WHY IS COMPETITION IMPORTANT FOR GROWTH AND POVERTY REDUCTION?

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Session 1.3.: Competition policy

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Executive Summary

Competition is central to the operation of markets, and fosters innovation, productivity and growth, all of which create wealth and reduce poverty. However, markets do not always work well, and uncompetitive markets are often those that matter most for the poor. This paper outlines the direct and indirect, and often complex, linkages between competition, competition policy, private sector development, growth and poverty reduction. The existence and importance of these linkages is still not sufficiently recognised in the developing world.

While anti-competitive conduct by firms is an obvious cause of weak competition, inappropriate public policies, and the power of vested interests to block necessary reforms, can also be important. Governments might not be aware of the ways in which competition is being harmed, or might be unsure how to identify where barriers to competition exist. In recognition of this, DFID has developed a new operational tool – the Competition Assessment Framework - to help policy makers in developing countries identify and address weak competition in key sectors of their economies. It takes a holistic approach to the state of competition, and is sufficiently flexible to be used in any country, regardless of whether competition has been considered systematically in the past. It could be applied to sub-national units of a country, such as states in a federation, where these involve separate markets, and in some cases to regional groupings. The CAF recognises the need to take account of governance capabilities and political realities. We see the CAF as being complementary to the OECD's 'Competition Assessment Toolkit', which provides valuable guidance on assessing the competitive effects of regulation.

Introduction

Competition, the process of rivalry between firms striving to gain sales and make profits, is the driving force behind markets. Efficient and fair markets are essential for catalysing private sector development and economic growth. Yet, while markets work fairly well much of the time, effective competition is not automatic, and can be harmed by inappropriate government policies and legislation, and by the anti-competitive conduct of firms.

The problem of identifying where competition is weak, and how to foster more effective competition to encourage economic growth and reduce poverty, is challenging. This paper presents a diagnostic tool developed recently by the UK Department for International Development (DFID) to help policy makers in developing countries address these questions. The Competition Assessment Framework (CAF) is flexible, and may be used in countries where competition policy has not been formally considered, as well as in countries with an existing competition law. It may also be used in sub-national units (e.g. states in a federation), or in a regional economic grouping.

How is Competition Policy Linked to Growth and Poverty Reduction?

Many developing countries now prioritize growth in their national poverty reduction strategies. Because effective competition is a driver of productivity, competition policy should be an essential component of any pro-poor growth strategy. Crucially, competition facilitates greater equality of opportunity by breaking down the barriers to fair competition that often help to protect incumbent elites.

A. Competition Policy.

'Competition policy' is the combined effect of all government policies that influence the level of competition in markets. Many factors influence the level of competition, and a holistic approach is needed to assess it. This is the basis of the CAF outlined in this paper.

Barriers to competition stemming from inappropriate government policies or anti-competitive behaviour by firms are common in developing countries. They diminish opportunities for innovation and growth, and make consumers worse off. Markets are often dominated by big business with close ties to government, and more effective competition reduces opportunities for corruption and creates more space for entrepreneurs and SMEs to grow. Competitive public procurement increases the effectiveness of expenditure on publicly provided services, such as education and infrastructure.

Effective and fair competition is not automatic. Sound competition policy can help markets work better, and is a key part of the investment climate that can help investor confidence, and provide a level playing field for domestic SMEs.

For markets to remain competitive there should be no unnecessary entry barriers, so that new firms can enter when they see business opportunities[1]. Barriers to exit should not be excessive, to allow firms to leave markets when they are unable to operate effectively. An effective competition policy should safeguard the rights of entrepreneurs to enter and to leave markets.

B. Competition policy and growth

The competitive process and the development process are so intertwined as to be indistinguishable[2].

Competitive markets allow a nation's resources to be used to best effect in the production of goods and services. For example, both theoretical and empirical research in recent years has emphasised the productive and dynamic efficiency gains from competition[3]. Competition gives firms continuing incentives to make their production and distribution more efficient, to adopt better technology, and to innovate[4]. These sources of productivity improvement lead to growth[5] and poverty reduction.

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1 For example, the ONS (2007), p. 141, noted that firm-level research in the UK found 20% to 50% of the increase in productivity in manufacturing resulted from the process of competition, including the entry and exit of firms.

2 Metcalfe and Ramlogan, in Cook et al. (2007), p. 26

3 Uchida and Cook, in Cook et al. (2007) p. 311

4 As Metcalfe and Ramlogan suggested in Cook et al.(2007) "the best competition policy is a pro-innovation policy". P. 21

5 A recent publication of the UK Office of National Statistics (2007) identified five key drivers of productivity. One was competition, while another, innovation, is strongly influenced by competition. Studies within DFID and elsewhere, such as Dollar and Kraay (2001) of the World Bank have shown a strong positive correlation between economic growth and poverty reduction.

The strength of competition is also likely to influence a country's competitiveness, that is, the ability of its firms to compete in export markets, or against imports in its home market. Research has found that the existence of a competitive environment in domestic markets is one of the most significant factors promoting the international integration of nations' industries.[6] For high productivity "the essential ingredient is intense fair competition"[7].

C. Competition policy and poverty reduction.

Poor people interact with the economy in a number of ways. Governments must take responsibility for helping markets to function effectively for the poor, so that they enable choice, encourage innovation and provide goods and services to consumers at the lowest possible prices.

Many of the poor are small entrepreneurs, including farmers. They will benefit if entry and exit barriers are low, if they can purchase inputs at fair prices, and if they are able to sell their output on fair terms. They need a level playing field.

Many of the poor are also recipients of government-funded services. Bid-rigging for government provided infrastructure and services appears to be common, and diminishes what governments are able to provide for their people from any given budget allocation (e.g. four new schools instead of five).

An appropriate competition policy will include measures to address all of these concerns.

Competition in Developing Countries

The 'really big' distortions to competition are in poor countries[8]

The positive contribution that competitive markets can play in development has been increasingly recognised in both Africa and in Asia.

For example, the 2005 Report of the Commission for Africa (CfA) concluded that investors need "effective competition laws", and observed that:

> "Robust competition laws and policies with strong institutions to enforce them are vital to improving productivity and to promoting innovation and better prices".[9]

The CfA noted the key role of competition policy in the investment climate and suggested that "Government policies and behaviours play a critical role by affecting the costs, risks and barriers to competition faced by firms"[10]. The CfA also pointed out that, in Africa, the "lack of competition … in services, such as sea and air transport…raise(s) costs significantly", and suggested that, reforms such as maritime deregulation leading to a satisfactory level of competition "could reduce freight costs by 25 – 50 percent".[11]

In Asia the importance of competition policy as a crucial component of a good business environment, and for stimulating further growth, was a key focus of the Asian Development Bank's flagship publication, *Asian Development Outlook 2005.* Competition policy was also

6 Broadman (2007) p. 191

7 Lewis (2004) p. 288

8 Lewis (2004) p. 15

9 Commission for Africa (2005), p. 48.

10 Commission for Africa (2005) p. 393.

11 Commission for Africa (2005) p. 268

highlighted as a key plank in a good investment climate in the recommendations of the Asia 2015 Business Action in Asia conference in 2006.

While research on the state of competition in key markets in most developing countries is limited[12] because of the paucity of data and the problem of attribution where competition reforms were part of a wider package of economic reforms, it is clear that barriers to competition resulting from the conduct of firms and from government policies are widespread across the continent. For example, a database on media allegations of anti-competitive behaviour in Sub-Saharan Africa for the ten years to December 2004[13] revealed a wide range of competition concerns in the region. There are frequently reported allegations for everyday commodities such as sugar and flour. Other practices identified included those affecting the prices of inputs needed by manufacturers, and practices hurting farmers as buyers of inputs (e.g. fertilisers and animal feed), and as sellers of outputs such as cotton, tea, coffee and tobacco)[14].

A recent paper by Aghion et al.[15] found that mark-ups are significantly higher in South African manufacturing industries than in corresponding industries world-wide, and that reforms to competition policy should have largely positive effects on productivity growth and employment in South Africa.

There is increasing recognition of the role that vested interests can play in restricting competition. For example, when plans were underway in Egypt to develop a competition law, opposition to the plan allegedly was organised by a leading MP who owned a dominant steel mill[16].

The strength of competition depends both on the conduct of firms and “the external environment in which they compete, the state of infrastructure, legal framework and the effectiveness of the financial system.”[17] Barriers to competition are often the result of government regulations, and private sector firms frequently find the regulatory burden a major disincentive to doing business. Moreover, cumbersome regulation for starting a business is associated with lower productivity and higher levels of corruption[18]. Such barriers tend to hit small firms the hardest.

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12 This was the finding also of Broadman (2007), p. 191.

13 Evenett et al. (2006)

14 Jenny, in Alvarez et al. (2007)

15 Aghion, P. et al. (2006) “Competition and Productivity Growth in South Africa”, CID Working Paper no. 132, Centre for International Development, Harvard University

16 “Politics Trumps Economics” (2007) CUTS

17 Uchida and Cook, in Cook et al. (2007) p. 311.

18 *Doing Business in 2004,(2003)* World Bank

The following table shows some of entry conditions faced by entrepreneurs.

Administrative Barriers to Starting a Business (Averages per region)

Starting a business	Sub-Saharan Africa	East Asia	South Asia
Number of procedures	11.0	8.2	7.9
Time in days	63.8	52.6	35.3
Cost (% per capita income)	215.3	42.9	40.5
Minimum capital (% per capita income)	297.2	109.2	0.8

Source: Adapted from Broadman [19]

Government preferences to favoured companies (state-owned or private) also can distort competition. In Zambia, the state owned telecommunications operator Zamtel was exempted from various taxes that private operators are required to meet, making it more difficult for the latter to compete[20].

The manner in which state-owned enterprises are privatised can create barriers to competition. For example, at a conference in March 2007, concern was expressed about Uganda, where "public sector monopolies are being transformed into private sector monopolies, due to the lack of enforcement of the competition regime"[21].

Government actions can lead to unexpected impediments to competition. In Kenya, a provincial administration led a strong campaign against a small company that produced alcoholic beverages, and claimed this was done with social objectives. The company had met all legal requirements for its business. Action by the competition authority led to the provincial administration abandoning its campaign.[22]

The price and quality of transport services can have a significant impact on the competitiveness of markets. Broadman found that, in Africa, "competition among providers of transport services is largely absent", and that because of "policy-based barriers to entry, private sector companies have only a weak commercial presence"[23]. He found that where regulatory reform has taken place "competition has led to substantial improvements in service delivery"[24]. A striking illustration of the effects of competition on the price of air services was reported in "Africa Investor" of March/April 2006. This review found that air fares per kilometre, for journeys of comparable distance originating in Johannesburg, were up to three times higher on routes with little competition than on routes with significant competition.

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[19] Broadman (2007) pp. 196

[20] "Politics Trumps Economics" (2007) CUTS

[21] Sserunkuuma, S. and Richard, K.H. Conference on "Competition Policy, Private Sector Development and Poverty Reduction in Africa", March 2007. Consumer Unity and Trust Society. conference, Mauritius, 29 – 30 March 2007.

[22] Kenyan Monopolies and Prices Commission, above, no. 16

[23] Broadman (2007) pp. 262-263

[24] Broadman (2007) p. 263

There are also some more fundamental barriers in Africa, including weak market supporting institutions and unsatisfactory standards of governance[25]. Limited access to finance can make it difficult to raise the capital needed for market entry, or to compete with incumbents with better access to finance and deeper pockets.

The positive catalytic effects of increased competition in particular sectors of economies in Africa are illuminating. An example from studies commissioned by the ComMark Trust[26] is the effect of increased competition among private sector providers of cell phone services who introduced more affordable phones, and pay-as-you-go services. Beneficiaries include small farmers who can now access current market information and use this to make better decisions on where to market their produce. Another example of the positive impact of reforms to induce more effective competition in markets was the successful identification by commercial radio stations in Uganda of what the poor wanted to listen to, and adapting their programming to reflect this. These stations “attracted advertising revenue and became sustainable businesses while also providing useful information to the poor in remote areas”.

The Competition Assessment Framework

Distortions to competition are not always obvious: “they have to be dug out in each market”[27]. But, given the prevalence and significant effects of barriers to competition in developing countries, it is important that policy makers are equipped with the operational tools to identify and assess their nature and impact. The Competition Assessment Framework has been designed to meet this need.

<u>Background</u>

The CAF suggests that valuable insights can be obtained on how competition policy can be applied in the interests of economic growth and poverty reduction, by assessing the state of competition in key sectors of the economy, and, where competition is weak, identifying the causes and possible remedies.

The CAF was designed in response to demand from the current DFID/FIAS programme that is supporting competition policy reform in India. It can be used by partner governments, advisers in donor agencies, and others in a range of situations, including:

- Formulating policy advice on the effects of anti-competitive practices in key markets
- Informing the design of programmes/projects to catalyse private sector development (e.g. using a Making Markets Work for the Poor approach)
- As part of a holistic "growth diagnostic"

The CAF is a flexible diagnostic tool for policy makers in developing countries to provide guidance on how a sector-by-sector approach to the state of competition can be undertaken. It takes a holistic approach that reflects the multiple causes of weak competition: private sector actions, policies and legislation at all levels of government, and the impact of vested interests.

The CAF can be applied in a range of situations – from countries in which competition policy has never been considered, through to those that have a competition law, a competition authority and sector regulators. It is well suited to providing guidance on where reforms are needed in the business environment to improve the prospects for new entry or of expansion by existing small competitors. Entry and expansion may be restricted by inappropriate or poorly

[25] Broadman (2007) pp. 196-197

[26] ComMark Trust and The Centre for Development and Enterprise (2006).

[27] Lewis (2004) p. 16

administered controls at any level of government, by the actions of incumbent dominant firms, or by collusion between incumbent competitors who act to limit access by new or small firms to necessary inputs or to distribution channels.

Content

The CAF is designed around sets of questions, with explanatory commentary, that are grouped under eight themes. A conclusion must be reached for each of the themes, after reviewing the answers to the questions posed.

1) How to select sectors and markets for assessment

The first set of questions is directed at applying objective measures to decide which sectors justify use of the resources required to undertake a competition assessment. Broadly, a sector should be both important to the economy or to consumers, and have characteristics suggesting the possibility of competition problems. The questions address the sector's role in the economy, its importance for consumers, evidence of concern about prices or availability of the sector's products, the record of the sector's past performance, entry barriers and the level of market concentration in the sector.

2) Identify the relevant markets and the competitors.

This section includes a set of questions designed to identify the relevant market or markets in the sector. A sector could contain a number of separate 'markets' in the economic sense, and, as the state of competition might vary considerably between them, each must be considered separately. The methods for identifying relevant markets are outlined. The section also addresses the need to identify the existing suppliers and major buyers and their relative importance in the market.

3) Examine the market structure

The questions in this section outline how to assess the level of concentration in the market, that is, the market shares of the major participants. While high concentration does not necessarily indicate high market power, it is often a significant factor in market behaviour.

4) Look for barriers to entry

This section poses questions that seek to establish whether there are any significant barriers to entry. For vibrant competition to exist in markets it is essential that new firms can enter without undue difficulty where they see a business opportunity (and that firms that are no longer viable can leave without excessive formalities). The questions examine natural barriers, strategic barriers, regulatory and policy barriers and gender-based barriers. Barriers may also result from government policies, as well as from vested interests (see (6).

5) Ascertain if government policies or institutions limit competition

This section reviews the legislation, policies and institutions of governments at all levels (national, state and local) that might adversely impact on the level of competition in markets. These may include licensing restrictions, FDI restrictions and trade barriers. This section notes the need to balance any harm to competition with the objectives and outcomes of the policies concerned.

A government agency might impose formalities for market entry that are costly, time consuming or unpredictable, and that discourage new entry. Limits might be imposed on the number of firms permitted to operate, or there might be limits on the categories of people able to enter particular markets.

Despite extensive privatisation, state-owned enterprises are still a significant force in many developing countries. The questions in this section seek to ascertain if state-owned enterprises receive any preferences that might restrict competition by the private sector.

Public procurement can constitute a significant part of trade in a sector, and a set of questions seeks to ascertain if procurement practices harm competition. This could occur if the practices are not transparent and fair, and do not include adequate safeguards to allow competitive bidding.

Regulation is needed in situations where competitive markets are unlikely to develop, such as with natural monopolies or market failures. A set of questions seeks to establish if the extent of the regulations goes beyond what is needed to achieve the policy objectives. Regulation should be undertaken in ways that do not stifle the emergence of competition where it becomes feasible.

Competition can be affected greatly by a country's trade policy and industrial policy. While policies that restrict import or export trade might have adequate justification in terms of national priorities, it cannot be assumed without investigation that this is necessarily the case.

6) Consider vested interests

In many situations there will be stakeholders who are opposed to increased competition in a market, while others will favour it. The questions in this section seek to identify the objectives, power and influence of these stakeholders. Politics, including funding for political parties from sector interests, may well be involved. The nature of some of these factors will at times require sensitive handling, but their significance cannot be ignored. Vested interest may be personal, corporate or institutional

7) Look for signs of anti-competitive conduct by firms

The questions in this section are directed at identifying practices of firms that can impede competition. They first deal with several aspects of the abuse of dominance, which could involve exploiting consumers and/or excluding competitions. Dominance is possible where a firm has strong market power that results from a high market share combined with barriers to entry.

Conduct that might suggest collusion among competitors (cartels) is then examined. This conduct might include agreements to fix prices or conditions of sale, or to limit the markets the competitors will supply. Cartels could be solely of domestic firms, or a mixture of domestic and foreign firms or solely foreign firms. While the effect on developing countries of overcharging by some international cartels (e.g. the vitamins cartel) has been widely publicised, domestic cartels are likely to be more numerous in most countries.

The possible impact of mergers and acquisitions is then noted. These can be undertaken for a variety of reasons. Many will not harm competition, and some will benefit consumers by allowing the achievement of economies of scale. However, they may harm competition where the purpose or effect is to eliminate a viable competitor as a separate organisation.

8) Draw conclusions

The questions in this section require the user to review the conclusions to each of the preceding seven sections, and to form a view on the overall state of competition in the sector, and the reasons for this. If the conclusion was that there are no significant competition concerns, then no further action would be required, other than dissemination of the findings. If competition is found to be weak, the causes, effects and possible remedies should be assessed. A range of possible remedies is outlined in the Framework.

Annexes to the CAF provide additional information on the definition of markets and the calculation of market concentration. The specific competition problems frequently found in a number of sectors that are important in many countries in Africa are reviewed. These are agriculture, construction, distribution, energy, finance, manufacturing, telecommunications and transport.

Conclusions

Barriers to competition are pervasive and harm innovation, productivity and growth – in developing countries. Fair competition matters, both for economic growth and for reducing poverty. Helping markets to work better, by removing unnecessary distortions to competition, can lead to significant reforms of the business environment.

These factors make competition policy and law a priority area for reform in developing countries. There is a need for a wider understanding at policy levels in government, in the business sector and by consumers, of the beneficial impact of effective competition and of competition policy on an economy.

Where competition policy is part of an open and well-regulated economy, it can help encourage both domestic investment and FDI, because it encourages investor confidence[28] by setting a consistent framework within which the business sector operates. An effective competition policy allows innovative new entrants an important role in the development process, and promotes growth. More effective competition reduces opportunities for corruption and rent seeking, and creates more space for entrepreneurs and small and medium sized-enterprises.

Having a good law is not enough. The introduction of a competition law needs appropriate supporting policies, and effective enforcement. Governments must show support for market economies and must recognise adequately the impact of other legislation and regulations on competition. The design of an appropriate national competition policy must keep local realities in mind, and give sufficient weight to governance capabilities and institutions and to political realities that will often include the presence of small and frequently vulnerable domestic markets.

To be fully effective, a competition policy must be supported by a 'culture of competition', where the objectives of competition are widely understood and form a natural part of the background to decisions by government, firms and consumers. Civil society and a vigorous consumer movement in particular, can play a constructive and valuable role in the development of a culture of competition. Vested interests that oppose reforms and fair competition have to be overcome. An open media and an informed judiciary are needed if competition policy and law are to be fully effective.

Above all, politicians must be committed to wanting to make markets work well, to ensuring that the government's responsibilities to markets are well understood and to help build the technical capacity needed for this task.

A productive way of finding where significant barriers to competition exist is by looking at the situation in key sectors of the economy, the approach taken in DFID's Competition Assessment Framework[29]. It is an approach that can help policy makers in developing country governments design a competition policy that meets their needs.

[28] As the ADB observed, "…appropriate enforcement of competition law both enhances the attractiveness of an economy as a location for foreign investment and is important for maximising the benefits that flow from such investment "Asian Development Outlook 2005", p. 270

[29] This is available on DFID's website: www.dfid.gov.uk.

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