UC Berkeley
Latin American and Caribbean Law and Economics Association (ALACDE) Annual Papers

Title
Market Regulation and Competition Policy -Towards a Dynamic Economy in the Benefit of Consumers

Permalink
https://escholarship.org/uc/item/5s35h94f

Authors
Beneke, Francisco
Helguera, Manuela de la

Publication Date
2010-04-26

Peer reviewed
Market Regulation and Competition Policy –Towards a Dynamic Economy in the Benefit of Consumers

By Francisco Beneke¹ & Manuela de la Helguera²

Abstract

Despite the many efforts in the advocacy of competition, we find a great difficulty in determining the appropriate mechanisms to introduce this discipline in the assessment of existing and proposed regulation. Many actors in the public sphere in charge of creating and implementing the regulatory regime ignore the great benefits that competition policy brings to society at large. In addition, when there is a certain level of awareness of such benefits, there is no consensus on the level of importance of analyzing market regulation through the lens of competition policy. This lack of consensus may be motivated by the fact that it is not easy to quantify the gains of eliminating the excessive restrictions on competition. Finally, some markets continue to be highly regulated for many different reasons, i.e. political and social goals, which can hinder the task of promoting the efficient allocation of resources.

I. Introduction

There has been a long debate over the effects of regulations on competition, and although there is no consensus on the right balance between their goals and competition policy principles, in essence the purpose of competition policy has been to achieve the least restrictive State intervention.

To address this vital issue of competition policy, their most important aspects are discussed in the following five sections. Section II examines the problems that regulations intend to solve, the reasons why in some cases they restrict the market forces, and the incentives they provide to the different actors in the market. Then, section III identifies the ways in which regulations can restrict competition, and afterwards, section IV analyses the main benefits that the abolishing of such restraints can bring to society. Finally, section V identifies the main factors that have to be considered by competition authorities in setting out an agenda for the promotion of a competition culture among regulators, the business community, and the public opinion, and Section VI provides the conclusions of the analyses made throughout the present work.

The methodology used includes the analysis of representative examples around the world on the different matters that are discussed, and therefore, it is not intended to give a regional approach to the arguments but rather a more general scope.

¹ Lawyer at the Intendence of Market Studies, Superintendence of Competition, El Salvador. The author can be reached at fbeneke@sc.gob.sv
² LL.M. in International Commercial Arbitration, Stockholm University. Lecturer, Escuela Superior de Economia y Negocios, El Salvador. The author can be reached at delahelguera@hotmail.com
II. A need for regulations? Their origins and results

There are many problems that State intervention aims to solve and, in some cases, this intervention takes the form of regulations. These problems that provide a justification for the existence of regulations are deemed to be caused by the excesses or shortcomings of the free market economy. Consequently, the mechanisms that are usually adopted are designed to control the forces of the market in order to achieve certain results, which can be: 3 advance the public interest, address market failure, protect strategic industries, and address redistributive concerns, among others.

The mechanisms that are usually implemented to achieve the abovementioned results include price controls, trade barriers, and establishing the level of output among others. This market controlling regulations often result in limited gains produced at a very high cost to society. The reason for this is that there is limited understanding of the incentives that this type of regulations provide to enterprises. For example, trade barriers in most cases aim to promote the growth of national industries by protecting them from foreign competition that is believed to have a certain advantage, but experience has shown that in reality these protected industries, instead of investing and seeking more efficient ways to produce, exploit the protection in order to enhance their rents at the expense of consumers. 4

It is also a valid position to affirm that neo-liberal policies failed in the 90’s to achieve a suitable model for growth and that the market was not able to regulate itself to prevent inefficient results 5, i.e. high industry margins above optimal levels. In most cases, this was the consequence of business behavior, which substituted the State in restricting competition and creating an uneveled-playing field. A deeper understanding of competition policy will demonstrate the inadequacy of taking a controlling approach of the market to solve this situation. In this way, when the results of liberalized sectors have been a net cost to society as a whole, State intervention must aim to provide the adequate incentives for the promotion of competition. Therefore, competition policy must not be viewed as a hindrance to the objectives that regulations pursue, but as a means of achieving them in a more efficient way of allocating the resources of the economy.

3 Other authors provide different categorizations of possible justifications for regulations. Crampton and Facey group them in the following categories: Correct market failure, advance the public interest, advance special interests, to assist in the transition to a competitive market. Crampton, Paul & Facey, Brian, Revisiting Regulation and Deregulation through the Lens of Competition Policy: Getting the Balance Right, World Competition 25(1), Kluwer International Law, 2002, p. 31. The list presented above is not meant to be a categorization, but as the most representative examples of motivations to enact regulations.
The rationale for promoting competition instead of regulatory intervention is that the functioning of the market is the result of very complex dynamics that interrelate in ways that cannot be comprehended in detailed cold numbers. Economics, as any science that studies human and social behavior, has an inherent limitation to achieve exact calculations; consequently, the misconception of restrictive regulation is the idea of trying to control the market players and their relations in order to procure certain results.

To illustrate this issue it is very useful to make a brief overview of Japan’s experience in regulatory reform. As it was stated above, the purpose of trade barriers, as well as other types of regulations aiming to protect strategic industries, is to promote their growth. In the case of Japan\(^6\) it was found that the lack of competitiveness of its products was due to high price differentials between Tokyo and other major cities around the world that corresponded to the industries where restrictions were imposed on imports and on business practices.\(^7\) The high prices were a consequence of high costs caused by inefficient production. The State intervention consisted in a peculiar way in which the government tried to guide the different sectors of the economy through informal relations with enterprises and trade associations was a means of supervising business behavior.

On the other hand, there is the case of the Mexican tortilla-crisis under NAFTA, which is a very representative example of the reality in many sensible industries of other Latin-American countries. Although the removal of barriers to imports from the United States was expected to displace small farmers, it was generally believed that the overall result would be a net gain because of the lower prices consumers would pay for corn products. As it turned out, the former occurred and the latter never happened. The elimination of trade tariffs displaced the production of farmers and the industries that transformed corn (tortilla manufacturers) were able to sustain a high level of prices. Furthermore, his situation was caused by the speculation of primary distribution and agribusinesses.\(^8\)

Apart from the differences in agricultural sectors of other Latin American countries, in essence they all share the same concerns raised by the tortilla-crisis. Therefore, agricultural activities have been subjected around the region to various schemes of protections, where the ultimate goal is to increase the income of small farmers. For this purpose, some mechanisms attempt to balance the asymmetries in the negotiating power between farmers and food processors to prevent an abuse of market power on the demand side, or the protection of

\(^6\) Because of the scope of the present work, the details of the cultural context and the nature of State intervention in Japan will not be described.


national farmers from competition of foreign farmers that are deemed to have a comparative advantage, i.e. farmers from developed nations.

To solve the negotiating asymmetries, a number of solutions are available, ranging from the promotion of association between small farmers for obtaining a greater bargaining power with the large food processing enterprises to the establishment of negotiating mechanisms supervised by the government to procure equal conditions on both sides. The regulation of agricultural organizations and trade mechanisms can implement various types of measures to secure their effectiveness, for example, exempting the associations from the application of competition laws, establishing the mandatory selling of agricultural goods through the associations or through the trade mechanisms, the supervision and approval of the contracts, or the prescription of their general guidelines, etc. However, the effectiveness of the different options depends on the feasibility of the government to carry through the measures imposed, and the incentives that economic agents are provided with.

In the case of the tortilla crisis, it can be argued that imposing price and output controls, as was the practice before NAFTA and the deregulation that followed afterwards, would have prevented the crisis. These types of regulation have an appealing sound in short-term oriented policies. But in the long run, such controls are impracticable to maintain, or an attempt to do so can cause governments to bear a very high cost in terms of supervision that exceed by far the benefits obtained. To address this problem, the pursuance of an active competition policy is a more effective and efficient way of preventing market abuses.

On the other hand, history has shown that price and output controls are usually accompanied by scarcity and black markets, and the intensiveness of the said phenomena has shown a positive correlation with the severity of the aforementioned controls. This happens because, usually, the price established below the market equilibrium leaves a segment of the demand that is willing to pay higher prices for the regulated good, and therefore, creates an incentive to buy and resale at higher prices in black markets. It is true that governments have different possibilities at hand to eradicate in a greater or lesser degree the situation described, for instance, to employ resources in the enforcement of the control or to create a State enterprise in charge of the exclusive distribution. The former implies the additional use of resources and their corresponding opportunity costs, and in the latter case, the performance of such enterprises has always resulted in deficits and, in consequence, additional resources of the State have to be employed for their sustainment.

It is not intended to deny that some degree of regulation of business behavior is necessary to prevent market failure or to achieve justifiable public policy
goals. Nevertheless, the options available must be viewed in a broader sense of a cost-benefit analysis, taking into account the effects of restraining competition.

This can prove to be a difficult task because it implies a prediction of how the dynamics of the market will function, and as it was argued above, this at best can turn to be a trial and error experience. But if the idea is correctly understood, this is not a reason to discourage the promotion of competition through regulatory reform. On the contrary, it is an easier task to supervise uncompetitive business behavior than designing complex mechanisms to control and estimate what are the desirable outcomes of regulated economic sectors that include setting up maximum prices or limiting the number of enterprises in a given market.

As a final consideration on the subject of the origins of regulations, as this work intends to have an economic and legal approach, political considerations that give birth to regulations are not analyzed. For the purposes of this paper is enough to state that in these cases, most of the times society is negatively affected because political gains considered only benefit the decision-makers, and society gains from such politic oriented regulations concentrate in a small group of enterprises, i.e. the ones that lobbied for the regulations.

III. Main restrictions of regulation over competition

Having discussed the justifications that support regulations, it is essential to review the ways in which they can limit competition. Regulations can have the following effects on competition: Impede the entry of new competitors, hinder the competitive potential on existing ones, and provide incentives for anticompetitive behavior. The same aspects of regulations can simultaneously have one or two of these effects. Hence, the purpose is not to establish clean-cut categories but to make an emphasis on the consequences that different types of regulations cause.

a. Entry barriers

The study of regulatory entry barriers in the advocacy of competition is different of the one conducted in other aspects of competition policy. For example, in the authorization of mergers that raise anticompetitive concerns, the analysis has a narrower scope because it intends only to determine if entry could occur in the market in a significant and timely manner to cure the harms of an eventual anticompetitive behavior. However, in the case of the advocacy of regulatory reforms, in addition to the analysis just described, competition authorities have to

---


10 As West argues, it is not sufficient that entry occurs; it has to materialize in a relatively short time and in a significant size in order to have a decisive influence on market conditions. Jeremy West, Analytical Note in the 2005 report of the Policy Roundtable on Barriers to Entry held by the OECD. Available at: [http://www.oecd.org](http://www.oecd.org).
ponder the policy goals that the barriers pursue and how effective they are in accomplishing them against the cost of limiting the entrance of competitors.

As was stated in the previous section, it is not intended to argue that there is no need for a certain degree of regulation to promote desirable public policy goals, but to prove that social welfare can be enhanced when they are pursued with the least possible restrictions on competition.

The regulations that erect entry barriers protect incumbent firms from the disciplinary effect that the threat of potential entrants could have on the market deterring an eventual raise of price above the optimal level. These barriers can be of an absolute character, when they forbid the entrance of new competitors, or have a delaying effect on the entrance. In the latter case, the longer the delay, the less difference there is in terms of the effects on consumers. On this matter, the US Federal Trade Commission held that:

“Unless there is a barrier to entry (...), market power cannot be exercised indefinitely. Sooner or later, new firms will enter the market and drive prices back down to competitive levels. From the standpoint of the public, however, it makes a great deal of difference whether this occurs sooner or later. There may be little practical difference between an absolute barrier to entry and conditions of entry that delay restoration of competitive prices for decades.

Therefore, we will also consider a second type of barrier to entry, which might more accurately be called an impediment to entry. An impediment to entry is any condition that necessarily delays entry into a market for a significant period of time and thus allows market power to be exercised in the interim.”

Although in the present work the essence of the idea is shared, the term “impediment to entry” will not be used in the sense the USFTC employs it, but rather as a broader concept encompassing both types of regulatory barriers (absolute and delaying entry barriers).

An example of an absolute entry barrier is a State protected monopoly. This usually happens in industries that are deemed to be natural monopolies. As technology evolves, the idea of a natural monopoly is rapidly becoming rarer, and most of the industries that once fitted in this category are now competitive markets. An illustrative example is land-lines in telecommunications and wireless technologies, as the second has made it possible for mobile companies to enter the land-line market without having to invest in additional infrastructure. The electricity sector has experienced a similar progress, at least in some of its markets, as is the case of power generation and wholesale distribution.

---

Examples of absolute entry barriers, even though less common, are more harmful to society since it prevents any possibility of competition to be introduced in order to counterbalance an eventual exercise of market power or cartelization by incumbents.

Regulations that cause the delay on entry are complicated to assess because it implies a quantification of an acceptable period of time that a firm can take to enter the market when high prices create the incentive. As West argues, there is no clear line between significant and insignificant delays, although many competition authorities have adopted a standard of two years.\(^\text{12}\) Nonetheless, it is better to assess every market in case by case basis.

An illustrative example of delaying barriers to entry, that has been the concern of competition authorities around the world, is the case of telephone land-line services, which are aggravated as the result of the market functioning as a State owned or protected monopoly for a long time.

In the case of the land-line market, the functioning as a monopoly of firms has made it more difficult for competition to occur and entrance can be expected to take a long time before being able to counterbalance the dominant firm’s power because of direct network effects. These occur when the benefit of consumers of a certain product increases with the number of people that is consuming it as well. In the case of telecommunications, as the users of a firm’s network increase, so do the possibilities of current users of communicating with more people. It is true that users of different firms can communicate with each other, but in many cases, telephone companies charge different prices for calls between different networks. If this is not the case, network effects can be disregarded as a barrier to entry. But when the price differentials exist, it will be harder to persuade users of the dominant firm, which is usually the former state-owned or protected monopoly, to switch company.

Communication between customers of different telephone companies is possible because the companies give access to each other’s network (interconnection) in the conditions resulting from a private negotiation. In these negotiations dominant firms have a greater bargaining power; hence, they can obtain better conditions for themselves. As a result, it is very likely that users of new firms will have to pay high prices to make a call to the users of the dominant firm. Under these circumstances, new entrants will have a greater risk to enter the market because it could take a very long time to acquire a significant market share to make enough profits for compensating their investments.

As Gal and Faibish sustain “where there is a market failure, regulation has the potential to increase social welfare”.\(^\text{13}\) On this matter, State intervention can play

\(^{12}\) West, Jeremy, Analytical Note in the 2005 report of the Policy Roundtable on Barriers to Entry held by the OECD. Available at: http://www.oecd.org.

an important part in promoting competition with the enactment of better regulations to neutralize network effects as an entry barrier. For this purpose, regulation must ensure transparent and equal conditions in the negotiations of interconnection.

What is interesting about this case is that regulating business behavior can help to promote competition. To address this problem, regulators can be tempted to establish price caps or other types of price controls. Apart from the considerations already made about regulating prices, it is important to bear in mind that not only reducing them can increase consumer welfare, and in the long run, these regulations can be counterproductive.

Depending on the severity of the control, the price would cease to be an incentive for new entrance. In this situation, incumbents, specially, dominant firms would enjoy relatively unchallenged market shares, in consequence, the incentives that competition provide for innovation and more efficiency in order to maintain or increase market shares disappear. Hence, even though consumers would enjoy what is deemed to be fair prices, their quality is expected, at best, to maintain certain stability and the options and variety of services in the market will follow the same trend. The acceptance of this result as desirable is caused by a lack of a dynamic vision of the market and of a simplistic approach of consumer welfare.

Some scholars as Crampton and Facey, advocate for price caps as a way for giving the incentives to be more cost-efficient. But they argue that it is the least restrictive option for the regulation of natural monopolies, and these are disappearing as globalization and technology evolve.14

Even though the public policy goals that regulatory barriers pursue are as justifiable as the results that competition policy seeks, decision makers must be able to make a right balance between the different State priorities, pondering more the ones that benefit society as a whole. In some cases, different State policies can be complementary with competition policy, i.e. when the latter can help to achieve the former increasing society’s net gain. In other cases, competition policy collides with other State priorities, creating the need to choose the one in which the greatest net gain is attained.

b. Obstacles for the competitive potential of existing enterprises

Usually, a regulation that prevents or delays the entrance of new competition has the effect of preventing incumbent firms’ growth in order to challenge an eventual exercise of market power. To illustrate this point, the same example of interconnection problems in telecommunications can be useful. Network effects

---

are a disincentive for new entrants as well as an obstacle for the ones already in the market.

The difference is that in the second case, enterprises had run the risk of entering, therefore, are subject to lose their investments. This new factor changes the situation, especially when the investments are regarded as sunk costs, because if the firm cannot recuperate them, it will be more reluctant to leave the market even if it experiences losses. Nevertheless, there is so much time that a firm can bear failing to achieve the necessary profits to compensate its investments before taking the decision of abandoning the market. If this happens, the options that are often available, include liquidating its assets or reorienting them where possible, being absorbed by one of incumbents or by foreign capital (usually by international companies with great experience in the sector). In terms of competition, the least desirable outcome would be the merger with the dominant firm.

Another hindrance for existing competitors can be the lack of raw material, which is the case in some agribusinesses of developing countries. The main cause here would be the small level of productivity of farmers due to the low level of the employment of technology and the generalized use of traditional farming techniques, but also regulations can have an aggravating effect. For example, in industries where importing the raw materials is viable, the establishment of trade barriers for the protection of local farmers can have a serious effect on consumers, taking also into account that in the cases of agricultural products, its consumption is often massive and the poorer sectors of society spend a greater proportion of their income on them.

Where access to raw materials is restricted, competitors cannot respond to a unilateral price increase by the dominant firm. Also it is important that if limited access to foreign input is provided, for example by import quotas equal conditions have to be granted to all participants, because if the biggest enterprises end up with the largest shares, they will enjoy a greater absolute cost advantage and therefore, a greater concentration of the market is likely to occur.

In the case of the tortilla crisis, although there were formally import quotas subject to licenses, the market functioned as a liberalized because imports that exceeded the permitted amount were never charged with the additional tariff, and the bigger processing companies ended up with the biggest amounts of imports because they were owned by the US biggest corn exporters. This experience is very useful to show that competition has to be promoted in every step of the production process in order to ensure consumer welfare.

---

16 Ibid p. 40.
c. Provide incentives for anticompetitive behavior

There are many ways in which regulations can provide incentives for anticompetitive behavior, and in some cases it goes as far as to promote it. Examples of regulations that can have this effect can be:

- Allowing for the self-regulation of industries.
- Mandating the publication of sensible information.
- Exempting specific economic sectors of antitrust laws.

The reasons why the State allows for the self-regulation of some economic sectors can be to optimize the resources employed in the supervision of public regulation and reorient them to more beneficial uses; also because intervention in areas of complex technical knowledge makes their supervision unfeasible or too costly.

Even though there are some benefits in the self-regulation of industries, a common concern is the bias that regulations can have towards benefitting the existing participants or a small group. Examples of this can be liberal professions in which boards composed by participants establish requirements for professionals to exercise their practice, which apply to existing and prospective practitioners. When these requirements go beyond of securing minimum standards, they can constitute an excessive restrain on competition. The situation can be more prejudicial if they are not applied on an equal basis to incumbents and new entrants.

In the case of obliging enterprises to publish sensible information, such as prices, can make it more easily for cartels to function. Nonetheless, regulations that mandate the publication of this information also aim to correct eventual information asymmetries that can limit competition as well.

An illustrative case can be financial services. Banks are often required to make public their effective interest rates, as well as other charges, with the purpose of eliminating the cost for consumers to obtain information about market prices and make a better-informed choice. Although the elimination of informational asymmetries can help to promote competition in this market, it makes it easier for banks to collude to a given price level and make it more difficult for competition agencies to find evidences of a cartel.

Under these circumstances, it is not wise to press for the elimination of the publication requirements because they help to promote competition. It is more advisable to keep a tighter control of anticompetitive behavior and limit the information to be published on a need to know basis. For example, publishing interest rates of credit cards and different associated charges is justifiable, but to
go as far as to publish information about the number of cardholders and other indicators of market shares could be more harmful to competition.\textsuperscript{17}

In the matter of exceptions from competition laws to specific economic sectors, the justifications are in most cases based on misconceptions of the results of a competitive market. In other cases, the exemptions are for conducts that in any case would not constitute violations of competition laws. In the second case, the purpose is usually to prevent that the fear of antitrust liability deters desired and efficient arrangements such as joint ventures and research projects.

When the exemptions permit anticompetitive behavior, it is often argued that competition would be harmful for certain industries. In the United States, the ocean shipping industry is exempted from the application of competition rules concerning collusion because it is considered impractical to sanction US cartels if they are permitted in the rest of the world, in which case US firms would be at a disadvantageous position to compete with foreign firms. Also, there were many problems that would be raised if the US antitrust laws were applied to foreign firms, which would ultimately be ineffective taking into account that many have minimal ties in the US. It is said that the industry is highly competitive and the cartels are not perfectly effective, but studies have shown that the system does restrain competition, and that rates are lower where the competition restraining rules are weaker.\textsuperscript{18}

At first, it seems reasonable permitting US enterprises to form cartels to compete on equal conditions with foreign enterprises, but this affirmation must be viewed in a wider context. First, in order to claim a certain disadvantage against the cartels, it must be considered if these have a significant share on the markets in which US firms compete so that the existence of market power would be likely. Other factor to examine is the contestability of the market, to determine the structural or behavioral conditions that would prevent the non-colluding firms from gaining a better position in the market as they become more efficient. If neither of these issues raises concerns, then the argument of damaging competitiveness with the foreign cartels would be weaker.

To defend the exemption, it was also said that the industry’s unique cost structure (a high ratio of fixed to variable costs) and the movable nature of its assets would make the application of antitrust law inappropriate. In opposition to this, it is argued that in the airline industry, which shares the same traits,

\textsuperscript{17} Mexico’s Federal Reserve Bank (Banco de Mexico) states in its monthly reports of the credit card market that their objective is to promote transparency and more competition, but as it is argued in the present work, the information published is too sensible. It includes the number of cardholders and amount of the total debt per bank. The publications can be found at: http://www.banxico.org.mx/sistema-financiero/publicaciones/reporte-de-tasas-de-interes-efectivas-de-tarjetas-/reporte-tasas-interes-efectiv.html

\textsuperscript{18} Clyde and Reitzes, \textit{The effectiveness of collusion under antitrust immunity: the case of liner shipping conferences,} 1995.
experience has demonstrated that the relaxation of regulatory constrains did not lead to destructive competitiveness.\textsuperscript{19}

In addition, it has also been said that the difficulties of transnational application of the law and fears of diplomatic friction would be a less important factor now as other countries are reviewing their respective policies that protect the ocean shipping cartels.\textsuperscript{20}

In other cases, exemptions are not in the field of anticompetitive behavior but in mergers control where several factors apart from competition policy principles are considered in the authorization of mergers. Looking again at the US experience, some industries that underwent a deregulating process left the regulators with some jurisdiction in the matter of mergers and acquisitions, as is the case of the Surface Transportation Board (STB) in the rail industry. In 1996 the STB approved a merger between the two largest corporations, out of three that existed in the western US market, “to foster sound economic conditions in transportation”.\textsuperscript{21} The authorization was granted despite strong objections raised by the Antitrust Division. As it turned out, the merger had serious consequences in capacity limitations, the main cause being the lack of transportation options. However, the STB hoped that its regulatory intervention could solve the problems that the merger raised, but it has not being able to do so.

This problem that has occurred in other industries is argued to be caused by the lack of understanding from the sectoral regulator of the dynamics in unregulated markets.\textsuperscript{22}

The problem with introducing considerations that contradict competition policy’s objectives in examining the potential effects of a merger is that the market’s structure after the approval of the transaction is irreversible and the costs of coping with the problems that the merger causes are greater than if they were properly considered in the first place to deny the authorization.

The restraining effects of regulations on competition have been discussed in the present section. The point that is attempted to be proved is that excessive limitations of the competitive forces can cause a great cost to society, and the limited gains, if any, hardly justify such State intervention.

Not all restrictions on competition produce a negative net effect. In some cases they are necessary to achieve certain public policy goals such as safety, health, and environmental standards. In these situations, decision makers have to carry out a careful examination of the various options in order to choose the one that

\textsuperscript{19} United States-The Role of Competition Policy in Regulatory Reform, 1998. Report prepared principally by Michael Wise for the OECD. Available at: http://www.oecd.org
\textsuperscript{20} Ibid.
\textsuperscript{21} Ibid.
\textsuperscript{22} Ibid.
proves the most effective. The cost-benefit analysis has to be of a wider scope so that the negative effects of hindering competition are balanced.

In the particular case of regulations that permit anticompetitive behavior, the justifications provided are often weak, the costs imposed on society are very large and the competitiveness of firms is relatively low. The main difficulty in these situations is that the exemptions are usually the result of political considerations, which poses a great challenge to competition authorities; especially where competition policy is still recent and is striving to gain a position among other State priorities.

IV. The benefits of promoting competition

Experience has a vast set of examples that prove the positive effects that competition brings to society at large, even in markets where it was thought it would lead to undesired results. The reason why the promotion of competition is so beneficial is that it provides the market with the right incentives to grow in a way that ensures the efficient allocation of resources. Understanding this can prove to be very useful for designing the right mechanisms to address public policy issues. As this work intends to prove, this logical thread of theoretical arguments is supported by strong empirical evidence.

The effects on the market that more competition brings are hard to measure but around the world there is some consensus on prioritizing the effects on consumer’s welfare. In the case of Japan, the Economic Planning Agency adopted these criteria, adding the effect on investment because of the program’s objective.

As was presented in the first section, Japan went through a regulatory reform process in the 90’s with the purpose to increase the international competitiveness of its national industries, by improving the cost efficiency of Japanese enterprises. Even though competition was not considered as goal of the deregulation process, the consequences were the introduction of more competition that resulted in price reductions in the industries concerned.

The Japanese Economic Planning Agency calculated in 1999 the effects of deregulation at an estimation of 6.6 billion yen between 1990 and 1997 measuring the following effects in the performance of the deregulated markets: an increase in consumption as well as in plant and equipment investment and the effects on consumers due to price reductions.

In 1998, price differentials between Tokyo and other major cities in the world (New York, Paris, London, and Berlin) also decreased, although the exchange rates account for the largest part of this tendency. Between 1994 and 1998 the

---

decreases of the ratio with New York, Paris, London, and Berlin were of 29%, 19.6%, 36%, and 16% respectively.\textsuperscript{24}

In the US airline industry, where competition was traditionally believed to be inappropriate, the government-enforced cartel controlling entry, services and rates, was abolished in the late 70’s. The introduction of new competition forced prices to decrease and the more inefficient firms were forced to file for bankruptcy. The competition-oriented deregulation was not complete and the mergers control was kept by a sectoral regulator, the Department of Transportation (DOT). For a decade, the DOT authorized virtually all the transactions that were submitted, assuming that the markets were highly contestable, and the result was the increase of concentration in several hub markets, that led to the elimination of competitors. Studies showed that in these cases the prices were significantly higher to passengers departing or arriving to these cities because they had fewer options.\textsuperscript{25} In cities where competition was fierce airlines did not destroy each other and consumers enjoyed lower prices.

A very peculiar case is the water industry in the United Kingdom. After its privatization in 1989, ten companies were statutorily appointed as regional suppliers, thus, geographically dividing the market. The Director of Water Services was established as the sectoral regulator who co-existed with quality and environmental regulators. According to Bailey, this inter-institutional jurisdiction reveals the need to balance the liberalization process with other State priorities.\textsuperscript{26}

The ever-increasing competition in the market shows again that the natural monopoly argument is becoming anachronic. Even in aspects where competition hasn’t been introduced, for example in some aspects of the retail water supply, is not because of technical obstacles but for other policy considerations.

The industry works in a regulated price environment, where the Director of Water Services sets price caps on the basis of the costs that the most efficient company has, which was thought would provide the incentive for all the water companies to become more cost efficient and therefore benefiting the consumers. Given the limitations of the price cap approach, despite the efficiency attained by the firms, the prices were not lowered for a long time, and for the first ten years after the privatization a trend towards steady price increases was observed.\textsuperscript{27} This was

\textsuperscript{24} Calculations based on the 1995 and 1999 price reports of the Japanese Economic Planning Agency.
\textsuperscript{27} Ibid. p. 132. The information about price increases can be consulted at: http://www.ofwat.gov.uk
mainly because firms were allowed to transfer in their price the costs of additional investments to achieve better quality and environmental standards.

However, in 2000 the Director revised the prices and cut them down by an average of 12%, justifying the decision on the basis of the increases in efficiency of the firms concerned, regardless of the water companies’ arguments of limiting the investment. The price cap mechanism did not provide the incentives for such cost optimization because of the trend mentioned above, and Bailey argues that the cause can be found in the competition among the water suppliers for the capital required to invest.\textsuperscript{28} It was said that the companies enhanced their return on equity to sustain a high price of their shares and reduce the cost of capitalization, which gave them the necessary motivation to reduce their costs by improving their processes.

Another competitive factor that was introduced in the market was the appointment of inset suppliers. As was explained, each of the ten companies has a regional monopoly in the water supply service, but the Director can appoint, in certain circumstances, another supplier inside a sub-division of an incumbent. This gives the incentive for more competitive prices because of the possibility of choosing more alternatives for providing the service, but the evidence of this effect is limited because the appointments have been very few after the privatization.

In the case of the retail supply, another idea has been introduced to improve competition: the common carriage. This works by allowing different firms to use the same pipelines system for the distribution of water (access to essential facilities), but it hasn’t made much progress, which Bailey attributes to political considerations as well as arguing that efficiency could conflict with another important aspect of public services’ policy, the universal supply.\textsuperscript{29} The argument is that competition will move the supply to the segments of the market where bigger profits are found, i.e. urban consumers, marginalizing rural consumers given the remoteness of their location, which increases the cost of the service. The argument continues by stating that under these circumstances, the cross subsidy system, that allows the monopolists to charge higher prices to segments with higher margins (urban consumers) in order to charge lower prices to segments with lower margins (rural consumers), would be abolished because of the increased competition in the first segment.

On the other hand, the Cave Report (2009) argues that in the introduction of household competition, i.e. where household customers can choose their service provider, some measures to protect vulnerable customers can be adopted, which include, among others.\textsuperscript{30}

\textsuperscript{28} Ibid. p. 143.
\textsuperscript{29} Ibid. pp. 144, 152.
Simple tariff structures, compulsory acceptance of customers and non-discriminatory price;
Information about competition to be made available; and
Minimum standards on price and service levels.

In his report, Cave gives examples of other measures to protect vulnerable customers to address specific problems of some of UK's policies that fall beyond the scope of the present work. Also it needs to be clarified that in his report, Cave recommends that for the time being competition is not introduced in household and non-household markets simultaneously, that the former should be postponed before assessing the results in the latter, which goes accordingly with his step by step point of view of the reforms.

As we have seen, the water industry in the UK is a very useful example to examine that where competitive forces are allowed to work, the result is a net benefit for society. Also, where there are other considerations to balance against the benefits of competition, or results that competition is deemed to be unfitted to deliver, the best results are achieved when the least restraining option is taken. Also, Cave's approach to reform seems to be the most prudent in the cases where industries have been subjected to heavy economic regulations, and the step-by-step introduction of competition can help regulators to make decisions based on the effects observed on the market.

As general considerations that explain the benefits of a competitive environment it is worth to mention that enterprises can increase their revenues by acquiring bigger market participations, and to do so, they can either sell their products at lower prices, greater quality or give them unique characteristics that would make them more desirable to consumers. An important aspect of consumer welfare is that it is enhanced when there is a balance between price, quality and innovation, and State regulations cannot attain this result that can only be produced by the interrelations of the market's dynamics.

If restrictive regulatory mechanisms can achieve lower prices and set minimum quality standards, with the limitations stated throughout the present work, they cannot oblige enterprises to innovate in order to provide better goods that suit the needs of consumers. The narrow point of view that most regulators share is that consumer's welfare is enhanced when prices are low, and anything that does not helps to lower prices is useless. But in the long run, the gap between developing and developed countries is determined, among other important factors, by their ability to innovate, and in the medium and long term, when policy makers in developing countries wonder what has been done wrong, they would face the same evidence that today policy makers currently face.

Innovation can be promoted by developing public programs for specific sectors and use public resources to carry them through, but these are always limited, and therefore, innovation cannot be promoted by the State in a large portion of the different economic sectors. To attain wider results, the State can adopt a role
of supervising that the right conditions exist to promote private initiative. In addition to intellectual property policy, competitive markets provide the necessary incentives and competition policy is the right tool to make sure markets perform this way.

Promoting competition can be one of the most effective options to achieve long-term steady growth. The reason is that it purports to provide the opportunity to succeed to the most capable players of the market in a level playing field. Competition policy does not intend to protect small and medium enterprises, or to attack the biggest ones, but to ensure that they have a good chance of entering the market and gaining a better position as they become more efficient in the first case, or to defend their market power in the second.

V. Advocacy of competition in the regulatory framework

The advocacy of competition to achieve a pro-competitive regulatory environment is a challenge faced by competition authorities around the world. An important consideration that has to be made is that in every country or region, the obstacles encountered vary according to each particular case due to different cultural and economic conditions. Botta points out that the prescriptions on best practices that can be generally found in the existing literature are based on the experience of developed countries, and therefore do not apply to emerging economies, especially where competition policy has recently been introduced.31

There are others who argue that a wider set of variables have to be taken into account to set out an advocacy agenda. De Leon sustains that the cultural and institutional framework in which competition authorities find themselves can be best understood by studying the historical background from which they evolved.32 In Latin America's specific case, he traces back the differences with North American and north-European countries' capitalist institutions, in which competition policy values are founded, to the economic institutions that the Spanish colonization brought to the region. In short, he explains that the centralized regime around the Spanish crown gave little space to develop private initiative, in contrast to the decentralized regime of the British colonies, and after the political independence gained in the 1900’s, this way of running affairs was maintained.

In the case of Japan, Yamane identifies that the main cultural obstacles are the result of a long historical background of “administrative guidance” that consists in a past tradition in which the government, through informal relations with enterprises and trade associations, guided the different sectors of the economy- instead of running them directly, and also, of Japanese consumers who are

generally unaware of the benefits of competition or even think it opposes their interests.³³

Apart from different contexts that have to be considered, in general, the advocacy efforts are targeted to the following sectors in society³⁴:

- Regulators;
- Businesses; and
- The public opinion.

Even though the present work focuses on the regulatory dimension, there are important factors of the other sectors mentioned above that relate to the former, and understanding this interrelation can help to design better policies.

In regards to the first group, whereas in developed countries the governments have given a proper place to competition policy among other State values, in developing countries it has still a long way to run before gaining ground, and the progress will be related to the competition authorities' skill to obtain credibility. This situation can affect how competition authorities relate with regulators and work with them towards achieving more competitive markets, and to add allies to this cause. For example, on issues that concern the jurisdiction of several government entities, the competition authority will have a more favorable position in the discussions as it secures the support of other institutions.

Also, regulators and competition authorities can cooperate through formal and informal channels, which would depend on the type of assistance that they need from each other or the type of work that is to be carried out jointly. For instance, for sharing information that can be considered confidential, a formal approach might be needed, as opposed to the creation of working groups to analyze a given issue. The relevant point is that the burden of opening these channels of collaboration is upon the competition authority, and the institution must be prepared with the necessary human resources to meet the task. In the case of financial resources, they are a bigger concern in the advocacy with enterprises and the public in general, because in addition to the personnel, a number of other expenses are necessary, for example, in the distribution of publications, organization of events, among others that are more usual than in the promotion of competition with other State entities.

Another aspect of the advocacy work with regulators is the importance of noticing when the regulations are still in the making-process, and therefore, having the opportunity of assessing their costs on competition before they are enacted. The fruits of this monitoring work when the competition authority's opinions are taken

into account is of an inestimable value because the resources employed are less than when the regulations already exist, in which case the advocacy effort needed is greater, especially when the regulations have been the product of a long process of consultations, or of the lobbying of big enterprises.

In what concerns the institutional design, according to Botta, advocacy work is more effective when is carried out by a different entity form the one in charge of the enforcement of the law, especially when competition authorities are relatively new. In the specific case of the regulators his argument is that in this way the enforcement agency’s independency is enhanced because its relations with regulators do not compromise its objectives, and also, it ensures the proper prioritization of the advocacy functions that are often marginalized. On this matter, he analyses the Brazilian institutional framework, which adopted this division and has a wide set of cases where they have succeeded in the advocacy area. Although Brazil’s experience supports his argument, institutions that perform both functions can replicate the conditions that allowed such success. For example, as the necessary financial resources are obtained, creating an advocacy area with the appropriate staff could undertake the task as a specialized unit, hence, avoiding the abovementioned concerns.

In regards to the business community, the strategy, as was stated above, bears more costs, but is also an essential duty of competition agencies. Here, the balance between enforcement and advocacy is of vital importance. It is a general consensus that in newly established agencies it is more recommendable to concentrate the efforts on promoting a competition culture to increase in the future the fruits of the enforcement activities. In short, this is because if the necessary conditions for a competitive environment, both regulatory and cultural, do not exist, then the effects of the enforcement to improve the market conditions will be undermined. While in essence the argument is true, the authorities have to be careful not to generalize it to all situations that present their own particularities.

To illustrate the point, it is useful to consider that in a market where both anticompetitive practices and restrictive regulations raise concerns, the pursuance of an active enforcement policy can give the competition authority a stronger position with the regulators to promote the abolition of unnecessary restraints on competition. The fundament of this is that around the world what has put competition authorities on the map is the ongoing attack on the most harmful cartels of the economy, which has influenced on regulators to consider the latter’s position on a given topic inside their jurisdiction. Also, if businesses are to comply voluntarily with the competition law, they have to perceive a real threat of a sanction in the case of an eventual or current violation.

In what concerns the public in general, they can be powerful allies of the competition authority’s cause. As Yamane affirms, in the case of the enforcement, the support of the consumers could enable the Japanese authority to take a bold stance.\(^{36}\) This applies to the advocacy efforts as well, because if public opinion is favorable towards competition policy, this can be exploited by a variety of means, which include press releases of the competition authority about concerns that a certain proposed or existing regulation raise and put some pressure on regulators to at least consider the arguments exposed.

There are a number of options that can be used to permeate the public opinion and one of the most effective ways of persuading the public opinion of the benefits of competition is proposed by Botta based on Brazil’s experience. He points out a case in which the *Secretaria de Direito Economico* (SDE)\(^{37}\) (Economic Law Office) conducted two dawn raids in gasoline retailing enterprises to prove the existence of a cartel. The SDE found that the prices decreased after the raids and published the results.

Taking into account the considerations discussed in this section, the advocacy strategies can be more effectively designed. It is also necessary to consider the value of the exchange of experiences of other agencies and develop a consensus on best practices, and also in each particular case it is necessary to understand the unique context.

### I. Conclusions

The promotion of competition through regulatory reform is an essential task that competition authorities around the world undertake. The obstacles that they find originate in a misconception among regulators about the dynamics of the market, and therefore the results of their policies haven’t been effective to achieve the goals purported in their enactment, especially where the restraints on competition have been disproportionate.

On the other hand, competition policy has proved to attain better results benefitting society as a whole. For instance, very illustrative examples, as is the case of the water industry of the United Kingdom and the United State’s airline industry, have shown that even in sectors where the competitive forces were deemed undesirable and inappropriate, the introduction of more competition has delivered great benefits to consumers by improving the quality and the prices of the goods without destroying the enterprises that compete among themselves.

Finally, the agenda that a competition authority adopts to promote a competition culture among regulators, businesses, and the public opinion can be better

---


\(^{37}\) One of Brazil’s Competition Authorities in charge of the preliminary investigation of anticompetitive behavior among other legal duties. Brazilian Law 8.884 (Competition Act).
designed by examining the experience of fellow authorities around the world and at the same time taking into account the different factors that affect the cultural and economic conditions of each society. In addition to these, in every particular case, the success of the advocacy effort rests in the creativity of the authority to approach the stakeholders and also understanding the interrelations among the different groups.