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COMPETITION POLICY AND SMALL ECONOMIES

-- Note by the Secretariat --

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COMPETITION POLICY AND SMALL ECONOMIES:

Note by the Secretariat

I. Introduction

1. Session III of the February 2003 meeting of the OECD Global Forum on Competition will consider whether and to what extent an economy's "small" size implies a need for a competition law enforcement regime that has substantive or institutional differences from those used by "larger" economies. Based on a review of the Background Paper [CCNM/GF/COMP(2003)4] and participants' contributions,¹ this note provides a suggested analytical framework for considering the various issues. It also briefly summarises participants' contributions and identifies how their main points fit into the suggested framework. Although size in the conventional sense (*e.g.*, population or GDP) is only one of the relevant measures of smallness, the importance of this topic is suggested in part by the world-wide trend toward small economies; ninety years ago, there were only 62 economies in the world, whereas there are almost 200 today, 87 of which have populations of less than five million.²

II. Suggested Analytical Framework

2. As is discussed in the Background Paper, the idea that small economies are "different" for competition law and policy purposes can be, and has been, expressed in a number of different ways. For example, there have been arguments that small, open economies need no general competition law, and arguments that small economies are more vulnerable to at least tacit collusion because of the limited size of their business elite. There have also been arguments that small, open economies need no merger control provision, that small economies should be more tolerant of potentially efficiency enhancing mergers because of economy-of-scale problems, and that small transition and developing economies should err on the side of creating a competitive market structure. In addition, there has been discussion of a wide range of special enforcement problems that small economies face.

3. To some extent, differing views on the competition law implications of being a small economy may reflect differing substantive analysis of a particular issue. More frequently, however, it appears that such differences reflect differing implicit definitions of "small economy." Such differing definitions may be entirely appropriate if they correctly identify the attributes of "smallness" that are most relevant for analysing particular issues, but differing implicit definitions can be very confusing. Moreover, even explicit definitions can be confusing when the defined term is used in a manner that differs markedly from its normal meaning. For example, as noted in the Background Paper, the definition of small economy in Professor Gal's book³ focuses on high concentration levels and entry barriers. These factors are more

¹ See list provided with the agenda for the Global Forum on Competition [CCNM/GF/COMP/A(2003)1].

² *The Economist*, Little Countries, Small but perfectly formed, 3 January 1998 (www.economist.com/editorial).

³ Michal S. Gal *Competition Policy for Small Market Economies* (Harvard University Press, 2003).

important than “size” in a conventional sense for analysing most competition issues, but Forum participants will need to bear in mind that under this definition, it appears that China would be “small” economy but the same would not be true for Latvia.

4. The Secretariat’s first discussion of this topic (Annex A) sent to participants in connection with the invitations to this meeting of the OECD Global Forum on Competition, raised a variety of definitional issues and divided the substantive issues into three categories: (1) special attributes of small economies due to economic factors; (2) special attributes due to “political” considerations; and (3) special enforcement issues. Fourteen contributions addressed these issues,⁴ and there was some relevant information in some of the contributions relating to the optimal design of a competition agency. Those contributions, together with the Background Paper, suggest that all of these issues can best be analysed by dividing them into three different categories, each containing a grouping of substantive issues that are associated with a different definition. The three categories correspond closely to Parts II.A, II.B, and III of the Background Paper.

- The first category relates to important economic attributes of small economies – their tendency to have high levels of concentration and domestic firms operating at less than minimum efficient scale. This tendency may mean that economies should adopt competition rules that are more tolerant of mergers or other agreements that may increase efficiency. Devising a definition that identifies the small economies where this situation exists and is economically significant is very difficult. The definition would presumably need to include measures of concentration and entry barriers, and some measure of smallness (*e.g.* population or GDP) would be necessary if one does not want this category to include economies that are very large in conventional terms.
- The second category relates to the competition law enforcement implications of small size in the conventional sense – population and perhaps GDP. The issues stemming from this aspect of smallness relate primarily to enforcement problems, such as preventing collusion among the members of a small business elite, other evidence-gathering problems, difficulties in preventing harm from firms in other jurisdictions, the cost of an enforcement agency, and the scarcity of qualified personnel.
- The third category addresses the implications of the legal, institutional, and economic factors that are common in developing or transition economies. Development-related differences in factors such as acceptance of the rule of law, the enforceability of contracts, the depth and breath of financial markets, and the existence of a competition culture (and entrepreneurs and managers) are generally seen as justifying some variations from developed-economy rules while competition enforcement is being introduced and while it is in its infancy. Like economies with high concentration and minimum efficient scale (MES) problems (see the first category above), developing economies are not all small in a conventional sense. Therefore, one would need to define this category in terms of development level and some size-related measure if one considered it important to cover only economies that are small in the normal sense of the word.

5. It is very important to note the relationship between these categories. Whereas the second category is defined by conventional measures of size, the first and third categories relate to economic attributes that include but are not limited to economies with small populations or GDP levels. More

⁴ As of 4 February 2003, most (9) of the contributions submitted to the Secretariat were from Europe and North Africa. (Denmark, Estonia, Ireland, Macedonia, Malta, Morocco, Switzerland, and Tunisia made contributions, and the Consumers’ International contribution was a report by the Slovene Consumers’ Association.) Two other African economies (Cameroon and Ivory Coast) also made contributions, as did two economies from the Pacific (Australia and New Zealand). In addition, Jamaica made a contribution (and its contribution on the optimal design of competition agencies also discussed small economy issues).

important, the Background Paper points out that the policy implications of the attributes in these two latter categories tend to point in opposite directions. Professor Gal's book focuses on concentration levels, economies of scale, and entry barriers, and her recommendation for all of the economies meeting her definition is to place increased emphasis on efficiencies. Ms. Boza's discussion in Part III of the Background Paper focuses on institutional and other attributes of being a developing or transitioning economy, and she urges greater attention to creating or preserving a competitive market structure. In addition to discussing the implications of these two categories, therefore, it will be important to discuss (a) whether the categories would benefit from the addition of some size-related element, and (b) the relative importance of the characteristics that define these two categories for economies that fall within both of them.

6. Participants may notice that this framework does not address the argument that small, open economies have no need for a general competition law. The argument was not made in any of the submissions. It is clear that even such economies face the risk of cartels and other anticompetitive conduct at least in nontradable sectors. Therefore, even small, open economies now seem to acknowledge that they need tools to deal with such conduct. It has been argued that a sectoral approach might be better than having a general competition law, but this argument seems clearly without merit in light of the specialised knowledge and powers that are required.

III. Overview of Key Issues and Participants' Contributions

7. **Definitions.** It appears that all of the contributions are from or relate to economies that regard themselves as small. Many of the European economies that made contributions, however, would apparently not be considered small under Professor Gal's definition.

8. Only the contribution of New Zealand offered a specific definition. Interestingly, while the New Zealand paper relies very heavily on the work of Professor Gal and reaches most of the same conclusions, its definition is quite different. Whereas Professor Gal's definition focuses on economic structure and entry barriers, without any actual measure of size, New Zealand's paper defines small economies as "those economies that are approaching the minimum size needed to operate a full set of regulatory and competition policies and institutions." The paper goes on to explain:

"This group includes New Zealand, Singapore, Hong Kong, Israel and Ireland. Economies that fall below this threshold, such as the micro states of the South Pacific and the Caribbean, are faced with a different set of issues. Somewhat larger economies, such as Australia and Canada, may face similar issues to small economies but often to a lesser degree."

9. It is noteworthy that one reason Professor Gal's definition appears to include even economies the size of China and Indonesia is that it includes both (a) economies whose political borders *constitute an area* that can support only a limited number of firms, and (b) economies whose borders *contain multiple areas* that can support only a limited number of firms. It would be interesting to consider whether it would be preferable to limit the definition to the first of these sets of economies.

10. **Benefits and costs of enforcement.** Both Denmark and the Slovene Consumers' Organisation specifically note that they view competition enforcement to be at least as important in a small economy as in a large one. Switzerland notes that it once considered competition enforcement to be relatively unimportant in a small economy but has changed its view on this. No contributions suggested competition enforcement is any less important in a small economy.

11. In terms of costs, both Denmark and Macedonia specifically noted that the benefits of competition enforcement far exceed its costs. Jamaica deals with cost issues in part by having part-time Commissioners, whereas Macedonia considers it more economical to have a full-time enforcement agency. New Zealand has the most complete discussion of these issues, and it notes that the cost may be relatively high in a small economy. To deal with the cost and the scarcity of personnel with the requisite skills, the paper suggests that it may be desirable to combine the competition agency with the consumer protection agency and with some sectoral regulators. Another way to address cost issues is to create a regional competition authority, as is being done in the CARICOM and COMESA regions.

12. **Minimum efficient scale, concentration levels.** Almost all of the contributions mentioned concentration levels and MES. Perhaps because so many of the contributions came from European economies with borders that are very open to trade, there was little real expression of concern about this. Ireland noted that domestic concentration is seldom important because most markets are international. Switzerland stated that many of its firms achieve MES by expanding beyond its borders. Estonia noted that many of its markets consist entirely of imports and said that this diminishes the MES problem; even for non-tradable goods and services, MES considerations are not seen as necessarily creating competition problems. Jamaica said that small economies face the same natural monopoly issues as large economies.

13. Various contributions state that like other market-related factors, small economy considerations may influence whether a particular practice will have anticompetitive effects, but that they do not require a different approach. Malta's contribution states that certain large economy approaches are or may be undesirable in a small economy, but in context it appears that like the others, it is really emphasising that that market difference must be considered, not that a different approach is necessary. Estonia concludes that multinational enterprises (MNEs) have more market power than their market share would indicate, and it notes two situations in which it believes that MNEs have subsidised predatory conduct.

14. Many contributions also mention that they consider it important to consider efficiencies in merger cases. Macedonia and Malta have an efficiency defence, Denmark and Estonia do not have one but find ways to consider them, and Cameroon has no defence but can authorise a merger that is expected to lead to lower prices in the long run. Australia has a system for authorising transactions when their restriction of competition is more than offset by one or more "public benefits", which can include import substitution and an increase in the real value of exports. Switzerland addressed this issue in part by setting high thresholds for merger review. No contribution argued that small size means that one should not have merger control. Jamaica's contribution to the session on optimal design of competition agencies states that its law does not include merger control because the drafters considered it unnecessary in light of Jamaica's level of development, but it does not state whether the Competition authority regards merger control as unnecessary.

15. **Enforcement problems.** The contributions mention remedy and other enforcement problems, but they do not raise important issues going beyond those discussed by Matti Purasjoki in the Background paper. To some extent, the described difficulties in gathering information and in remedying overseas conduct are by no means unique to small economies. Some are shared by all economies, and others by all but the largest.

16. **Development Issues.** The background paper provides a fairly detailed discussion of these issues. The contributions that contain the most telling comments on these issues are those of Cameroon, Ivory Coast, Morocco, and Tunisia. Cameroon, for example, mentions that it faces a situation in which financial markets have not been liberalised, the state continues to play a very interventionist role in the economy, there is no competition culture, there are no entrepreneurs, and there is a large informal market. Morocco emphasises market imperfections, "public sector grey zones," lack of transparency, and corruption. In such circumstances, it is easy to see why Ivory Coast states that competition law must be tailored to the situation

at hand, and Cameroon observes that the government considers it important to protect smaller domestic firms. As amplified by Tunisia, keeping unemployment at an acceptable level is worth a certain amount of inefficiency.

SPECIAL ASPECTS OF COMPETITION POLICY IN SMALL ECONOMIES**-- Suggested Issues for Discussion --**

The following is a preliminary list of relevant issues, some broad questions that should be addressed in any discussion of competition policy in small economies (e.g., what aspects of an economy's size are relevant) and some narrower questions whose discussion would be useful if information and time are available. In its current form, the list is being provided to two experts for their use in preparing a general background paper and to all projected Forum participants for their information.

I. What aspects of an economy's "small" size imply a need for competition policy principles, laws, or institutions that are different from those of other, "larger" economies?

That is, what is it about being a small economy that makes a difference for competition policy purposes? Is it the size of the economy's population or GDP, its level of development, the number firms its domestic demand can support (at "world" prices), or some other attribute? Whatever attributes are considered important, are they measured in absolute relative terms, and if the latter, relative to what?

Analysis of the abstract questions identified above will require consideration of the following specific issues, among others:

1. What difference does it make whether a small economy is surrounded by large, dynamic economies, by large or small developing economies, or by geographic "barriers" such as oceans, mountains, etc?
2. In what circumstances does it make a difference how many firms can be supported by domestic demand? What are the implications of liberal trade foreign investment regimes?
3. Does whether an economy is "small" depend on precisely which practice or instance of a practice is under consideration? (For example, were some economies "small" when Boeing and McDonnell Douglas merged, but "large" when Gillette and Wilkinson merged?)

II. Special attributes of small economies due to economic factors

Several attributes of small economies may be thought to call for different approaches to competition law and policy. For example:

Relationship between the size of truly domestic geographic markets and minimum efficient scale. When there are valid product and geographic markets within any economy, demand within such markets may be small compared to minimum efficient scale ("MES," i.e., the scale at which average cost is minimised.)

To what extent is this a “small economy” problem, as opposed to a “small geographic market” problem? Do small economies face fundamentally different, more serious problems or do they encounter the same problems with respect to a larger number of markets?

- It is sometimes said that considerations relating to MES mean that a small economy does not need to have merger control as part of its competition law. Is this correct? What are the relevant factors to consider?
- If, as Michael Porter discusses, domestic competition is the training ground for companies to be effective competitors in the wider world, should competition authorities in small economies prohibit anticompetitive mergers between firms smaller than MES?
- On the other hand, should competition authorities in small economies address static efficiencies earlier in their evaluation of a merger? For example, should they allow an anticompetitive merger that enables the post-merger firm to attain MES?
- What is the value of concentration measures for an authority reviewing mergers in small economies?
- Under what conditions would an effective remedy to a merger between MNEs be reducing barriers to imports?
- To what extent do concerns of small economies reflect a tendency on the part of policy-makers and the public to assume or fear that firms’ dominance within an economy’s own territory means that the firms have market power? In other words, to what extent do the concerns reflect a failure to appreciate that firms’ agreements and practices can only be assessed after defining markets and assessing entry barriers.

Relationship to the size of the informal sector. Are small economies any more likely than others to have large numbers of informal enterprises that operate outside of the formal regulatory framework? If so, their informal sector raise special competition issues, and are formal competition rules the best way to deal with those issues?

Relationship to the speed of technological change and new entry. Are technological change and new entry likely to be slower (or unable) to ameliorate competition problems in small economies? If so, what measure(s) of “smallness” are involved, and what does this situation imply for enforcement practices? For example, do/should competition authorities in small economies assign a greater probability (than do those in large economies) to foreclosure when evaluating a vertical merger?

Implications for regulating “natural monopoly” bottlenecks. In large or small economies, owners of bottlenecks such as ports, telecommunications, rail handling facilities, and airlines may raise the cost of imports and reduce the returns from exports. Are small economies different in this regard? How?

III. Special attributes of small economies due to “political” considerations

Distribution of welfare changes. Small economies may be particularly likely to have one or very few large export-oriented enterprises and a large number of small enterprises that provide inputs to the large enterprises (e.g., local transport and repair services). If it is the case, the losses that increased competition will have on the many local owners of such firms may be particularly large – and politically difficult to accept – even though domestic consumers may benefit from the static and possible dynamic

efficiency gains realised by the (relatively) small number of local and MNE buyers. Is this the case? What evidence exists?

Concentration of social/political power. Is there a greater risk of firms wielding social and political power, as well as economic power, in a small economy? If so, what dimension(s) of smallness are relevant? What does this imply for the design of a competition law and policy regime? Does controlling the concentration of economic power through a competition regime also control social and political power?

Size of the business elite.

- If the business elite is small, and businesspersons have many other relationships such as going to the same school and being part of inter-related families, can competition be so "personal" that tacit collusion (*e.g.*, to divide markets) can proceed without any agreement or even any communication?
- If the business and government elites are very small and have close relationships, how do those relationships affect competition law enforcement or the use of competition policy?

The costs and benefits of competition law enforcement.

- There are obviously some fixed costs in setting up an enforcement institution and regime. If an economy has a small GDP, and if the benefits to competition are proportional to GDP, then might the fixed costs of a competition institution and regime be small compared with the benefits? Is there evidence on this question?
- In a small economy, there may be relatively few officials capable of designing and enforcing economic policies in general and competition policies in particular. On the other hand, when compared to its needs, a small economy's supply of capable economic regulators may be relatively large. Do small economies have a relatively high or low opportunity cost of having its talented officials work in competition policy rather than in some other policy field?
- Is it less costly to set up a part-time competition authority than a full-time authority? Is there necessarily a loss of independence and specialisation?

IV. Special enforcement issues faced by authorities in small economies

Getting evidence. Do competition authorities for small economies face significantly larger obstacles to gathering evidence? For example, when investigating a cartel, are there special problems due to MNEs not keeping significant documents in the country, and due to potential witnesses not being present in the jurisdiction? If these are problems in practice, what are possible solutions?

Remedies. When a transnational merger is not prohibited or modified by large jurisdictions, but a small economy would experience a significant negative effect on competition, what effective relief is available? Is this a "small economy" problem or a problem faced by all but the very largest jurisdictions?

- Under what conditions are mandatory long-term licences of key trademarks plus divestiture of local production assets effective? Are there problems of divested assets being below minimum efficient scale? If so, how can they be addressed?
- Under what conditions are lower import trade barriers effective?

- Under what conditions is maximum price regulation effective? For example, some jurisdictions may measure “excessively high prices” by comparison with price level in a reference market. Would this be a feasible and low cost for *ex ante* regulation?

Sanctions. Can small economies be effective in imposing sanctions or other obligations given the risk that firms may simply pull up roots, adversely affecting the economy? Can small economies impose effective sanctions against individuals, given that individuals may find it easier to avoid entering into their territory?

International co-operation. Do competition authorities from small economies find it difficult to receive timely and useful co-operation from the competition authorities from large economies? Do competition authorities from large economies, or companies headquartered in large economies, benefit from those authorities co-operating with competition authorities from small economies?

Reference: Michal S. Gal, "Market Conditions under the magnifying glass: General prescriptions for optimal competition policy for small market economies." Working Paper #CLB-01-004, New York University Center for Law and Business, April 13, 2001.