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COMPETITION POLICY IN SMALL ECONOMIES

-- By Ms. Michal Gal --

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SIZE MATTERS FOR COMPETITION POLICY

PREPARED REMARKS FOR THE OECD SESSION ON SMALL ECONOMIES

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This issue of whether and to what extent size matters for competition policy is an extremely important one, which has so far been mostly neglected by the antitrust community at large. Yet many courts, competition agencies and scholars around the world recognize its significance, as exemplified, inter alia, by the country-specific contributions to this roundtable. The OECD's initiative is thus both timely and important.

The relevance of the size of an economy for market performance has long been recognized. Richard Caves, Michael Porter, Robert Scott and Nobel Laureate Michael Spence from Harvard argued that the fundamental structural traits of small economies are so pronounced that small economies belong to a "different class of market economies."[1] This short note will focus on some of the implications of this "different class of market economies" on competition policy. It is based, to a large extent, on my book, *Competition Policy for Small Market Economies* (Harvard University Press, 2003), and on my previous work on the subject.[2]

As will be shown, the economic paradigms on which the competition policies of large economies are based do not always apply to small economies. The main factor that creates the need to tailor competition policy to economic size is that competition laws often consist of "fit-all" formulations. Such formulations are designed to achieve the goals of the law in each category of cases to which they apply, while recognizing that some false positives and some false negatives may occur at the margin. The marginal cases of large economies constitute, however, the mainstream cases for small economies. The effect of small size is similar to that of a magnifying glass: special market phenomena become more significant as extremes become the rule. This requires small economies to change the focus of their competition laws to regulate their markets efficiently.

1. What is a Small Economy?[3]

Let me first define a small economy. For the purpose of competition policy, a small economy is an independent sovereign jurisdiction that can support only a small number of competitors in most of its

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1 Richard Caves, Michael Porter, Michael Spence and Robert T. Scott, *Competition in the Open Economy- A Model Applied to Canada* (Cambridge, Mass.: Harvard University Press, 1980).

2 See also Michal S. Gal, "Size Does Matter: The Effects of Market Size on Optimal Competition Policy" 74 *Southern California Law Review* 1437 (2001); Michal S. Gal, "Reality Bits (or Bites): The Political Economy of Antitrust Enforcement" in *Fordham Corporate Law Institute- International Antitrust Law and Policy*, Barry Hawk ed. (New York: Juris Publishing, 2002), Chapter 23.

3 This section builds, mainly, on Michal S. Gal, *Competition Policy for Small Market Economies* (Cambridge, Mass.: Harvard University Press, 2003), p. 2-4.

industries, when catering to domestic demand. Accordingly, the definition applies to domestic markets, that is, markets which serve domestic consumers (who are, naturally, located within the borders of the economy). This does not imply, however, that consumers should be served only by domestic firms. Rather, they might be served by foreign firms importing into the domestic market, if trade barriers in the specific market are low. Thus, the focus is on the fulfillment of consumer demand within the jurisdiction. In such markets, the number of firms a market can support is competitively significant.

This definition does not have a specific cut-off point in the sense that there is no "magic number" that distinguishes a small economy from a medium or large one, as any such point would necessarily be arbitrary.[4] Jurisdictions can be placed on a continuum in accordance to their size. Some jurisdictions are very small, such as Faro Islands, Jersey, Malta or Cyprus. Others, such as New Zealand and Israel, are much larger. Of course, the smaller the economy the more concentrated its industries are likely to be and *vice versa*. Yet all small economies are characterized by monopolistic or oligopolistic structures in most of their industries.

Three main factors influence market size: population size, population dispersion, and the degree of openness to trade. Small population size decreases demand and reduces the number of firms that can efficiently serve the market. Population dispersion over a large geographic size may create several small local markets within a geographically large jurisdiction. Accordingly, as Caves has shown, Australia is a small economy because the large distances between its five main domestic population centers and their distance from most foreign markets create concentrated domestic markets protected by high entry barriers.[5]

The size of an economy is also influenced by a combination of additional economic, geographical, technological, legal or political factors that create market boundaries and restrain entry of potential competitors. Primarily, the relevance of the jurisdiction in economic analysis is dependent on the international environment in which it is placed, including its trade agreements or arrangements with other economies, as analyzed below. Liechtenstein, Andorra and Monaco, for example, are so economically integrated with their larger neighboring states that they can be economically regarded as part of their markets. In these jurisdictions a high degree of openness to trade *negates* a conclusion of smallness, based on population size alone.

Yet jurisdictional borders may be relevant to competition policy. These boundaries may result from natural trade barriers, such as language differences when language is an important part of the product (e.g. computer software) and geographic boundaries (e.g., maritime borders, high mountain chains, secluded areas) that create high transportation costs. Transportation and adaptation costs are especially influential when low-priced, high-shipment-cost or perishable products are involved. Political conditions may also influence trade levels—accentuating geographic isolation both by closing certain passages to trade and by preventing trade between adjacent jurisdictions. Differing tastes or cultural preferences may also affect trade levels. These natural trade barriers are often compounded by policy choices of tariffs, quotas, limits to the convertibility of currencies and transfer of credits and even the standardization of consumer choice created by the central authority. Trade levels are also affected by domestic laws and regulations such as those regulating dumping liability, preferential treatment in government tenders for local products and intellectual property rights protection. The relevance of the jurisdiction in economic

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4 It should be noted that several studies use a cut-off point, such as a population that does not exceed 1.5 million. See, e.g., Commonwealth Secretariat and World Bank, *Small States: Meeting Challenges in the Global Economy* (April 2000). While these cut-off points might be relevant to the study of other factors, they are often of little relevance for the special attributes of smallness that affect competition policy.

5 Richard E. Caves, "Scale, Openness and Productivity in Manufacturing Industries" in *The Australian Economy: A View from the North*, Richard E. Caves and Lawrence B. Krause eds. (Sydney: George Allen & Unwin, 1984), 313.

analysis is thus dependent, inter alia, on its agreements or arrangements with other jurisdictions with which it has economic contacts, actual or potential. A liberal trade policy may make the jurisdiction de facto less relevant as a unit in economic analysis. Yet openness to trade is quite often a limited tool that does not remove many trade boundaries. Accordingly, jurisdictional borders may be relevant for competition policy.

It should be emphasized that to be considered small, not all the industries of an economy should be highly concentrated. Some industries, such as retail services, are highly competitive even in small economies. Nonetheless, when such firms are the exception rather than the rule, the jurisdiction should still be defined as small. Conversely, firms located in small economies might compete and even dominate world markets. In these cases the size of the domestic market does not constrain the scale and scope of production of such firms. Nonetheless, such firms will, most likely, enjoy dominant positions in the domestic market as well.

2. Why are Small Economies "A Different Class of Market Economies"?[6]

Research has shown that there are three main economic characteristics of small economies.[7] First, small economies are characterized by high industrial concentration levels in many of their industries. Industrial concentration signifies the concentration of an industry as determined by the number and size of firms operating in it. The main factor that leads to industrial concentration is the size of minimum efficient scales of production- that is, the point of production that minimizes costs ("MES"), relative to demand.

Second, markets in small economies are often characterized by high entry barriers. The main entry barrier is created by scale economies, by the need to produce at levels that cater to a large portion of demand in order to achieve minimum costs. Also, the existence of high MES levels in one market might create high entry barriers into a vertically linked market if it requires a new entrant to enter more than one market in the chain of manufacturing and distribution or if it raises significantly its costs relative to the costs of its rivals.

On top of high concentration levels and high entry barriers, the most important cause of small economies' inefficiencies is the problem of sub-optimal levels of operation. A recurring observation in studies of manufacturing industries in small economies is that a non-negligible fraction of all output is produced in sub-optimal volumes and sub-optimal plants, much lower than pure MES considerations would suggest. There are numerous reasons for the persistence of small and diversified plants in small economies. The most influential factor is the high levels of interdependence between firms in concentrated markets.[8]

These economic characteristics of small economies create a basic dilemma between productive efficiency and competitive conditions. If a given number of firms can operate efficiently in the market, productive efficiency requires that the market contain this number of firms, all operating at efficient productive levels. At the same time, productive efficiency imperatives often cause industrial concentration in a small economy to be high enough in many markets to allow some market power to be realized. Efficiency can be adversely affected by patterns of market behavior to which producers in monopolistic or highly concentrated industries are prone. Higher levels of concentration are not a free good also due to the income distributions caused by increased market power, the impact that widespread cartelization can have on dampening entrepreneurial vigor, and the social and political malaise that follow from excessive

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6 This section builds, mainly, on Gal (2003), Chapter 1; Gal (2001) p. 1444-1449.

7 See, e.g., Caves *et al., ibid*., and Scherer, F.M., *et al*., *The Economics of Multi-Plant Operation* (Cambridge, Mass.: Harvard University Press, 1975), 94.

8 For the seminal work on the subject see H.C. Eastman and S. Stykolt, *The Tariff and Competition in Canada* (Toronto: MacMillan of Canada, 1967).

concentration of economic power. Yet the benefits from achieving MES in small, sheltered markets can be sufficiently compelling in at least a subset of cases that policy makers should create rules that balance these two effects.

3. The Need for a Specially Tailored Competition Policy[9]

These salient characteristics have important policy implications as they require small economies to devise appropriate endogenous policies that offset at least some of the adverse effects of their small size. To reduce them, competition policy has to be designed to deal effectively with the unique obstacles to competition that are inherent in an economy, including those that stem from small size. Moreover, in small economies the importance of an appropriately structured and efficiently enforced competition policy may be more important than in large economies. Given that the market's invisible hand has a much weaker self-correcting tendency, the costs of improper design and application of competition laws might be greater both in the short and the long run.

To be sure, many of the principles and doctrines that apply to large jurisdictions apply equally to small ones. The goals of competition policy, which is aimed at creating and maintaining the conditions for workable competition in order to maximize social welfare, and its main tool and ideological choice- a market economy, as well as the basic economic theory that stand at the basis of competition policy, are similar in all economies. Yet the comparative prevalence of concentrated market structures in a small economy creates a set of trade-offs that may require a different set of rules to regulate the conduct of market participants. As noted above, the need for specially tailored competition laws arises from the fact that, in reality, many competition rules are one-size-fits-all formulations that are based on general presumptions about market conduct, which are informed, in turn, by the economic conditions that exist in most of the relevant markets. Let me illustrate this by several prescriptive examples. Some relate to rules that are applied in some jurisdictions around the world but not in others, and some relate to legal presumptions that are applied in large economies.

3.1 The Primacy of Efficiency[10]

Small economies should generally strive to achieve economic efficiency as their main goal, because they cannot afford a competition policy that is prepared to sacrifice economic efficiency for broader policy objectives, such as ensuring that small and medium-sized firms can operate in the market. Most importantly, when social goals conflict with economic efficiency, courts either cannot materially promote them or can only do so at unacceptable costs. Undeviating pursuit of wealth dispersion and small size of firms at the expense of efficiency will be costly in small economies, because inefficient firms will be preserved in the market, and thus the market will operate inefficiently. If such protection were nonetheless pursued, it would have to involve the whole scope of the market since sporadic protection of small firms would make little contribution to social goals. Systematic protection, however, would impose unacceptably high economic costs on the economy. Also, competition law efforts to preserve small business units over more efficient larger rivals would often be futile without costly on-going regulation, because these inefficient firms would either exit the market or grow internally to efficient sizes. But even if efforts to preserve small-sized firms would not be futile, they would involve the courts in essentially political decision-making for which there are no appropriate legal criteria, and in a costly regulatory, supervisory role for which they are ill-equipped. Thus, the protection of competitors instead of competition

9 Gal (2003), p. 4-8; Gal (2001), p. 1450.

10 This section builds on Gal (2003), p. 47-51; Gal (2001), p. 1451-1454.

would appear to be costly as well as producing arbitrary results that would make competition law unpredictable and obscure clear thought about its proper and attainable objectives. Even when there is no evident conflict, injection of social goals, by broadening the proscriptions of business conduct, would multiply legal uncertainties. In addition, such protection of small firms harms consumers who, on average, are likely to be less wealthy than the owners of small businesses, especially when such businesses are protected by competition law.

Moreover, even if the protection of small businesses *is* our chosen goal, competition policy should not be chosen as the method to achieve this it. Competition law, as its name indicates, is aimed at facilitating competition among potential rivals. It strives to achieve this goal by reducing artificial barriers to competition and by allowing market participants to interact independently. Tax measures, for example, might be better tools for achieving such goals. Finally, monopoly, or rather the incentive to become one, is an important 'engine' that facilitates competition. Limiting business size, per se, thus conflicts with the basic principles on which competition policy is based.

Although these arguments apply to any economy, regardless of its size, smallness exacerbates the importance of the primacy of efficiency. In large economies social values are served, to a considerable extent, by the competition policies that promote economic efficiency and progressiveness. The goals of dispersed power and better business opportunities are achieved, in many cases, by a competition policy that eliminates monopoly not attributable to economies of scale or superior skill and that prevents mergers, agreements, or practices that obstruct competition. But even if competition policy makes concessions to social goals, the few islands of market imperfections in a largely competitive sea are not apt to have much adverse incremental impact on the distribution of income and the maintenance of small, dispersed firms. In a small economy, on the other hand, economies of scale in production or distribution reduce, by definition, the number of firms necessary to supply any given demand and may reduce or altogether eliminate competition in the affected market. Accordingly, economic and social objectives may substantially diverge when efficiency dictates displacement of small firms by larger business units.

Moreover, in small economies the argument that the protection of small business is based on individual choice is limited. Once we constrain the size each business can achieve and limit its ability to take advantage of the natural conditions of the market, we inevitably constrain the freedom of choice.

Finally, the importance of economic efficiency as a primary objective becomes highlighted in a small economy in which interdependencies in the interests of various stakeholders are likely to be more significantly affected by a particular market transaction. This reality increases the probability of lobbying, rent-seeking behavior, and political posturing aimed at the 'safeguarding' or pursuit of other objectives that a public benefit or interest criteria promotes if not facilitates. If competition policy is influenced by non-economic considerations, the risk of costly industrial policy in the guise of competition policy becomes high.[11] At the same time, however, efficiency considerations might justify the creation of larger enterprises. These enterprises may exert political pressure to strategically use the competition law system as a method for achieving private interest advantages. Efficiency might therefore have to be qualified by public choice considerations when dealing with very large and influential enterprises.

Accordingly, in small economies social goals should generally be given little or no independent weight in formulating competition policy. This is not to say that when non purely economic considerations exist, such as producing a certain product within the jurisdictional borders for security reasons, they should be disregarded. Yet these considerations should be limited in their extent and specifically set out in the proper legislation.

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11 R.S. Khemani, "Merger Policy and Small Open Economies- The Case of Canada," in *Perspectives in Industrial Organization*, B. Dankbaar et al. ed., (London: Kluwer Academic Publishers, 1990) 216, 223.

3.2 Recognising the Relative Importance of Productive Efficiency Considerations

One implication of the fact that in small economies large firm or plant size might be required in order to achieve MES is that high levels of industrial concentration might be a necessary evil to achieve productive efficiency. Accordingly, a small economy should not pursue a policy that views high concentration levels as undesirable per se. Rather, competition policy should be sympathetic toward the enhancement of output by individual firms, through either internal growth, mergers or joint ventures, which allows for the exhaustion of economies that were not exhausted by the previous market structure, and could not be exhausted in less anti-competitive ways.

The drawback of such a policy is, of course, higher levels of concentration. Competition policy should thus strive to strike the optimal balance between structural efficiency and competitive vigor so that firms operate at efficient scales and pass at least some of the benefits of greater efficiency on to consumers. The key questions are a matter of degree: how sizable are the benefits as compared to the drawbacks of larger size of operation.

Merger policy best illustrates the need for a balancing approach over an absolute value of competition approach. A horizontal merger reduces the number of competitors in the market, and the merged entity ordinarily has a larger market share than either of the merging parties had before the merger. This reduction in the number of firms and increase in market shares may substantially lessen or prevent competition by increasing the market power of the merged entity or by facilitating interdependent behavior among firms. At the same time, a merger may enhance efficiency by allowing firms to attain scale economies which were not attainable under the pre-merger market structure either because of firm interdependence or the absolute size of firms. Some of the benefits of reduced costs may be passed-on to consumers if the cost advantage is great enough that the monopoly price is lower than the pre-merger price. Thus, horizontal merger policy should balance these competing considerations.

Most large economies use structural variables as the main guide in determining the likely competitive consequences of mergers. The dilemma between increased efficiency by the realization of scale economies, on the one hand, and the increase in market power and reduction in competition which accompany it is, in most cases, non existent in a large economy. Thus, a common approach signifies the value of competition. The underlying assumption is that there is no need for high concentration levels to achieve efficiency. Such an assumption generally holds in most markets, as they tend to have a large number of firms that can operate efficiently.

Take, for example, the EC approach towards horizontal mergers. Until very recently, merger policy was based on rigid structural assumptions implying that high degrees of concentration are harmful and thus should be prohibited, even if they entail improved efficiency. Accordingly, a merger was not permitted if it lessened competition substantially. Such a policy would necessarily have harmful results for a small economy. Given that concentration is a necessary evil in order to realize scale economies, prohibiting all mergers that increase concentration in a non-negligible way would be economically harmful.

Attempts to balance this approach and acknowledge efficiencies in large economies have been quite limited. U.S. merger policy, for example, acknowledges the benefits that can accrue from the merging of competitors in some market settings, even if they bring about high levels of concentration. Most importantly, they allow an efficiency defense as long as the merging parties can show by “clear and convincing evidence” that the proposed merger’s efficiency benefits to consumers will outweigh the impact of increased concentration on consumer welfare. Yet the basic rules, especially legal presumptions and burdens of proof, still convey an underlying assumption against concentration. Primarily, the efficiency defense is very limited and hard to prove and can only exonerate a merger that significantly

increases concentration in exceptional circumstances. In fact, no merger decision in the U.S. has, as of yet, turned on efficiencies.

That this approach is not well suited to deal with concentrated market structures justified by scale economies can be exemplified by the U.S. treatment of mergers in the health care industry. The U.S. health care industry suffers from many of the problems of markets in small economies: Markets are regionalized such that scale economies are large relative to market size and interdependent conduct is widespread. In determining the legality of horizontal mergers in this industry courts have exhibited little sensitivity towards the unique characteristics of the market. Even where efficiency defenses are recognized by the courts and smallness acknowledged, the analysis resembles that of a large, non-concentrated market: Similar concentration ratios are used for presuming anti-competitive effects and efficiency claims are dealt with the same skepticism as such claims in large markets. Similarly, the DOJ and FTC Health Care Industry Guidelines, while acknowledging the issues of smallness, have adopted low concentration thresholds and count on an efficiencies defense to address the special characteristics of the market. Such analysis almost always produces strong inclinations towards the condemnation of a merger. This factor, combined by the often insurmountable burden of efficiency defense, causes the problems of scale economies to be systematically under-treated.

A small economy should thus adopt a merger policy which recognizes the existence of oligopolies in which potential efficiencies remain unexploited and which are realizable by merger. Small economies should thus be more accommodating to efficiency defenses and rely less on structural variables alone or on rigid and limiting structural assumptions. While in general merger policy in small economies cannot aim at promoting competition, it can and should aim at the improvement of industrial structure and performance.

3.3 The Effect of Size on Legal Presumptions

An important effect of the economic characteristics of small economies is that they cannot blindly transplant legal presumptions that are applied in larger markets without careful consideration of their suitability for efficiently regulating their markets.

The Herfindahl-Hirschman Index (“HHI”) levels adopted in the U.S. illustrate the importance of fine-tuning legal presumptions to economic size. The HHI is a methodological tool employed to measure concentration and screen mergers. This static index indicates the level of concentration in the market based on both the number of firms operating in the market and their relative market shares. It is calculated by summing the squares of the individual market shares of all the participants. Although the HHI is only a prima facie indicator of the anticompetitive effects of a merger, its thresholds are important for setting merger review standards since they create a presumption of illegality, absent a clear showing to the contrary. The U.S. Merger Guidelines create a legal presumption that “where the post-merger HHI exceeds 1800, it will be presumed that mergers producing an increase in the HHI of more than 100 points are likely to create or enhance market power.” This choice of index is based on generalized predictions of gains from size as well as behavioral assumptions of the market, specifically oligopolistic coordination. It is presumed that, absent clear showings to the contrary, firms in markets that meet this threshold (e.g., a market with five equal-sized firms) have already exhausted scale and scope economies. Thus, the cost savings from the merger will be very low.

Such an assumption- regarding the exhaustion of minimum efficient scale in a market that meets this threshold- does not hold true in small economies. Adoption of the U.S. HHI levels will result, for example, in a presumption of illegality in a merger between the two smaller firms in a market with six businesses, four holding approximately 20% market shares and two holding approximately 10% each.

Objection to such a merger will not comply with the special economic conditions of a small economy. In small economies, especially when fixed costs and scale economies are substantial, it is not uncommon for firms to possess such market shares. Accordingly, many if not most proposed mergers would cross this threshold, although they will not always enhance or create market power or facilitate its exercise, and firms might be prevented from realizing scale economies.

Another example of a rule of thumb that does not equally apply to large and small economies alike involves the use of predetermined market shares in determining whether or not a firm possesses market power. Most courts worldwide rely on market shares, which are reasonable accurate and obtainable, as a primary- although only a preliminary- indicator of market power.

In small economies the typical market share which signifies market dominance should be lower than in a large one, since elasticity of supply is usually lower, given the prevalence of scale economies and oligopolistic interdependence. In other words, the smaller the market, the higher the barriers to entry usually are (lower elasticity of supply), and therefore the lesser the constraints that potential entry places upon a firm that tries to raise price, and the lower the market shares necessary in order to infer dominant market power.[12] Thus, in small economies, a given market share will usually signify more market power than in a large one, all else equal. Of course, this is true only as a general presumption, recognizing the possibility of adjustments where other factors, such as the elasticity of demand or supply, differ significantly from the typical case.

Of course, not all legal presumptions of large economies should be rejected by small economies. Many apply efficiently. Yet small economies should not adopt all legal presumptions blindly, without first ensuring their suitability for their markets.

3.4 Structural Considerations[13]

The concentrated nature of an economy also raises a structural consideration that is generally absent in large economies. In using its remedial powers, a competition court in a small economy should take into account, when attempting to restore competition in the market, the effect of its remedy on the current market equilibrium. Otherwise, it might create a situation which is counter-productive to competition. This will happen if several conditions are met: the remedy necessarily leads to the exit of a competitor from the market; the market can support only a small number of firms which actually compete in the market; entry barriers are high, and the assets of the exiting firm may not be utilized by a new firm (for example, where reputation is an important factor in the consumer's decision) or the process of establishing a competitor in the market is lengthy. In such situations, it is important to exercise caution with regard to the viability of competitors, if their viability is crucial for competition.

Take, for example, a market situation in which the relevant market can support only three firms, the number of competitors that actually exist in the market. Assume that one firm is found to engage in anti-competitive behavior, and that the court does not exercise enough caution in its decision such that the firm has to exit the market due to a significant comparative disadvantage created by the court remedy. If a

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12 This can be simply proven mathematically. If we leave the degree of market power and demand elasticity constant and we vary supply elasticity, then the only factor that can balance this change is the market share factor. [Li=Si/(Edm+Esj(1-Si)) where Li is the Lerner index of firm i, Si is the market share of firm i, Edm is the market elasticity of demand, and Esj is the elasticity of supply of competing or fringe firms. It is simple to see that when we hold Li (the degree of market power) and Edm constant and we vary Esj, the lower Esj is, we need a lower Si to offset its effect.]

13 This section builds on Gal (2003), 106-109.

new entrant faces high barriers to entry, this change in market structure may affect the pricing behavior of firms in the market, given that the remaining duopoly is more likely to engage in price fixing or price coordination. This may also be of great economic impact where the market can or may support only one firm, and several firms engage in competition *for* the market. Efficiency dictates that the most efficient competitor serve the market. However, if a superior potential competitor engages in anti-competitive conduct while competing for the market, and a court creates a great comparative disadvantage to this firm, the firm might exit the market. Consequently, efficiency will not be achieved.

3.5 Implications for the Globalization of Antitrust[14]

Size also has important implications on the harmonization of competition policies. To give but one example, small size affects the enforcement tools that should be adopted in a globalise system, should it strive to enhance antitrust enforcement worldwide.

Small economies cannot always make a credible threat to prohibit a merger or an export cartel of foreign firms. Given that trade in the small economy is usually only a small part of the foreign firm's total world operation, were the small economy to place significant restrictions on the foreign firm's conduct, it would, most likely, choose to exit the small economy. Thus, a small economy usually cannot pose a credible threat to the foreign firm by threatening that it will be prevented from trading within the small economy if it does not comply with the economy's competition laws. It will also not be welfare-enhancing to do so, as the negative welfare effects of the exit of the foreign firm from the small economy may well be greater than the negative welfare effects from the continued operation of the foreign firm within its borders. The foreign firm, acknowledging this effect, will not take into account, in its decision, the effect of its conduct on the small economy. In addition, political obstacles might also stand in the way of a small economy attempting to prevent a merger or an export cartel among foreign firms. If the effects of such conduct are positive in the home jurisdiction or in other jurisdictions (higher taxes, lower unemployment, lower production costs) it might encounter political resistance to its policy, especially since foreign firms have an advantage in shaping public opinion in their home jurisdiction. Similarly, small economies often face problems in regulating the conduct of multinational firms that serve a large part of their domestic demand. This consideration is based on a presumption that the small economy's size is positively correlated to its political power.

One conclusion from the above is that harmonized rules that rely for their enforcement on unilateral actions taken by the harmed jurisdiction would create a disadvantage to small economies. Such rules do not meet the concerns of small economies with regard to extra-territorial conduct with negative effects on their domestic markets. To deal effectively with at least some of the enforcement problems of small economies, harmonized rules should include a rule that prevents all export cartels. Global or regional dispute settlement mechanism that base their judgments on the welfare effects of the challenged practice on all economies affected may also solve some of the problems of small economies.

14 This section builds on Gal (2003), p. 242-247, 258-262.