THE PHILIPPINE REVIEW OF ECONOMICS
VOL. XL NO. 1 JUNE 2003

Understanding competition policy: a suggested framework*

*Erlinda M. Medalla***

Abstract

This paper defines the elements that comprise a competitive setting and clarifies the objectives of competition policy. The role and primary task of competition policy are emphasized. A framework for competition policy and the basic elements to implement it are spelled out. The major areas of competition policy are also identified and current competition policies in selected countries are briefly surveyed. The concluding section addresses some of the issues that confront competition policy.

JEL classification: L50, L43
Keywords: Competition policy, deregulation, anti-trust policy

1. Introduction

Competition is a concept that is firmly entrenched in economic thinking. Since the last decade, it has become naturally coupled with "policy" in view of the increased prominence it has been given in policy discussions around the globe. This development can be traced to the growing need for new approaches in dealing with competition, or the lack of it, in specific countries. The reduction of trade barriers worldwide has increased the pressure on governments and called greater attention to the linkages between international grade and competition policy.

The concern for competition policy is, however, not limited to its implications for international trade. There are also far-reaching implications on the domestic economy that need to be understood. This is especially important in the context of comprehensive policy reforms undertaken by various governments during the past two decades. The Philippine Institute for Development Studies (PIDS), under the Philippine APEC Study Center Network (PASCN), has been undertaking a series of studies on competition policy in recognition of this need for a new perspective, a new way of understanding the issues, and hopefully a better approach to reforming economic policies.

* This paper was presented during the Pacific Trade and Development (PAFTAD) Conference, held on 16-18 September 2002 at the AIM Conference Center, Makati City, Philippines.

** The author is a Senior Research Fellow of the Philippine Institute for Development Studies (PIDS).

This paper reviews the fundamentals and suggests a competition policy framework that can apply to any market economy in any stage of development. The paper draws heavily from the findings of the PIDS-PASCN studies, particularly the integrative chapter by the author, in the recent volume, *Toward a National Competition Policy for the Philippines.*

2. Objectives of competition policy

When one thinks of competition, one envisions a number of sellers/producers competing among each other to sell the most products to the most number of consumers. In this context, there is active rivalry among firms trying to outdo each other in terms of price and/or quality of product or service they offer.

Such a competitive situation may also be brought about by "market contestability." That is, competition comes not only from actual firms or sellers already in the market but also from firms or sellers that could enter and contest the market. In other words, when the market is contestable,[1] the threat of entry is enough to provide competition. Monopolists and oligopolists would behave like perfect competitors when faced with threat of new entrants into the market. (Baumol and Willig [1981])

In general, a competitive setting is expected to lead to optimum welfare, as it "orchestrates" resources to go where they would yield best results like the *Invisible Hand* postulated by Adam Smith. If there is competition, whether coming from existing rival firms or the threat of new entrants into the market, the seller or firm must make sure that it produces the best quality of products at least cost and sells its product at the price dictated by the market. Otherwise, it loses its clientele and market share to some other seller or firm that can do better. In other words, the producer/supplier has no "market power."[2] That is, it cannot manipulate prices and extract excess profits (rents). The end result is optimized welfare for all.

The benefits from competition are easy to comprehend. Competition promotes efficiency and consumer welfare. It promotes efficiency not only in terms of constraining firms to produce more with less (technical efficiency) but also in terms of inducing better resource allocation (allocative efficiency). Allocative efficiency in a competitive setting is encouraged because producers and investors receive the correct market price signals which help direct investments to where returns are highest. In other words, competition acts as an efficient market regulator that limits the market power of any individual or group of individuals and induces production and consumption at optimal levels and at least cost. As such, the highest overall welfare is made possible, reflected in wider consumer choices,

[1] A necessary condition for market contestability to exist is, that there are no barriers to entry.

[2] Market power is the ability of the firm to dictate prices and the quantity supplied. In the case of a monopoly, the firm's market power, or how much it can actually increase prices, depends on how inelastic is the demand for the product. In a perfectly competitive situation, individual firms face perfectly elastic demand and prices it cannot manipulate. Limiting output would simply let other firms take over supply.

lower prices and better quality of products.[3] Perhaps even more important are the dynamic gains from innovation that competition fosters and the flexibility that it develops, on the whole enabling the economy to cope better with the ever changing environment.

Aside from these direct benefits, another important and positive effect of competition is that on equity. Competition, by reducing, if not eliminating, the economic power of certain sectors and providing the best product for the best price, intrinsically advances equity objectives.

3. The role of competition policy

Increasing competition may not always be enough to ensure that the market would be able to perform its role of allocating resources efficiently. There are instances of genuine market failures that may require some limitation in competition— when more competition might even cause inefficiencies. In addition, some rules or regulation of the market (competition rules) may be needed to take the place of the competitive process that the market fails to bring about. To illustrate, the most notable of these cases of market failures is the so-called natural monopoly. This is where the product or service is nontradable (*i.e.*, cannot be imported or exported) and the market is too small to be optimally served by more than one firm.[4] Allowing another firm to be established only implies duplication and waste of scarce resources. At the same time, such a monopoly may be an "essential facility" that is essential for the survival of rival firms using the facility. Hence, not only is it necessary to allow a monopoly to exist. In addition, there is a need for competition rules on access to the essential facility to assist the market and substitute for the subsequent lack of a competitive process of allocation.

There are also cases when seemingly anticompetitive set-ups (high concentration, mergers and acquisitions leading to few firms in the market) have pro-competitive effects (efficiency gains), such as in cases where there are economies of scope, synergies, and transaction cost economies. This would, again, require some deviation from the general competition policy "rule" of discouraging market concentration.[5]

In short, competition is not the end in itself. Instead, competition policy should be one that promotes competition as long as it encourages efficiency and growth. In addition, if possible, competition policy should also be made consistent with

---

[3] There are cases where "unregulated" competition may not yield optimum welfare, that in certain cases, the market would, left to itself, result in efficiency losses. This is elaborated on in the subsequent discussions.

[4] The natural monopoly could theoretically extend outside the national border. This, however, is not within the concerns of this paper.

[5] Market concentration is the case where value-added (or some other indicator of performance, *e. g.*, sales) is concentrated in a few firms (three or four).

social objectives. These principles are, of course, easier said than actually applied in practice. Different objectives could lead to conflicts and the resulting trade offs are often difficult to resolve.

These considerations suggest what ought to be the primary role of competition policy—to safeguard, protect and promote competition and the competitive process and ensure that the market is able to function effectively and bring about economic efficiency. While in many instances, this will simply entail making the market contestable by easing entry of new firms, there would be cases where the market completely fails and more will be required from competition policy. Specifically, this may call for additional competition rules to assist the market in bringing about the highest welfare. Hence, competition policy is not necessarily a *laissez faire* policy. It is about ensuring that the market works properly.[6]

In reality, most industries may not completely possess the characteristics of a perfectly competitive model.[7] Thankfully, in practice, there need not be perfect competition for the benefits to be realized. There need only be "effective" competition that could threaten the firm, that is, the presence of a viable, actual or potential rival. The goal is not to attain perfect competition, but realistically, in many cases, simply to ensure effective competition.

In sum, the primary task of competition policy is two-fold: (1) to make sure that no entity has market power it can abuse, and (2) where necessary, to implement competition rules that emulate the competitive process and make up for the market's failure to perform its price-allocation function efficiently. As such, in most instances, competition policy may simply require making the market more contestable (*e.g.*, by removing artificial barriers to entry of new firms). At the same time, it should be able to disallow naked restraints of trade and discipline firms when such acts are committed. Where market power is inherent (in the structure), enforcement of competition policy should effectively strip the owner of such market power of the ability to use (abuse) it. In this regard, this may require punishing anti-competitive acts with appropriate sanctions and/or enforcing competition rules to guide the market.

Several steps are implied in carrying out this task. The first is determining whether or not there is any firm (or concerted group of firms) in the market that has market power. If so, the next step is to find out the source of such market power.

4. Identifying problems in competition policy

There are many factors that affect the state of competition and existence of market power in any industry. The first factor to consider is the presence of trade

[6]The central role of the market is price-allocation. A properly working market is thus one that performs this price-allocation function efficiently.

[7]The main characteristic is the existence of many firms and/or open entry and exit of firms.

barriers. There is no question that the kind of trade regime adopted by the Philippines affects the state of competition in the country. Simply by allowing imports to come in, some barriers to entry are broken down, and the market becomes more contestable. Hence, with its widespread impact on the whole economy, trade policy can act as major competition policy tool. Indeed, this is deemed to be the first layer of competition policy to be implemented. Hence, if the good is tradable, and there are no significant barriers to trade, there is reason to believe that the market is more or less contestable.

Although the impact of trade policy on competition should not be underestimated, there are other factors to consider in assessing how much competition actually results. Most importantly, if the local distribution channels are somehow tied up with local producers (e. g., through vertical integration or some vertical agreement like exclusive dealing), then the impact of trade liberalization may be limited (especially if substantial sunk costs are involved in putting up another distribution channel). Furthermore, not all goods are tradable.[8] For these goods, the geographic market (e. g., due to huge transport costs or remaining trade barriers) is limited to within local borders. As such, the barriers to entry of new firms constitute the second major factor affecting the state of competition.

The next step is to determine what kind of barriers to entry there are. Has the firm deliberately erected barriers to entry (behavioral barriers to entry)? If it has done so by becoming more efficient, then, this should not pose a problem as it is intrinsically part of the competitive process. However, if the firm came about that market power by deliberately setting out to prevent other firms from entering the market other than by becoming more efficient, then it is committing exclusionary abuse which competition policy (through an anti-trust law) should disallow.

Is the market power the result of structural factors? There are inherent market failures and rigidities which may lead to limitations on competition. These are what constitute the so-called structural barriers to entry. Again, this may not necessarily be bad for the economy if there are efficiency gains entailed. These include, for example, cases where there are economies of scope, synergies and transactions cost economies. In a class of its own is the case of natural monopolies, where huge capital requirements make duplication unviable and socially wasteful. These are cases where the market fails completely and competition policy requires more than just trying to make the market contestable. It requires setting up competition rules to make up for the market's inability to allocate resources efficiently.

These different factors have different impacts, and hence, different implications on the kind of competition policy action needed. Anti-competitive behavioral barriers require sanctions from competition policy. Others require allowing anti-competitive set-ups if there are efficiency gains involved. Still others require

[8] In this sense, barriers to trade are in effect barriers to entry. However, a distinction is made between barriers to trade and barriers to entry in this paper to highlight their unique significance and importance for a small developing country like the Philippines

even more the need to enforce competition rules to make up for the failure of the market to properly perform its price allocation function. Such cases of market failures are what have been considered to be the justification for government regulation of an industry. This leads to the last set of factors affecting the state of competition— those that arise from government policy.

Is there government policy or regulation intervening in the market? Is government policy or regulation justified? If not, then reforms are needed to let the market perform its work more efficiently. However, as implied above, this government policy or regulation may just be what the market needs, primarily because of the structural barriers involved. Government intervention in the form of competition rules is needed precisely to help the market mimic the competitive process. The question should then be, are these rules appropriate? Or should they be reformed?

Aside from direct government regulation of an industry, there is a wide array of government policies that may have other social objectives but may impact negatively on competition. No matter how essential the stated objectives of these other policies are, if they seriously conflict with competition policy, there is enough reason to question if they indeed serve national welfare. This does not presume that competition policy objectives are superior. Rather, it is always wise to weigh the possible trade-offs arising from any policy: the losses, if there are, from limited competition and the foreseen benefits from the policy.

What all this implies is that there is a need to re-examine government policies and regulations in the light of their impact on competition. Among the government policies, perhaps the more crucial to examine are government policies and regulations which directly interfere with the market. This is perhaps where the needed competition policy reforms (removing unwanted anti-competitive elements) are easier to isolate and where the impact of the reform on the state of competition is most direct.

Another major source of market failure that impedes the competitive process is imperfect information. Where there is information asymmetry between consumers and producers, producers could exercise some market power. Where consumers are not aware of the quality and even presence of available competition, the best decisions and best choices are inhibited, leading to lower welfare. In this case, the best form of consumer protection is the provision of information.

Whatever the nature of the barrier to entry, what ultimately matters is whether the implied market power is actually abused or not. The more important question is how competition policy is able to deal with potential abuse of market power. Hence, wherever the market power is coming from, the next step is to determine whether the firm "abuses" that market power and how (exploitative abuse). If there is abuse of market power, a working anti-trust law should be able to deal with it accordingly.

Two general types of anti-competitive behavior are distinguished here. The first is the act itself of the firm (or group of firms) to exclude potential firms from entering the market by means other than becoming more efficient. This is referred to as exclusionary abuse. Examples of such exclusionary abuse include: predatory pricing, arrangement to divide the market, unjustly raising rival's costs, and unjustified refusal to deal with other firms. The second type of anti-competitive behavior mentioned above is exploitative abuse. This refers to actual abuse of market power, manifested in setting prices above competitive levels and limiting supply. A prime example of exploitative abuse is a cartel agreement to fix prices and/or to limit levels of outputs.

Figure 1 provides a diagrammatical representation of the different steps involved and the primary role of competition policy.

5. Suggested framework for competition policy

The above discussion implies two major requirements for competition policy to carry out its primary tasks. First, there is a need for an effective anti-trust law to deal with anti-competitive behavior of firms. Second, there is a serious need to re-examine and re-evaluate government policies themselves which impact on competition. These needs, however, would be difficult to fulfill without the necessary information and education campaign, and adequate advocacy work. There are thus four major elements that must be present in an ideal competition policy framework.

1. Effective enforcement of an anti-trust legislation aimed at preventing restrictive business practices that significantly lessen competition and result in abuse of dominant position, inefficiency and reduction in welfare,
2. A process for review of government regulations and policies with respect to its impact on competition and competition policy objectives,
3. Advocacy for competition policy to facilitate and implement the required reforms in government policy with welfare reducing anticompetitive effects, and
4. Information and education campaign.

This is presented again in Figure 2, with the inclusion of these four elements.

Finally, an important point to emphasize is that although the chart appears to indicate a central competition policy body, this need not necessarily be the case in practice. For example, the task of reviewing government policies and regulations could be undertaken by the government agency involved, although this may not be as effective as when an independent body initiates the review.[9] In sum, the final form the organizational set-up takes should ultimately depend on what is

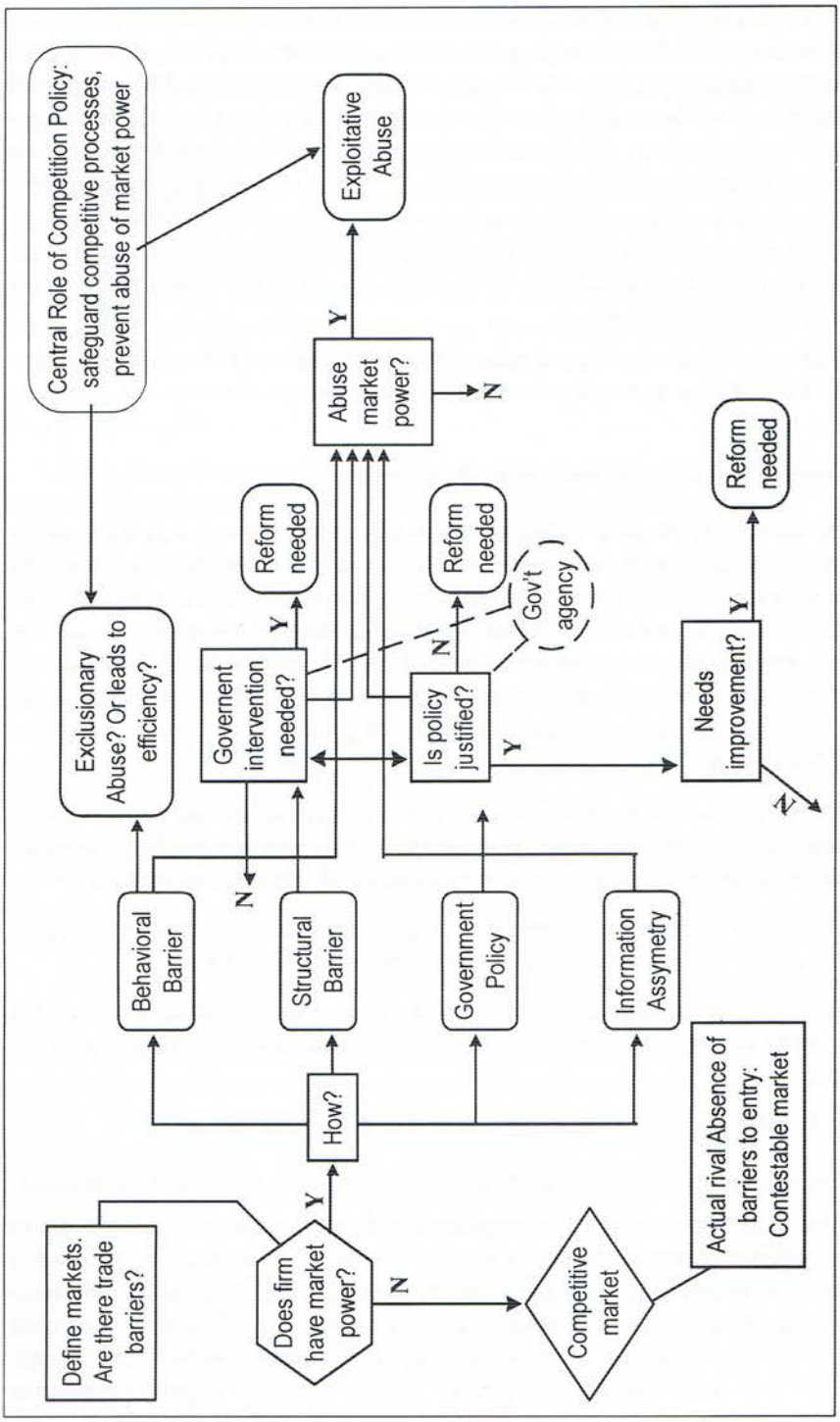

Figure 1. Role of Competition Policy

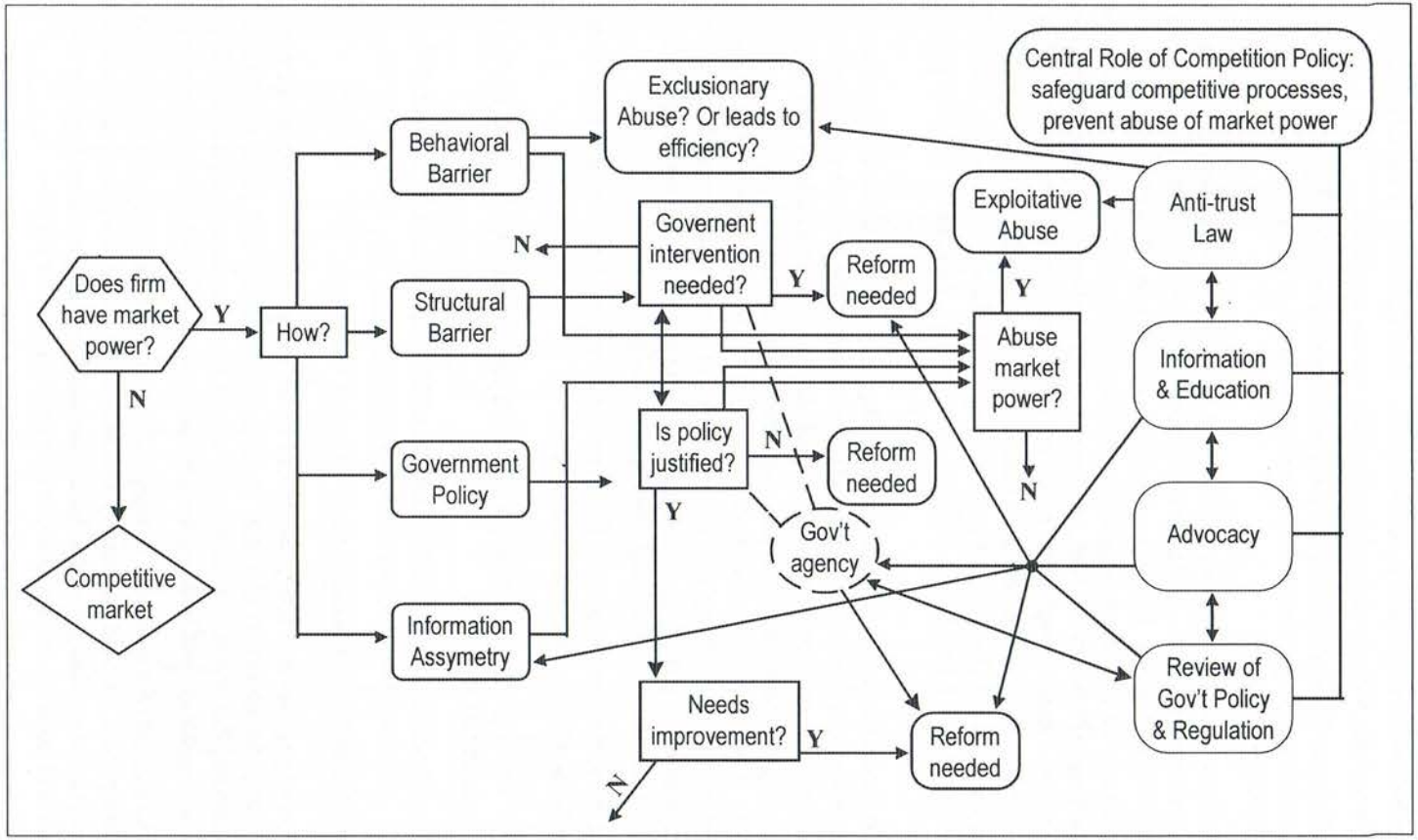

Figure 2. Framework for Competition Policy

most administratively feasible and efficient. This flexibility is the advantage of this framework, with its general applicability across countries.

Whatever the approach of the particular country and the organizational set-up, a working competition policy is one that should yield the potential outputs represented in Figure 3.

An essential element to implement a workable competition policy is an effective anti-trust law. Such an anti-trust law would be aimed primarily at preventing restrictive business practices and abuse of dominant position. Considering the encompassing nature of competition and the interrelationships and linkages between sectors, an anti-trust law should also be general in application— that is, applicable to all sectors, regardless of ownership. Thus, even firms under certain regulatory boards should be subject to the discipline of the anti-trust law. The objectives of the regulatory board need not be violated, as the law should be able to enhance, not restrict, efficiency and the public interest.

Perhaps even more crucial to undertake, in the case of the Philippines, is the review of government policies and regulations. If the objective is to improve the competitive environment, what is probably most worthwhile to tackle is the reform of government policies and regulations which directly interfere with the market. This is mainly for three reasons: (1) their impact on the state of competition is most direct and more visible, (2) they would complement well the trade reforms already in place, and (3) there is still a long way to go before the anti-trust law is passed and used successfully.

In particular, the major tasks involved in the review of government regulations and policies should cover the following:

- The regulatory framework covering natural monopolies and access to essential facilities;
- Possibility of deregulating further certain segments of the industry where more competition may be introduced; and
- Competitive neutrality in government businesses.

From these review activities should result more definite competition rules, particularly on access to essential (bottleneck) facilities and price regulations. Furthermore, the review would cover ways to improve the administration of the anti-trust legislation and build up the administrative capability for its enforcement.

The suggested framework is designed to be comprehensive, covering not just anti-trust policy. It could potentially deal not only with anti-competitive behaviour of firms (anti-trust law), but also with monopoly regulation and addressing other government policies and regulations that impinge on competition.

---

[9]There would likely be less objectivity and probably even some resistance to reforms from within. On the other hand, an independent body would have less resources to investigate all government measures and regulations.

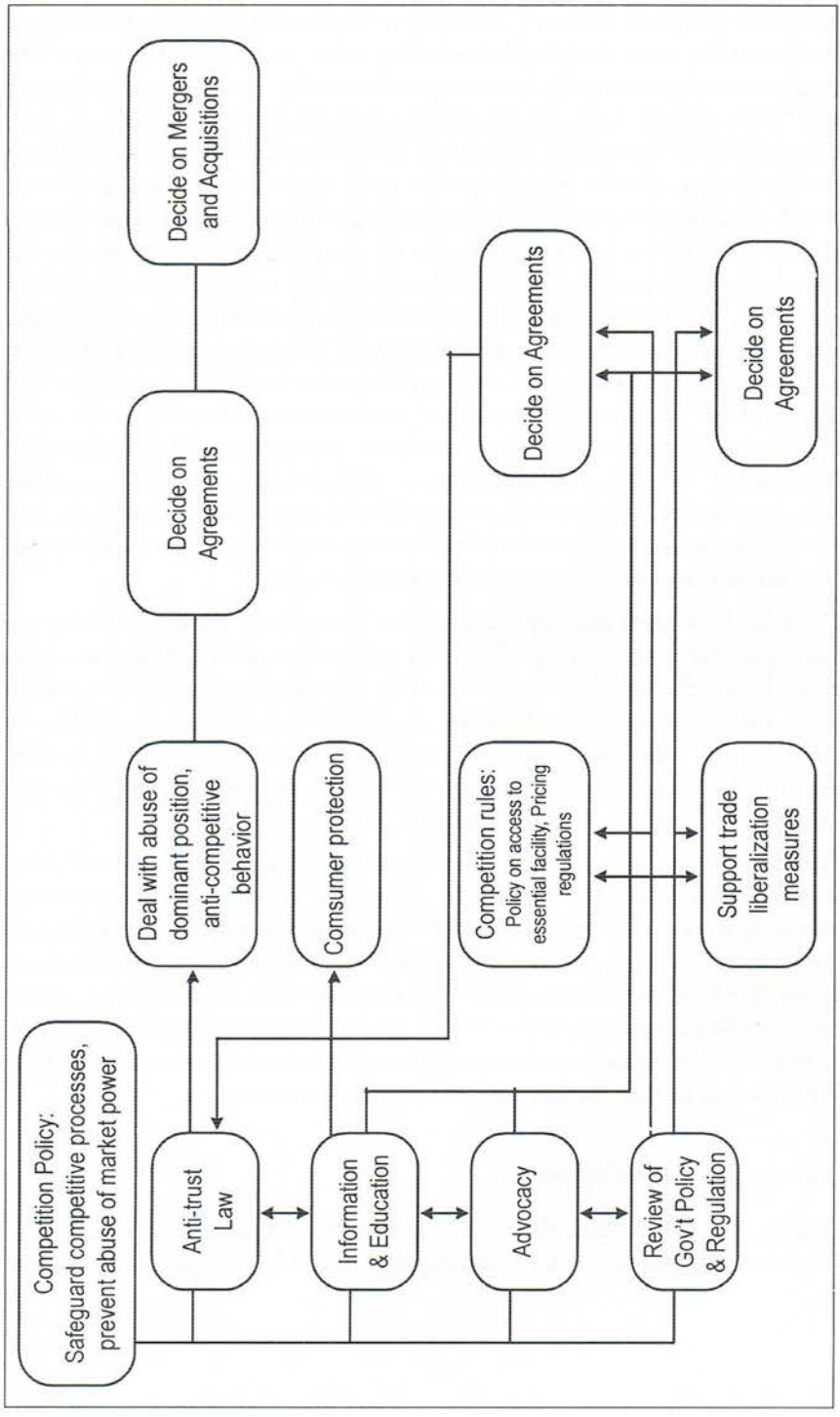

Figure 3. Potential Outputs of Competition Policy

To clarify this point further, it is helpful to distinguish the major functions of competition policy from the perspective of key result areas. (See Figure 4.) The first area can be considered the core competition policy: the anti-trust policy and law that deals directly with anti-competitive behaviour of firms. Second, there will be cases where the market completely fails and more will be required from competition policy. This is particularly the case of natural monopolies, where additional competition rules, e. g., regarding access and pricing regulations may be needed. Hence, the second major area of competition policy relates to the regulation of natural monopolies, which are primarily in the utilities sector. A third function, which is an inherent objective of competition policy, is consumer protection. This is implicitly what the discipline of firm behavior is aimed at. On top of this, there could be information asymmetry between consumers and producers, which could endow producers with some market power. As such, possibly the best form of consumer protection is information and education, and public advocacy. Finally, as indicated above, another major area of concern deals with the interface of competition policy with other government policies and regulations. Government policies and regulations could benefit from a review of their impact on competition and the competitive process.

The first three areas (the top three shaded areas in the rectangular box) are generally considered to be integral parts of competition policy. There are some questions, however, regarding the fourth. This is primarily because of the more difficult issues and conflicting objectives involved. Nonetheless, it could be an important part of a national competition policy. It would surely bring in new perspectives that would make for a more efficient administration of policy and identification and implementation of needed reforms.

Table 1 provides an overview of competition policy/law in selected APEC economies (Abon [2002]). The table shows the various legal frameworks implementing competition policy in the (21) selected countries. Eight (including Brunei Darussalam, Hong Kong, Malaysia, Papua New Guinea, Philippines, Singapore, Thailand and Vietnam), although they may have anti-trust laws, do not have a comprehensive competition law or specific institution for enforcement. Furthermore, for those that have the mechanisms for enforecement, many are quite new, most having passed the law only during the past decade.

6. A cursory look at some issues

Despite their differences, there are some notable circumstances common to most countries that could have important implications on the conduct of competition policy.

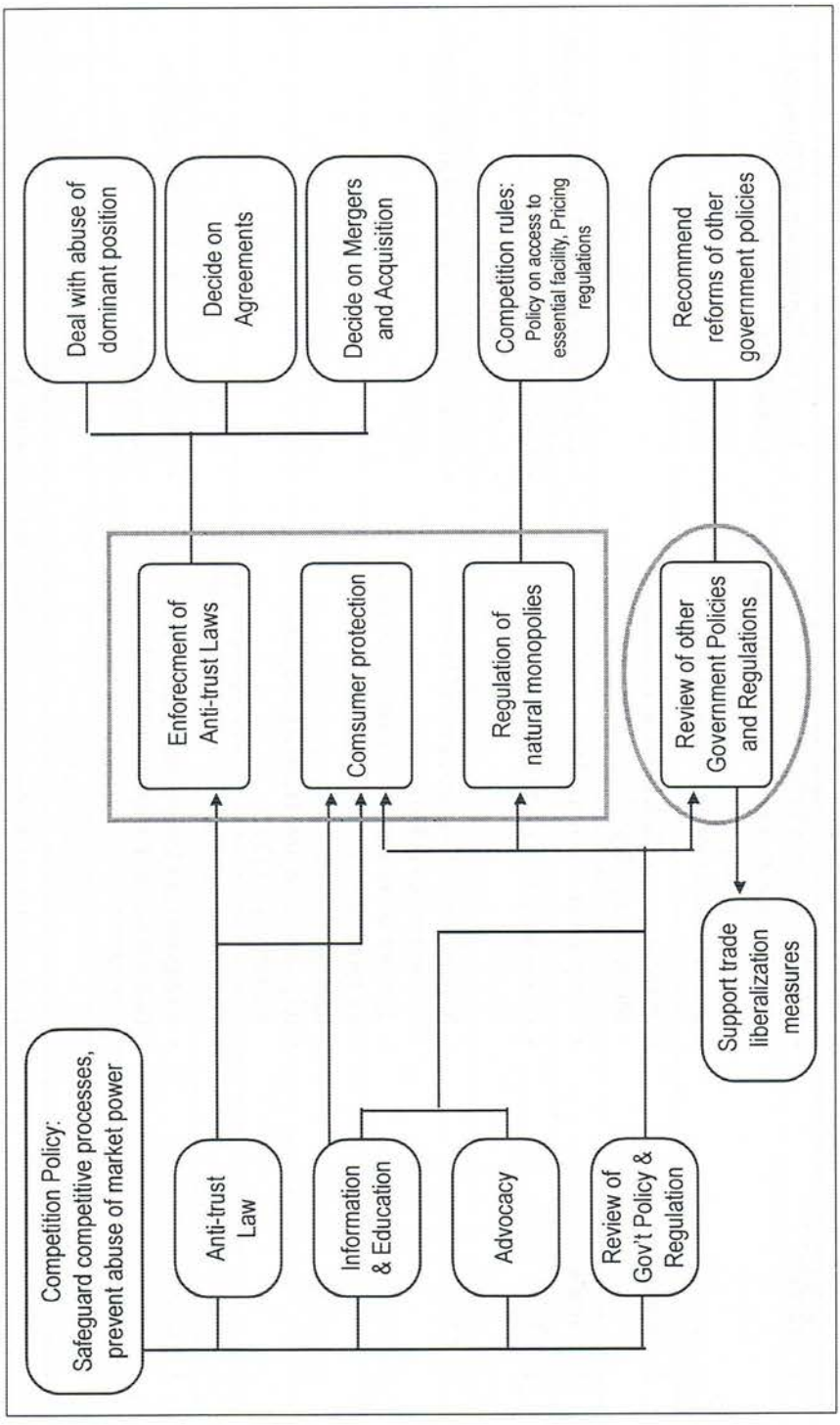

Figure 4. Areas of Competition Policy

Table 1. Competition policy/law in NTC economies

Country	*Competition Laws*	*Enforcement Agencies*
1. Australia	• Trade Practice Act 1974 • State Territory Competition Policy Reform Application Acts • Prices Surveillance Act 1983	• Australian Competition and Consumer Commission
2. Brunei Darussalam	• There is no specific legislation pertaining to competition policy	
3. Canada	• Competition Act (Amended in 1986)	• Competition Bureau of Industry Canada
4. Chile	• Competition Law (1973)	• National Economic Prosecutor's Office • Antitrust Commission
5. China	• Regulations on Development and Protection of Competition (1980) • The Law of the People's Republic of China for Protecting Consumer's Rights and Interests (1993) • Regulations on Anti-Dumping and Anti-Subsidization (1997)	• Industrial and Commercial Administration of China
6. Hong Kong	• There is no comprehensive competition law	
7. Indonesia	• Prohibition of Monopolistic Practice and Unfair Business Competition (1999)	• Commission on Business Competition Supervision

Table 1. Competition policy/law in NTC economies (continued)

Country	*Competition Laws*	*Enforcement Agencies*
8. Japan	• Anti-Monopoly Act (1947) • Act Against Unjustifiable Premiums and Misleading Representations (Premiums and Representations Act) • Act Against Delay in Payment of Subcontract Proceeds	• Fair Trade Commission
9. Korea	• Monopoly Regulation and Fair Trade Act (1980)	• Korea Free Trade Commission
10. Malaysia	• There is no specific Act governing competition policy at present.	
11. Mexico	• Federal Law on Economic Competition (1993)	• Federal Competition Commission
12. New Zealand	• Commerce Act (1986)	• Commerce Commission
13. Papua New Guinea	• There is no comprehensive competition law or specific institution to enforce competition policy.	
14. Peru	• Legislative Decree 701 (2000) • Law 26876 • Supreme Decree No. 017-98-ITINCI (2000)	• INDECOPI, Commission on Free Competition
15. Philippines	• **There is no comprehensive competition law or specific institution to enforce competition policy.**	

Table 1. Competition policy/law in NTC economies (continued)

Country	*Competition Laws*	*Enforcement Agencies*
16. Russia	• RF Law "On Competition and Limitation of Monopolistic Activity on Commodity Markets"	
17. Singapore	• There is no comprehensive competition law or specific institution to enforce competition policy.	
18. Chinese Taipei	• Fair Trade Law (1991)	• Commerce Commission
19. Thailand	• There is no comprehensive competition law or specific institution to enforce competition policy.	
20. United States	• Sherman Act (1880) • Clayton Act (1914) • Robinson-Patman Act (1914) • Hart-Scott-Rodino Antitrust Improvement Act (1976)	• Antitrust Division, Department of Justice • Federal Trade Commission
21. Vietnam	• There is no specific law on competition policy at present	

Source: Abon, Edgardo B. "The Need for a Philippine Comprehensive Competition Policy and Law". Paper presented on Competition Policy Seminar organized by NEDA and KDI. June 20-21, 2002.

1. In varying degrees, there is government intervention/ regulation in many sectors for various reasons/objectives. These include industrial promotion, sector development, safety and standard regulations, monopoly/essential facility regulation, and equity and access.

   In general, the government would have reason to intervene in cases of market failure. Among the most important and most recognized of these are (a) the case of public goods, (b) equity (including access) objectives, (c) imperfect information, and (c) presence of externalities. In such cases, the intent of regulations could, in fact, be basically pro-competitive— since the market would not be able to function efficiently[10] if left to itself. Thus, a regulatory framework may be justified. What needs to be examined then is whether the regulation is indeed intended and designed to perform its role of correcting for market failures and how well it is able to do so, or whether the regulatory framework only distorts the market further.

2. The list of government policies and regulations includes those which are primarily meant to serve other social objectives (housing, education and health). This paper assumes for now that these social objectives are paramount.

   The presence of government regulation does not necessarily imply bad policy. Presumably, the government policy or regulation is there for some other social objectives. Nonetheless, the interface of these other government policies with competition policy should be reviewed. (See Medalla in the PIDS-PASCN volume). What this means is a need for a regulatory review, preferably an impact assessment, to make sure that optimum competition regulations are being implemented.

   A good example is the case of education. Education is a merit good. It could also entail externalities. And equity/access objectives are indisputable. However, the question is how well these objectives are achieved by regulating tuition fees. In general, price intervention creates serious distortions that could only lead to further misallocation of resources. In the case of the Philippines, there appears to be a substantial number of institutions that can provide viable competition. The market failure is mainly in the lack of information. Tan (2002) argues that competition just needs to work properly. In this regard, the provision of readily available and adequate information (about school performance, among others) would go a long way in improving the workings of the market and the competitive process.

3. There is often a mix of objectives in regulating a sector, including a natural monopoly like power and telecommunications.

   There will be cases where multiple, conflicting objectives cannot be avoided, where both efficiency (maximum returns) and equity (access at affordable

[10] That is, match supply and demand at optimal levels.

prices for the underprivileged sectors of the economy) are simultaneous objectives. Price regulation for monopolies is complex enough. Mixing it with equity objectives complicates it even more, such that it becomes unclear how the objectives are being met.

The problem is how to separate the issues. Hopefully, there are ways to separate competition concerns from other social objectives and to bring in these concerns in policy making. This deliberate policy to bring in competition policy concerns is particularly crucial in infrastructure projects which are usually characterized by large capital requirements and long gestation periods. This deliberation should be done from inception of the project, to its completion, and to its actual operation. This means, for example, a proper bidding process (or the so-called Swiss Challenge for unsolicited projects), burden of proof on the part of the firm to show efficiency gains translated to better prices and products to consumer if limitation of competition is called for, and clear access policies in its operating stage.

Various studies on utilities, telecommunications and the airline industry, show further the complexities of industry regulation. The sectors covered involve essential (bottleneck) facilities, which justify the need for the industry regulation[11]. In general, the Philippine studies show that significant reforms have been implemented in terms of liberalization and deregulation, leading to the introduction of greater competition and resulting in substantial benefits. At the same time, a number of questions still remain and new challenges and issues emerge requiring new approaches to sustaining these benefits.

Among the major recommendations, the unbundling of services to separate segments that should be subject to greater competition is among the important reforms that should be sustained. This is resonant of findings of other studies in the area. Global trends in the industrial organization of these utilities suggest that they are not as "natural" a monopoly as they used to be or are thought to be. Possibly the only segments that are real natural monopolies are in the provision of the "local loop" in the fixed line telecommunications, international ports in the transport industry, and transmission in the power sector. Related to this, another key area for improvement is formulating a clear policy on access to these essential facilities. (How is it allocated, what order, etc.)

Another important question that should further be looked into is the use of price/rate fixing itself as part of the regulatory framework. This includes the rate of return to base regulation. In addition, some product (service) price setting is enforced.

At the outset, price fixing appears to be a logical policy handle of the regulator, especially since there is a presumption of market failure in the regulated industry. Where competition as market regulator fails, the ultimate impact is on prices and it seems reasonable that this is where the regulator takes over. Price fixing is also

[11] See Serafica [2002] and Austria [2002] in the PIDS-PASCN volume for the case of the Philippines.

very politically appealing. However, as often experienced in many countries, government price fixing often creates more problems than it solves. A major reason is the information problem. It is difficult to predict demand and supply. Data on costs are not easily available.

In some cases, the problem is the point of price of intervention. In the Philippines, the end-user price (price paid by consumers) is set by NTC (National Telecommunications Commission) but interconnecting carriers are allowed to negotiate access charges between them (intermediate price). A firm enjoying network externalities can effect a price squeeze in its effort to gain market power before the regulator can step in. In this case, it might be better for the regulator to intervene at the intermediate level and deregulate end user price where enough competition exists. This would also lower the cost of negotiation. Just imagine the costs involved with *n* carriers negotiating bilaterally per product (service) for *m* types of products. (Serafica [2002])

The other usual price regulation is the rate of return cap. Here, the rationale is more difficult to comprehend. Presumably, the rate of return to base regulation is an alternative to user price fixing and is much easier to manage and determine. However, if government wants to encourage investments, it should not impose limits on how much a firm can earn, and certainly not at an unreasonably low nominal rate of return of 12 percent which is not even enough to cover interest costs. Rate of return caps create, for prospective investors, "regulatory risks" on top of the commercial risks they already have to face. Moreover, the regulation only encourages cheating and effectively forces out of the market honest new players.

A related issue to price regulation that needs to be reviewed is the policy of cross-subsidization, which complicates the process even more. Usually this arises from trying to achieve a mix of objectives-regulating the monopoly (ideally to mimic the competitive process) and addressing equity objectives (usually the provision of service or product to underserved or underprivileged sectors of the economy at affordable prices). There is a need to re-evaluate the costs and benefits of cross-subsidization, which has been used as a reason for limiting entry to prevent new entrants from "skimming off the top". In the first place, it is very difficult to set the right prices and the cost of making a mistake could be high. In the second place, there are other alternatives to attaining the objective, e.g. more direct subsidies which can be more easily targeted than block cross-subsidization.

Another issue to look at is privatization. For many countries, most of the natural monopolies are, or used to be, public monopolies. In the Philippines, privatization has been part of the reforms undertaken during the past decade. There is a perception that publicly owned and run corporations are less efficient than private enterprises. This is due to a number of factors. Among these are the civil

service regulations that make it extremely difficult to hire and fire employees, the incentive and compensation structure, and the lack of accountability. These factors, among others, deprive the public enterprise of the usual motivation for profit maximization that is present in private firms.

However, transfer of ownership alone will not ensure increased efficiency and (may only transfer rents) if the necessary conditions for a competitive market are not set forth beforehand. Indeed, the problem is not whether to transfer ownership but rather how the competition process and discipline can be introduced. If there should be transfer of ownership, all unnecessary advantages previously enjoyed by the firm should be removed and competitive neutrality should be ensured. These issues need to be examined further in the reforms of public enterprises.

The case of financial regulation is perhaps of unique importance because of the nature of the financial sector and its vital link to the rest of the economy[12] Financial sector regulation can be justified on two grounds: (1) the presence of asymmetric information, and (2) the presence of systemic risks. Perhaps the more compelling of the two is the second. The risk to one bank is a risk to all. The failure of one bank can cause the failure of others, if not the whole system. Thus regulation of the financial regulation is indeed well founded.

Ideally, the regulation should address only the particular market failure it is trying to correct. In the case of the financial sector, this calls for ensuring the stability and soundness of the banks and the payment system, which means prudential regulations. This does not mean limiting the number of firms *per se*. It means disallowing entry only if the entrant can not prove its soundness and stability. In the Philippines, Milo [2002] has noted some strides in this area resulting in better and wider array of services available as well as lower average profit margins after liberalization.

Finally, an emerging problem in the Philippines, and possibly in other countries, too, is the recent trend towards mergers and acquisitions. This could very quickly worsen the state of competition in affected markets. Again, this highlights the need for competition policy, especially an effective anti-trust law dealing with mergers and acquisitions, which have laid bare the distortions in some of the regulations (e.g., access charge for universal application which has created asymmetries between firms, especially between old and newer ones). This again points to the need for closer review and re-examination of government policies and regulations, especially on their impact on the state of competition, and the ideal competition rules that are needed to compensate for the failure of the market.

6. Bottomline

A full-blown national competition policy would require, at the very least, a good amount of technical expertise. The competition authority should have very

[12]See Milo [2002], also in the forthcoming PIDS-PASCN volume.

competent and knowledgeable staff to define markets, identify anti-competitive actions, and judiciously construct and administer "competition tests" on issues of concentration, agreements, mergers and acquisitions. As such, a legitimate question to ask is how ready the country is to implement the necessary reforms. Being new in the area of implementing competition policy, there is expectedly a lack of expertise and a need for institution and capability building. The question then becomes what would be the best way of developing such expertise and institutions. This is on top of the problem of building public support for the reforms and overcoming political constraints.[13]

For countries still trying to develop a workable national competition policy, one approach is to proceed gradually, possibly on a piecemeal basis, starting with the creation of a coordinating body, and an austere law, which can be augmented over time, with emphasis on the establishment of implementing institutions and the promotion of competition advocacy. Another approach is to transform an existing body which is performing some of the functions of competition policy. A third approach would be to create a new central body which can be designed to develop and evolve into a national competition authority.

Different countries have different circumstances that determine what is the most feasible and effective way to implement the suggested competition policy framework. For sure, a "good" central authority is best able to accomplish the task. Whether it is feasible to create one, however, is another question. For many, the challenge is how to craft a competition law that would allow for the possibility of creating a national authority that to oversee competition policy.

Whatever the approach, initial efforts should already focus on the development of physical and human capital, the training of judges, education of consumers, business community and government officials on the rationale for and content of an antitrust statute. The approach should first establish the institutional foundations for competition policy and introduce the mechanisms for enforcing a comprehensive set of commands. This process will take some time. The drafting of the law and the creation of a competition authority should follow efforts to study the major sources of market failure and identify distinctive institutional conditions that affect the choice of strategies for correcting such failures.

In the long run, any government stands to benefit from the creation of a competition authority. Ideally this authority would be responsible not just for the prevention of anticompetitive behavior of firms, or simply anti-trust legislation, but rather for the broader area of competition policy and law, including the review of existing government policies and regulations from the point of view of competition policy, supported by competition advocacy, information and education.

---

[13] Indeed there are valid fears about possible regulatory failures — about the "competition authority" making serious errors in judgment (both Type I and Type II), punishing those who should not be punished and leaving those who should be punished go unpunished.

References

Abad, A. R.A. [2002] "Recommendations for Philippine anti-trust policy and regulation" in: Erlinda M. Medalla, ed. *Toward a national competition policy for the Philippines*. Makati City: Philippine ASEAN Study Center Network (PASCN) and Philippine Institute for Development Studies, pp.339-402.

Abon, E. B. [2002] "The need for a Philippine comprehensive competition policy and law". Paper presented during a Competition Policy Seminar organized by NEDA and KDI. Pasig City.

Aldaba, R. M. [2002] "The state of competition in the manufacturing sector" in: Erlinda M. Medalla, ed. *Toward a national competition policy for the Philippines*. Makati City: Philippine ASEAN Study Center Network (PASCN) and Philippine Institute for Development Studies, pp.33-63.

Austria, M. S. [2002] "The state of competition and market structure of the Philippine air transport industry" in: Erlinda M. Medalla, ed. *Toward a national competition policy for the Philippines*. Makati City: Philippine ASEAN Study Center Network (PASCN) and Philippine Institute for Development Studies, pp. 189-251.

Baumol, W. and R. Willig [1981] "Fixed cost, sunk cost, entry barriers and sustainability of monopoly". *Quarterly Journal of Economics*, No. 96 (3): 405-31.

Bautista, R.M., J. H. Power and Associates [1979] *Industrial policies in the Philippines*. Makati City: Philippine Institute for Development Studies.

Gilbert, R. J. [Spring 1990] "The Role of Potential Competition in Industrial Organization", *Journal of Economic Perspectives* 4(2): 213-215.

Lamberte, M. B. *et al.* [1992] *Barriers to entry study*. Final Report, Volume I. United States Agency for International Development (USAID).

Medalla, E. M. [2002] "Government policies and regulations: interrelationship with competition policy objectives" in: Erlinda M. Medalla, ed. *Toward a national competition policy for the Philippines*. Makati City: Philippine ASEAN Study Center Network (PASCN) and Philippine Institute for Development Studies, pp. 307-337.

_____ [2002] "Trade and industrial policy beyond 2000: an assessment of the Philippine economy" in Josef T. Yap, ed. *The Philippines beyond 2000: an economic assessment*. Makati City: Philippine Institute for Development Studies.

Medalla, E. M. *et al.* [1996] *Catching Up with Asia's Tiger*. Volume II. Makati City: Philippine Institute for Development Studies.

Milo, M. R.S. [2002] "Analysis of the state of competition and market structure of the banking and insurance sectors" in: Erlinda M. Medalla, ed. *Toward a national competition policy for the Philippines*. Makati City: Philippine ASEAN Study Center Network (PASCN) and Philippine Institute for Development Studies, pp. 253-306.

Pineda, V. S. [1997] "Effects of the uniform five percent tariff on manufacturing". Discussion Paper No. 97-16, Philippine Institute for Development Studies (PIDS). Makati City.

Serafica, R. B. [2002] "Competition in Philippine telecommunications: a survey of the critical issues" in: Erlinda M. Medalla, ed. *Toward a national competition policy for the Philippines*. Makati City: Philippine ASEAN Study Center Network (PASCN) and Philippine Institute for Development Studies, pp. 157-188.

Stigler, G.J. [1968] *The organization of industry*. Homewood, Illinois: Richard D. Erwin, Inc.

Tan, E. A. [2002] "The structure and inflation of tuition fees in Philippine colleges and universities." Paper presented during PIDS-PES Distinguished Speakers' Lecture Series.

U, Peter L. [2002] "Competition policy in the Philippine downstream petroleum industry" in: Erlinda M. Medalla, ed. *Toward a national competition policy for the Philippines*. Makati City: Philippine ASEAN Study Center Network (PASCN) and Philippine Institute for Development Studies, pp. 99 – 155.

World Bank (WB) and Organization for Economic Co-operation and Development (OECD) [1999] *A framework for the design and implementation of competition law and policy*. Washington.

ANNEX

Suggested provisions for an anti-trust law

It is crucial to have a truly effective legal and regulatory framework to effectively implement competition policy. This annex suggests some key provisions of an anti-trust law, especially relevant for those countries that as yet have to craft one. How the framework for a national competition policy shapes up will depend on the design of a simple and enforceable model and a careful consideration of the political realities of the country.

As previously noted, the anti-trust law should be general in application. Bearing in mind the factors affecting the state of competition and what should be the objectives of competition policy discussed in the main sections of the paper, the law should contain rules governing monopolies and cartels, restrictive agreements, mergers and acquisitions, and provisions identifying outright prohibitions of clearly unfair competition practices, all aimed at preventing exploitative and exclusionary abuses. These rules, where possible, should identify per se prohibition to simplify some of the tasks. For other cases, rule of reason (e.g. by applying judiciously crafted competition tests), should allow for limitation in competition where found to be so justified. The anti-trust law should endow investigative powers to whichever agency is tasked to implement it. There should, however, be transparency in the procedures, ideally with published guidelines. Finally, there should be clear possible courses of action, in terms of remedies and/or penalties for those found to be in violation of the anti-trust law. To elaborate a little further, as suggested in the World Bank/OECD Framework for the Design and Implementation of Competition Law and Policy, these cover the following provisions:

- Rules governing monopolies and cartels and abuse of dominant position
  - Establish if firm has dominant position
  - Examine entry barrier condition
  - Identify *per se* prohibitions involving anticompetitive actions (creating obstacles to entry, e. g. predatory pricing)
  - Set guidelines for rule of reason regarding what anticompetitive, exclusionary actions could be allowed. There should be a competition test to determine if the obstacle to entry is solely created by increasing efficiency of the firm. This competition test allows for limiting competition on efficiency grounds
  - Provide for possible remedies (e.g. reorganize, divest)

- Rules governing restrictive agreements. The premise is that not all agreements are cartel agreements. Similar considerations apply in the case for rules governing concentrations (below)
  - Identify per se prohibitions. These would include clear cartel agreements (naked restraints of trade) such as:
    - Price fixing or setting
    - Output fixing or setting
    - Bid rigging
    - Division of markets
  - Examine entry barrier conditions
  - Identify other forms of anticompetitive (exclusionary) conduct where rule of reason could apply
  - Set competition test guidelines
- Rules governing mergers and acquisitions
  - Examine entry barrier conditions
  - Set and define threshold for what constitutes small enough mergers where prior notification is not required.
  - Set rule of reason guidelines for permitted mergers and acquisition even for those above the threshold. For these there should be a competition test which shows that there are on balance efficiency gains.
  - Burden of proof— firm
- Provisions for prohibited unfair competition practices

  List specific actions which should be prohibited unfair competition practices. Examples of such practices of unfair competition which should be prohibited could include:
  - Distribution of false or misleading information— which could harm competing firms
  - Distribution of false or misleading information (including information lacking basis) to consumers (e.g. related to price, quality, characteristics, etc.)
  - Unauthorized use, receipt, or dissemination of confidential scientific, technical, production, business, or trade information

The recommendation is silent on the additional mandate to incorporate the other elements of competition policy in the legislation and if a central competition authority should be created. This is because of the far-reaching implications of creating such a body. This is the biggest issue that would need to be resolved for those countries still starting to implement a "working" national competition policy.