Part Two

Foreign direct investment, market structure and competition policy

Introduction

The past decade has witnessed a remarkable process of liberalization of foreign-direct-investment (FDI) policies worldwide. This has been part of a broader liberalization of international trade in goods and services and flows of finance, technology and knowledge. In previous years, the *World Investment Report* focused on two components of the process of FDI liberalization: the reduction of restrictions on FDI and transnational corporation (TNC) activities, and the establishment of standards of treatment and protection of FDI.[1] These are the dimensions of liberalization to which the attention of countries has also largely been devoted. As firms respond to these measures in the broader context of their own strategic objectives by increasing investments abroad, a third component of liberalization -- maintaining the proper functioning of the market -- becomes important, and competition policy is central here. The issues addressed in this Part of *WIR97* round out, therefore, earlier discussions of FDI liberalization and related regulatory frameworks, including in reference to international investment arrangements.

More specifically, Part Two of this *Report* examines the relationships between FDI, market structure and competition (chapter IV) and considers policy implications, especially as they relate to developing countries (chapter V). Foreign-direct-investment-related competition issues deserve increased focus because TNCs play an important role in the globalizing world economy. The first of the chapters that follow examines the interaction between FDI, market structure and competition in product markets in the national economies of host countries. It also examines the evolving nature of this relationship in the context of the regionalization or globalization of markets and production and, especially, the emergence of integrated international production. The next chapter discusses the implications for policies aimed at maintaining the contestability of markets and ensuring that markets function as competitively as possible. Considerations related to competition and competition policy become particularly relevant for developing countries as they liberalize and become more closely integrated into the world economy -- albeit to different degrees and in different ways. Balancing efficient resource-use with dynamic growth of their economies presents new challenges for countries

as regards maintaining policy coherence, as well as formulating and implementing competition policy. This introduction highlights the main issues and questions that Part Two will address and introduces the key terms and concepts that will be used in the analysis.

The ultimate objective of FDI liberalization is to enhance economic growth and welfare. Developing countries, in particular, have increasingly turned to FDI as a source of the capital, technology, managerial know-how and market access needed for sustained economic growth and development. The move towards more open FDI regimes has been accompanied by a shift in many countries towards greater deregulation of economic activity and greater reliance on market forces in their domestic economies, as well as on international trade and factor movements (especially those relating to capital and skilled human resources). Liberalization has contributed to increased FDI flows to countries with those economic characteristics that TNCs find attractive, and has promoted more complex and integrated patterns of international production by TNCs. However, the benefits that result depend not only on the volume of the resource flows, but also on how competitive markets are and how efficiently the industries and economies in which TNCs operate function. In addition, the equitable distribution of the benefits may not be easy to achieve. The pain of adjustment to competition is all the more severe when FDI liberalization, trade liberalization and domestic economic reform go hand in hand, as is the case of many developing countries today.

"Economic efficiency" refers to a situation in which participants in an economy make economic choices that accurately reflect the relative scarcities of goods, services and resources available for consumption and production. When production and consumption take place efficiently (box 1), the economic welfare of a society (the consumers and producers taken together) is maximized, in the sense that it is not possible to make any member of the economy better off without making someone else worse off. In other words, moving from a situation of inefficiency to one of efficiency can make all members of a community better off, assuming that ways can be found by which the gainers can compensate the losers. In general, efficiency, broadly defined in dynamic as well as static terms (box 1), not only maximizes welfare, but also supports and strengthens economic growth and development. However, the adjustment costs involved in implementing efficiency-enhancing policies should not be underestimated. Furthermore, there may be reasons to limit the pursuit of efficiency as an immediate economic objective. Such reasons often reflect competing objectives, including, in particular, development considerations, and they depend, among other things, on the importance attached to competing objectives and the degree of difficulty perceived in pursuing them through measures that do not distort market behaviour and diminish efficiency.

In market economies, competition among firms and among consumers provides the incentive for firms and consumers to behave in a manner that leads to efficiency. In economies that have opened up to FDI, therefore, the efficient operation of industries with TNC participation, and of the economies as a whole, depends on the extent and nature of competition that prevails. In particular, it depends on whether FDI liberalization does, indeed, inject greater contestability into these markets, and whether greater contestability is, indeed, maintained.

"Contestability" refers to the ease with which firms can enter and exit a market. A market is deemed to be fully contestable if: (I) the suppliers are sufficiently numerous for none of them, acting alone or in collusion with other suppliers, to be able to raise prices above average cost, yielding super-normal profits; or (ii) entry into the market is sufficiently easy that, if incumbent suppliers

Box 1. Market competition and performance: key concepts and theories

Competition in a market refers to rivalry among the sellers and among the buyers of a good or service; the sellers and buyers that can enter the contest constitute the market. The extent and nature of market competition is considered important in determining the performance of economic systems. Under static conditions (i.e., under given conditions with respect to technology or resources), economic performance is judged in terms of efficiency, which has two elements:

- Technical efficiency, which exists when the production and distribution of goods take place with minimum inputs, given technological constraints.
- Allocative efficiency, which exists when resources are allocated in the optimal manner -- that is, they cannot be reallocated among parties, or production and distribution reorganized, to serve better the demand for goods and services.

As mentioned, however, these concepts refer to performance under given technological constraints. A third concept, that of "dynamic efficiency" or efficiency under conditions of technological change, becomes important in order to assess performance over time. It refers to the rate at which technological constraints change over time and new products are added to the feasible set.

The relationship between competition and economic performance was traditionally described in terms of the "structure-conduct-performance" (SCP) paradigm, according to which economic performance in a well defined market depends upon the interaction between the structure of the market and the conduct of buyers and sellers in the market (Boner and Krueger, 1991, p. 3). As originally interpreted, this theory held that market structure, as captured mainly by the concentration of sellers and barriers to entry, was the primary determinant of both conduct and performance. At one extreme of perfect competition (with very large numbers of sellers and no barriers to entry, among other conditions), no seller has the power to influence, on his or her own, the price (or terms) at which a product is sold; at the other extreme, monopoly, the seller has the power to set the price (or terms) most advantageous for her/him. A great majority of market situations fall between these two situations and involve imperfect, but workable competition. In such markets, high levels of seller concentration, protected by entry barriers, provide fertile conditions for collusive practices, which will lead to high price, and perhaps costs (Bain, 1959).

More recent economic theory and empirical research have, however, established that both "competition" and "market structure" are, in practice, multi-faceted concepts, and that the relationship between the two defies simple generalizations, especially when deriving policy prescriptions:

- Most obviously, in a world in which many products are differentiated, consumer welfare does not depend on price alone -- product variety, quality and innovation are all crucial, and there is little evidence that large numbers, or the absence of concentration, necessarily fosters better performance on these counts.
- As shown in contestable market theory (Baumol *et al*., 1982), even highly concentrated industries will be forced to price "competitively" if they face the discipline for potential "hit and run" entry (see box 2). Thus, concentration is not the most important dimension of market structure; contestability (or free entry and exit) is key, and here, the main factor is the extent to which entry requires expenditures on sunk costs: without sunk costs, incumbent sellers, even oligopolists, will always be vulnerable to the rapid entry of new firms, and thereby be unable to exploit their apparent market power. Of course, many real world industries are, in fact, characterized by substantial sunk costs, and this may often deter *de novo* domestic entry. However, the market may still be contestable to competition from foreign firms which have already incurred the necessary sunk costs elsewhere or which may have resources superior to those of potential domestic rivals. Whether they enter by exporting or through FDI, their presence may render even markets for products of domestically concentrated industries in a particular location inherently contestable.

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(Box 1, cont'd)

This raises, of course, the question of the relevant market. The appropriate scope of a market in terms of the products to be included is usually defined in terms of products that are sufficiently close in attributes that a rise in the price of one will induce consumers/buyers to substitute the other. However, in an increasingly globalized world economy, the geographic scope of the market also needs to be defined -- it might be national, regional or global. The level of concentration of domestic producers in a given country may tell us very little about the *extent of competition between sellers* in that market (or the market for their product). This is most obviously the case within blocks of countries, such as the European Union, in which, as markets become increasingly integrated, the concentration of producers in a particular country may be of no more relevance than was the concentration of producers within a particular region of a national market before integration took place (Davies, Lyons *et al*., 1996).

- Furthermore, as boundaries blur between industries and new products emerge that are based on technology discontinuities and on combinations of generic technologies from across hitherto distinct industries, identification of the market becomes more difficult (Delapierre and Mytelka, forthcoming).

- Market structure and concentration are themselves the product of the competitive process. It has been argued (Demsetz, 1973) that the reason why firms in concentrated industries earn higher profits is not because they set higher prices, but, rather, because they are more efficient. It is this greater efficiency which enables them simultaneously to secure dominant market positions and high profits. A somewhat similar message emerges from some modern game theoretic analyses of market structure (e.g., Sutton, 1991), which show how tougher competition between incumbent firms may itself *cause* higher concentration; the reason is that competition means lower prices, and lower prices force out marginal producers, while offering less favourable prospects for new potential entrants.

Modern theory also highlights the importance of understanding the nature of the competitive game, and the types of competitive weapons firms use. In particular, where goods are differentiated and/or technologically sophisticated, competition may involve heavy and escalating outlays on advertising and research and development, as incumbent firms strive to enhance the quality (either actual or perceived) of their product, and new innovative firms enter the market. This is relevant for at least two reasons: first, it underlines the earlier observation that consumer welfare does not depend on price alone; second, these types of expenditure are invariably sunk costs. Thus, the competitive process may itself give rise to ever-escalating sunk costs, making new entry difficult and the market less contestable. There is growing evidence (e.g., Sutton, 1991; Davies, Lyons *et al*., 1996) that, in many such markets, market enlargement (and, by implication, globalization) may not result in falling concentration; rather, as the market expands, sunk costs increase apace, and there is the possibility that a stable and tightly-knit oligopolistic group will continue to dominate (or emerge), unconstrained by the competitive discipline of potential entry. On the other hand, as long as markets remain contestable, competition through innovation may ultimately contribute more to economic performance by expanding production possibilities than competition through price or other variables that merely ensure the best use of existing production possibilities.

In sum, there is no simple (inverse) mapping between concentration and the state of competition in a particular market. If “structure” is to be a concept of operational relevance, it cannot be simply equated to concentration: market contestability and openness to trade and FDI competition are equally important. It is also important to define the scope of the effective market appropriately and to acknowledge that the nature of the competitive process will differ importantly depending on the innate nature of the product(s) involved.

Source: UNCTAD.

tried to raise prices substantially, new entry would be likely to occur. In either case, firms would hesitate to increase prices substantially, because of risk of loss of market share (boxes 1 and 2). Thus, fully contestable markets (which may rarely exist in reality) are necessarily highly competitive. More generally, the greater the ease of entry to (and exit from) a market, the more competitively and hence, efficiently, it functions. In the context of a national market, this would refer to ease of entry by domestic producers/sellers, by foreign producers selling the product through international trade, and by TNCs engaged in FDI (or non-equity arrangements) for production and sale in the market.

Box 2. Contestability of markets

The concept of "contestability" emphasizes the role that potential competition plays in disciplining the behaviour of firms. According to the contestability theory of markets, even highly concentrated markets would function as if they were competitive if entry and exit are free enough that the potential entry of competitors will force incumbents (even in a two firm oligopoly or in a monopoly) to behave as if they were price takers in a highly competitive market (Baumol *et al*., 1982). In a highly contestable market -- one characterized by "ultra-free entry and exit" -- any supra-normal profits arising from the exercise of market power will result in "hit-and-run" entry by new firms, the erosion of market share for incumbents and a subsequent return to competitive behaviour on the part of these. The requirement of ultra-free exit implies that there are no (or very limited) sunk costs to act as barriers to entry. The contestability paradigm -- which has yet to be established through rigorous and extensive empirical testing -- therefore considers ease of entry and exit as the salient characteristic of market structures that give rise to efficient outcomes. The concept of contestability associated with the paradigm focusses upon the "entry and exit" characteristics of industries with a view to developing a conceptual framework that would allow for more informed regulatory decisions related to these market structures and competition in specific industries.

A more recent literature has applied the idea of contestability to an analysis of the broader policy framework and structural factors that affect the ease with which foreign firms can enter into and serve national markets, be it through trade or investment (OECD, 1995; Lawrence, 1996; and Feketekuty and Rogowsky, 1996). The term "contestability" is used in this literature mainly to emphasize that the ability of foreign suppliers to serve markets depends on both the ease with which firms can *enter* an economy (which, in turn, depends on the removal of impediments at the border) and the ease with which they can actually participate in that economy's markets (which depends upon many other factors that serve as impediments to firms' operations as producers and sellers). This new contestability literature differs in several respects from the "contestability theory" literature. For example, whereas the latter emphasizes the importance of both free entry and exit, the former largely focuses on the issue of entry. One reason for this is that, while exit from a micro-economic perspective involves the termination of a firm's activities in a particular industry, exit of a foreign firm from a particular national market relates only to a firm's activities in that market; the issue of sunk costs as an impediment to exit is therefore muted in the new contestability literature to the extent that sunk costs related to foreign market participation constitute a smaller share of the firm's total sunk costs.

Another difference relates to the attention paid to government policies. The earlier --contestability theory -- literature emphasized the structural characteristics of particular industries (or markets) and their implications for potential competition and the application of competition law. In contrast, the more recent contestability literature has a broader policy-focus, and draws attention to the role played by trade and investment policy, competition policy, government regulation, technology policy, government procurement, corporate governance, standard setting and tax policies (Lawrence, 1996, p. 32) in achieving contestable markets.

Source: UNCTAD.

Governments rely on a number of policies and policy instruments to maintain the contestability of, and competition in, their markets for goods and services: trade policy, including the rules governing the supply of goods and services through international trade; FDI policy, including the rules governing the entry and participation of foreign enterprises in production (and sales); competition policy, including the rules governing arrangements among firms/suppliers and the conduct of individual firms/suppliers generally (but not exclusively) in a national market; and other policies related to economic activity that affect market transactions.

There is a high degree of inter-dependence between trade policy, FDI policy and competition policy. Appropriately configured, these three policy tools can be mutually reinforcing and ensure that markets function effectively to promote efficient resource allocation and economic development. Indeed, failure to achieve proper coherence between the three can lead to distortions and reduced welfare gains. For example, if investment policies are liberalized but trade policies remain restrictive, the scope for foreign affiliates and domestic firms to abuse their market power is much increased, because they are shielded from an important source of competition in the form of imports. Conversely, free competition from imports will enable the market to check the propensity for abusive practices such as collusion, price-rigging and profit-gouging. In the case of activities that are insulated from trade competition -- in particular, non-tradeable services -- FDI becomes the principal modality of competition by foreign providers; the role of competition policy, both for maintaining competition in markets generally and as a critical element in the process of FDI liberalization, therefore, assumes greater importance, since one important source of competition (imports) is lacking. Considering that services account for more than half of GDP in all developed countries, and contribute the single largest sector in most developing countries, this makes both FDI policy and competition policy important for increasing the contestability of many markets.

Investment liberalization can be expected to make product markets more contestable in so far as it reduces formal barriers to market entry by foreign firms seeking to establish operations to produce for local sales, and allows incumbent monopolies or cartels to be challenged. Ease of entry for the establishment of operations by foreign firms in export-oriented production would, moreover, affect the contestability of the market(s) -- national, regional or global -- to which their output may be exported.

Since FDI involves production, the initial impact of its entry will be on the contestability of the markets for the factors of production on which TNCs draw for their production operations. This has implications for competition in the factor markets concerned -- an issue (beyond the direct purview of this volume) that is of interest particularly with regard to markets for non-mobile factors of production, including, especially, labour (UNCTAD-DTCI, 1994). It is also of relevance because of the links between factor and product markets: FDI contestability in product markets will depend on, among other things, ease of entry into factor markets in host countries.

Increased contestability by means of FDI can generally be expected to increase competition in the product markets concerned. The actual relationship between FDI and competition involves, however, the interaction of FDI with three interrelated variables:

- The structure of the markets -- national, regional or global -- for the products of the industries in which FDI takes place. Transnational corporations tend to enter industries with a relatively high concentration of firms in production; this often translates into a concentration of sellers

in the markets for their products. This suggests that opening up industries and their markets to TNC entry increases contestability. However, the ownership-specific advantages of TNCs might sometimes give them sufficient lead over single-nation competitors to create a new pattern of concentration in which the former assume a dominant role. But concentration within national markets is not necessarily important if there are no barriers to entry and exit (see boxes 1 and 2); where such barriers exist, there is greater potential for anticompetitive business practices by dominant firms, including TNCs. This also applies to regional or global markets.

- The conduct of firms in the markets involved. The business practices or conduct of TNCs (as of other firms) can also affect competition directly or by influencing market structure. Of particular interest here are entry barriers that might be erected in an industry, as well as anticompetitive practices (including restrictive business practices), especially by TNCs that acquire dominant positions and that can benefit from their transnational character. Apart from business practices of firms that replace regulatory impediments to entry with private impediments, accepted business practices that characterize specific markets but pose special difficulties for new foreign entrants are receiving increased attention.

- Government policy and practices. The relationship between FDI and competition may also be influenced by public policy and practices that are not explicitly related to FDI restrictions or standards of treatment, but which frequently continue in spite of FDI liberalization. Of particular importance are government policies and actions aimed at attracting foreign investors, especially when major investment projects are at stake. Exclusive or monopoly-type inducements that grant legally protected market power may be given to TNCs by governments, either because they are considered necessary to attract an investor, or because they are required by firms as a precondition for undertaking an investment; such inducements, by definition, undermine the pro-competitive effects of FDI. (Naturally, similar protection can also be given to domestic private or state-owned companies for various reasons -- such as, for example, building "national champions" -- with similar scope for anti-competitive effects; these are not within the purview of this volume.) Also important are various exemptions from competition legislation (for example, of corporate governance practices that impede contestability) that act as impediments to FDI. What is common to all of these policies and practices is that they do not allow the pro-competitive effects of FDI to occur and therefore undermine the prospects for enhancing contestability through FDI liberalization.

The relationships between FDI, market structure and competition have several implications for policy. In particular, as countries progressively liberalize their trade and FDI policies and therefore increasingly exhaust the potential of these policy tools to contribute to greater contestability of their markets, the relative importance of competition policy as a tool to increase further and maintain contestability rises. This is not to suggest that trade and FDI policies (and, indeed, other domestic policies, such as deregulation and privatization) have already exhausted their potential to contribute to greater contestability -- in fact, changes that have taken place in this respect vary greatly among countries and industries. Moreover, there are policy objectives other than contestability, and these may require different policy approaches. And, in any event, it is not easy to put in place a well functioning competition policy. Nevertheless, in a liberalizing world economy competition policy is likely to acquire, in the long term, the status of *primus inter pares* among policy tools used to promote contestability and ensure competition. Given that other aspects of the liberalization of FDI and trade policies have been discussed earlier, special attention is therefore given in this volume to the interface of competition policy and FDI.

The task of assuring consumers and entrepreneurs that efficient outcomes are not being disturbed by anti-competitive practices, including restrictive business practices, is likely to become more complex. Given the oligopolistic structures of many of the industries in which TNCs operate, and the competitive strengths that a number of firms have in those industries, liberalization could increase their market power. Another factor that underscores the importance of competition policy in a liberalized environment is the concentrated market structures prevailing in many national economies, especially developing economies, that have liberalized. Therefore, policies related to mergers and acquisitions, as well as business practices, would assume greater significance with FDI liberalization. Countries that have not adopted competition laws might find it increasingly necessary to do so, and some countries that do have such laws might need to strengthen their provisions and the institutional capabilities for implementing them. With regard to implementation, this includes competition authorities taking into account explicitly -- and perhaps even on par with domestic producers and imports -- new FDI when considering supply responses. This is particularly relevant as FDI has become more important than trade in delivering goods and services to foreign markets, and as FDI is by far the most important mechanism for such delivery when it comes to services.

While the competitive and efficient functioning of markets is the overriding objective of competition policy, the balancing of efficiency objectives with competing objectives is a task facing policy makers in both developed and especially developing countries. For example, although concentration remains a rough parameter triggering competition concerns, many governments now apply competition policy in this regard in a flexible manner, permitting highly concentrated markets -- especially where market imperfections exist -- because these are seen as yielding dynamic efficiency outcomes. In other words, limitations exist with respect to competition in the interest of long-term economic growth. This has been the case, for example, as regards competition among firms -- generally TNCs -- in industries with high research-and-development costs or network-related scale economies.

For policy makers in developing countries, the challenge of identifying and pursuing policies and measures conducive to achieving their long-term economic development objectives, while ensuring the positive benefits of increased contestability and competition through FDI liberalization, is particularly complex. Coherent and mutually supportive policies balancing static and dynamic efficiency considerations, as well as other economic and social objectives, are required if competition policy is to support sustainable development (box 3) and, given the characteristics of industries and markets in developing countries, this is not easy. Furthermore, resources and institutional capabilities need to be strengthened if competition authorities in developing countries are to enforce competition rules, advocate competition before their own governments, and educate firms and consumers on the benefits of competitive markets.

Finally, the increasingly regional or global nature of markets and underlying production structures more and more limits the extent to which competition policy can be pursued successfully at the national level. Correspondingly, it increases the need for international cooperation on competition issues. The scope for international cooperation is greatest as regards the exchange of information and finding effective remedies to competitive abuses. Indeed, competition rules may, ultimately, be needed at the international level. These and other policy issues are pursued in chapter V.

Box. 3. Competition, development and competition policy

Competition allows the market to reward good performance and to penalize poor performance by producers. It thus encourages entrepreneurial activity and market entry by new firms, and also provides a stimulus for enterprises to become more efficient, to invest in the production of a greater variety of, or better-quality, products at prices close to costs, and to create new products. This enhances consumer welfare (including for business users of intermediate inputs, whose product quality and cost structure is improved by competition among their suppliers), efficient resource allocation throughout the economy, growth and, ultimately, development.

In the past, many countries, particularly developing countries, have seen competition as leading to excess capacity or diseconomies of scale, and they have also been concerned about weakening the market position of national enterprises vis-à-vis foreign firms. Such concerns have decreased in recent years as it has been realized that exposure to competition is generally the most effective way of promoting the ability of firms and industries to perform effectively in international markets (subject to competing objectives). Conversely, the key role that competition can play in increasing efficiency and, thus, in supporting development, has been better appreciated.

This shift in perception has contributed to the widespread adoption of market-oriented reforms promoting competition. These include deregulation, price liberalization, demonopolization, privatization, removal of barriers to market exit (such as subsidies) and liberalization of trade and FDI policies.

In parallel with these reforms, many countries from all regions have also adopted competition policies, or reformed existing policies and strengthened their implementation. Amongst other things, competition policy seeks to promote competition through the liberalization of governmental policies and measures where they unduly distort competition. Indeed, many governments have tried to ensure that the principles of competition policy are duly taken into account when developing and implementing other governmental policies (competition policy authorities are often given an advocacy role to play in this respect). Competition policy is also concerned with the enforcement of rules of the game to ensure that enterprises do not undertake restrictive business practices and, again, many governments have attempted to ensure that incumbent firms do not take advantage of liberalization to "privatize" governmental restraints and block market entry -- particularly as there may be many disincentives to market entry in developing countries, such as small market size, limited availability of entrepreneurial or technical skills or production inputs, or inefficient distribution and communications systems.

This does not mean that competition policy is formulated and implemented in a doctrinaire and inflexible manner. For example, action against restrictive business practices is usually taken on the basis of economic analysis, which may take into account the likelihood of market entry (including actual or potential competition from imported goods) and efficiency considerations (including economies of scale and the competitiveness of national firms in domestic and overseas markets). Other public interest criteria may be taken into account as well. In several competition laws, exemptions from restrictive-business-practice controls (or relatively lenient controls) may be provided for some types of practices or for joint ventures, for some industries, for small transactions or for cooperative arrangements among small enterprises. Competition principles may also sometimes be modified in respect of some policies relating to trade or industrial promotion.

In the context of developing countries, flexibility in applying competition policy may be even more necessary in order not to impede efficiency, growth or development goals, and policy coherence should be ensured between competition policy and other policies aimed at promoting development (chapter V deals in more detail with such aspects of the development dimension, while box V.18 describes some provisions of the Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices relating to special and differential treatment of developing countries in this area). However, while pragmatic compromises may sometimes be justified, the misuse of efficiency arguments by vested interests needs to be guarded against, and the momentum of progressive movement towards competitive markets should be encouraged. This requires a strong competition authority with the mandates and resources to enable it to act as an effective "watchdog" for competition.

Source: UNCTAD.

Note

[1] For a more detailed discussion of the dimensions of the FDI liberalization process, see UNCTAD, 1994, chapter VII, and UNCTAD, 1996, Part Three.