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## Institutional Analysis of Competition Policy in Transition and Developing Countries: The Lessons from Latin America

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# INSTITUTIONAL ANALYSIS OF COMPETITION POLICY IN TRANSITION AND DEVELOPING COUNTRIES: THE LESSONS FROM LATIN AMERICA\*

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This Article explores how institutions in developing countries shape competition policy-making and regulatory reform, the implications of this process on the adoption of a pro-market strategy to promote development, and the implications of its application to a country transitioning from a command economy to a market economy such as China.

Institutional analysis is important for two reasons. First, it enables us to highlight the decisive role of social arrangements in shaping the way a policy aimed at changing institutional structures, like competition policy, is understood and enforced. This is important because institutional change creates unexpected challenges as market forces increasingly replace central planning as the driving force in allocating social resources. If not properly addressed, such challenges could frustrate the whole transition process.

Second, exploring the role of institutions the development of competition policy raises important and controversial issues of law and economics, which scholars have not yet settled. In particular, institutional analysis overcomes some of the limitations of conventional economic and legal theory, which, due to its excessive emphasis on logical positivism, has blinded policy-makers to the fundamental role of institutions' values and beliefs in enforcing social rules, thereby precluding a richer appraisal of social reality.

Scholars usually agree institutions are defined by ideas, routines, and beliefs.<sup>1</sup> But in order to assess their impact, we must examine the impact of these values and beliefs on the conduct of those involved in executing the policy. For example, we know that stronger institutions improve economic performance, but what does that imply? How do institutions

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1. See DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE 3 (1990).

impact individuals' actions? How do we build stronger institutions in developing countries to enforce competition policy?

To understand the impact of social institutions on competition policy enforcement, this Article suggests that competition policy enforcement is influenced by a combination of institutional factors that create positive incentives to encourage specific policy outcomes. The institutional factors influencing competition policymaking can be organized at three levels:

1. the organizational level which refers to the structure of the decision-making process, creates external constraints on policymaking that influence the expediency of policy decisions;
2. the ideological level which includes the personal beliefs of the policymakers, determines the policy priorities and normative choices of the decision-maker towards business arrangements; and
3. the cultural, social level which refers to the set of social values within which the competition authority applies the policy, determines the long-run sustainability and legitimacy of the policy.

This Article will examine the extent of each level's influence and propose some guidelines for policy enforcement for the institutional constraints prevailing in a transition economy such as China's.

#### I. ORGANIZATIONAL STRUCTURE OF COMPETITION AGENCIES AND ITS INSTITUTIONAL IMPLICATIONS ON THE EFFECTIVENESS OF POLICYMAKING

Institutional analysis first examines the structure of the social organization that determines given political outcomes. It explores the impact of organizational arrangements that are set up by legal rules and impact the incentives of those involved in the policy enforcement "game." In other words, we examine the effect of legal rules on the conduct of the decision-maker, lawyers, expert witnesses, prosecuted firms, businesses in related sectors of the economy, and judges. In this analysis, policy enforcement is the outcome of a game the rules of which are determined by the given set of organizational arrangements embodied in the competition law of the jurisdiction concerned.<sup>2</sup>

Research from several economic schools has contributed to the development of this perspective of institutional analysis, which some refer to as the "New Political Economy." For example, Public Choice theory

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2. See DANIEL A. FARBER & PHILIP P. FRICKLEY, LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION (1991).

has emphasized the allocation problems that emerge in political markets whenever policies are made.<sup>3</sup> Neo-Institutional Economics theory focuses on the impact of institutions on individual incentives and the resulting effect on economic performance.<sup>4</sup> Additionally, Law and Economics theory argues that the legal system is simply a system of economic maximization, and that laws must be examined using economic principles and price theory.<sup>5</sup> Finally, the Economics of Regulation theory explains how private businesses might have incentives to capture regulatory authorities.<sup>6</sup>

The unification of these theories provides a new perspective of the law, beyond formal interpretation of the mere wording of legal rules. In competition policy, these theories challenge the conventional idea that policies will achieve their goals and objectives if well-intentioned officials, guided by the pursuit of the public good, implement them. The New Political Economy gives us a less optimistic (or perhaps more balanced) view, suggesting that achieving the goals and objectives of a given policy depends entirely on the incentives of those implementing the policy.

Based on the analytical tools of the New Political Economy, scholars suggest that the effectiveness of competition policy ultimately rests on both the internal organization of the competition authority and the external control exercised over the enforcing agency, most notably, by the judiciary and the government itself. These factors will impact the authority's power to impose fines, declare injunctions, request information from the business sector, remain isolated from undue influence by political forces in the government and the business community, and exercise prosecutorial powers.

Thus, the effectiveness of competition authorities initially lies in the agency's internal organization and its power to implement its decisions. Competition authorities take the form of most government authorities (i.e., a specialized administrative agency vested with powers to investigate, prosecute and decide cases brought before it). In Latin America, most

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3. An introductory review on public choice can be found in DENNIS C. MUELLER, *PUBLIC CHOICE* (1979). See also James M. Buchanan, *Politics without Romance: A Sketch of Positive Public Choice Theory and Its Normative Implications*, in *THE THEORY OF PUBLIC CHOICE-II* (James M. Buchanan & Robert D. Tollison eds., University of Michigan Press 1984).

4. See generally DOUGLASS C. NORTH, *supra* note 1; see also Richard A. Posner, *The New Institutional Economics Meets Law and Economics*, 149 *J. INSTITUTIONAL & THEORETICAL ECON.* 73 (1993).

5. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 15-16 (1977).

6. See generally George J. Stigler, *The Theory of Economic Regulation*, 2 *BELL J. ECON. & MGMT. SCI.* 3 (1971).

competition authorities take this form, either as a body corporate commission (e.g., Argentina, Costa Rica, and Mexico), or as a single-authority superintendency (e.g., in Colombia and Venezuela). Because of this organization these authorities are subject to judicial control, or occasionally, to political control in specific matters (e.g., merger and acquisitions in Spain). Alternatively, competition authorities may take the form of independent public prosecutors whose role is to investigate markets and bring cases before the specialized judicial entities.

As always, there are advantages and disadvantages to adopting either scheme. Administrative entities may enjoy more flexibility in enforcement actions, because they handle the entire antitrust case, from investigation to final disposition. However, consolidating these activities under a single authority may inject rule-of-law problems, because of the personal involvement of the prosecuting authorities in the investigation. Due to the potential lack of protection for individual's rights where one body determines the outcome at all stages there may be problems, especially in a country that lacks experience implementing that particular policy. It may be very difficult for the same people who carry out an investigation and bring a case against a business, not to find the investigated party guilty as charged. This could create considerable uncertainty in the business community and have negative effects on further investment.

Another feature of administrative entities is their close relationship with the government in general, which has advantages and disadvantages. One advantage is the likelihood of effective involvement in regulatory reform initiatives. Regulatory reform is probably the single most important contribution that a competition authority can make to the transition process. However, competition authorities can also interfere with the government's objectives, because their proposals contradict many of the government's anticompetitive policies. To ensure a fruitful relationship, safeguards must be established to preserve the independence of the competition authorities, in financial and functional terms, as well as in its recommendations on regulatory reform. The most recent Latin American competition laws, vest competition authorities with powers to judicially challenge anticompetitive regulations enacted by governments.<sup>7</sup> However, these powers are rarely exercised in deference to a cooperative rather than confrontational approach.

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7. The most notable example is the Costa Rican Law to Promote Competition and Defense of the Consumer, Promoción de Competencia y Defensa del Consumidor, D.O., 4 de Septiembre de 1995.

Judicial entities have limitations as well. In general, courts are unfamiliar with the economic substratum underlying market functions; their decisions frequently rely on formalities and “black letter” law rather than a substantial examination of the issues. Yet, in a democracy, courts have obvious advantages over government entities in terms of sufficient investigative powers, as well as injunctive authority, which may be necessary to preempt anticompetitive behavior. Finally, judicial authorities are more independent from the government than administrative commissions, which is crucial for the success of competition policy.

After weighing the advantages and disadvantages of administrative versus judicial competition authorities, some Latin American countries have opted for hybrid structures for their competition agencies rather than strictly adhering to administrative or judicial models. In Peru, for example, the competition authority is an administrative commission that investigates, prosecutes, and decides cases. However, a specialized administrative tribunal on competition enforcement reviews its decisions, thereby providing external controls. An important feature of this scheme is that the competition tribunal is also vested with powers to review matters that are closely related to market supervision, such as intellectual property issues, anti-dumping and subsidies claims, consumer protection issues, and unfair competition matters. In this way, the Peruvian scheme ensures that the tribunal covers a broad (yet, closely related) range of subjects, so that its portion of the national budget is justifiable.

In conclusion, the effectiveness of the policy depends on ensuring that enforcement procedures integrate the three prosecutorial stages, thereby balancing effectiveness with preservation of impartiality in decision-making. In ensuring both ends, it is fundamental that the authority have the necessary powers, while also guaranteeing the professionalism of the officials handling the cases and the impartiality of those deciding them.

## II. THE EFFECTS OF IDEOLOGY ON THE CHOICE OF POLICY DECISIONS

Institutional analysis is useful to explore the extent to which policy decisions are influenced by the decision-makers’ beliefs, values, and perceptions about the real world that they must appraise and judge.

It may seem counterintuitive to argue that decision-making is ultimately based on ideology, not science. However, policy decisions are, overall, basically moral decisions about social welfare. Hence, they comprise value judgments on how to achieve well-being. Contrary to popular belief, policymakers are not immune to the influence of ideology; on the contrary, they embrace it as part of their ordinary policy-making

activities. This fact is often dismissed. There seems to be a prejudice against the idea that policy choice ultimately rests on ethics, not science. There is likely an underlying fear of being regarded as less “objective” or “impartial” in the decision-making process. The tension in policy-making is evident. On one hand, policymakers strive to preserve their image as impartial actors, which is essential for convincing the business community of the transparency of their decisions. On the other hand, their activities require them to achieve a state of social welfare, which could result in eroding the property rights of some individuals at the expense of others. Therefore, the implementation of such a system could overturn their endeavors to preserve the rule of law.

It is clear then that science is not a value-free undertaking, especially in the realm of normative economics, from which competition policy draws many of its inferences and conclusions about economic causation and market behavior. Competition policy entails value choices about social resource allocation. There are some who believe that such allocation should be based on economic efficiency, and others who believe that other socially valuable goals, such as market integration or the protection of smaller competitors, should bear some weight in the allocation. The former view is commonly associated with policy-making in the United States, whereas the latter is associated with policy enforcement in the European Union.

In support of their view, Americans claim that economic efficiency is much more transparent and predictable than other social welfare goals. In addition, they claim that it is not the goal of competition policy to seek social justice; indeed, other policies such as taxation and subsidies specifically target this concern much more effectively. The Europeans contend that other values are equally important. Nevertheless, over the years, European policy enforcement has yielded to the efficiency standard. Thus, there seems to be a growing consensus towards accepting economic efficiency as the guiding goal of competition enforcement endeavors.

To be sure, in order to remain “transparent,” competition policy should avoid becoming involved in ideas of “distributive justice.” However, it is unclear whether economic efficiency (much less “distributive” criteria, such as equity) provides policymakers with a clearer standard to follow or makes decision-making more predictable or transparent. In fact, a closer look reveals that the strict enforcement of the Pareto efficiency standard would undermine the rule of law, and could become a potential hinderance to achieving market competition.

To understand this concept, it may be useful to examine the essence of the efficiency standard, and its working on the mental framework from

which the policymaker derives specific normative conclusions about business behavior. Such normative conclusions are based on a contrived market view that is epistemologically flawed.

The next part explains why implementing social welfare goals like economic efficiency might undermine rather than promote competition in the marketplace.

#### *A. The Nirvana Mindset and Social Policymaking*

The lure of economic efficiency is rooted in the policymaker's quest to achieve a utopian standard of social welfare through targeted intervention. This idea stems from the assumption that policymakers can attain a complete picture of the underlying factors that comprise social reality, and regulate it to attain social welfare. However, to achieve this, policymakers must meet two conditions. First, they must possess the adequate analytical tools to understand and appraise reality properly. Usually, they refer to market "models," which enable them to capture the essence of market forces. Therefore, an in-depth exploration of the nature, meaning, and epistemological flaws of these models is necessary to understand why policymakers' picture of reality is often dimmed.

A second condition for attaining social welfare is to identify what exactly optimality entails in terms of the costs that the social system (i.e. governments and entrepreneurs) must bear to reach this ideal point. Indeed, it is pointless to attain social welfare if the costs of achieving it largely exceed those benefits accruing from reaching Nirvana. Nevertheless, policy-makers often take for granted the costless nature of such an exercise. This phenomena flows from the belief that the goal of social policymaking is to recreate a world without costs.

These two premises are deeply ingrained in the minds of policymakers. They stem from the Cartesian assumption that reality is an objective self, located outside the individual mind, which we can fully appraise and understand.<sup>8</sup> There converts social policymaking into a "pretense of knowledge" where "optimality," "social welfare," and other synonymous expressions of "social perfection" appear accessible and become a moral imperative on the shoulders of policymakers.

This Nirvana mindset equates to the attainment of "perfect justice." As a goal of policymaking, perfect justice requires rooting out error in every

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8. See generally F. A. HAYEK, *LAW, LEGISLATION AND LIBERTY*, VOL. 1 (University of Chicago Press 1973).

case, regardless of the costs involved.<sup>9</sup> Similarly, Thomas Sowell refers to “cosmic justice” or justice that is cost-free and takes into account the particular welfare position of each individual in society so as to level its condition to that of the rest.<sup>10</sup> Sowell criticizes this endeavor on the grounds that it is impossible to devise an ideal standard of equality that would satisfy the individual condition of everyone alike given the costs involved in such efforts. Thus, “with justice, as with equality, the question is not whether more is better, but whether it is better at all costs.”<sup>11</sup>

In Sowell’s view,

those pursuing the quest for cosmic justice have tended to assume that the consequences would be what they intended—which is to say, that the people subject to government policies would be like pieces on a chessboard, who could be moved here and there to carry out a grand design, without concern for their own responses.<sup>12</sup>

Similar concerns arise in economic science and competition policymaking. Those who support economic efficiency and consumer welfare base their views on the Pareto efficiency standard. The normative reference stems from the assumption that markets resembling the perfect competition model are “optimal” and enhance social welfare. Substitute standards, such as “Workable Competition,” follow the same logic, namely, that somewhere in our minds we can devise models enabling us to see how things would be different if we lived in a world without market failures.

Conventional wisdom of competition policy tells us that market failure is responsible for the sub-optimal allocation of resources. Monopolistic behavior causes such failures in markets by creating special conditions within which information asymmetries are exploited to the advantage of alleged monopolists. As a result, market performance is driven away from the optimal conditions laid down by the perfect competition model, in which production is undifferentiated, information flows freely, and firms are price takers, rather than price manipulators.

Therefore, the crux of this view is the comparison between the mental or idealized model of perfection and the reality that we perceive through our senses. This is a faulty intellectual exercise because comparing reality

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9. RICHARD A. EPSTEIN, *SIMPLE RULES FOR A COMPLEX WORLD* 38 (Harvard University Press 1995).

10. THOMAS SOWELL, *THE QUEST FOR COSMIC JUSTICE* 27 (1999).

11. *Id.*

12. *Id.* at 40.

with such ideal standards excludes from analysis two kinds of costs that are also part of reality and must be taken into account by regulations. The first is the cost of acquiring that information, which optimal regulation requires. This intellectual error considers the possibility of perfection, but ignores how hard it is for the authority to obtain the necessary information to make this a reality. Thus, compared to Nirvana, reality always appears full of "market failures."

Second, comparing reality with Nirvana neglects the costs that members of society have to bear to invest in productive actions. These actions would never take place (and therefore, could not be considered part of the regulatory analysis) in isolation, but only occur once investors have internalized their costs. This fact is a reality that regulators simply cannot afford to ignore.

Consider the following example. Imagine that we visit a children's swim club and ask the kids if they are willing to make the sacrifices necessary to become Olympic champion swimmers. We would probably get many positive responses despite the fact that perhaps only one in ten thousand young swimmers is really willing to pay the costs of becoming an Olympian. Efficiency analysis implies that we would be better off if we just asked the swimmers what they would sacrifice to make the Olympics, and then appointed those who bid the highest to the Olympic team. In the opinion of those who promote this way of thinking, this intellectual exercise would certainly save all the time it takes to do costly training. Thus, reality "fails" because many individual swimmers do spend time training even though most of them fail to make it to the Olympics.

In the world of business, such comparisons between ideal standards of perfection and the actual business world leaves the regulator with the pervasive impression that any business behavior is suspicious of restricting competition, because entrepreneurs enter into costs and limit their own possibilities of action to achieve a degree of certainty with which to pursue productive investments. From the viewpoint of efficiency, these limitations on rivalry represent a departure from the perfection competition model. It is not examined whether the limitations imposed are in fact necessary for entrepreneurs to seize a business opportunity, which, in order to happen, must necessarily displace other competitors in the market. The nature of competition entails the success of some alert entrepreneur in "getting there first," before other competitors do, but this does not necessarily mean that our entrepreneur has "gotten there" at the expense of another.

Applying the perfect competition model as a normative standard is at odds with the alleged purpose it should serve. Instead of promoting

entrepreneurial alertness to improve competition, it informs regulators that competition is less likely the further the examined market is from the idealized “perfection” of perfect competition.

In criticizing the use of the perfect competition model (or similar surrogates, such as the workable competition model) as a normative standard, Professor George Richardson, emphasized that such a model is meaningless as a normative reference, because the economist cannot simply do away with the economic organization that is necessary for economic actors to compete in the marketplace.<sup>13</sup> He highlights the inadequacy of the perfect competition model in appraising reality, because the viewpoint it adopts is one of equilibrium, whereas reality is in a permanent process of change and evolution.

Richardson’s critique is subtler than it appears on the surface. The very assumptions that would otherwise make the perfect competition model useful for policymaking purposes are in error—namely that information in the system as modeled is shared with all economic agents, thereby making equilibrium possible and bringing about perfectly competitive markets. Not only are these conditions absent in the real world, but more importantly, *the model itself* denies them. There is no other way of explaining how real social systems achieve equilibrium except by postulating that the information of the system is already known by economic agents *before* it has in fact passed to them.

Richardson says this because at equilibrium the model assumes that information has already passed to individuals who then will rest in their actions. Yet, in order for this to happen, individuals must coordinate their actions, construe routines, and create rules, which enables information to be codified and universally understood. Thus, coordination, rule creation, and standardization of market behavior drive the market away from the world predicated on the perfect competition model, where individuals act independently. It is a paradox that, in order to attain equilibrium, individuals must coordinate their actions, but the coordination leads real markets away from the world of perfect competition, where industrial organization is virtually non-existent. Thus, in the words of Richardson:

there is no reason to expect that the hypothetical market conditions which define perfect competition would in fact ensure that production would be carried on by the most efficient means, for there is no reason to believe that the supposed equilibrium position

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13. See generally G. D. RICHARDSON, INFORMATION AND INVESTMENT, A STUDY IN THE WORKING OF THE COMPETITIVE ECONOMY (2d ed. 1990).

would ever be reached. The link between market structure and the scale of investments is to be sought more in the particular modes of adjustment, than in the supposed equilibrium situations, with which the structure can be associated. Here, as elsewhere, much that is of importance has been denied adequate analysis as a result of the tyranny which the equilibrium concept has exercised over modern economic theory.<sup>14</sup>

Economic organization, business arrangements, coordination and cooperation among businesses are essential for information to flow between economic agents. But at the same time, such arrangements cause reality to depart from the equilibrium. This is a critique that is equally applicable to models of “imperfect competition” that appraise reality from an equilibrium perspective. These models assume that the information necessary to attain the optimal point is readily available to the individuals in the model’s equation. Therefore, it also undermines the efficacy of the workable competition model and the pure monopoly model as normative standards to be enforced upon reality.

However, the perfect competition model:

undoubtedly stood, for many people, as an ideal or model form of organization—strictly speaking only a logical as opposed to an ethical ideal, although this distinction was not always sharply made. It does not seem to have been recognized that the fact that ‘imperfections’, in some forms and degree of strength, are clearly an obstacle to adjustment, does not entitle one to conclude that it would be best if [market] ‘imperfections’ were absent altogether. Yet the pedagogic convenience of perfect competition, and its suitability as a base for extensive formal and mathematical elaboration, gave the system a central place in theoretical discussion.<sup>15</sup>

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14. *Id.* at 89.

15. *Id.* at 39. Klein explains the importance of the Perfect Competition model for antitrust purposes as follows: “of all the various analytical toolkits that constitute contemporary political economy, perhaps the most important model for the economist is the model of perfect competition.” B. Klein, *The Use of Economics in Anti-trust Litigation: Realistic Models of the Competitive Process in THE LAW AND ECONOMICS OF COMPETITION POLICY 420*, (F. Mathewson et al. eds., 1990). J.M. Clark argues:

The conception of ‘perfect competition’ has itself for the first time received really specific definition and elaboration. With this has come the realisation that ‘perfect competition’ does not and cannot exist and has presumably never existed [ . . . ] *What we have left is an unreal or ideal standard which may serve as a starting point of analysis and a norm with which to*

In sum, evaluating market functioning based on the standard of ideal perfection required by the perfect competition model is not only naïve (in assuming that the information necessary to attain perfection will be readily possessed by the government authority), but also misleading, because it tells the regulator very little about the true nature of the behavior in the market. The truth is that we do not live in a world of perfection, but one in which individuals must bear costs to achieve goals. Assuming that reality would be different if we were angels instead of human beings does not contribute much to the task that the competition authority is charged with—namely, promoting market exchanges. Comparing reality with perfection only leads one to misjudge the important role played by economic organizations in conveying knowledge to market participants by making such organizations look like negative forces that manipulate markets away from perfect competition.

Schumpeter warned us about this normative spin in the regulator's mind when he said:

the problem that is usually being visualized [by regulators] is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them. As long as this is not recognized, the investigator does a meaningless job. As soon as it is recognized, his outlook on capitalist practice and its social results changes considerably.<sup>16</sup>

Put simply, the Nirvana mindset is epistemologically flawed, because it induces the analyst to focus her attention on irrelevant equilibrium problems of resource allocation, which are futile for understanding how markets actually evolve endogenously.

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*compare actual competitive conditions. It has also served as a standard by which to judge them.*

(emphasis added).

J. M. Clark, *Toward a Concept of Workable Competition*, 30 AMER. ECON. REV. 241 (1940). Finally, Hayek indicated with regard to the perfect competition model that: "This ideal case came to be regarded as the model and was used as a standard by which the achievement of competition in the real world was judged". F. A. HAYEK, *LAW, LEGISLATION AND LIBERTY: THE POLITICAL ORDER OF A FREE PEOPLE*, VOL 3 (1976). Burton recently wrote an analysis on the use of perfect competition as a normative yardstick. John Burton, *Competition over competition analysis: a guide to some contemporary economics disputes*, in *FRONTIERS OF COMPETITION LAW* (Julian Lonbay ed., 1994).

16. JOSEPH A. SCHUMPETER, *CAPITALISM, SOCIALISM AND DEMOCRACY* 84 (3d 1950).

*B. Practical Consequences of the Nirvana Mindset of Competition Policy Regulators*

This Part outlines some implications of the conventional ideology embodied in the model of perfect competition on competition policy enforcement.

First, from the perspective of law enforcement, comparing frail human beings to the optimal standard of perfection leads policymakers to develop ambiguous and hesitant enforcement procedures, thereby sacrificing the rule of law and market transparency. Any level of cooperation between actors will be regarded with suspicion unless justified with economic efficiency, but such efficiency exists only in the mind of whoever enforces the policy. Therefore, no one else (e.g., a prosecuted businesses) can predict whether a particular arrangement will match the standard of efficiency devised in the regulator's mind.

The distinction between "per se" and "rule-of-reason" behavior will not help in distinguishing right from wrong. This is a legal, non-economic distinction that merely purports to spare the competition agency the costs of examining cases, which, from the viewpoint of competition authorities, appear "obvious." It can be easily seen as simply another way of saying that "per se" prohibited behavior will always be prohibited because it is already regarded as conduct that cannot ever be allowed. In other words, it is a tautology, explaining under what factual circumstances the authority should tolerate or allow restrictive behavior on the basis of efficiency.

The truth is that given that the standard of economic efficiency is ultimately found in the ethical preference of the regulator, her judgment cannot be subject to any rule of precedent. What she finds efficient today may be found inefficient tomorrow. Predictably, her inability to make meaningful judgments on the basis of efficiency induces her to look at other factors to indicate what is right and wrong. Her natural tendency will be to lean on her own perception of which industrial, highly concentrated market should raise concerns to competition authorities.

In this connection, George Stigler observes:

[d]efinitions do not yield any knowledge about the real world, *but they do influence impressions of the world*. If only markets with a vast number of traders are perfectly competitive, and if markets with few traders are called oligopolistic (literally, "few sellers"), that suggests that these latter markets are not competitive, as well as

not perfectly competitive. [Consequently] the suspicion of small numbers was gradually reinforced by the antitrust cases.<sup>17</sup>

It is not surprising that the perception of illegality has changed so dramatically in American jurisprudence and European competition policy enforcement, if one compares contemporary trends with those prevailing at the time the policy was developed. Conduct that was previously “per se” illegal is examined under the rule-of-reason today; conduct that was prosecuted in the past is tolerated today. Consider the evolution of policymaking in the fields of resale price maintenance, monopolization, and mergers and acquisitions. In all of these areas the change in the jurisprudence has been notorious.

Of course, antitrust enforcement has not been entirely chaotic. It has essentially remained stable. From the institutional perspective, it can be argued that competition law enforcement has been stable over time due to the positive effect of *other* institutional factors distinct from the personal beliefs of the enforcer—notably, the organizational structure of the authority through legal rules that delay or impede a given course of action considered socially good by the policymaker.

In particular, the stability of the rule of law surrounding the organizational structure of competition policy enforcement in developed countries has prevented competition enforcement from falling out of bounds. By contrast, such institutional stability cannot be taken for granted in many transitional and developing economies. It is for this reason that it is important to consider this second factor as well.

The very transition from a planned to market economy introduces a great deal of uncertainty among economic agents, which is absent from the jurisdictions of developed countries. This is a consideration that is often overlooked, especially by those recommending the adoption of traditional competition policy enforcement in developing countries. It illustrates the importance of tying competition enforcement analysis to the institutional framework within which it is inserted. This uncertainty in policy enforcement contributes to the uncertain business environment that prevails in developing countries, which could be quite chilling on investments and economic development.

A second consequence of focusing policy attention on achieving social welfare goals such as efficient resource allocation, is that such an exercise neglects the role of resource creation through innovation. Clearly, this focus ignores another essential goal of developing countries, namely,

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17. GEORGE J. STIGLER, MEMOIRS OF AN UNREGULATED ECONOMIST 94 (1988).

promoting innovation, resourcefulness, entrepreneurship, and competitiveness.

This insensitivity stems from the static or equilibrium view of competition introduced by the model, which by definition neglects the role of innovation and creative entrepreneurship in driving efficiency—what economists refer to as the production frontier. Conventional models have attempted to address this limitation by introducing some dynamics into model building. Unfortunately, these models are still unable to grasp both the evolutionary nature of market systems and the role of innovation in introducing new information into the market. Even under this analysis, antitrust policy still upholds its structural bias inherited from the old days of the Sherman Act, when industrial firms dominated the landscape of the economy. Today, however, in light of rapid innovation in high-tech industries, such definitions appear somewhat constraining to the policymaker. Consider the elements necessary to determine a firm's dominance or possession of market power under competition analysis. Under such analysis, product substitution is strictly limited to competing products that already exist in the market. However, the pace of innovation in some industries is such that new competing products may emerge into the market before the completion of legal proceedings.

It is not surprising that all comparisons to the equilibrium state of perfect competition are doomed to fail in explaining a constantly evolving reality. The intellectual error of believing in such a comparison lies in the fact that markets cannot be compared to equilibrium positions such as the perfect competition model (or, at the other extreme, the pure monopoly model), simply because markets are, to put in Schumpeterian terms, under a constant process of creative destruction of evolutionary change. “The essential point to grasp is that in dealing with capitalism we are dealing with an evolutionary process.”<sup>18</sup>

A third implication of the epistemological spin of the conventional approach on market competition as a “perfect” (or “imperfect”) market rather than an ongoing process of entrepreneurial discovery is that it forces

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18. SCHUMPETER, *supra* note 16, at 82- 83. More specifically he states:

Capitalism, then, is by nature a form or method of *economic change and not only never is but never can be stationary*. And this evolutionary character of the capitalist process is not merely due to the fact that economic life goes on in a social and natural environment which changes and by its change alters the data of economic action. [ . . . ] The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprises creates.

*Id.*

the analyst to focus attention on the assumed welfare implications arising out of the particular conditions prevailing in the marketplace at that time in which the analysis is made. All of the concern about the role of institutions is virtually excluded from the analysis. The focus of regulators is on allocating resources using equilibrium models, which, again, take for granted the role of those institutions that make market exchanges possible at all. Therefore, attention is not focused on the institutional conditions that make markets, but on comparing isolated points of such movement against the optimal standard of the perfect competition model. No attention is placed on the institutional conditions enabling or frustrating the ongoing market process in carrying out its “destructively creative” advancement towards innovation and economic progress. Economic analysis stops short of comparing optimal states of equilibrium with those of “real” markets.

In other words, no meaningful research is aimed at answering the vexing institutional questions that are important for development, such as: what are the springs of economic development and how do entrepreneurs strive to out do their rivals?

In conclusion, the ideology element of competition policy is responsible for the development of alternative views of policy enforcement, by either emphasizing the pursuit of efficient market outcomes or strengthening the institutions that enable the market process to become viable.

### III. THE ROLE OF CULTURE IN THE DEVELOPMENT OF COMPETITION POLICY MAKING

In order to give a complete picture of the institutional determinants of competition policy, it is important to highlight the role played by the cultural setting in which competition policy is to be enforced. Culture plays a fundamental role in the policymaking design that ought to complement, not distort, competition policy enforcement. For this reason, it is important to examine the institutional development of the society to determine the extent to which potential restrictions on competition may accrue in the form of policies, which are actively promoted by governments. This reveals it is for transitioning and developing countries to deal with such governmental restrictions.

This realm includes the social perception of whether competition and free markets are social goods. It exposes the contradictions frequently found in transitioning and developing countries as a result of their economic history and past policies. Additionally, it reveals how historic

institutions influence social perception of free markets and fundamental institutions enabling competition, such as individual property rights.

In Latin America the development of colonial institutions played a fundamental role in stifling the emergence of property rights. These colonial institutions resulted in a high concentration of wealth and heavy involvement of the Spanish Crown in economic affairs. Institutions such as the “Encomienda,” whereby the Crown empowered the Spanish conquerors to oversee the Indians at their charge, never evolved into feudal institutions as in Northern Europe at the end of the Middle Ages. The conquerors never acquired a similar status as that of the feudal barons, who had judicial powers and became a rival force to that of kings. Municipalities in the Spanish colonies, were closely overseen by royal representatives and never evolved into real parliaments. Commerce was stifled at the expense of the military society, which the Spanish colonies inherited from the Castilian military society that evolved from the Spanish wars against the Moors in the Middle Ages.

After independence was gained in the nineteenth century, the pattern of institutions remained virtually unscathed. During the twentieth century, economic centralism became even more pronounced. This development was a sub-product of the prevailing State interventionism, which eventually became the core of public policy until the 1980s. As a result of economic centralization public policy tended to eliminate competition, which was regarded as a dangerous threat to planning development. Economic planning was considered the fundamental means of allocating resources. Most industries were either nationalized or had their prices heavily controlled by the State. Licensing was made compulsory in many economic sectors, which impeded competition. These policies particularly affected small and medium-sized firms from abroad. Tariff and non-tariff barriers heavily restrained foreign trade to the detriment of domestic competition, which remained isolated from foreign competition. Most Latin American countries did not enter the General Agreement on Trade & Tariffs (GATT) until the 1980s or afterwards. Domestic industries were closely regulated by the state. Cartels and other forms of competitive restrictions were not only tolerated but also openly promoted by the State.

These features of industrial policy are clearly replicated in many developing countries, such as China. Although China’s economic institution history is quite different from that of Latin America, the replication of ideological similarities is remarkable. In both cases, the exercise of close government interventionism on economic affairs was the by-product of adhering to the idea that central planning represents the best tool of promoting economic development. Professor Ding Lu of the

National University of Singapore lists a number of structural legacies inherited from the centrally planned economy in China.<sup>19</sup> This list is almost identical to that of any Latin American country prior to economic liberalization.

First, the high concentration of resource allocation in certain key industries was a legacy of China's central planning. China's economy grew as a result of the highly centralized resource allocation in strategic industries, particularly heavy industries and infrastructure. However, such concentration did not reach the levels of some Latin American countries, where nationwide industrial monopolies were created. Instead, specialization took place in China at the provincial and local level.

Second, the development of a fragmentary domestic market was a legacy of China's central planning. Due to the difficulties that central planning caused in coordinating information in the command economy, the production targets were not effectively disaggregated according to the planned hierarchy. As a result, high uncertainty levels ensued, which created recurrent problems of supply shortage. As a result, local managers tried to solve the supply problem by becoming self-sufficient. However, markets had become vertically integrated, resulting in insufficient specialization, excessive duplication, and a low level of standardization of machinery and component parts.

In Latin America, the effects on the industrial organization of many industries have been remarkably similar. This phenomenon is due to the uncertainty created by the distrust and judicial ineffectiveness in enforcing contracts. To avoid these problems, many familiar businesses have developed and effectively replaced the formal legal system.

Third, the proliferation of cartel-type collusive conduct among businesses was prevalent. In Latin America, cartels were actively promoted in view of the interest of governments in ensuring the permanence of inefficient domestic producers in the market. Additionally, prices were controlled with the consumer often paying the price of inefficiency. Similarly, in China, notorious cartels existed as a means of ensuring planned targets and coping with supply shortages.

Fourth, the development of large enterprises as mini welfare states was a legacy of the centrally planned economy. In China, centralized resource allocation, State ownership, and empire building have influenced the perception towards state-owned enterprises. Instead of regarding these

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19. Ding Lu, *Regulatory Framework against Unfair Competition for an Emerging Market Economy* 39 SINGAPORE ECON. REV. 33, 33-58 (1994).

enterprises as firms that produce goods and services, they came to be viewed as welfare entities to distribute benefits to its members. Likewise, the difficulty in undertaking privatization in Latin America evidences a similar phenomenon.

Finally, the lack of mechanism of free entry and exit and the absence of import competition were also a lasting impact of central planning.

To overcome these problems, the Chinese government has pursued a policy of gradual, but steady economic liberalization. However, the stifling legacy of central planning is still reflected in heavy-handed government policies, which may actually complicate matters for competition. Professor Lu explores an alternative approach to use a more direct kind of government interference, which is aimed at directly shaping business arrangements.<sup>20</sup>

There are several examples of an industrial policy sponsored by the government that would help achieve these goals. First, the promotion of anticompetitive behavior, such as horizontal economic cooperation (*hengxiang jingji lianhe*) between enterprises in different regions and under different industrial ministries would help to break down artificially imposed market segmentation. The means of cooperation can take various forms such as joint ventures, coordinating production, and contracts coordinating raw material provision and processing.

Second, government supported enterprise groupings (*qiye jituan*), involving enterprises from different regions, industrial ministries, and ownership structures would facilitate the transition. These groupings may take the form of vertical integration of raw material supply, production, marketing and sales, or corporation in the production and sales of similar or correlated products.

Third, the government should support mergers by large and medium-sized State-owned Enterprises (SOEs) that promote interregional and interministerial mergers, as well as the joint operation between enterprises (*lian ying*).

Instead of adopting these policies designed to directly shape business arrangements, China imposed other governmental policies that had an adverse impact on market competition.

First the government implemented an unequal tax treatment of different ownership, which changed only after the introduction of the 1994 tax

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20. See generally *id.* Other sources referred by Lu comprise the State Commission on Restructuring the Economic System, ZHONGHUA RENMIN GONGHEGUO GONGSI FAGUI HUIBIAN [COLLECTION OF CORPORATION LAWS OF THE PEOPLE'S REPUBLIC OF CHINA] (1991); ALMANAC OF CHINA'S ECONOMY (1987).

reform. But this reform still has not addressed the administrative protection of local interests, which created a special tax treatment in favor of firms located in local jurisdictions.

Second, the lack of a unified company law up to the end of 1993 gave rise to numerous administrative companies. In these companies, applications enjoying official backing have an advantage in the process of establishment.

Third, there existed a “dual pricing system,” which tended to favor administrative companies. Although these distortions have been significantly reduced, they still affect much of the business landscape, in addition to the market expectations of economic agents.

In sum, it is important to highlight the role played by the cultural setting of the society in which the competition policy is to be enforced. Culture plays a fundamental role in policymaking that should complement competition policy enforcement. For this reason, one must explore institutional development of the society to evaluate any potential restrictions on competition that may exist in the form of government policies. Institutional development reveals the importance for countries emerging from the road of central planning to address competition policy to deal with such government restrictions.

#### IV. TOWARDS AN ALTERNATIVE INSTITUTIONAL COMPETITION POLICY MAKING FOR DEVELOPING AND TRANSITION COUNTRIES

Conventional competition policymaking, and design competition policy must be challenged to overcome the anti-competitive culture. Evolutionary thinking of markets provides an alternative conceptual framework for the design of competition policy.

This alternative view emerges from the simple awareness that if the world is in permanent disequilibrium, it is futile for policymakers to be concerned about attaining equilibrium. In other words, analysis of a permanently changing reality should rest on models capable of capturing the evolutionary essence of disequilibrium, in order to infer normative conclusions from it.

Schumpeter clearly saw the risk of deducing normative conclusions from a misguided perception of the real world. Due to the relevance of his insight, his comments are worth quoting in full:

First, since we are dealing with a process whose every element takes considerable time in revealing its true features and ultimate effects, there is no point in appraising the performance of that process *ex visu* of a given point of time; we must judge its

performance over time, as it unfolds through decades or centuries. . . . Second, since we are dealing with an organic process, analysis of what happens in any particular part of it—say, in an individual concern or industry—may indeed clarify details of mechanism but is inconclusive beyond that. Every piece of business strategy acquires its true significance only against the background of that process and within the situation created by it. It must be seen in its role in the perennial gale of creative destruction; it cannot be understood irrespective of it or, in fact, on the hypothesis that there is a perennial lull.<sup>21</sup>

For this reason, as he suggests:

[Antitrust] economists who, *ex visu* of a point of time, look for example in the behavior of an oligopolist industry . . . and observe the well-known moves and countermoves within it that seem to aim at nothing but high prices and restrictions of output are making precisely that hypothesis. They accept the data of the momentary situation as if there were no past or future to it and think that they have understood what there is to understand if they interpret the behavior of those firms by means of the principle of maximizing profits with reference to those data. The usual theorist's paper and the usual government commission's report practically never try to see that behavior, on the one hand, as a result of a piece of past history and, on the other hand, as an attempt to deal with a situation that is sure to change presently—as an attempt by those firms to keep on their feet, on ground that is slipping away from under them. In other words, *the problem that is usually being visualized is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them. As long as this is not recognized, the investigator does a meaningless job. As soon as it is recognized, his outlook on capitalist practice and its social results changes considerably.*<sup>22</sup> (emphasis added)

He concludes:

In analyzing such [restrictive] business strategy *ex visu* of a given point of time, the investigating economist or government agent sees price policies that seem to him predatory and restrictions of output

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21. SCHUMPETER, *supra* note 16, at 83-84.

22. *Id.* at 84.

that seem to him synonymous with loss of opportunities to produce. He does not see that restrictions of this type are, in the conditions of the perennial gale, incidents, often unavoidable incidents, of a long run process of expansion which they protect rather than impede. There is no more of paradox in this than there is in saying that motorcars are travelling faster than they otherwise would *because* they are provided with brakes.<sup>23</sup>

Clearly, Schumpeter advocates an alternative appraisal reality, capable of illuminating policymaking activities in a different light than that of conventional equilibrium economic analysis.

This is all the more important to developing economies that are undergoing institutional change. During transition, the most pressing problem for these countries is the lack of the rule of law. This deficiency undermines the expectations of economic actors, thereby raising transaction costs. Competition policy should address these concerns upfront. Therefore, a proper policy agenda should avoid creating further distorting factors that could undermine the rule of law. It is very difficult to achieve this through enforcement based on Pareto efficiency, or indeed, other social welfare goals, as they ultimately reflect the preferences of those in charge of the policy, which could easily differ and cause the erosion of market expectations.

Several mechanisms exist for competition authorities to reinforce the rule-of-law in market exchanges. The development of a clear agenda aimed at addressing both government and business created anticompetitive restrictions is an essential starting point. Concerning government restrictions, it is advisable to give the competition agency sufficient powers to undertake active regulatory reform. Such an initiative would facilitate the dismantling of government rules through deregulation, in support of privatization and trade liberalization.

Some guidelines could help in this task. First it is important to simplify administrative rules to create a “level playing field. However, clear principles should not sacrifice the flexibility needed to adapt to market change. Second, the agency should rely on white papers and other means of identifying voluntary business standards for each industry. These instruments could enable the authorities to devise general principles of fair conduct, a necessary element to promote regulatory reform. Third, private parties should be allowed to settle their disputes, thereby facilitating an efficient means of rights’ allocation. Fourth competition authorities and

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23. *Id.* at 88.

sectorial regulators should cooperate with each other. Fifth, network industries should have fair access to the network. "Fairness" should be defined in accordance with the conventions, customs and traditions of the industry concerned. If principles cannot be identified and extracted from the industry itself, it may be useful to examine similar industries elsewhere.

Competition authorities should also develop policy priorities for business conduct as follows: First, authorities should be very conscious of cartels created by government fiat, through regulations or legislation in the area of horizontal restraints. Second vertical restraints should be tolerated unless the claimant, proving the anti-competitive effect, provides specific evidence tradeoff trade impediment. In principle, long-term contracts are indicative of such intentions, provided they are exercised in areas where import competition cannot counteract these restrictive effects. Third, unilateral dominant behavior should be examined in cases where network access to smaller firms is constrained, especially where evidence shows a connection between the dominant firm denying access and the victim's downstream or upstream competitor. Fourth, mergers and acquisitions should generally be tolerated, especially if import competition remains open. the services industry, foreign competition should be ensured through the elimination of licensing and special permits.

## V. CONCLUSION

Exploring the role of culture in competition policy development immediately raises important issues of law and economics, which are far from settled. Given its broader perspective, institutional analysis overcomes the constraints of logical positivism that inspires much of the conventional economic and legal theory. Such reliance has driven policy makers away from a more complete understanding of the issues that explain the fundamental role played by institutions, thereby departing from a richer appraisal of social reality.

Institutions embody collectively shared, individual values and beliefs. But where do these values come from? How do they acquire shape? And perhaps more importantly, what role do they play in policymaking design and implementation? These questions suggest that policymaking is far from a science, and in fact, is closer to art. Hence, it cannot exist without all the surrounding institutional circumstances conditioning business behavior.

It is important, for this reason, to acknowledge several points. First, competition policy, like any human endeavor, is grounded in ideology and

normative values, not hard science. This is not necessarily a disadvantage, provided society is fully aware of the nature of the ethical debate entertained by competition policy authorities. In this way, the necessary institutional constraints will be instituted to prevent competition policy from becoming unbridled or uncontrolled. Indeed, such constraints are essential to reinforcing the rule of law, predictability of the policy, and transparency of market rules. Second, the fact that normative standards are ultimately ethical does not necessarily qualify the conclusion that anyone can genuinely draw from the mere understanding of market dynamics. For this reason, rather than judging entrepreneurial behavior from a normative standpoint, competition policy authorities should concentrate on making surrounding institutions more transparent and open to entrepreneurs, so as to draw tentative guidelines about the best possible way to promote market exchanges. By doing away with contrived social welfare imaginary constructions, and looking past business experience in closer inspection, the market exchanges have a greater opportunity to reach their utmost potential. Third, competition authorities should avoid falling into the intellectual trap of endorsing contrived social welfare standards that essentially contradict market competition. Developing and transitioning countries should be particularly careful to remember that the ultimate goal of competition must be connected to the development of competitiveness, innovation and economic development. Fourth, culture is a fundamental factor that policymakers must take into account at the time of a competition policy's development. A central planning tradition perpetuates ways of conceiving policymaking that may run against the logic of introducing markets, thereby making the initial work of competition authorities particularly cumbersome. It is necessary to give them the right tools to devise alternative policy solutions to government interference on the markets.

These fundamental reasons suggest that the competition authorities' policy agenda should address regulatory reform and exercise strong "competition advocacy," thereby challenging government regulations and rules that inhibit innovation and business development. Based on the experience of Latin America and other countries outside the region, this should become a central concern of policy making for competition authorities. It is essential that professional, independent, and highly motivated officials enforce competition policy. In addition, proper rules should be instituted to ensure that decisions are balanced, carefully drafted, quickly enforced, and above all, always controlled by a well-trained judiciary.