deep-seated market failure. Memory of state failure will recede into the mists of time. We see in our own country demands made for the imposition of price controls and across-the-board support for a developmental state which, though variously defined, is clearly a state characterised by activist industrial policies.

No-one, least of all those concerned to maintain the credibility of pro-market competition policies, should advocate ignoring these demands in the name of fundamentalist free market doctrines. However, now more than ever, competition policy advocates need to make their voices heard, precisely in order to ensure that pro-poor and pro-producer policies do not, as a result of the repression of market forces, inadvertently undermine consumer interests or make it more difficult to emerge from recession.

The direct and indirect demands on competition law and policy will – already are – taking three, often contradictory, forms. These are:

Firstly, a simultaneous demand for more robust enforcement of anti-trust rules and for greater selectivity in the application of those rules. Hence every price shock will generate public and official suspicion of cartel conduct when in truth they may reflect rising input prices which may in turn be the outcome of many influences. Every market subject to single firm domination will be presumed to reflect exclusionary monopolistic conduct even if low entry barriers or an unusual degree of technological dynamism render the monopolised markets subject to contestability and so relatively protected from the exercise of market power.

On the other hand, there will be pressure to permit mergers that are manifestly anti-competitive in order to save troubled firms or create ‘national champions’ just as there will be pressure to permit ‘export cartels’ or even ‘recession cartels’ again in order to bail-out troubled domestic firms or to provide them with an advantage in the export market. One need look no further than the response in Europe and the USA to the turmoil in financial markets. Hence the UK government effectively arranged, without reference to its respected competition authority, the merger of Lloyds and HBOS, a merger which would not have passed competition muster a few short months back. The range of mergers facilitated by the US treasury will leave the US with highly concentrated financial markets. While the dangers of systemic failure are always said to single out the banking sector for special treatment, there is, in truth, no reason to expect a more benign public reaction to the second rounds effects of the financial crisis that may inhibit the ability of, say, an already highly indebted and poorly rated US auto manufacturer to roll-over its considerable debt. Here too there will be a massive public demand to rescue, through mergers or direct subsidisation, the relatively innocent tenants of Main Street particularly when the dreaded denizens of Wall Street, who are perceived to have caused the problem in the first place, have been rescued.

Secondly, there will be a general demand for more activist state intervention directed at supporting beleaguered businesses and tax payers, that is, for interventionist industrial and social policies. Evidence abounds already: European competition regulators are coming under intense pressure from political leaders to relax EU imposed limitations on national state aid. President Sarkozy in particular has demanded a relaxation of European state aid rules in order to enable his government to subsidise its automobile industry. This is endorsed by one commentator who argues:

We have to take into account that the rest of the world, and particularly the US, live without any kind of constraint in this world, and that the gap is huge. The current crisis must be a starting point for a rethink of our approach to state aid.

To which the Commission responds:

Under the current framework governments can provide aid for research and development, training and environmental projects.

And another commentator adds:

The worst things would be for governments to start escalating aid to their respective national champions as this would only make the crisis worse. Look at what started happening when the Irish limited their bank guarantees to their own six national banks and depositors started fleeing from the UK or UK banks in Ireland.

This is borne out by a recent article in the Financial Times which identified massive subsidies provided by a wide range of individual US states anxious to attract new investment as the primary reason why the US was increasingly viewed by prospective international investors as a low cost manufacturing centre! We have also seen no end of examples of national governments which have imposed price controls on various food products or which have prohibited or taxed exports of food products.

We have seen strong general and particular evidence of these policy directions in our own country's responses to the economic downturn. Hence the requirement for a developmental state – which seems to amount to little more than an activist industrial policy – is widely accepted. We have heard demands for the imposition of controls on food, pharmaceutical and energy prices and strident attacks directed by senior policy makers at private health care providers who are somehow perceived to be responsible for poor delivery of public health.

Thirdly, regulators are going to be pressurised to give more weight to the imposition of public interest mandates on those whom they are responsible for regulating with a concomitant de-emphasis on efforts to create or simulate competitive conditions in those vital sectors. Regulators are also going to be dealing with state enterprises who are seen to constitute increasingly vital instruments of the developmental state.

How should competition authorities and regulators respond to these demands?

While it's incumbent on competition enforcers to resist the view that every price increase is the product of anti-competitive conduct, they have to demonstrate their willingness to use their considerable powers to robustly enforce their rules. These include, particularly in an economy like South Africa whose markets are strongly susceptible to single firm dominance, rules against abuse of that dominance. This is the subject of intense debate between national anti-trust enforcers, with the US sceptical of an enforcement approach which it fears will discourage large firms from pursuing pro-competitive, innovative conduct for fear that this will be erroneously prosecuted as anti-competitive abuse of dominance. The EU has taken a strongly opposed view with its robust treatment of Microsoft as its primary departure point. Other influential agencies – including South Africa's competition authorities – have sided with the European standpoint, in our case most strongly manifest in the finding against Mittal SA for excessive pricing of flat steel products.

In addition to robust enforcement in general, competition enforcers have to develop strategic responses that enable them to utilise their constrained resources to attack anti-competitive conduct most injurious to the poor and to critical pillars of growth strategy. Hence the South African Competition Commission has publicised its enforcement strategy which includes a focus on food markets and on bid rigging, the latter a scourge on public sector procurement everywhere. The South African competition authorities have already apprehended a bid rigging

cartel in the provision of certain critical pharmaceutical products purchased by hospitals. Given the emphasis in South Africa's growth strategy on public investment in infrastructure provision, vigilance in guarding against bid rigging in large public tenders is particularly important.

But the competition authorities will have to be equally vigilant in their scrutiny of well-intentioned government initiatives that may give rise to adverse unintended consequences. For example, from the considerable contact between the competition authorities and the private healthcare providers, I am persuaded that any expectations of positive social impact arising from their activities are more likely to be realised if they are subjected to more vigorous competitive disciplines rather than greater regulation which appears to characterise the knee-jerk response of many South African healthcare policy-makers.

Industrial policy is going to provide South Africa's competition authorities with some of their greatest challenges, the more so given the power of producer and union lobbies. The correct approach here is for the competition authorities to take the initiative in identifying the elements of a competition-friendly industrial strategy rather than to emphasise the in-built tensions between these important branches of economic policy. Hence government support for industrial development directed at providing generic capabilities rather than privileging specific firms will not undermine market mechanisms. Support for human resource development or physical infrastructure or R&D – all critical constraints confronting South African industry – will rarely, if ever, conflict with competition law and policy.

By the same token, the competition authorities should identify and advocate against those elements of an industrial strategy that are most likely to engender severe market distortions. This will generally be the case were particular firms are singled out for support although it will be less damaging if support excludes the dominant firm in the market in question and focuses rather on supporting those firms whose ability to enter and thrive in a market is undermined by high entry barriers. Certainly government procurement programmes – though potentially highly distorting if selectively deployed – are less likely to harm competition if they are directed at supporting new entrants. But on one score there can be little doubt and that is to get involved in an escalating subsidy race with the US and the EU, not to mention the Koreas, Brazils, Indias and Chinas, is not a smart way of approaching industrial policy – market distortions aside, it will amount to nothing more than an extremely expensive gesture to producer lobbies.

What of regulation? In South Africa the approach adopted by government to the SOEs is critical from the perspective of the credibility of competition policy and, more important, from the perspective of the country's economic fortunes. The SOEs, particularly the energy, transport and telecommunications providers, are considered vital elements in the government's growth and redistributive strategies and there is little doubt that in the context of general economic weakness even greater reliance will be placed upon them despite incontrovertible evidence that certain of these institutions have, as a direct consequence of their market dominance, acted as a clear constraint on economic growth. If enhanced reliance on these institutions translates into a national champion-type strategy where the SOEs are further sheltered from market disciplines, be in no doubt that South African consumers and general economic prospects will suffer the same expensive and inefficient service that has long characterised these markets even if

continued freedom from effective regulation is presented, yet again, in the form of a compact, a trade off, for meeting public interest mandates and goals, whether expressed as universal service or capacity enhancement. This was, of course, precisely the approach initially taken to Telkom whose monopoly was notoriously extended in exchange for a commitment to roll out additional fixed-line telephone connections. What we have landed up with is an inefficient monopoly that never met its public interest mandate and a compromised regulatory framework. And yet we are consistently reminded that high telecommunications costs and poor uptake of new communications technologies are significant inhibitors of our competitiveness.

There are few areas where the case for the introduction of competition is as strong as in telecommunications. A similar case can be made out for effective regulation of other utilities even if in those increasingly rare cases of genuine natural monopoly the role of the regulator is to simulate competitive outcomes rather than introduce actual competition. I have no doubt that the returns – whether from a growth or redistributive perspective – from developing an effective regulatory framework for our telecommunications, energy and transport markets are significantly greater than those from any of the range of industrial strategies that are endlessly pedalled. While the difficulty of achieving this in the face of politically well-connected SOEs and weak, compromised regulators should not be underestimated, nor too should the benefits of getting this right be in doubt.

In summary, then in response to the failures of statist approaches to economic policy, liberal policies were introduced from the 80's with little thought given to the need for the development of effective rules for this new game. This framework of rules and institutions has now been built albeit under difficult circumstances. The combination of liberated markets and reasonably effective regulation has coincided with, is arguably responsible for, a period of sustained global economic growth. This period of relative prosperity is now under severe threat partly because the regulatory framework, particularly in relation to financial markets, did not prove up to its considerable task. However we are going to require a strong, flexible and independent regulatory framework and effective institutions to manage the bad times, and particularly to ensure the survival of the markets that will allow the world economy and its national components to re-emerge from their present dire predicament. However this is going to have to be achieved in the face of government's impatience to restore growth and forestall popular disaffection, with government more inclined to turn, once again, to state-led rather than market-led solutions. While intervention is going to be necessary and inevitable, it may, as before, store up considerable problems for future growth and prosperity. Much will depend on the strategic capacity of the regulators and competition authorities to adjust to this new context and to continue defending the requirement for competitive markets.