The Developing Economies, XLII-1 (March 2004)

BOOK REVIEW

Competition Policy for Small Market Economies by Michal S. Gal, Cambridge, Mass., Harvard University Press, 2003, xii + 324 pp.

Developing countries are finding it imperative to reshape or modify their policy frameworks, due to the intensification of economic competition accompanying globalization as well as growing calls for the harmonization of laws and institutional arrangements. Against this backdrop, the question of how developing economies should and can build competitive environments suited for economic development has become an issue of both theoretical and practical importance. For example, the 2002 issue of the World Bank's *World Development Report*[1] focuses on building institutions well adapted for market economies. In Chapter 7, "Competition," the report comprehensively discusses problems that developing countries face as they implement competition policies. Joseph E. Stiglitz, a Nobel Prize laureate and former World Bank chief economist, also notes that though appropriate competition policies must be at work properly in order to deal with market imperfections resulting from imperfect information, satisfactory policies are not yet in place, and implementing an optimal competition policy entails a number of problems.[2]

In this regard, the book under review, which focuses on the competition policies of small market economies and examines mainly the legal and institutional aspects of the problems that are attendant on the implementation of such policies, is a very interesting piece of academic work. The implementation of competition policy always involves the question of how best to strike a balance between scale and scope economies, on the one hand, and the benefits of enhanced competition. In realizing economies of scale and scope, it is necessary to pay attention not only to the per capita GDP figure as an index of economic development, but also to the fact that the absolute market size of an economy is an important factor in its development. In order to build market and industrial structures that are conducive to realizing economies of scale and scope, due consideration must be given to the market size, as measured in terms of the absolute size of the economy, its population, and other indices. Written from a standpoint that places importance on the relationship between the absolute market size of an economy and its competition policy,

1 World Bank, *World Development Report 2002: Building Institutions for Markets* (New York: Oxford University Press, 2002).

2 Joseph E. Stiglitz, *Whither Socialism*? (Cambridge, Mass.: MIT Press, 1994), pp. 132–34. More specifically, Stiglitz calls attention to the following problems attendant on the implementation of competition policies: (1) that, in some cases, competition policy has been used as an instrument to limit competition; (2) that antitrust policies interfere with cooperative effort to engage in R&D; (3) that antitrust policies put domestic (American) firms at a disadvantage relative to foreign firms; and (4) that antitrust policy is with its costs from lawsuits.

this book undertakes both theoretical inquiries and case studies about the designing of competition policy.

The overall problematique of the volume is to demonstrate that given the important implications of the size of an economy for its competition policy, small market economies need to formulate competition policies based on rules different from those underlying the competition policies of large economies such as the European Union and the United States. In Introduction and Chapter 1, the author delineates the characteristics of small market economies. It is assumed here that the market size of an economy is influenced by three main factors: population size, population dispersion, and openness to trade (pp. 1–2). Because of scale economies and the existence of high entry barriers, small economies cannot support more than a few competitors in most industries, and thus concentration tends to be high in many of their markets. This means that a small economy faces a difficult question of how to strike a balance between permitting firms to be large and integrated enough to enjoy scale economies, on the one hand, and numerous enough to ensure effective rivalry, on the other (pp. 4–5).

In Chapter 1, Gal employs an important concept in dealing with this question, namely, that of "minimum efficient scale" (MES, p. 14), defined as the "level of output that minimizes average costs." In an industrial sector where production takes place at less than the MES, there is room for realizing scale economies in the sense that expanded production will lead to a decrease in unit costs. In a small economy, however, the large size of the MES relative to demand gives rise to a number of problems, including high industrial concentration levels, high barriers to entry, sub-optimal (i.e., below MES) levels of production, a low tendency for firms to specialize in the production of a narrow range of products, and a high percentage of economic activities accounted for by the largest firms in the economy. The main factors that hinder a small economy in its effort to implement a competition policy are natural monopolies, single-firm dominance, and oligopolies.

Chapter 2 of the book deals with the basic policy alternatives and principles that are important for the competition policies of small economies. Here, the primary standard for the evaluation of regulatory methods is the extent that they can enhance economic welfare. Emphasis is also placed on the need to formulate the regulatory framework in such a way that it offers not only incentives to promoting allocative efficiency, but also to minimize production costs and promote innovations. Given the fact that the competition policy of a small economy must, by nature, be designed with due consideration paid to its impact on the economy as a whole, the author contends that it is impossible for the policy to encourage competition at the cost of economic efficiency, and that, instead, the realization of economic efficiency itself should be one of the policy's important objectives. Gal points out, for example, that achieving economies of scale in production or distribution in a small economy reduces the number of firms necessary to supply any given demand, and may reduce or even totally eliminate competition in the affected market, with the result that, unless proper countermeasures are implemented, the economy as a whole will suffer from a loss of efficiency. Thus, when small firms are displaced by larger ones, economic and social objectives may substantially diverge.

Chapter 3 addresses the issue of regulating single-firm dominance. The author believes that because of scale economies and high barriers to entry in a small economy, the threshold market share for the regulation of concentration should be set at a lower level than in large economies. From this standpoint, Gal undertakes an international comparison of the market power thresholds adopted by six economies of limited size, namely, Canada, Australia, New Zealand, Israel, Malta, and Cyprus, and examines whether the market-share threshold of 50 per cent adopted by Israel is justifiable or not (pp. 59–68; p. 66, Table 3.1). Asserting that market power cannot be evaluated solely by market share, she also refers to an instance where the Israeli Competition Tribunal required the submission of an additional piece of evidence to avoid the "pitfalls of a market-share approach" (pp. 67–68).

Chapter 4 discusses the regulation of natural monopolies. The problem of natural monopolies is important in considering the efficient supply of infrastructure-based services (such as transportation, shipping, electric power, and communications).[3] The author finds it especially important to regulate natural monopolies in a small market. At the same time, however, she also believes that natural monopolies themselves should not be condemned, and thus tries to propose a more realistic approach to their regulation.

In Chapter 5, the author deals with the regulation of oligopolistic markets. The chapter begins by offering an overview of the economic characteristics peculiar to oligopolistic markets, thereby laying the foundations for discussing legal arrangements for the regulation of oligopolies. She focuses on the conditions conducive to cooperative conduct among oligopolistic firms operating in a small economy. The latter half of the chapter is devoted to discussions of two policy questions that emerge when dealing with such cooperative conduct. The first is how to regulate corporate behavior that promotes cooperation among oligopolistic firms in a way that does not harm social benefits. The second is whether there is any possibility that the government's support to firms that refrain from cooperative conduct can reduce allocative and productive efficiency.

Chapter 6 is devoted to a discussion of merger control policy, which is an important means for a small economy to realize "potential efficiencies in oligopolistic markets" (p. 194). In this chapter the author compares the consumer welfare approach and the total welfare approach as criteria for evaluating specific mergers. Under the consumer welfare approach, a merger is permitted if it increases consumer surplus. Under the total welfare approach, by contrast, a merger is permitted so long as it increases total surplus, consisting of both consumer and producer surplus.[4] In other words, even if the merger brings about a deadweight loss (p. 204) in consumer surplus or an increase in prices which would not take place under a competitive situation, it is permitted so long as it reduces costs by a greater margin than the deadweight loss or the price increase. In this case, the transfer of welfare from consumers to firms is not counted as a loss of surplus. However,

3 See, for example, World Bank, *World Development Report 1994: Infrastructure for Development* (New York: Oxford University Press, 1994), p. 53.

4 See also Kotaro Suzumura, *Competition, Commitment, and Welfare* (Oxford: Clarendon Press, 1995). In the field of economics, too, Suzumura uses net market surplus, which is the sum of consumer and producer surplus, in his theoretical analysis of the effects of an entry restricting policy in cases where research and development investment is involved. Suzumura's findings reveal that so long as consumer surplus is employed as the basis for determining whether entry should be permitted or not, no excess competition emerges, but that if producer surplus or net market surplus is employed, there is a possibility that the industry's performance may be improved, because the number of firms is reduced below the long-term equilibrium level (p. 208).

in the sense that the permission of a merger under the total welfare approach is predicated on the cutback on production costs to be attained by the merged unit, the total welfare approach may be regarded as setting a higher threshold value to mergers.

Gal regards the total welfare approach as more desirable for a small economy than the consumer welfare approach, for the following reasons. "First and foremost, given the concentrated nature of most markets in small economies, a policy that requires a high standard of proof of no negative effect on consumer welfare may well lead to market stagnation of oligopolistic structures that not only charge supracompetitive prices but do not achieve productive efficiency…. Second, the consumer welfare approach may conflict with the goal of enhancing the international competitiveness of domestic firms" (p. 203). The author also calls attention to the fact that the consumer welfare approach does not necessarily accomplish distributive objectives. On the other hand, she asserts that, under the total welfare approach, it is desirable to leave the task of wealth redistribution in the care of the means which are specifically designed to handle wealth redistribution, including redistributive taxation schemes, social security programs, and social insurance schemes. She also considers it imperative for voters to directly supervise and monitor the performance of these redistributive measures. From this perspective, she examines the extent to which the total welfare approach has been adopted in the competitive policies of small economies such as Canada, Australia, New Zealand, and Israel (pp. 226–39, especially Tables 6.1 and 6.2).

The concluding chapter addresses two sets of problems. One encompasses those concerning prescriptions on competition policies, and problems pertaining to elements that supplement competition policies, namely, the question of how to build the institutions indispensable for implementing the policies efficiently, and the question of how to educate the general public and the business community about the policies. The second encompasses problems that emerge when laws of large economies are applied to small economies, including in particular problems stemming from the globalization of economic activities and the harmonization of competition laws. The author regards economic efficiency as a stand-alone objective that is beyond comparison with others (p. 252), and contends that a small economy should adopt the total welfare approach rather than the consumer welfare approach (p. 253). She also points out that attempts to harmonize competition laws dictated mainly by the requirements of promoting international trade can impair the autonomy of each country's competition law, or discount the peculiar needs of each small economy. She goes on to assert that it is indispensable for a small economy to be equipped with "a competent competition authority and competition court" (p. 255) in order to carry out a sufficiently effective competition policy. As is clear from this assertion, the book underlines the importance of pursuing competition policy in a highly transparent way. Given the fact that, as pointed out by Suzumura[5] by referring to the experience of postwar Japan, not only legal systems but also an informal means of administrative guidance have often been mobilized to help industrial policies accomplish their goals, the reviewer finds the observations made in this book very useful and meaningful.

Reading this book, which incorporates not only research findings in business and economic law but also in economics, has been very rewarding for this reviewer, who special-

5 Suzumura, *Competition, Commitment, and Welfare*, pp. 202–28.

izes in development economics. In what follows, instead of commenting directly on the book's accomplishments, I would rather like to say a few words about important themes for future research that should be addressed, expanding on the findings of this book.

First, it seems worthwhile to expand on Gal's suggestions about the institutional basis that is necessary not only for small economies, but also for developing economies, in implementing appropriate competition policies. She points out that a merger policy that places absolute value on competition may hinder the realization of scale and scope economies, and therefore is inappropriate for a small economy (pp. 214–15). However, in order to ensure that a merger will make the best possible use of the gains from scale economies, it is necessary, for example, to actively improve and maintain the competitive environment, and thereby to encourage the merged firm to smoothly integrate or readjust the organizational structures of the merging parties. Gal herself observes that in order for a competition policy to be able to enhance welfare, it must be supplemented by several complementary elements (p. 255). While noting that the concrete institutional setups for the enforcement of a competition law are beyond the scope of her book, she tentatively suggests that it should be necessary (pp. 255–57):

(1) to staff the competition authority with people who are well versed in and have expertise about the theory of industrial organization and competition law, and invest it with strong competence and research capability;
(2) to create "a specialized judicial body that is empowered to hear competition law cases and is composed, inter alia, of economic experts; by ensuring that an appellate court has a limited mandate to overrule economic cases decided by the specialized judicial body" (p. 256); and
(3) "to educate the general public and the business community about the goals and the substantive contents of competition policy" (p. 256).

Given, moreover, the fact that competition authorities in developing countries suffer from serious shortages in human resources and funds, as pointed out by the 2002 edition of the World Bank's *World Development Report* (pp. 141–42), I also find it important to narrow down the ranges of these duties to the levels corresponding to their actual capabilities. The World Bank suggests, for example, that these authorities should start by dealing with problems concerning cartels, and exclusive supply or distribution contracts, rather than problems of price discrimination and predatory pricing, which are more complicated but are not less critical.[6]

Second, given the fact that competition produces not only economic benefits but also other benefits, it seems appropriate and easy for a government with limited capability to carry out a competition policy that is more competition-enhancing than the level recommended in this book. Suzumura emphasizes the importance of the competitive market mechanism by referring to the intrinsic value of competition, namely, its tendency to facilitate the discovery of information and efficient utilization of resources.[7] The 1994 edition of the World Bank's *World Development Report* (pp. 52–72), on the other hand, emphasizes that introducing competition to the supplies of infrastructure-based services

6 World Bank, *World Development Report 2002*, p. 142.
7 Suzumura, *Competition, Commitment, and Welfare*, pp. 198–200.

brings about, in addition to the effects of competition, the side effect of making the institutional setups and policy measures more transparent and accountable.

Third, it seems necessary to look into the issue of risks involved in competition policy. In this book, Gal focuses on dynamic factors, such as innovations and international competitiveness, and emphasizes the importance of taking a balancing approach in competition policy (p. 216). It should be remembered, however, that international competitiveness is determined not only by the results of competitive policy implemented within the economy, but also by the results of policies carried out by rival governments. Innovations are also affected by various uncertainties. When these factors are taken into account, what Gal regards as optimal competition policies in this book seems to entail the risk of failing to achieve the expected results. As part of the effort to make a competition policy transparent and accountable to the population, it is imperative to make explicit the basis for the evaluation of such risks.

It is the reviewer's sincere hope that this book will be read and examined by a wide audience, so that the foregoing important research topics will be tackled in earnest.

(Hiroki Nogami)