

trade hot topics

Political Economy Factors Affecting Efficient Functioning of Markets

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Background

The potential benefits of a competitive market environment for stimulating economic efficiency, innovation, greater productivity and economic growth are now widely recognised. Competition policy and law plays an important role in disciplining businesses, preventing unfair business practices, and creating a level playing field between firms, which are all important for attracting investment and developing the private sector. However, political economy factors act as a major obstacle for undertaking reforms to ensure a healthy competition regime. Political economy barriers refer to the constraints due to conflicts of interest between different agents in the economy and the need for the state to make collective choices in the face of these conflicts. This issue of Commonwealth Trade Hot Topics, drawing upon findings from case studies of various sectors in different countries, summarises the key lessons learned with respect to how political economy factors can affect efficient functioning of markets even in the presence of liberalised trade regimes and the role of competition policy in dealing with such a problem.

1. Liberalisation and privatisation programmes are insufficient to ensure competitive domestic markets. Although trade liberalisation, by increasing the number of players, reduces room for anti-competitive

practices and complements competition policy, liberalisation policies alone are not sufficient to ensure a competitive market outcome. Disincentives for entry arise from the concentrated nature of domestic markets in developing countries, as the level of demand can support only a small number of firms. There are other impediments to trade unrelated to trade policy, such as transport costs, language barriers, lack of information on domestic demand and differences in product safety laws. These barriers tend to segment markets, creating geographical market niches that allow firms to exercise market power. Firms can also undertake actions relating to product design, advertising and design of contracts with distributors and retailers that limit competition. Competition could also be limited by technological factors, as existence of economies of scale and irreversibility in investment could create a market structure with a limited number of firms, exploiting some monopoly power. In addition, non-tradables are unaffected by trade except through foreign investment. Thus, in addition to trade liberalisation, effective competition policy is essential for creating competitive market and industry structures.

Experience also shows that privatisation programmes alone are not enough to ensure a competitive market outcome. Such programmes can potentially

* The authors are affiliated with the Overseas Development Institute (ODI), London, UK. This paper is an outgrowth of a study commissioned by the Commonwealth Secretariat. Many of the lessons summarised here are based on case studies prepared by the authors as part of their ongoing research in similar areas. Views expressed here are those of the authors, and do not necessarily reflect those of the Commonwealth Secretariat.

lead to the replacement of public monopolies by private monopolies. Competition policy thus plays an important role in augmenting the effectiveness of liberalisation and privatisation programmes in developing countries.

2. Adoption of a competition law is an important but not sufficient condition for achieving good competition outcomes. Often, the passing of competition law has been treated as a cornerstone of the liberalisation and pro-market reforms that have been undertaken in many developing countries. But even when a country has a competition law in place, political economy issues can arise which prevent its effective implementation, despite the existence of anti-competitive conduct.

3. Governments sometimes benefit from uncompetitive situations, and thus can prevent or even reverse pro-competitive reforms. This may occur because government shares in the high profits earned by dominant players in an uncompetitive situation, for example, through higher taxation, or other types of payments, or because state owned enterprises (SOEs) are likely to be threatened by new market entry. Papua New Guinea, for instance, had earlier prevented new entrants in the mobile phone market to protect the state monopoly in this sector, as the SOE would have been unable to compete effectively and because the government saw the public enterprise as a source of revenues. In the end, however, this decision was reversed, in light of political and public recognition of the benefits of competition in the mobiles sector to the wider economy.

4. Vested interests opposed to reform are often more vocal and influential than those with an interest in the reforms going ahead. Opposition to reform is often voiced by small but vocal and influential groups, while potential beneficiaries from reform (including the wider population) are diffuse and unaware of the benefits, so do not actively lobby for reform. Other potential beneficiaries, such as potential new entrants to the market, and the employees they would hire, are not present at the negotiating table, as by definition they do not yet exist or operate in the market. So for all these reasons, those opposed to reform are more vocal and influential than those in favour. This illustrates the important role of advocacy groups in analysing and publicising the costs associated with uncompetitive arrangements, and the potential benefits of reform, and mobilising the potential beneficiaries to advocate for change.

5. Sometimes government and business can be closely linked and form strong vested interests opposed to reform. This may be because they are simply the same people or because of state ownership of businesses. Often, the linkage is more discrete, however. Governments may permit a particular firm to dominate the market as they can benefit by sharing in the monopoly profits via taxation or other kinds of payments, or they may permit them to continue in return for the business undertaking other activities which help meet their objectives (such as protecting jobs, or providing goods at reduced rates to government-favoured suppliers, etc). Sometimes 'public interest' arguments may be given for certain actions taken which are actually anti-competitive and which have been taken due to underlying vested interests. Such vested interests may prevent pro-competitive reforms and also constrain competition authorities from taking effective action. However, case studies on the Zambia cement and sugar sectors show that although competition authorities can sometimes find it difficult to enforce competition law by way of corrective or punitive action because of these constraints, they can still play an important role in investigating and publicising information about anti-competitive conduct in a particular market.

6. Public sector enterprises may benefit from preferential treatment relative to private sector firms. A case study on Vietnam shows that private sector firms there allege SOEs are enjoying preferential treatment in access to capital, land and other resources which creates an unlevel playing field for competing private sector firms. To overcome such problems, competition authorities must assess the impact on competition in specific cases. Such cases could provide a window for rectifying more systemic policy frameworks which in effect, even if not deliberately, discriminate between public and private sector enterprises.

7. Pragmatic implementation of competition law may be needed to overcome arguments against the introduction of competition law. It is found that sometimes a gradualist approach to reform is preferable, especially when a 'first-best' solution is not possible. For example, in Ghana, the enactment of a competition bill has been delayed (in part) due to opposition from sector regulators who feared that their powers may be subordinated by the introduction of the bill. By exempting existing regulatory institutional arrangements from the purview of the competition bill, although not ideal

from a competition viewpoint, the government appears to have overcome this opposition, and was able to press ahead with the bill.

8. Industrial policy concerns can be a deterrent to the introduction of competition policy. Sometimes it is argued that the introduction of competition law may hinder the inflow of foreign direct investment (FDI), as protection from competition and the potentially high profits that this allows may represent one way to encourage new investment. However, most national competition laws include some allowance for specific national priorities, and competition policies can be designed so as to complement industrial policy. A competition authority can play a role in monitoring and overseeing the implementation and competition impact of particular aspects of industrial policy for example, and preventing the abuse of market power in this situation, even if some degree of protection from new entry or foreign imports is permitted.

9. Electoral considerations and fear of bankruptcies and job losses can be powerful barriers to reform. This is often the case where short-run economic costs to reform are likely to be high, while benefits are likely to be longer term. One example of this is due to a case study of the Kenyan sugar sector, where production is highly uncompetitive by international standards and where state-owned mills are highly indebted and require regular government bail-outs. The industry appears unsustainable without continued government support and protection unless reforms are undertaken. However, given the number of livelihoods that are currently dependent on the existing sugar market and the fact that many electoral constituencies in Kenya are dominated by sugar growers, the opposition to reform is substantial. This is a case where the opposition to reform is voiced by small but vocal and influential groups, while potential beneficiaries from reform are diffuse and unaware of the benefits.

Overcoming vested interests

The best way to tackle vested interests opposing reform is to establish and facilitate co-ordination among interest groups who stand to gain from reform (pro-reform lobby groups). This includes consumers, both household (who can be mobilised through consumer groups) and industrial, who may gain considerably from lower priced inputs (for example, confectionery companies can lobby against a lack of competition in sugar production). It also includes potential new entrants to the market, who can make their voices heard through

business associations.

If these groups can be mobilised to lobby effectively for reform, this can help to offset the political pressure to maintain the status quo. Competition authorities can play an important role here, in co-ordinating such groups, publicising the issue and providing evidence of the benefits of reform. Donors can also help support the development of constituencies for reform, by building the evidence base on the benefits of competition, working with civil society to develop a culture of competition, and supporting the establishment of effective competition authorities.

When organised groups (for example, consumer, industry, or civil society) are armed with the evidence of the benefits of competition they will be able to advocate for reform far more effectively. Particularly if they can tell stories about how competition has affected the common man in a positive way. Despite best efforts, however, overcoming political economy barriers to reform is never going to be easy. The vested interests of elite groups of incumbent businesspeople and politicians pose formidable barriers to economic reforms that would have potentially huge benefits for the poor. Achieving a sound framework for competition is difficult, and beset by vested interests, but it is crucial to ensuring that markets work to deliver growth development, and poverty reduction.

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ISSN: 2071-8527 (print) **ISSN: 2071-9914** (online)

Series editor: Dr Mohammad A Razzaque
Produced by the Economic Affairs Division of the Commonwealth Secretariat

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