

## A General Theory of Trade and Competition

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As a former scientist - my Masters was in Chemistry at Oxford - I appreciate the opportunity to address this august group of scientists, but it is also with some trepidation that I talk to you today about a subject that has the words "General Theory" in it. As an international trade and competition lawyer, I don't even count as a "dismal scientist."

To start, let me tell you how I came to be here today with this newly published book, rather grandly titled "A General Theory of Trade and Competition". I hasten to add the title is not mine, but that of my publisher, Cameron May. They felt that my title "Towards a General Theory..." was too long. I have been privileged to have been in the right place at the right time from the beginning of my career. It started in the 1980s in London during the Thatcher years. We were called on to assist the UK government to privatize the electricity industry. This was the first of the wave of UK and US privatizations that, in particular in the UK, took whole chunks of the economy that had been nationalized after the Second World War and transferred them to private hands. While introducing competition into the electricity markets is now the accepted reason for the privatization, it is important to note that these privatizations were primarily for domestic political purposes, to lessen the power of the coal unions. Political issues kept cropping up during the privatization - including a requirement for the Regional Electricity Companies to buy a minimum amount of coal, that distorted the electricity markets and prevented privatization from unleashing the forces of competition. These early privatizations were then exported around the world, and as counsel, we followed them, advising the former Soviet Union countries as they transitioned out of communism as well as the Central and Eastern European economies, between 1990 and 1992. In September 1992, I advised on trade barriers in Latin America from a Miami base, as that region underwent its own apertura or market opening. During the 1990s we advised the Asian countries as they opened up their economies. During this entire period, I began to feel that there was a vital missing piece in our advocacy of free trade and liberalization around the world. It was missing because, coming from a UK and US background, I had made certain assumptions that simply did not hold in the countries which were liberalizing their economies. Fundamentally, this assumption can be crystallized into one notion - competition policy as an organizing principle for the economy. Since, by and large, the US and UK economies with which I was familiar operated by this maxim, I assumed that other countries did (or aimed to) and so once trade was freed up, competitive markets would automatically follow. I was not alone in making this assumption, as most (then all) trade economists tended to focus on border liberalization and assume markets inside borders were perfectly competitive. Similarly, industrial organizations economists worried about market structure inside borders only.

The reality is that a country could simultaneously embrace trade liberalization while still maintaining significant anti-competitive market distortions inside borders. Indeed our failure to account for this meant that a significant part of the liberalization gains of the 1990s did not flow to consumers, because anti-competitive markets withheld the gains of trade from them. This created a backlash against free trade and globalization that we still feel today. Global consumers said that they did not see the benefits of trade liberalization, and blamed the whole process as opposed to where blame should properly have been placed, the failure of their own markets.

Why was this allowed to be the global consensus? Because while tariffs were high, what happened inside markets did not have a particularly profound impact on trade. But as trade tariffs and other more conventional border measures decrease, then the impact on the trading system on anti-competitive restraints, both public and private that have an impact on trade and lessen economic welfare, increases. In fact, if you envision a world without borders, the principle damage done by such anti-competitive restraints is to consumer welfare and efficiency, sucking huge chunks out of the economy. Commercial interactions between people or firms are non-zero sum in nature. Wealth can therefore be increased or decreased. By maximizing efficiency, wealth is increased. Now when you introduce actual borders, and therefore tariffs and other border restrictions to trade, you simply increase the overall level of distortions, and the overall move away from an equilibrium where productive and allocative efficiency is maximized. Hence viewed in this way, free trade is merely a special case of competition policy. The goal, if we are trying to increase global welfare and therefore wealth is to ensure that competition policy is the organizing global economic principle. Rather than expecting free trade to lead automatically to competitive markets, the embrace of competition principles will unlock free trade.

So assuming all of this is true, how do we do this, and what precisely do we mean by “competition”. After all, one’s man’s competition policy is another man’s industrial policy. So it is very important that we are very clear about terms. This means that we must define terms like competition policy and pro-competitive regulation. I treat this subject at some length in the book, and note that competition policy means the maximization of consumer welfare in the economic sense. In other words, in economic terms it means the maximization of allocative efficiency - ensuring that products are made in the most efficient manner possible, and the maximization of productive efficiency, which means that each productive process is the most efficient possible. This last element is particularly important as it tends to increase innovation. Since new technologies can make production more efficient there is no limit to the level of productive efficiency, whereas in the case of allocative efficiency, ensuring that existing resources are most efficiently allocated means that there is an equilibrium point. Allocative efficiency alone assumes a static universe, where human interactions are zero sum in nature. One man’s loss is another’s gain and vice versa. However, a combination of allocative and productive efficiency yields consumer welfare, and a non-zero sum set of interactions, where the overall pie can be increased (or contracted, something, I fear we are about to experience). If indeed that is the guiding spirit of competition policy, as Adam Smith certainly hints, then can we apply this also to free trade. This is not a new concept, but one that Smith espoused in an intriguing phrase in the Wealth of Nations which is often overlooked:

“Monopoly is the sole engine of mercantilism.”

Not an engine, or one of the engines, but the sole engine. In this way, Smith recognizes that anti-competitive markets, brought about through private practices or public rules (or some combination of both) actually lead inexorably to mercantilism. Mercantilism, industrial policy, producer welfare bias -- all of these come from the zero sum side of the economic ledger. The policy consists of encouraging exports and restrict imports, and it is the kind of beggar thy neighbor policy that gave us the Great Depression and ultimately the Second World War. In a

sense the entire theory of trade and competition springs from that one sentence, and the word “the”.

The theory of trade and competition which we point to in the book links the level of anti-competitive public or private practices or rules (collectively known as an aggregate measure of distortion) to a direct impact on exports or imports. The aggregate measure of distortion leads to an artificial reduction in the cost base of certain firms that can then export more, and increase their market share in other markets, or it can lead to an artificial increase in the operating costs of firms trying to import into the distorting market. Both these variables are measurable. For example, in the case of a particular agricultural product where a market is distorted, we can look at market shares and trade flows, as the distortions took effect. A good example of that would be in the European sugar market, where the domestic, distorting program was initiated in the 1970s and meant that Europe went from being the world’s largest importer of sugar in 1977 to the world’s second largest exporter in 1981 - an interesting achievement for sugar grown on very cold Danish islands! Of course, this would not have been possible without the significant distortions of the EU sugar program. So far we have tackled these distortions by focusing only those that constitute recognizable government subsidies. But if the same distortion results from a non-subsidy government rule (such as an exemption from regulatory requirements) or from private activity (such as a cartel), we have no way of addressing it. In order to truly build up such a theory, it would be necessary to analyze first the connection between aggregate measure of distortion and trade impact, and then do that for multiple sectors in order to assess whether a single general theory holds for all these sectors. This is not an easy task (especially from a dismal science perspective), but I believe it is feasible, and no more difficult than much antitrust analysis that goes on today. The difficulty is chiefly in getting good data, and disaggregating different kinds of distortions, as it is reasonable to suppose that different types of distortion might have different effects on trade.

In the book we build up the theory by looking at a number of different sectors to illustrate how these market distortions can impact trade.

Before we do that, I would like to take a moment to discuss in closer detail what was happening historically over the last twenty years to forty years or so. We have seen during that period as I referenced above a gradual reduction of trade barriers at the tariff and border level. This has been accomplished through a series of trade rounds which we discuss in detail in the book. We are now encountering difficulties at the trade negotiation level (most recently at the Doha Development Agenda) because we are now dealing with much more difficult subjects that do relate to domestic regulatory issues, and bring in national sovereignty thoughts.

In the last fifteen years, we have also seen a gradual increase in the number of competition agencies around the world whose goal was supposed to have been the promotion of competitive markets around the world. In some respects, competition agencies have been successful in this area, but there have also been instances of competition agencies misapplying competition concepts to deliver anti-competitive markets. In the book, we discuss at length how competition policy has evolved in countries such as the US and EU toward consumer welfare enhancement as the guiding spirit of competition implementation and enforcement - by consumer welfare

enhancement we mean the maximization of allocative and productive efficiency, and this is the measure or metric by which we assess whether markets are distorted.

In order to make progress on the assessment of the metric, we will need to first of all define the different types of distortion. We can define distortions into a number of distinct types each of which have different welfare effects. These welfare effects can be measured, just as the welfare effects of private distortions are measured by the antitrust agencies.

### Type 1 Distortions - Public Laws or Regulations that Lessen Competition in a Particular Product Market

An example of a Type 1 restraint are distribution laws that lessen competition at the distribution level.

#### Distribution Restraints

Many countries maintain anti-competitive distribution laws that decrease competition at the distribution level. These laws have a direct impact on preventing foreign firms from getting good market access in the markets where they are selling their products through local distributors. If those distributors are protected by laws that make it difficult to terminate supplier-distributor relationships, then that is an anti-competitive public sector restraint that may be problematic if consumer welfare damage results. This is an example of a public sector restraint on trade that has anti-competitive effects.

### Type 2 Distortions - Distortionary Tax Measures

Many countries deliberately distort their tax laws in order to give a benefit to a particular type of firm or industry.

#### Distorting Tax Policy

Countries can alter their tax policy in order to give advantage to certain firms. To the extent that these changes lead to a reduction in efficiency (for example by making efficient activity uneconomic, such as a tax to remove the incentive to engage in trade in services), then that welfare reducing effect, which is measurable, can lead to an actionable market distortion under this theory. However not every tax measure will have an anti-competitive, measurable effect from a welfare perspective. Most taxes and tax changes will be either neutral or have minimal welfare effects from a consumer and producer surplus perspective.

An example of this that has already been disciplined in WTO agreements are Article III.2 violating taxes that discriminate between foreign and domestic producers of certain types of products (see Japanese Alcoholic Beverages, Korea Alcoholic Beverages, Chile Alcoholic Beverages). These cases turned on equality of competitive of competitive opportunity.

Discriminatory tax measures have welfare effects that can be measured. We should also note that discriminatory tax laws violate European competition law, and so have been analyzed through a competition lens in the past.

### Type 3 Distortions: Regulatory Exemptions

#### Regulatory Exemptions

Some countries maintain laws that enable certain firms to be exempt from domestic regulation (for example, certain health and safety regulations). To the extent that such exemptions are not uniform, which by their nature they are not, they will have welfare impacts. These impacts certainly alter the cost base of affected firms, and, by lowering operating costs can lead to export advantages for the preferred firm. Regulatory exemptions as type 3 distortions can take place in a number of ways. This can include regulatory exemptions affecting health and safety legislation, safety in the workplace legislation, exemptions from certain kinds of environmental laws and so forth.

#### Type 4 Distortions: State-Owned Companies

State-Owned companies have a variety of impacts on the market place that affect trade. We must be clear that there is nothing distortive about SOEs per se, but that many of the government privileges and benefits that they receive are distortive. We should not view private firms and state owned firms as separated by a clear dividing line, but rather that there is a spectrum between the two, with indicia of state ownership arising from the conferring of various privileges, rights and benefits. There are many types of distortion that benefit SOEs which we list as sub-type 4 distortions:

##### Type 4a: Government Privileges in Licensing

State owned companies may be given privileged licensing provisions which are unique to them because of their status. They may have to comply with simplified licensing procedures, or no procedures at all to undertake activities in regulated areas. These regulatory exemptions have a similar impact as other regulatory exemptions (Type 3).

##### Type 4b: SOEs in Sale and Purchase of Goods and Services

SOEs that compete directly with private firms in the supply of goods and services, as well as those that purchase inputs either for their own use or for inclusion in products to be sold in the markets can have impacts on the private firms with which they compete. They can do this in a number of ways. SOEs like private firms seek to maximize their revenues by expanding their market share. They are less cost sensitive than private firms, given that their underlying costs structures can be affected by government grants and other distortions. They tend, therefore to be revenue maximizers, seeking to increase market share at any cost in order to increase revenue. Private firms by contrast are very cost-oriented and tend to seek to maximize profits.

SOEs will therefore engage in a number of practices in order to achieve these goals. These include lowering price to levels designed to knock out competitors. But SOEs may lower prices and succeed in knocking out competitors even without market power and without going below what a comparable private firm's costs would be. In other words, by an ordinary antitrust analysis, which would require below cost pricing in order to establish proof of anticompetitive harm, the SOEs low pricing might not violate the antitrust laws. However, this is because the SOEs cost base has been artificially reduced by government privilege and interference in the economy. SOEs can also act in similar ways during the ordinary purchase of goods. Particularly where they are purchasing needed inputs, SOEs can to use monopsony-like power to put downward pressure on the price of the inputs they are buying.

#### Type 4d: Abuse of Regulatory Process

SOEs can use their status to ensure abuse of the regulatory process. Here SOEs are often also the regulator for the services which they provide. By changing the manner in which they regulate in order to favor their own products or services, they can secure advantages for themselves that they would not be able to secure if they were not able to be simultaneously regulator and competitor. The abuses of the regulatory process, and securing of regulatory advantages constitute market distortions that can be measured in terms of their welfare effect.

#### Type 5 Distortions:

##### Type 5a: Perverse Actions by Competition Agencies

Perhaps one of the most pernicious market distortions to properly deal with are distortions introduced by the very agency whose function was to ensure pro-competitive markets, domestic competition agencies. Where these agencies make mistakes (often caused by being guided by producer welfare or competitor welfare concerns), their negative impact on the economy can be hard to define and discipline. If competition agencies discipline firms because they have too high a market share (even if that market share cannot as an economic matter give rise to market power), then their decisions distort the market in anti-competitive ways. The resultant shift away from a consumer welfare enhancing equilibrium is measurable.

##### Type 5b: Government Toleration of Private Behavior

The market may be distorted by ordinary anti-competitive private sector practices. To the extent that governments tolerate, or even encourage these there is a public sector restraint component. A recent China case involving a Vitamin C cartel that had pernicious effects in the US, the Government of China filed an amicus brief maintaining that the cartel was required by the Chinese government as part of its industrial policy. If the case in the US is then dismissed under the Foreign Sovereign compulsion doctrine, then there will be a negative trade impact in the US of the Chinese cartel. While this is an extreme example, there are many cases of governments simply not enforcing their antitrust laws, or turning a blind eye to anti-competitive practices occurring their territories that have trade effects elsewhere.

#### Type 6: Anti-Competitive State Aids

Governments can give aid to certain firms that prevents the efficient operation of a competitive market (because the Government is in effect picking winners). Europe maintains rules that make state aids illegal in certain cases. Where the state aid has a negative welfare effect, then it should certainly be actionable under the theory described above. European state aids law provides a useful template of what kinds of rules should be applicable in this case. European jurisprudence has developed a market economy investor test, where if the state is acting as a market economy investor, it should be subject to ordinary market rules. However, there are exemptions for services in the general economic interest, and this is where complications arise. Many firms will rely on the SGI exemption to conceal a protectionist motivation by building up a fund with which to compete against rivals (the universal service fund in telecommunications services is often abused in this way), for example.

### Telecommunications

Telecommunications trade has been in the vanguard of trade liberalization of services. This is because telecommunications services was the subject of the first separate annex on services, the annex on Basic Telecommunications Services as part of the General Agreement on Trade and Services (“GATS”). Recognizing that competition and domestic regulatory issues were indistinguishable from more conventional trade restraints, there was a concerted effort to include competition type disciplines in the telecoms trade agreements. These have been included in the Reference Paper on Competition Safeguards, part of the telecoms agreements -- which outlaws such anti-competitive practices as anti-competitive cross-subsidization by incumbent operators, and anti-competitive interconnection policy.

### State Owned Companies

We are seeing a rise in the number and influence of state-owned companies in the economy, or government sponsored enterprises. This is part of the battle between a consumer welfare economic orientation as we have described above, and a producer welfare, national champions and industrial policy orientation. International trade rules have sought to discipline state trading companies from 1947, recognizing that where state trading entities compete directly with private firms, they are able to rely on government largesse given in a number of ways that are anti-competitive market distortions. These are enshrined in Article XVII of the GATT which broadly provide that state trading enterprises when they are trading in the market like a private firm must operate subject to commercial considerations, but where they are buying products for their own use are subject to fair and equitable standards. These vague terms have spawned some litigation, and we still do not have clarity on the issue of precisely what commercial considerations means. Since the goal is to ensure that there is a competitive market as between the private and state-owned firm, it would stand to reason that it should at the very least build on the accepted GATT definition, as interpreted by case law of “equality of competitive opportunity.” However, a strict competition test would have to be modified in order to ensure that a level playing field is achieved between private and state-owned firms. The government is not a profit maximizer and can sustain below cost pricing for long periods of time. Hence the test of whether there has been

an anti-competitive practice for a state-owned entity should not require recoupment of lost profits or market power, as it typically would for a private firm. Here it is important to point out that in order to achieve equality of competitive opportunity between private firms and state-owned firms, it is necessary to apply a different antitrust test. Application of the same test would lead to a market that highly favored the state-owned firm as anti-competitive practices would be exceptionally difficult to prove.

### Future Steps

We should have greater competition and trade dialogues with other countries. These should replicate the dialogues we have had in the past that have focused on regulatory and structural issues. Examples include the Japan Competition and Deregulatory Dialogue as well as the China Strategic Economic Dialogue. We should include in our dialogues opportunities for trade ministries from one country to talk directly to competition agencies from other countries. On offensive issues, both have an interest in ensuring overall consumer welfare, as opposed to two opposing trade ministries who have mercantilist producer interests at heart.

We advocate a set of disciplines building on existing trade measures in the WTO to deal expressly with the kinds of distortions set out above. These could be included within a public sector restraints agreement that disciplined these kinds of restraints that have an anti-competitive effect, measured by some aggregate measure to welfare.

We also advocate a competition safeguard which would operate in the same way as other safeguard measures -- except that it would be triggered by market distortions in other markets that had a causal connection to an rise in imports that damaged producers in home country markets. Unlike standard trade remedy actions, market distortions would be measured by reference to their aggregate effect on welfare and the safeguard would also be linked to the measure of market distortion. Unlike trade remedies that tend to be set in stone for a number of years, this would give the distorting country and incentive to end the distortion.

Finally at a domestic level, by which I mean not just in the US but in all our domestic markets, we should strive to find ways in which regulation is promulgated that ensures that pro-competitive regulation has the best chance to emerge. There are some role models we discuss in the book, notably where competition agencies are introduced into the process early, not to shape regulation, but rather to act as the consumer welfare conscious of the regulator or legislator so that the anti-competitive, welfare damaging impacts of new regulation can be evaluated and the true costs made explicit. The question that should be asked is whether the costs from a market standpoint have been properly weighed against the alleged benefits of the public goals regulation is intended to bring about. If legislators expressing the will of their people want to promulgate the regulation despite costs outweighing benefits, then that is a perfectly legitimate outcome. But what is problematic is the situation we have now, where the costs are largely ignored, buried or unknown.

All of these actions will help in the process of integrating competition and trade together in ways that simultaneously promote free trade, liberalization, competitive markets and property rights protection, which is fundamental since that is what individual firms and people actually compete with.

In order to do all those, it is necessary to develop a clear and coherent theory of trade and competition that applies an agreed metric for the measurement of distortion. Once this is accepted and established, it will be easier to translate this into policy prescriptions. In order to do this we will have to develop datasets for specific types of distortion and their impact on market shares, and then understand the relationship. If we can then use each of these datasets across different industry sectors to frame a general theory linking market distortions and trade flows, we will have gone a long way to developing policies that help ensure that the benefits of globalization will truly be spread to consumers across the world, and we will be able to better manage the very real fears that free trade and globalization have engendered worldwide. The stakes are very high. We are already seeing a global shift towards more government involvement in the economy, here and abroad, more focus on the producer welfare side of the economic ledger - industrial policy, national champions, and a greater risk of the conflict which is attendant on those policy choices. Losses will be visited on global consumers through rising inefficiency, and US firms, or those who operate in environments characterized by the consumer welfare side of the ledger, will be less profitable and less able to compete in a world characterized by the industrial policy/producer welfare side. This will create a vicious cycle in which we will all be impoverished. I will leave with one anecdote - Angus Maddison has developed a chart showing that global growth increased by a factor of 2 between 0 AD and 1913. It grew by a factor of ten between 1947 and 2001. Between 1913 and 1947, global GDP contracted. We have, most of us lived through a period that was unique in human history in terms of its growth. We have not really known consistent contraction of global GDP. We may be about to experience that now (indeed a panel of UN economists just noted that the contractions we are about to feel are similar to contractions in the 1930s). While I won't pretend that our inability to grasp the importance of dealing with market distortions has caused this situation, our failure to deal with the underpinning economic reality and challenge of the 21st century will prevent us from seeing again the spectacular growth we once took for granted.