



Competition Policy and Economic Growth – *Is There a Causal Factor?*

It is widely accepted that competition policy contributes to economic development. However, the extent to which economies of those countries that have adopted competition policies and laws are performing better than those still to adopt is not quite apparent. This lack of clear evidence could be responsible for the reluctance by some developing countries to adopt competition policies, or for the slow pace of adoption of competition reforms by others. This paper attempts to dwell on the issues surrounding the relationship between competition policy/law and economic growth. It discusses various channels through which economic growth and competition policy/law can be interlinked. The paper also describes some of the empirical research studies done on the subject and the findings. It also identifies some of the challenges and bottlenecks that could be responsible for the absence of a clear link between competition policy and its intended objective, economic development.

Introduction

Over 100 countries, in both developed and developing countries, have now adopted competition law and policy, while others are considering, or are in the process of, developing competition policies as well. Competition policy, in this context, is defined as those government measures that affect competition, by directly affecting the behaviour of enterprises and the structure of industry.

Competition policy, basically, covers two elements. The first involving putting in place a set of policies that promotes competition in local and national markets, such as relaxed industrial policy, liberalised trade policy, easy exit and entry conditions, reduced controls and greater reliance on market forces. The second one, considered most critical, comprises legislation, judicial decisions and regulations specifically aimed at preventing anti-competitive business practices, avoiding concentration and abuse of market power. Although competition law is part of competition policy, the majority of countries started with the adoption of competition laws, without any competition policy in place.

The most common immediate objectives of competition policy have been to protect the process of competition and free market access, by prevention and elimination of monopolies, monopolistic practices and other restrictions for the efficient functioning of markets, as a means of attaining economic efficiency in production. This includes the preservation and protection of the process of competition (not competitors), with a view to maximising economic efficiency (static and dynamic), by achieving efficient market outcomes, in the form of lower

consumer prices and better quality products. The ultimate objective of competition policy is generally agreed to be the attainment of economic growth, through the interplay of these immediate objectives, hence a causal relationship between competition policy and economic development is posited.

The link between economic growth and competition policy is, however, neither straightforward nor clearly distinct, in terms of observed reality. There are a lot of economies that have performed reasonably well, in terms of economic development, without any competition policies in place. Similarly, there are economies that have adopted competition policies and reforms for quite a long time now, but are still struggling, in terms of economic development. There are, therefore, a lot of apprehensions and misgivings about the benefits of competition law in developing countries, among both of those that have enacted them and those that are reluctant to adopt one.

A Review of the Literature

Theoretical Link

Competition policy and law essentially focus on two areas: the conduct of business and the structure of economic markets. The structure of the market plays a leading role in determining the different market indicators. It determines the opportunities that are available for both a greenfield investment and further expansion by the existing firms, as this would determine the size of the expenditure that is required to gain a significant share of the market from the established firms. Market structure also plays a part in determining the level of profitability of the industry, with monopoly and monopolistic structures

normally associated with more profits. It is on this basis that it is expected that competition policy will have a significant impact on economic development.

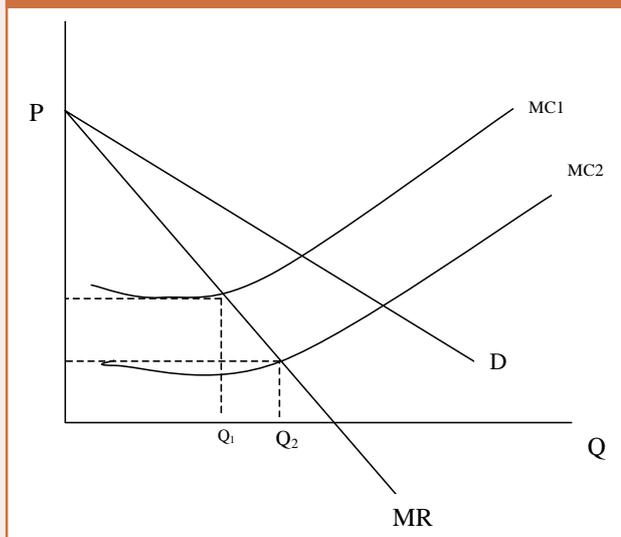
It is generally conceivable to accept the notion that the nature of competition prevailing in the market will have an impact on innovation, implying that adopting competition policy, to induce competition, will affect the incidence of innovations. The fact that innovation has an influence on economic development is not a subject of debate. Hence, linking competition to innovation implies that competition policy will affect economic development.

Generally, the expectation of some form of transient *ex post* market power is required for firms to have the incentive to invest in R&D. Similarly, it is the possession of *ex ante* market power that is more likely to favour innovation. When capital markets are imperfect, the rents from market power provide firms with the internal financial resources for innovative activities. Market power also helps reduce the uncertainty associated with excessive rivalry, which tends to undermine the incentive to invest (Ahn, 2002). This premise is normally referred to as the *Schumpeterian hypothesis*, named after Joseph Alois Schumpeter, from whom the idea originates.

The reason why market power or monopoly characteristics can result in innovation works out as follows. Monopolies tend to charge higher prices and restrict output, in order to maximise their profits. These same profits can be used for innovation, which would result in a reduction in marginal costs and increase in output, over time. This is illustrated in Figure 1, showing the demand, marginal revenue and marginal cost curves for a monopoly. A shift in the marginal cost curve from MC_1 to MC_2 , as a result of successful innovation, will result in an increase in output produced from Q_1 to Q_2 . Such decrease in marginal costs and increase in output, over time, may not be possible under a competitive environment. Adopting competition laws that can result in prosecution of companies for suppressing entry, through anti-competitive behaviour, may, therefore, reduce the incentive towards innovation and economic growth can be slowed down. This is a possible channel through which competition policy can reduce the economic growth rate.

On the other hand, the link through innovation is also not one way. Competition will render price-increase-induced profit-making unviable, as price increase will be equivalent to driving away buyer patronage to rivals. In such a scenario, firms need to innovate, in order to reduce costs and produce more output at prevailing market prices. It is through the introduction of competition in the markets that enterprises will be compelled to re-invest in new production technologies, new production processes and new products. Managers would strive for better incentives and there would be a general reduction in slackness and inefficiencies.

Figure 1: Monopoly Output under Different Marginal Cost Curves



The promotion of productive and dynamic efficiency will make enterprises achieve economies of scale, enhance international competitiveness and promote R&D capacities. Competition, therefore, stimulates increased efficiency in innovation, production and resource use, which, in turn, leads to enterprise development and increased aggregate welfare. Further, competitive markets provide macroeconomic benefits. Competition provides enterprises with incentives to adjust to internal and external shocks and these individual adjustments help reduce the cost of such shocks to the macro-economy (Lipimile, 2004).

Again, from a standard microeconomic theory perspective, decisions on what output to produce are determined by the cost structures, as well as the demand for the product. A monopolist, given the nature of the demand for the product, would tend to maximise profits, through limiting the output to a level which is lower than what would have obtained under a competitive environment. If there are a lot of sectors with monopolies under conditions of elastic demand, this then would imply that the total production in all those sectors would be much lower than those in a situation in which the markets were competitive. By adopting competition laws, these sectors could see the entry of more players and this would reduce the incentives for these companies to produce less than the competitive output levels. Thus, competition would be expected to result in increased levels of production.

Competition policy is also expected to result in economic development, through investment attraction. Investment is generally a gamble about future outcomes. It can be regarded as a bet that the revenue from an investment will exceed its costs. An investor can only be confident of success if the environment is conducive for entrepreneurship and policy makers and regulatory

authorities are not given too much discretion for interventions in the market. This enables investors to predict the future outcome of their investment.

Transparent information on how governments implement and change rules and regulations dealing with investment is a critical determinant in the investment decision. A transparent and predictable regulatory framework dealing with investment helps businesses to assess potential investment opportunities on a more informed and timely basis, shortening the period before investment becomes productive. An effective competition policy regime is an important component of a good overall regulatory environment. Competition laws and policies that are transparent and characterised by predictable implementation and consistent rulings on competition cases on the basis of non-discriminatory criteria will remove most of the uncertainty surrounding investment decisions.

Empirical Findings

Having discussed various avenues in which competition policy and laws can be linked to economic development, it is important to discuss the extent to which this relationship has been proven empirically.

In one study, Bucci (2004) demonstrates that it is possible to reconcile the different innovation-driven growth theories, through an extension of the basic Romer model of horizontal innovation and deterministic R&D activity. He reconsiders the relationship between product market competition and growth and the results showed that an *inverted-U relationship* between these two variables may take place. This implies that an increase in competition initially increases growth, but beyond a threshold level, it reduces it. Product market competition was modelled by the elasticity of substitution across varieties of capital goods.

The results show that there is evidence that the relationship between competition and economic growth can either be positive or negative. More intense competition brings negative results, while a minimum level of competition leads to economic growth by promoting the need for innovation, hence an *inverse U relationship*. His explanation is that there are two effects (the positive *resource allocation effect* and the negative *profit incentive effect*), which implies that the relationship between product market competition and aggregate productivity growth might be *inverse U-shaped*. For low initial levels of competition, more competition is beneficial to growth, since it allows a substantial better use of resources, without hampering that much innovation incentives (the resource allocation effect outweighs the profit incentive effect and the correlation between competition and growth is positive).

On the other hand, when product market competition is sufficiently tough, more competition reduces drastically

technological progress, improving only marginally the allocation of resources across economic activities (the profit incentive effect prevails over the resource allocation effect and the correlation between competition and growth is negative). There is, therefore, an optimal amount of competition for promoting economic growth and competition in excess of this would have negative effects on growth.

The testing of whether economy-wide anti-trust policy or measures of concentration are significantly and robustly correlated with higher rates of per capita economic growth was done by Dutz and Hayri (2001). They used data from over one hundred countries during 1986-1995. The effectiveness of anti-trust policy was measured by answers to a large survey of top executives in 53 countries, posing questions about anti-monopoly policy in their country, as well as a measure of mobility of the largest firms. They found that measures of effective anti-trust policy are positively associated with residual growth (that is, growth that is not explained by variables for which there is some consensus that they lead to higher economic growth – trade openness, human capital and investment in physical capital). Additional sensitivity analysis indicates that effective anti-trust policy has an impact distinct from that of trade openness. In a previous study using the same data set, Dutz and Hayri (2000) had also established that there is a strong correlation between the effectiveness of competition policy and growth. The analysis suggests that the effect of competition on growth goes beyond that of trade liberalisation to institutional quality and a generally favourable policy environment.

Yun (2004) investigated whether or not competition has contributed to productivity gains in Korea, by focusing on the impact of product market competition on productivity, using firm data. The study uses four proxies to represent competition (or lack of it) – the number of firms, firms' market share, industry concentration (CR3) and rent. The study is based on an unbalanced panel data set of manufacturing firms for the period 1990-2002, with labour productivity being used as the dependent variable. The results show that changes in the number of firms is an important source of competition and productivity growth, while a high number of firms in the market itself is not conducive to productivity growth. Increased monopoly rent may boost productivity growth in the short run, but hinder economic development in the long run. The conclusion reached was that competition policy should not narrowly focus on curbing market dominance of firms already in the market, but rather employ a broad approach that keeps entry and exit barriers low.

The influence of competition policy on firm level performance was also tested by Kahyarara (2004). The study sought to establish the extent to which firm-level performance, measured by investment, productivity and

exports, is influenced by government measures aiming to stimulate competition (competition policy) and protect consumers against monopoly in Tanzania. The study analyses the role of competition policy in influencing productivity, investment and export performance of Tanzanian manufacturing enterprises. The results indicate a positive relationship between competition policy and productivity, investment and exports. It was also established that for the productivity effect of competition policy, the results are influenced by firm-specific attributes, suggesting that the positive relationship between competition policy and firm productivity is highly dependent on firm-specific characteristics. The competition policy variable used was a dummy variable, taking the value of zero before the introduction of competition law and one after the introduction.

There are a lot more studies that can be dug out from the literature shelves, but the findings are more or less similar to those described above. The implication then is that some evidence exists on the ground to suggest that competition policy and law will have a role to play in determining enterprise performance and, hence, economic development.

The Benefits – Are They Material?

Given that several studies have demonstrated the links between competition policy and economic development in different countries, does it, therefore, imply that countries that have adopted competition laws are faring better than those without the laws? The answer to this is not likely to be in the affirmative, the reason being that there is nothing concrete on the ground to separate the two sets of countries, in terms of economic performance. But, before absence of this lack of a clear distinction can be attributed to the ineffectiveness of competition policy, it is important to focus on the extent to which the adopted laws and policies are being fully implemented. Adoption of a law is important, but implementation of the law is even more important. Thus, the extent to which the implementation process is constrained is the most important issue. A critical assumption that is made on studies on the impact of competition policy on economic development is that competition policy/law adoption leads to competition in the market. But, are markets in all countries with competition laws competitive? This section tries to provide the answer.

It has been sadly observed that there are hurdles in countries with competition laws, which render the implementation process less smooth, and most markets are not open to competition. Such hurdles include: (i) policy-induced barriers (government regulations, policies affecting market processes and competition, protectionist approach, etc.); (ii) nexus between government and big firms; (iii) poorly evolved ‘business environment’; (iv) actions in the guise of ‘public interest’; and (v) inter-institution relationships.

(i) Policy-induced Barriers to Competition

This can take place because of various reasons, such as (i) lack of political will; (ii) government regulations; (iii) policies affecting market processes and competition; and (iv) ‘protectionist’ approach.

Most developing countries (particularly those in Africa) implemented the structural adjustment programmes (SAP) in the early-1990s, prior to the enactment of their competition legislations. Adoption of competition law was largely on the premise that the countries were now subject to market reforms, yet many of the countries are still to fully embrace the reforms. There remain significant potential barriers to competition in many countries. These barriers include government regulations in product and factor markets, which deter firm entry, exit and growth. In Vietnam, although the Competition Law was passed in 2004, there still exist significant barriers to international trade, factor markets, entrepreneurship and innovation. Moreover, several sectoral policies and laws, with significant implications for the market structure in various industries, are at cross purposes. Thus, building an effective competition regime in Vietnam is still a challenge¹.

The efforts of competition authorities to enable competitive markets can also hit brick walls, due to the absence of enabling investment regulations. Observers opine that investment laws that open the industry to all players are the best suited for the promotion of competition. Although developing countries also need to protect their local companies against foreign domination in critical sectors of the economy, in line with national interest objectives, this tends to be overdone. Such conditions have a huge bearing on competition and investment promotion. State-induced institutional barriers exist in Lao PDR, despite the country having passed the Decree on Trade Competition, which came into effect in 2004. Many manufacturing as well as service and utility sectors that display high market concentration receive state protection in various forms, including state control and quantitative restrictions and stringent licensing conditions².

(ii) Nexus between Government and Big Firms

Vested interests often cast an influence on the implementation of policies. Under such circumstances, lack of good governance and transparency compounds implementation problems. Governments are often alleged to provide extra benefits to certain companies or players, at the cost of the others. In Mauritius, using funds from business houses for political party funding is a normal practice. Concerns have often been raised that such proximity could influence the government while framing policies aimed at private sector development, like a competition policy or law³. Such an action of the government leads to inefficiency and creates entry

barriers for new players trying to enter the market, which act against efforts to attract new entrants and competition.

(iii) Poorly Evolved Business Environment

Despite significant progress made in terms of liberalising the business environment, several approvals are required to start a new business. These approvals often take substantial time and costs and thus constitute major obstacles to entry by a new business operator into the market, thus hampering private sector development. In Malawi and Uganda, business registration for foreign investors itself costs more than the per capita income of the country⁴. In Mozambique, it takes 153 days to get a business registered. In many of these countries, the cost involved is more than that in the US, even in absolute dollar terms. Thus, competition law does not necessarily result in entry by firms into markets and hence competition.

(iv) In the Guise of ‘Public Interest’

There is a general scepticism in developing countries about relying on the forces of supply and demand to produce outcomes reflecting consumer interests. This results in several regulations and reactive laws being put in place, as a way of safeguarding “public interest”. Price controls are a common feature in many developing countries and, in most instances, they have a huge bias towards consumers than producers. The price control mechanisms are administered under a bureaucratic process that results in reviews lagging behind inflation. Such mechanisms act against the promotion of competition and investment, by lowering profit levels. An extreme case is Zimbabwe, which is currently under a hyper-inflationary environment. The Government fast-tracked a National Incomes and Prices Commission (NIPC) Act is now considered a barrier to investment, as businesses undergo significant time periods of loss-making, due to controlled prices that are below the production costs, thereby curtailing competition. This is despite the presence of a competition law and a competition agency.

(v) Inter-institution Relationships

The overlap of functions between the competition authority and the sector regulator may also be responsible for failure to promote a healthy competition culture in many developing countries. It is important to point out that both competition authorities and sector regulators play important roles in promoting a competitive environment. What is lacking in most developing countries is a forum that allows the two groups to exercise their mandates in a manner that is not conflicting and confusing to the different economic agents. The Securities Exchange Commission (SEC) in Zambia also has overlapping responsibilities with the Zambia Competition Commission (ZCC). The SEC decision and that of ZCC have often clashed in share

transfer cases, despite the fact that the Executive Director of the ZCC is an *ex officio* member of SEC⁵. In Tanzania, a case of conflict arose between the competition authority and the Tanzania Communication Commission, where the former filed a complaint against the latter for permitting dominance of two mobile phone operators (Mobile and Tritel) in the country⁶.

Implications and Way Forward

The fact that competition policy should contribute towards economic development is more or less an agreed concept, it is largely the barriers to competition that exist that are sources of apprehension. There is need, therefore, for competition culture to prevail in the whole economy, to remove the distortions. This should start at the top level, before it can eventually cascade to consumers. Political will turns out to be one of the key factors that determine the success of implementation of competition policy and laws. If competition law and policy is to yield all the envisaged benefits, political will and consensus for reform is a necessary condition and strengthening an existing law or adoption of a new one in the absence of such willingness will not help. Political will might also result in an assurance to investors about security and predictability of returns of their investments. Some developing countries, such as Malawi and Bangladesh, have adopted competition laws and policies, but it took ages for the laws or policies to come into effect and for structures to be put in place towards the implementation of the law.⁷

Also related to the political will is the issue of the need for a holistic approach towards competition. Competition law should, generally, be part of a competition policy, if all the desired objectives of competition law are to be achieved. However, even if used as a starting point, the competition law adoption should be followed or accompanied by removal of restrictions on competition from the investment policy, the industrial policy, the consumer policy, the trade policy and other sector-specific policies that have an impact on competition. There is need for all the policies and sector law in the economy to be pro-competition as well. This situation is absent in most of the developing countries, despite their claims about having adopted market reforms. Botswana can be regarded as an example that is following a more focused approach, with the exception that the procedure is being unnecessarily prolonged.

Thus, there is need for a platform for ensuring that all the different stakeholders with different expectations and aspirations develop a sense of being a part of the market reforms. Carrying out awareness campaigns and soliciting views and suggestions from all the crucial stakeholders should, therefore, be part of the competition policy process. The competition laws for each country should try and ensure that the competition law and the accompanying policies are designed to try and meet

expectations of all stakeholders, rather than being biased towards either business or consumers. Consumer interest issues should be explicitly recognised in the designing of competition policy and advocacy should be included as a tool for awareness promotion among consumers. At the same time, however, the promotion of efficient markets, as an objective, need not be necessarily compromised; platforms should be allowed to address other public interest issues that the competition law can not handle. This exercise of ensuring participation in the reforms by all stakeholders ensures a reconciliation of the perceptions of various players, by taking into account their different characteristics and expectations.

Conclusion

The paper has largely demonstrated that there is generally expected to be a causal relationship between competition policy and economic development. This two-way relationship comes from the fact that while competition may bring with it increased production levels, as output restriction tendencies by monopolies are

removed and more companies enter the industry, competition may also reduce incentives for innovations, as monopoly profits are the largest sources of innovation. The paper has also highlighted some empirical findings on the relationship between competition policy/law and economic growth, with results that are largely supportive of the theoretical expectations. Various institutional factors, which may act as barriers towards the realisation of most of the intended benefits of competition policy/law, have also been discussed. These may also be responsible for the lack of a directly observed benefit of competition reforms that can act as motivational factor for those countries that are still to embrace competition reforms. The need for political willingness to fully embrace the reforms, involvement of all the stakeholders in the economy in the competition reform process, so as to instil a competition culture in the economy, as well as extensive awareness campaigns in countries that have already embraced the competition reforms on a piecemeal basis, are some of the measures that the paper is suggesting as the way forward.

Endnotes

- 1 CUTS (2006).
- 2 Supra note 1.
- 3 Sahebodin, M. (2007), 'Political Economy Constraints in Implementing Competition Regimes: Experience from Mauritius'.
- 4 Doing Business Report (2008), World bank Group.
- 5 CUTS (2003).
- 6 Supra Note 4.
- 7 Mehta, P S, Manish A., V V Singh (2007), "Politics Trumps Economics - Lessons and Experiences on Competition and Regulatory Regimes from Developing Countries".

References

- CUTS (2006), Fairplay Please, CUTS International, Jaipur, India.
- CUTS (2003), Pulling up Our Socks, CUTS International, Jaipur, India.
- BUCCI Alberto (2004), An Inverted-U Relationship between Product Market Competition and Growth in an Extended Romerian Model, Working Paper n. 26.
- Dutz, A. and Hayri, A (2001), Does Effective Anti-trust Policy Spur Economic Growth? October (2001).
- Ahn, S. (2002), Competition, Innovation and Productivity Growth: A Review of Theory and Evidence, OECD ECO/WKP(2002)3.
- Lipimile, G.K (2004), Competition Policy as a Stimulus for Enterprise Development in Competition, Competitiveness and Development: Lessons from Developing Countries, UNCTAD/DITC/CLP/2004/1.
- Dutz, M. and Hayri, A. (2000), Does More Intense Competition Lead to Higher Growth? Policy Research Working Paper 2320.
- Yun, M. (2004), Competition and Productivity Growth: Evidence from Korean Manufacturing Firms in Competition, Competitiveness and Development: Lessons from Developing Countries, UNCTAD/DITC/CLP/2004/1.
- Kahyarara, G. (2004), Competition Policy, Manufacturing, Exports, Investment and Productivity: Firm-level Evidence from Tanzania Manufacturing Enterprises in Competition, Competitiveness and development: Lessons from developing Countries, UNCTAD/DITC/CLP/2004/1.

This Briefing Paper is researched and written by **Cornelius Dube** of and for CUTS Centre for Competition, Investment & Economic Regulation (CUTS C-CIER).

CUTS CCIER Briefing Papers are to inform, educate and provoke debate on issues related to competition, investment and economic regulation. Readers are encouraged to quote or reproduce materials from this paper for their own use, but as the copyright holder, CUTS International requests due acknowledgement and a copy of the publication.

© CUTS International, 2008. CUTS International, D-217, Bhaskar Marg, Bani Park, Jaipur 302 016, India. Ph: 91.141.228 2821, Fx: 91.141.228 2485, E-mail: c-cier@cuts.org, Web: www.cuts-ccier.org. Printed by Jaipur Printers Pvt. Ltd., M. I. Road, Jaipur 302 001, India.