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THE OECD INITIATIVE ON INVESTMENT FOR DEVELOPMENT

A POLICY FRAMEWORK FOR INVESTMENT: COMPETITION POLICY

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PART I. BACKGROUND

1. Introduction

1. This paper addresses one of the policy areas that will be included in the *Policy Framework for Investment* within the context of the OECD *Initiative on Investment for Development* – competition policy.¹ Competition policy has long been recognised as being closely related to both development and international investment issues. However, it is also an area where considerable scope remains for building capacity and consensus. The purpose of this paper is to examine the various ways in which competition policy can contribute to creating an environment that is attractive to domestic and foreign investors and that enhances the benefits of investment to societies. It is intended as an initial input and to serve as background documentation for an eventual chapter of the *Policy Framework on Investment* on competition policy issues.

2. Section 2 briefly outlines the relationship between competition policy and development. Section 3 examines the relationship between competition policy and investment, including issues that are relevant from a foreign direct investment (FDI) perspective. Section 4 concludes by outlining questions that policy makers should take into consideration, based upon experience both within and outside the OECD, in the formulation and implementation of competition policies in order to promote an attractive environment for domestic and foreign investment, and to maximize the contribution of investment to development.

2. Competition policy and development

3. Competition policy has come to play an increasingly important role within the context of the global development agenda. For example, the Monterrey Consensus, the values and objectives of which underpin the OECD *Initiative on Investment for Development* and the *Policy Framework for Investment*, emphasized “the promotion of a competitive environment” in order to allow “businesses, both domestic and international, to operate efficiently and profitably and with maximum development impact” (paragraph 21). The Monterrey Consensus also called on members of the WTO to implement the commitments made in the Doha Development Declaration, which recognised “the needs of developing and least-developed countries for enhanced support for technical assistance and capacity building in [the area of competition policy], including policy analysis and development” (paragraphs 23-25).² Work undertaken at the OECD,

1. Other proposed policy areas to be covered in the *Framework* include, *inter alia* investment policy; investment promotion and facilitation; trade policy; tax policy; corporate governance and responsibility, and market integrity; human resource development; infrastructure development; and public governance. In addition to host country policy action, the contribution of international co-operation and developed countries will also be addressed.

2. A number of existing WTO agreements already contain provisions that are relevant from a competition and investment perspective. For example, the TRIPS agreement (the Agreement on Trade-Related Intellectual Property Rights) stipulates that Members of the WTO may take “appropriate measures...to prevent the abuse of intellectual property rights by right-holders or the resort to practices which unreasonably restrain trade or adversely affect the international transfer of technology” (article 40). A number of regional agreements that deal with trade and investment issues have also incorporated provisions dealing with competition issues. For example, the North American Free Trade Agreement (NAFTA) contains provisions that address competition issues related to SOEs and also has provisions on co-operation between competition authorities (chapter 15). See *Trade and Competition Policies for Tomorrow*, Ch. 4, “Competition Elements in International Trade Agreements: A Post-Uruguay Round Overview of WTO

UNCTAD, the World Bank and the WTO, among others, has underscored the relevance of competition policy from a development perspective. Furthermore, developing countries have been adopting competition laws and policies in ever-increasing numbers, pointing to benefits that these would seem to associate with doing so. While approximately 27 developing countries adopted some form of competition law during the 1990s,³ an additional 35 were in the process of implementing competition laws as of February 2004.

4. The primary objective of competition policy is to enhance consumer welfare by promoting competition. Economic efficiency is generally enhanced by encouraging competition, and thus one of the key links between competition policy and development has been the role that competition policy plays in increasing economic efficiency. The efficient use of resources is especially important in the development context where resources are particularly scarce, an issue emphasised in the Monterrey Consensus. The economics literature generally distinguishes between static and dynamic economic efficiency. Competition policy has variously been ascribed a role in promoting both. The main static effects of competition are to reduce the ability of firms to raise price above marginal cost and to ensure that firms produce at the lowest possible costs. The dynamic consequences of competition can include incentives to innovate, to imitate, and to invest in the development of new technologies and know-how. Competition policy reinforces economic efficiency by preventing or providing remedies for market structures and business practices that weaken the degree of inter-firm rivalry in markets.

5. In addition to the potential benefits of the implementation and enforcement of competition law and policy in terms of static and dynamic efficiencies, competition authorities have also been ascribed a more general advocacy role. Although the advocacy role of competition authorities defies a precise definition, it has been associated with public education and awareness activities, development of a competition culture, research documenting the need for market-opening measures, and involvement in policy formulation and implementation beyond competition law itself. It has been suggested that these activities “may be among the most useful and high payoff activities undertaken by [competition authorities]”, especially insofar as the removal or reduction of regulatory impediments to market entry across a range of policy areas (e.g. trade policy, investment policy, regulated industries, etc.) “can be central to the establishment of healthy market economies in developing and transition economies” (Anderson and Jenny, 2002, p. 7, cited in WTO, 2003, p. 14).

6. In addition to these overarching links between competition policy and development, a number of more specific contributions of competition policy to development have been identified in work undertaken by the OECD, UNCTAD, the World Bank and at the WTO, among others. These include:

- The promotion of consumer welfare;
- Preventing excessive concentration levels and resulting structural rigidities;
- Addressing anti-competitive practices of enterprises (including MNEs) that can negatively affect the trade performance and competitiveness, on both the import and export sides, of developing countries;
- Reinforcing the benefits of privatization and regulatory reform/deregulation initiatives;

Agreements” and Ch. 5, “Implications of the WTO Agreements on Basic Telecommunications,” OECD (1999).

3. By 2001, approximately 80 countries in the world had some form of competition law.

- Establishing an institutional focal point for the advocacy of pro-competitive policy reforms and a culture of competition; and
- Increasing an economy's ability to attract and maximize the benefits of investment.⁴

7. It is this last issue that the following section addresses, including issues that are particularly relevant with respect to the relationship between competition policy and the creation of an attractive environment for FDI in the development context.

3. The relationship between competition policy and an attractive environment for investment

Barriers to entry constitute an important impediment to investment.

8. Within the context of efforts by governments to create an environment which is attractive to investors (both foreign and domestic), a key challenge consists in identifying and eliminating unwanted barriers to entry.⁵ Barriers to entry consist in a wide array of factors that discourage investment. Some barriers to entry discourage investment directly, such as, for example, government prohibitions on investment in certain sectors. Other barriers to entry are less direct but nonetheless can also be prohibitive. For example, trade restrictions can make a national market too small for certain investments that require minimum economies of scale to be viable. More generally, and apart from outright government prohibitions on investment, barriers to entry usually consist in the various costs faced by prospective investors in the relevant market. Barriers to entry are different from ordinary costs that are a natural part of the everyday business calculus of firms in a market economy (e.g. the cost of capital). These 'natural' costs provide important economic signals to market participants, allowing these to make rational economic decisions. Barriers to entry, however, involve costs that are borne uniquely by entrants, as opposed to incumbents. They impede market entry and, indeed, are sometimes avoidable. For example, restrictive agreements might make it difficult for new airlines to obtain landing slots at some airports. An important role for governments is to identify and to try to eliminate or reduce unnecessary barriers to entry that unduly serve to discourage investment (e.g. onerous administrative requirements for new entrants).

Barriers to entry can take the form of structural barriers...

9. One type of barrier to entry consists in what is usually referred to as structural barriers. Structural barriers to entry pertain primarily to the various sunk costs (i.e. costs that cannot be recovered by the firm in the event of exit from the industry) that firms must bear upon entry. In other words, sunk costs represent the investment that is put at risk by the investor.⁶ Generally speaking, sunk costs act as a barrier to entry when these push the total cost of the project (variable costs, plus sunk and non-sunk fixed costs) above the expected net present value of the investment in question.⁷ Other structural barriers to entry can

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4. One of the dynamic benefits associated with competition concerns the continuous investment in newer, more efficient technologies that supplant older products and processes. As such, competition policy is not just associated with the quantity of investment but (perhaps more importantly) the quality of investment that an economy is able to attract.
 5. In some cases, barriers to entry are intentional and aim to serve particular policy objectives, as, for example, in sectors of the economy reserved for state-owned enterprises.
 6. Sometimes regulatory barriers to entry are treated as a distinct type of barrier to entry. However, many regulatory barriers can be seen as a specific type of sunk cost. For example, many performance requirements or requirements that attach conditions to entry, such as testing for product safety, represent sunk costs for firms that must bear them.
 7. In other words, an investor will want to at least break even, i.e. the expected returns over the life of the investment need to at least cover sunk plus variable costs.

include absolute cost advantages enjoyed by competitors (e.g. if the competitor has an inimitable technological advantage), economies of scale, and large capital requirements, including those associated with network industries (e.g. telecommunications).

...or behavioural barriers.

10. Another type of barrier to entry is generally referred to as behavioural in nature. Behavioural barriers to entry consist of the various ways in which incumbent firms (domestic, foreign or state-owned) can impede market access by abusing their market power. For example, if a firm maintains exclusionary arrangements with retail or wholesale distributors in a given market (reciprocal exclusivity), and access to this distribution network is essential for serving the market in question, this effectively acts as a barrier to entry (assuming that the cost of establishing a second distribution network is prohibitive). Another type of behavioural barrier concerns predatory behaviour, which involves undercutting rivals with a view to eliminating these from the market in question (or “foreclosing” the market to new entrants). This can and usually does involve selling products below their cost of production with a view to recouping losses once weaker rivals (or new entrants) have been eliminated and monopoly pricing can be implemented or resumed. Predatory behaviour can have both an immediate and a more long-term impact on new investment insofar as the threat of predatory behaviour by a powerful incumbent (e.g. based upon precedent and reputation) could act to discourage prospective investors.

11. In practice, the distinction between structural and behavioural barriers to entry is not clear cut, with behavioural barriers usually being facilitated by structural barriers (and both often underpinned by aspects of the regulatory or policy environment). In the absence of structural barriers to entry, new firms will normally respond to any abnormal profits being earned by incumbents by entering the market, thus bringing prices back down to competitive levels. One of the challenges faced by governments has been to sort out, between various structural and behavioural market barriers, those that do not unduly harm competition and those that can and should be eliminated.

12. A good example of the sorts of trade-offs that competition authorities have to deal with involves policies towards intellectual property rights (IPR). At the highest level of analysis, IPR and competition policies are complementary because they share a concern to promote technical progress to the ultimate benefit of consumers. Firms are more likely to innovate if they are at least somewhat protected against free-riding. They are also more likely to innovate if they face strong competition. The problem is that even completely legitimate use of IPR can restrict competition at least in the short run, thus producing a trade-off between the benefits of increased competition and the gains from further innovation. The protection of IPR is an example of a limit to competition that is generally considered beneficial. The difficulty for competition authorities lies in determining at what point such limits to competition begin to encounter negative marginal returns to society.⁸

Open trade and investment regimes can significantly reduce barriers to entry...

13. It has been argued that one of the best ways of ensuring that structural and behavioural barriers to entry do not impede investment is to simply maintain open trade and investment policies.⁹ The reasoning behind this line of argumentation is that competition from potential foreign investors or from imports will naturally act to discipline firms that would seek to exercise some form of market power. In effect, by

8. “Roundtable on Intellectual Property Rights”, Competition Committee Roundtable, OECD, 2004 (forthcoming); “Synthesis Report on Parallel Imports,” [COM/DAFFE/COMP/TD(2002)18/Final], OECD, 2002; *Competition and Intellectual Property Rights*, OECD, 1998.

9. Indeed, it has even been argued that, especially for smaller economies, open trade and investment regimes can effectively substitute for competition law and policy.

maintaining open trade and investment regimes the relevant market is no longer limited to the national market. For example, a firm that enjoys a monopoly position in a given country (in the sense that it is the sole producer located in the country) will nevertheless not be able to behave like a monopolist if monopoly pricing and above normal rents attract international competition which, in turn, drives prices back down. Alternatively, restrictive investment (and trade) policies are probably one of the “best” ways of establishing impediments to entry that enable incumbents to exercise market power.

...but experience suggests that open trade and investment policies are not sufficient to ensure that incumbents act competitively.

14. However, experience suggests that open trade and investment regimes are not sufficient for ensuring the maintenance of contestability in national markets (i.e. the threat of new entrants in response to signals indicating abnormally high rents). Structural characteristics in any given economy can act to ‘buffer’ incumbent firms from competition, even in the context of liberal trade and investment regimes. These can include, *inter alia*, the inherently local nature of some markets, the non-tradability of certain products and services, and regulations that are not *per se* restrictive from a trade or investment perspective (e.g. standards and licensing requirements). Furthermore, private restrictive practices, such as collusion in an adjacent (upstream or downstream) market, may inhibit trade and investment. Indeed, a number of countries with relatively open trade and investment regimes have reported on the need to complement open trade and investment regimes with active enforcement of competition laws (see Box 1 on the experience of Argentina).

Some barriers to entry are particularly relevant with respect to FDI...

15. One source of investment that has become increasingly important for developing countries consists of FDI. Although many of the barriers to entry identified above are “neutral” insofar as they do not ‘discriminate’ between foreign and domestic investors (i.e. they will discourage both), some barriers to entry are more specifically relevant with respect to their potential negative impact on FDI. In some cases this is because foreign and domestic investors are provided different levels of treatment. In other instances barriers to entry are *de facto* pertinent to FDI because the latter is a major, if not the main, source of the type of prospective investment in question. An important policy implication of this observation is that competition authorities, in their capacity as advocates of a culture of competition, including competition from foreign investors, need to cast their nets wide in order to identify potential policy impediments to the entry of foreign investment, even where these are not labelled as such or directed at foreign investors.

Box 1. The experience of Argentina with competition law and policy in the context of trade and investment liberalisation

In 1989, the Government of Argentina launched a radical reform of the economic system, involving, among other reforms, the lowering of trade barriers, the privatization of the majority of state enterprises, the elimination of many industrial regulations, and the complete deregulation of foreign direct investment. During the early stages of this reform process, competition law and policy played a minor role in the expectation that the deregulation of markets and the liberalization of trade and investment would be sufficient to provide competitive discipline and to achieve economic efficiency. However, over time, competition policy came to play a more important role as it became clear that, although the liberalization of trade and investment did serve to encourage competition and economic efficiency in many sectors, this was not the case in all sectors. Examples of structural constraints and private business practices that served to constrain competition despite trade and investment liberalisation, and for which investigation by the Argentine National Commission for the Defence of Competition was deemed necessary, included:

- Concentration in the liquefied petroleum gas industry, including control over key parts of the value chain (port facilities in particular), was associated with domestic prices remaining abnormally high;
- Suspected collusion among incumbents within MERCOSUR in certain industries aimed to keeping out new entrants;
- Apparent 'stickiness' of response by potential new (especially foreign) entrants into the market in response to liberalisation due to structural barriers, including extremely strong brand dominance in one industry and the small size of the domestic market in another;
- Suspected differential pricing by a quasi-monopolistic supplier, according to which a key customer was offered the international (competitive) price and smaller customers, for whom international sourcing would have been more difficult, were offered a much higher price;
- Suspected discriminatory pricing by the subsidiary of an MNE with a dominant position globally for the product in question.

Source: UNCTAD (1997). See also OECD (2004) for similar examples from Russia.

...such as the granting of exclusivity as a form of FDI incentive;

16. As mentioned above, structural and behavioural barriers to entry often complement each other. In many instances, government regulation underpins this relationship. For example, one unusual issue at the inter-face of competition policy and FDI that has emerged in recent years concerns the granting of exclusivity to foreign investors as a form of FDI incentive. From the perspective of the firm offered this type of concession, the advantage lies in being able to exercise market power in the market in question (i.e. the firm enjoys some control over pricing and can therefore charge above marginal cost). From the perspective of government, the appeal of this type of incentive is that, at least on the surface, there is no immediately obvious financial cost and a firm that is granted some form of exclusivity is likely to be willing to pay more for the assets in question than would otherwise be the case. Indeed, the ultimate costs of this type of incentive are difficult if not impossible to calculate since these are borne by the customers of the supplier in the form of the above-normal prices the latter is able to charge and by the economy more generally in the form of the forgone benefits of subsequent investment, including FDI (i.e. subsequent investment that is barred as part of the exclusivity contract granted to the original investor).

17. For example, in 1995, the Sri Lankan government privatized the Colombo Gas Company through the sale of 51 per cent of the company to a foreign investor. As part of this deal, the foreign investor was given a five-year monopoly for natural gas in the Sri Lankan market, protected from both import and

foreign investment competition. As in most cases involving exclusivity as an incentive to attract FDI, the foreign investor was immune from the Sri Lankan competition authority and competition law until the end of the term of the agreement (UNCTAD, 1997).

18. Setting aside the question whether the granting of exclusivity to attract FDI is a good idea or not, competition authorities should be involved in decisions such as these since they bear directly upon the competitive structure of an economy. Competition authorities have come to play an increasingly important advocacy role such that their mandate extends beyond merely enforcing competition law, and in the case of incentives for FDI based upon exclusivity this advocacy role should involve, at a minimum, an evaluation of the (largely hidden) costs associated with such arrangements.¹⁰

...granting privileged market positions to SOEs or other regulated firms;

19. One of the most important areas of government regulation that can impact negatively on the ability of MNEs to enter a national market through FDI concerns regulated industries, including industries dominated by state owned enterprises (SOEs). Regulated sectors occasionally fall outside the reach of competition law. Indeed, certain types of firm behaviour and industry structures that would normally be considered anti-competitive (or potentially anti-competitive) in the private sector are sometimes permitted in the public sector. The most obvious instance of SOEs or otherwise highly regulated firms acting as impediments to FDI is when these have a mandate to act as the sole supplier in a particular industry (i.e. private firms, either foreign or domestic, are simply not allowed to enter this market). This has been the case, for example, in the energy and telecommunications sectors in a number of countries. However, regulated firms can also serve to impede entry to the extent that they are able to engage, through their linkages to the private sector either as buyers or suppliers, in many of the restrictive business practices associated with private firms (see Box 1). While recognizing that legitimate differences exist between countries with respect to the relative roles ascribed to the private and public sectors,¹¹ it remains that competition authorities can play an important role in shedding light on the costs and benefits of policies that limit competition, thus contributing to more transparent, and informed policy formulation.

20. Competition authorities have sometimes found themselves at the margins of policy formulation and oversight of regulated industries,¹² including with respect to the wave of privatizations that swept through many regulated sectors during the 1990s. The motivation for many privatizations has been the recognition that many activities can be run more effectively and efficiently by the private sector. However, a concern of governments and competition authorities has been to avoid replacing public with private monopolies. This challenge has sometimes been complicated by conflicting objectives associated with privatizations, namely the desire to create more efficient industry structures, on the one hand, and the desire to sell state owned assets at the highest possible prices, on the other. Bidders for publicly owned companies, including MNEs, will be willing to pay more if they believe that they are buying a monopoly position in a particular market. However, as with the provision of exclusivity as a form of incentive to attract FDI, the primary consideration of competition authorities should be the long-term competitive benefits that FDI can bring to an economy rather than possible short-term budgetary windfalls.

10. Including the possibility that a position of market dominance may last much longer than the formal period of exclusivity, unless special measures are taken to encourage new entry when that period ends.

11. Indeed, the Policy Framework for Investment recognizes a country's sovereign "right to regulate".

12. It should be noted, however, that in a number of economies competition authorities have come to play a greater role in policy-making and formulation concerning regulated industries.

...and in efforts to promote “national champions”.

21. Within the context of their development strategies, some governments have sought to promote “national champions”, which, by definition, involves granting preferential treatment to some firms over others on the basis of nationality.¹³ Although not SOEs, *per se*, national champions often do involve significant state involvement (both financial and with respect to management), and are usually granted some form of exclusivity (i.e. protection from trade and investment-based competition) in the national market. The arguments for national champions usually rely on considerations of dynamic (versus static) efficiency. They include arguments to the effect that economies of scale cannot be attained without restrictions on competition, these economies of scale allow for more spending on research and development, and, by extension, only once such economies of scale have been reached can firms realistically expect to be able to compete on international markets. The issue of national champions has been contentious and underlies one of the key difficulties in incorporating dynamic efficiency objectives into competition policy – how to find the right balance between static and dynamic efficiencies without reducing competition to such levels that any potential dynamic gains are completely eroded through “slack” – the inefficient use of resources within firms resulting from a lack of external market discipline, i.e. competition.

22. As in the case of “exclusive contracts” and regulated industries, efforts to promote national champions generally entail specific provisions aimed at limiting FDI. This is usually done on the grounds that the costs to the economy associated with limits placed on competition are outweighed by some other, either dynamic (e.g. promoting innovation) or social (e.g. provision of essential services) benefits. However, it remains that any policies specifically aimed at limiting competition in particular sectors run the risk of creating inefficiencies, reducing welfare in parts of the economy due to the exercise of monopolistic or monopsonistic market power, reducing investment in sectors of the economy that depend on protected firms due to the knock-on effects of higher costs, and creating powerful vested interests opposed to any reduction in protectionism. As such, there is a strong case to be made for the on-going involvement of competition authorities in the formulation and implementation of policies that would limit competition, especially with a view to ensuring that the costs of such limits (as difficult as these are to evaluate) do not outweigh any hoped-for benefits.

In addition to these general pre-establishment issues, FDI by MNEs can give rise to additional competition issues...

23. To this point, the discussion of the relationship between competition policy and the attractiveness of an economy for investors has focused on various barriers to entry that can impede domestic and foreign investment. In the second half of the discussion, several barriers to entry that are particularly relevant from an FDI perspective, such as “exclusive contracts”, regulated industries, and efforts to promote national champions, were highlighted. However, once FDI takes place, a number of additional issues can come into play. The main reason for this relates to the fact that many MNEs have considerable financial resources at their disposal, they operate in industries that are often dominated globally by a handful of large firms, and they are able to establish dominant positions in many national markets through their foreign investments (even when this dominant position is not offered by the government as an incentive). Within the development context, the two main concerns of governments and competition authorities with respect to MNEs have been; 1) that MNEs expressly seek to exploit particular national markets, and 2) that the activities of MNEs can have structural implications with potentially negative effects on competition in some national markets.

13. Such as protection from competition through restrictions on FDI and trade protection, exemptions from competition law and various fiscal advantages.

...such as international market sharing arrangements...

24. With respect to the possibility that MNEs expressly seek to exploit their positions in particular national markets through FDI, this issue has received increasing attention in recent years as competition authorities have become more active in prosecuting various anti-competitive practices, and as evidence that MNEs are able to engage in market sharing arrangements at the global level has come to light. Many examples of successful prosecution in competition cases have involved competition authorities in developing countries, indicating that the implementation *and enforcement* of competition laws is not limited to developed economies (see, for example, WTO, 2003). Furthermore, empirical studies indicate that countries that have implemented competition laws have generally experienced less egregious price gouging at the hands of international cartels than countries without competition laws, indicating that these can serve as an important deterrent to abuse of market power (see, for example, WTO, 1993, section III).

...and issues of concentration relating to mergers and acquisitions.

25. With respect to structural issues, one of the key links between competition policy and FDI pertains to the involvement of competition authorities in reviewing proposed mergers and acquisitions. The potential importance of this issue is highlighted by the fact that mergers and acquisitions constitute the predominant mode of MNE expansion into foreign markets, accounting for 57 per cent of FDI inflows in 2002 (UNCTAD, 2003). Mergers and acquisitions are routinely reviewed by competition authorities with a view to determining whether particular combinations might give rise to levels of concentration that could be inimical to competition and, hence, efficiency.

26. Although the role of competition authorities in reviewing cross-border mergers and acquisitions has been limited predominantly to developed countries, in some cases competition authorities in developing countries have intervened where a merger between firms based outside the country has had implications for industry structure and competition in the host economy. For example, the proposed acquisition of one United States multinational by another in 1996 would have given their Mexican affiliates up to 67 per cent combined market share for certain products. The Mexican Federal Competition Commission therefore ordered the acquiring multinational to divest five major brands, thus reducing the combined company's market shares to around 50 per cent or less.

27. In another case of an international merger having implications for levels of concentration between existing foreign affiliates, two leading tea suppliers to Pakistan fell under common control of a major multinational. The Pakistan Monopoly Control Authority found that the prices paid by the companies for tea imported from related suppliers were higher than prices paid to unrelated international suppliers and therefore required that the multinational withdraw one of its brands and reduce its shareholding in one of the affiliates to 40 per cent.

28. Apart from a few fairly specific issues raised in the context of mergers and acquisitions involving MNEs and the possible implications of such transactions for market structures in countries in which the firms involved previously competed, generally FDI does not present challenges for competition authorities that require these to distinguish between foreign and domestic investors.¹⁴ Indeed, competition law in most countries implicitly embodies the national treatment principle insofar as no distinction is made between domestic and foreign firms. As argued above, one of the overarching links between competition policy and an attractive environment for investment consists in ensuring that structural and behavioural impediments to market access do not discourage investment, irrespective of whether the investment is domestic or foreign. However, it remains that MNEs, by definition, operate across borders and thus create

14. See Trade and Competition Policies: Options for a Greater Coherence, Ch. 5, "Merger Review and Market Access," OECD (2001).

cross-border policy issues. Consequently, international co-operation among competition authorities has become more common with a view to addressing competition issues that span jurisdictions. This is the topic of the next section.

PART II. TOWARD A CHECKLIST

Introduction

29. A country's competition policy influences both domestic and foreign investment and is important for any development strategy. Through an annotated list of questions, this chapter explores how competition policy can:

- Encourage investment – both domestic and foreign;
- Maximise the contribution of investment to development.

30. Competition policy has come to play an increasingly important role within the context of the global development agenda. For example, the Monterrey Consensus, the values and objectives of which underpin the OECD *Initiative on Investment for Development* and the *Policy Framework for Investment*, emphasized “the promotion of a competitive environment” in order to allow “businesses, both domestic and international, to operate efficiently and profitably and with maximum development impact” (paragraph 21). The Monterrey Consensus also called on members of the WTO to implement the commitments made in the Doha Development Declaration, which recognised “the needs of developing and least-developed countries for enhanced support for technical assistance and capacity building in [the area of competition policy], including policy analysis and development” (paragraphs 23-25). Work undertaken at the OECD, UNCTAD, the World Bank and the WTO, among others, has underscored the relevance of competition policy from a development perspective. Furthermore, developing countries have been adopting competition laws and policies in ever increasing numbers, pointing to benefits that these would seem to associate with doing so.

31. In general terms, one of the key links between competition policy and development has been the role that competition policy can play in promoting economic efficiency. The efficient use of resources is especially important in the development context where resources are particularly scarce, an issue emphasised in the Monterrey Consensus. The economics literature generally distinguishes between static and dynamic economic efficiency. Competition policy has variously been ascribed a role in promoting both. The main static effects of competition are to reduce the ability of firms to raise price above marginal cost and to ensure that firms produce at the lowest possible costs. The dynamic consequences of competition can include incentives to innovate, to imitate, and to invest in the development of new technologies and know-how. Competition policy reinforces economic efficiency by preventing or providing remedies for market structures and business practices that weaken the degree of inter-firm rivalry in markets.

32. In addition to the potential benefits of the implementation and enforcement of competition law and policy in terms of static and dynamic efficiencies, competition authorities have also been ascribed a more general advocacy role. Although the advocacy role of competition authorities defies a precise definition, it has been associated with public education and awareness activities, development of a competition culture, research documenting the need for market-opening measures, and involvement in policy formulation and implementation beyond competition law itself. It has been suggested that these activities may be among the most useful and high payoff activities undertaken by competition authorities, especially insofar as the removal or reduction of regulatory impediments to market entry across a range of policy areas (e.g., trade policy, investment policy, regulated industries, etc.) can be central to the

establishment of healthy market economies in developing and transition economies. By helping to bring about the removal of regulatory barriers to competition, advocacy makes a major contribution to increasing static and dynamic efficiencies.

33. The following draft checklist is intended as a non-prescriptive guide to help policy makers identify aspects of a country's competition law and policy where reform could contribute to a healthier environment for investment. It could also serve, in the context of the other chapters of the Policy Framework for Investment, to help policy makers identify policy priorities.

COMPETITION POLICY FOR INVESTMENT: A DRAFT CHECKLIST

1. ***Are the competition laws clear, transparent, and non-discriminatory? What actions have competition authorities taken to help businesses understand and abide by competition law? For example, have the authorities issued guidelines that explain the approach they will take in enforcing the law(s)? Are agency and court decisions published, along with a statement of the reasoning behind them? How are changes in competition law communicated to market participants?***

For competition policy to be effective, businesses (and other parts of government for whom it might be relevant) need to understand the “rules of the game.” Competition law and policy should be transparent and implementation should be predictable. Transparency means that businesses and other interested parties have access to all necessary information, such as the laws themselves (and any changes to them), guidance with respect to interpretation of the law, and information on decisions, including reasons for particular outcomes. Transparency reduces firms’ costs of compliance and promotes confidence by reassuring investors that they are being treated fairly and that government is exercising its power responsibly. Predictability improves the investment environment by reducing the risks that businesses and investors associate with inconsistent application of laws and regulations. While no two situations are exactly the same, under reasonably similar circumstances decisions should be consistent with each other. In support of greater predictability, competition authorities could use standardised measures or tests to evaluate common issues, particularly where the concepts of competition policy are novel and the analytical capacity to examine details of market context is not yet developed.

2. ***Do competition authorities have the resources and necessary political support to implement the competition laws effectively?***

The distinction between adopting a new law or policy and effectively implementing it can represent the difference between success and failure. Effective implementation requires that the competition authority have the necessary resources and political support to do the job properly. Competition authorities must often challenge powerful vested interests, such as private firms with monopolistic positions in the market or state-owned firms that fall under the regulatory authority of other parts of government. In the absence of strong political commitment supporting those challenges, efforts to promote competition, and hence investment, in such cases are likely to fail. Furthermore, strong commitment and oversight at the political level can help to protect competition authorities themselves from becoming captured by particular interests. Political support for competition policy, which includes supplying enough resources for effective enforcement, is an important determinant of the potential contribution of competition policy to an attractive investment environment. Institutional settings vary widely, complicating the assessment of the degree of political support for competition policy or of its vulnerability to special-interest intervention. Criteria that might be considered could include the status of the competition authorities within the government structure and the means for insulating enforcement decision-makers from political direction or influence.

3. ***To what extent and how have competition authorities addressed anticompetitive practices by incumbents that inhibit investment?***

Incumbent firms (domestic, foreign, state-supported or state-owned) can sometimes discourage investment by abusing their market power. For example, if an incumbent maintains exclusionary arrangements with retail or wholesale distributors, and access to this distribution network is essential, then there are potential implications for competition and, hence, the investment

environment (assuming that the cost of establishing a second distribution network is prohibitive). Predatory behaviour can and usually does involve selling products below their cost of production with a view to recouping losses (by setting prices at monopoly levels) after weaker rivals have been eliminated or would-be new entrants have been deterred. Predatory behaviour can have both an immediate and a long-term impact on new investment insofar as the threat of predatory behaviour by a powerful incumbent who has a record or reputation for such conduct could discourage prospective investors. These exclusionary practices, if uncorrected, could discourage investment, not only in competition with the dominant incumbent, but also in industries that are upstream and downstream from it. The legal and practical capacity and demonstrated willingness of competition authorities to prevent, correct or sanction such anticompetitive exclusionary practices can have a significant bearing on competition and, hence, on investment opportunities.

4. *Do competition policy authorities have the capacity and the resources to evaluate the impact of other policies and decisions on the ability of investors to contest the market? What channels of communication and co-operation have been established between competition authorities and other relevant government agencies?*

Within the context of efforts by governments to create an environment which is attractive to investors (both foreign and domestic), a key challenge consists in identifying and eliminating unwanted impediments to new investors. In addition to impediments that originate in the actions of incumbent firms (mentioned above), a wide array of government policies and regulations can also discourage new investment. Some government policies and regulations discourage investment directly, such as, for example, government prohibitions on investment in certain sectors. Other policies and regulations are less direct but nonetheless can also be prohibitive. For example, trade restrictions can make a national market too small for certain investments that require minimum economies of scale to be viable. Indeed, almost any area of government policy making can influence the quality of the investment environment. Consequently, without prejudice to the authority of government to regulate and the authority of other agencies in the conduct of their responsibilities, it is generally desirable to involve competition policy authorities in the development and consideration of laws or regulations that have potential implications for competition and, hence, the investment environment.

Ensuring policy coherence across different policy areas is in the spirit of the Policy Framework for Investment but can present particular challenges. A good example of the sorts of trade-offs that competition authorities have to deal with involves policies towards intellectual property rights (IPR). IPR and competition policies share the common goal of promoting technical progress to the ultimate benefit of consumers. The relationship is complex, though: firms are more likely to innovate if they are at least somewhat protected against free-riding, but they are also more likely to innovate if they face strong competition. Legitimate use of IPR temporarily restricts direct competition with the item subject to the IPR. The protection of IPR is an example of a limit to competition at one level that is generally considered beneficial to competition at another level. The difficulty for competition policy lies in determining at what point such limits produce negative marginal returns to consumers by discouraging new investment.

5. *With respect to industrial policies, aimed, inter alia, at creating national champions, have competition authorities assessed the costs and benefits of such policies? Are industrial policies periodically reviewed by competition authorities?*

Within the context of their development strategies, some governments have sought to promote “national champions,” which, by definition, involves granting preferential treatment to some

firms over others on the basis of nationality.¹⁵ National champions often involve significant state involvement (both financial and with respect to management), and are usually granted some form of exclusivity (*i.e.*, protection from trade and investment-based competition) in the national market. The arguments for national champions usually rely on considerations of dynamic (versus static) efficiency. They include arguments to the effect that economies of scale cannot be attained without restrictions on competition, these economies of scale allow for more spending on research and development, and, by extension, only once such economies of scale have been reached can firms realistically expect to be able to compete on international markets. The issue of national champions has been contentious. It underlies one of the key difficulties in incorporating dynamic efficiency objectives into competition policy – how to find the right balance between static and dynamic efficiencies. If competition is reduced too much, potential dynamic gains could either be completely eroded or simply not realised in the first place due to “slack” – the inefficient use of resources within firms that do not face enough external market discipline.

Setting aside the question whether governments should promote national champions, competition authorities should be involved in decisions about them because they bear directly upon the competitive structure of an economy and, by extension, its attractiveness from an investment perspective. Competition authorities have come to play an increasingly important advocacy role. In the case of industrial policies aimed at creating national champions, this advocacy role should involve an evaluation of the costs associated with limits on competition and exemption from competition law enforcement.

6. *What has been the role of competition authorities in the privatization process? Have competition considerations been adequately addressed?*

Competition authorities have sometimes found themselves at the margins of policy formulation in areas not directly associated with competition law or policy, *per se*. This has been the case, for example, with respect to the wave of privatizations that swept through many regulated sectors during the 1990s. The motivation for many privatizations has been the recognition that many activities can be run more effectively and efficiently by the private sector. However, a concern of governments and competition authorities has been to avoid replacing public with private monopolies. This challenge has sometimes been complicated by conflicting objectives associated with privatizations, namely the desire to create more efficient industry structures, on the one hand, and the desire to sell state owned assets at the highest possible prices, on the other. Bidders for publicly owned companies, including MNEs, will be willing to pay more if they believe that they are buying a monopoly position in a particular market. However, as with the provision of exclusivity as a form of incentive to attract FDI, the primary consideration of competition authorities should be the long-term competitive benefits that FDI can bring to an economy rather than possible short-term budgetary wind-falls.

A special case of this issue concerns the granting of market exclusivity to foreign investors as a form of FDI incentive. From the perspective of the firm offered this type of concession, the advantage lies in being able to exercise market power in the market in question (*i.e.*, the firm enjoys some control over pricing and can therefore charge above marginal cost). From the perspective of government, the appeal of this type of incentive is that, at least on the surface, there is no immediately obvious financial cost and a firm that is granted some form of exclusivity is likely to be willing to pay more for the assets in question than would otherwise be the case.

15. Such as protection from competition through restrictions on FDI and trade protection, exemptions from competition law enforcement, and various fiscal advantages.

The ultimate costs of this type of incentive are borne by the customers of the supplier in the form of the supra-competitive prices the latter is able to charge and by the economy more generally in the form of the forgone benefits of subsequent investment, including FDI (*i.e.*, subsequent investment that is barred as part of the exclusivity contract granted to the original investor).

Competition authorities should be involved in decisions concerning privatizations and the use of exclusivity as an incentive because they bear directly upon the competitive structure of an economy. Their advocacy role should involve, at a minimum, an evaluation of the costs associated with arrangements that lead, either tangentially or by design, to monopolies. Merger control powers might be applied to prevent or correct anti-competitive dispositions of privatised assets; however, it could be more efficient for the competition policy authorities to be involved in decisions about privatisation well before transactions reach that stage.

7. *Have competition authorities been given the authority and capacity to deal with international competition issues, such as international mergers and acquisitions and cartels, that could have implications for competition in the national market?*

With the rapid increase in cross-border investment over the past decade, competition authorities are increasingly dealing with competition issues that span borders, such as international mergers and acquisitions and international cartels. While competition law and policy is generally blind to the nationality of the firms involved in particular investigations or cases, competition issues that have an international dimension can have particular resource and capacity implications for competition authorities. For example, can competition authorities examine anticompetitive practices that might originate outside of the national market, such as international cartels? Can they examine mergers and acquisitions taking place in other jurisdictions that could affect competition in the national market? In some of these instances, co-operation with competition agencies in other countries is likely to be useful if not essential. For effective co-ordination in applying competition law efficiently to matters with international dimensions, the competition authority should have adequate channels for communication and co-operation with other competition agencies.