# CHAPTER 2: METHODOLOGY AND LITERATURE REVIEW

## 2.0 Methodology

The approach taken is to sieve through the various works from OECD, UNCTAD, the Ministry of Domestic Trade and Consumer Affairs, the Working Committee on Competition as well as numerous works from independent local and international scholars to put together a compelling outline that discusses the rationale for a competition policy in Malaysia and what that framework should be. Discussions with the Ministry and their minutes of the working committee on competition act as a background to this introductory research on competition.

## 2.1 What Is Competition Policy?

In promoting competition per se, most nations have adopted some form of competition policy. In the region, APEC (Asia Pacific Economic Cooperation) has been at the forefront of encouraging its nations to make its markets for goods and services more competitive. 'The 1995 Osaka Action Plan included Competition Policy as one of the fifteen specific policy areas that are to be developed by member economies. The objective of this policy area is given as:

"APEC economies will enhance the competitive environment in the Asia-Pacific region by introducing or maintaining effective and adequate competition policy and/or laws and associated enforcement policies, ensuring the transparency of the above and promoting cooperation among the APEC economies, thereby maximising, *inter alia*, the efficient operation of markets, competition among producers and consumer benefits (APEC 1995)[3]"'.

3 Peter J. Lloyd, 'A competition policy for Malaysia?', Seminar at University Malaya 2001, page 1

## 2.2 Definition

But what is a competition policy? Simply put, competition policies are 'government measures that directly affect the behaviour of enterprises and the structure of industry. An appropriate competition policy includes both:

(a) Policies that enhance competition in local and national markets, such as liberalised trade policy, relaxed foreign investment and ownership requirements, economic de-regulation, and

(b) Competition law, also referred to as antitrust or antimonopoly law, designed to prevent anticompetitive business practices by firms and unnecessary government intervention in the marketplace[4]'.

Note: Where competition policy refers holistically to the legal, regulatory and enforcement framework supporting competition; competition law on the other hand refers to only the legal aspects in support of competition.

Having said that, the underlying concept that you should understand about a good competition policy is that it should it should address the basic 3 basic facets of competition called the 'structure-conduct-performance' paradigm (**SCP paradigm** by Roger Alan Boner and Reinald Krueger). 'The basic tenet of the SCP paradigm is that performance in a well-defined economic market depends on the interaction between the structure of the market and the conduct of the buyers and sellers[5]'.

4 Extract from FAQs on competition policy and law from http://www1.worldbank.org/beext/faq.htm
5 Roger Alan Boner and Alan Krueger, 'The basics of antitrust policy, A review of ten nations and the European communities', World Bank Technical Paper No. 160, page 3

**Structure** refers to the economic 'organisation of production and distribution and the determinants of competition, namely the number and size of buyers and sellers, the extent of product differentiation, the ease of entry and exit by suppliers, the degree of unionisation, and the contractual and legal relationships linking buyers and sellers (for example, through vertical integration and the extent of conglomeration). **Conduct** refers to the general competitive strategy and specific tactics by suppliers, such as pricing, product development, advertising, innovation and investment. **Performance** refers to the goals of economic organisation, namely pursuit of productive and allocative efficiency, technological progress, price, and availability of goods, and full employment of resources[6]'.

In simpler English, if the largest car manufacturer in the automobile market sets prices of cars by predatory pricing (also referred to as below-cost pricing); this action may drive the smaller manufacturer out, thus reducing the number of players in the industry. This shows the impact of illegal '<u>conduct</u>' activities interacting within a monopolistic market '<u>structure</u>' – that reduces competition. To curtail predatory pricing, policy makers implement competition policies that influence economic '<u>performance</u> ' of a market by possibly intervening in the car prices via some means of administrative pricing to ensure that there are floor-pricing rules to abide to. (Note: Predatory pricing though may be harder to detect under normal circumstances because most anti-trust laws encourage competition that leads to lower prices. Likewise, administrative pricing typically is dictated in the form of lower, not higher prices).

6 Ibid, page 4

## 2.3 The Role Of Competition Policies

Why do we need competition policies and what role does it play in promoting competition? It is essential for a nation to understand the role it plays so that it can develop sensible and effective policies. The role that a good competition policies plays is three-fold:

**Firstly**, it should increase consumer welfare through the assurance of low prices and high quality of goods. It does this by ensuring that there are ample firms in the market to promote competitive pricing for local goods and services as well as the imports. The benefits accrued from more intense competition will benefit both buyers and sellers because more firms in the market will encourage positive multiplier effects in the form of increased upstream and downstream activities. Increased competition is met by competitive supply prices, thereby, lowering the cost of production for the final good or service to the consumer. Nationally, lower cost of production also may mean export-competitiveness for domestic producers.

**Secondly**, it should ensure that there is a level and fair playing field for entrepreneurs. In other words, there should be free entry conditions or minimal barriers to entry. 'The condition of entry into an industry or market refers to the presence or absence of barriers around it and, if any are present, to their *'height'*. Entry barriers refer to the disadvantages of potential entrants, vis-à-vis already established firms - that impose on the former higher per-unit costs (e.g., royalty payments for the use of patents) or require them to accept lower per-unit prices for goods of the same quality (e.g., buyer preferences for established "brands"). These barriers are measured in terms of how much the established firms can raise the price above a competitive level without inducing new firms to enter. Thus, if existing technology would permit a firm of optimum efficiency to produce and sell product A for $1.00 per unit (including a normal or competitive return on its investment), and if the established firms in the industry are in fact charging $1.15 without inducing the entry of new firms, then there is said to be a 15% entry barrier. The condition of entry into an industry or market is generally classified as either:

(a) "*easy*" (no barriers at all);

(b) "*ineffectively impeded*" (barriers too low to make deliberate entry-forestalling worth while);

(c) "*effectively impeded*" (barriers high enough to make entry-forestalling profitable); or

(d) "*barricaded*" (barriers high enough that the full "monopoly" price can be charged without inducing entry by new firms). Entry forestalling refers to the selection of a price that, while above the competitive floor, is not quite high enough to make the market attractive to the most likely potential entrants[7]'.

Ideally, when entry is "easy", the state of allocative efficiency for a market is easily achieved because efficient suppliers will displace inefficient suppliers at prices that the latter cannot afford to produce.

Entry conditions are a central feature of antitrust analysis because potential entry represents a significant market force that undermines incumbents' tendency toward unilateral or joint (collusive) exercise of market power. A good policy design prohibits competitors from certain types of collusive agreements like setting similar prices or merging with other competitors to structurally increase the concentration of the market.

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7 Charles E. Mueller, 'Glossary of antitrust terms', American Law And Economics Review, Vol. 26. No. 4

In devising competition policies, it is also wise to note that barriers to entry need not entirely arise from the conduct of the market players. Some of the other factors, which contribute as impediment to competition, are:

- Large capital expenditure that is difficult to recover such as a plant, high-tech machinery, research and development,
- 'Economies of scales requiring that an entrant capture a significant portion of the market (to avoid being a high-cost supplier)[8]',
- Regulatory policies on quality such as FDA approvals in US,
- Trade and industrial policies like tariffs, quotas and domestic content regulations.

Hence, policies should be designed appropriately to address these barriers to entry as well.

**Thirdly**, an explicit competition policy provides a developing country a control framework in carrying out reforms in the areas of privatisation and regulation. Peter J. Lloyd from the University of Melbourne explains that the essential principle of competition policy is that of "**competitive neutrality**" – that all firms should be allowed to compete on equal terms without favouritism. In the case of 'privatisation that involves the sale or leasing of government-owned assets to private sector buyers, the principle of neutrality implies that the sale or leasing should be done in a way that is open to all potential buyers or leasers[9]'. He continues to say that this can be done via closed-bid tendering with no restrictions on who may participate.

8 Roger Alan Boner and Alan Krueger, 'The basics of antitrust policy, A review of ten nations and the European communities', World Bank Technical Paper No. 160, page 3
9 Peter J. Lloyd, 'A competition policy for Malaysia?', University of Melbourne for a seminar by FEA, University Malaya

Without a clear stand on competitive neutrality, Malaysia's privatisation records have been scared by innuendos of less than favourable antics such as the 'government's award of contracts without competitive bidding or the sale of assets without actively seeking the best possible offer. Apart from the fact that such policies avoid competition that may benefit consumers and taxpayers, they have also exacerbated the politicisation of access to lucrative business opportunities controlled by the government (Investors Digest, August 1989)[10]'. (We recognise, though, that this argument may be overly simplistic because it does not cover social ethnic objectives that the government may had such as ethnic equity, which will be discussed in the later chapters).

The works of Lloyd (2001) and Jesudason (1989) similarly voice the same point that it is more critical to introduce competition with any deregulation of previously government-owned enterprises. Lloyd states that 'privately owned natural monopoly may be worse than a government natural monopoly[11]' because a business seeks to maximise profits and generally does not have a social objective. Jesudason adds to that by saying that 'unless privatisation is supported by strong competition and antitrust legislation, a new set of allocative inefficiencies may eventually replace existing ones[12]'. A good example of such a scenario is the local telecommunication sectors, which is a typical natural monopoly that has high barriers to entry and that left unregulated may result in lower consumer welfare. Understanding this, most developed countries have introduced 'equal access' telecommunication regimes that reduce entry barriers by assuring potential competitors that they may have access to the incumbent's telecommunications networks. This increases the number of players in the market,

10 Edmund T. Gomez and Jomo K. Sundram, 'Malaysia's political economy', Cambridge Press, page 89.
11 Peter J. Lloyd, Ibid.
12 James Jesudason, 'Ethnicity and the economy: the state, Chinese business and MNCs in Msia', Oxford, page 189

which eventually increases consumer choice and quality of services as well as lowers communication costs and prices.

### 2.4 Anticompetitive Business Practices

The Federal Trade Commission in the US has published a booklet called "*Promoting competition, protecting customer – A plain English guide to antitrust laws*", which describes the 5 main categories of illegal business practices that it considers anti-competitive:

- **Horizontal agreements among competitors**
- **Vertical agreements between buyers and sellers**
- **Maintaining or creating a monopoly**
- **Mergers – horizontal and vertical assimilation**
- **Price discrimination**

**Horizontal agreements** are agreements amongst parties in similar competing positions to restrict competition within the market through some collusive action that attempts to raise prices or restrict supplies. If the antitrust authorities get a whiff of such collusions, the alleged firms will be susceptible to thorough investigation on illegal business conduct. FTC treats the following sample business practices as illegal:

a) Agreements on prices, for example, blatant price-fixing or agreement to fix price-related matters such as credit terms. We take note, however, that similarities in prices does not necessarily imply collusion because competitive pricing also results in equilibrium based prices, for example the prices of crude palm oil. To prove that an illegal agreement to set prices has taken place, antitrust authorities will need to find tangible evidence of such an agreement.

b) Agreements to restrict output, for example, restricting petrol supplies, which inevitably raises the price of the good.

c) Boycotts – generally, this practice is illegal when a group of suppliers agree to not engage in any business with another person or entity causing the affected party to procure products or service at higher prices than what he would have paid if all suppliers were available to provide products or services to him.

d) Market division – Agreements amongst competitors to divide sales territories or allocate customers amongst themselves (to prevent competition) are considered illegal. This is an interesting statement because it essentially makes many of the franchising and licensing practice illegal as most of these deals involve some sort of guarantee that the franchisee or licensee will have exclusive rights to a particular product or service or particular area of business. Zahira Mohd. Ishan and Suhaila Abd. Jalil of Universiti Pertanian Malaysia strongly advocate that franchising itself is illegal because 'there are a series of unfair conduct which is said to have transpired out of franchising such as tie-in sales, exclusive dealing arrangement, and vertical restraints such as resale price maintenance and exclusive territories[13]'.

e) Agreements to restrict advertising – 'Restrictions on price advertising can be illegal if they deprive consumers of important information. Restrictions on non-price advertising also may be illegal if the evidence shows the restrictions have anticompetitive effects and lack reasonable justification. The FTC recently charged a group of auto dealers with restricting comparative and discount advertising to the detriment of consumers[14]'

13 Zahira Mohd. Ishan and Suhaila Abd. Jalil, 'Industrial regulatory activities: the Malaysian case', Universiti Pertanian Malaysia, NBER working paper, page 8.
14 Extract from 'Promoting competition, protecting consumers: A plain English guide to antitrust laws' from http://www.ftc.gov/bc/compguide.htm

f) Code of ethics – If professionals are restricted from competing by certain codes of ethics, then, FTC regards these codes as illegal as it did with the American Medical Association which prevented doctors from participating in health care programs. This may not necessarily apply in developing countries like Malaysia because most professional are not allowed to advertise because it goes against the nation's social objectives. One possible reason that Malaysia disallows medical and legal professionals from advertising is to ensure that number of these professionals can continue to grow (to support the population's requirements) without fear of being cannibalised by the bigger players whom have larger capacities to advertise.

**Vertical agreements** are price and non-price related agreements between parties in a buyer-seller relationship (vertical relationship), for example, a retailer who buys from a manufacturer; a franchisee is required to buy specific products from a supply franchisor. FTC treats the following sample business practices as illegal:

a) Resale price maintenance (RPM) agreements – When a supplier fixes the minimum retail price for a product, FTC will consider this an outright illegal conduct. The supplier is, however, allowed some leeway in "recommending" a retail price to the retailer but it is the retailer who independently decides if he wants to follow this price. 'Agreements on maximum resale prices are evaluated under the "rule of reason" standard (as opposed to a "per se" standard discussed in more detail later) because in some situations these agreements can benefit consumers by preventing dealers from charging a non-competitive price[15]' or charging much lower prices that generally is accompanied by a provision of sub-level service standards.

15 FTC, Ibid.

b) Non-price agreements between manufacturers and dealers – When a manufacturer restricts its dealers to a territorial area via an 'exclusive dealing arrangement which prevents the manufacturer from obtaining enough access to sales outlets to be truly competitive[16]' may be deemed illegal. The most visible antitrust case of such a nature is that of Microsoft against the Department of Justice (DoJ) in US for its unethical business practices in the internet browser market. The US government alleged that Microsoft engaged in exclusionary behaviour that denied their rivals to some sets of customers that eventually raised their rivals' cost and weaken their ability to compete effectively. 'One set of arrangements was with online an internet providers such as America Online (AOL) and AT&T Worldnet, in which Microsoft agreed to include a feature in its operating system that made it easy for a user to establish an account with a service provider, but only if the service provider agreed to deny most or all of its subscribers a choice of internet browsers[17]'. (Note: This is separate to other predatory conduct activities such as pricing the Internet Explorer below cost as well as tying and bundling MS Windows with Internet Explorer which eventually shut out other players like Netscape, which had a 90% market share at that time).

c) Tie-in sales – Sellers that try to sell one product on condition that the buyer buys another product that he may not want or can get cheaper elsewhere is also committing an illegal business practice. In Malaysia, one of the more infamous infringements was the sale of Proton cars a few years back that bundled the car with a pre-set number of packaged car accessories some of which was may not required by the buyer. Consumers who did not choose to take this pre-set package was required to wait much longer delivery lead times. The authorities clamped on this practice due to the numerous complaints received by the public.

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16 FTC, Ibid.

**Maintaining or creating a monopoly** is an act of behaviour involving an abuse of a dominant position of market power, which excludes other firms from the market or significantly impairs their ability to compete. 'In this concept, there are two elements, namely the question of dominance and the ability to exert market power. When a firm holds market shares of 40 per cent or more, it is usually a dominant firm, which can raise competition concerns when it has the capacity to set prices independently and abuse its market power[18]'. The most common complaint is predatory or below the cost pricing. This can drive out smaller firms that cannot compete at those prices. Since lower prices from a larger manufacturer may simply reflect efficiencies from spreading overhead costs over a larger volume sale, antitrust authorities are more careful in taking action before conducting thorough fact-finding.

**Mergers** usually benefit consumers by increasing a firm's efficiency level via scale economies. However, it is said to have anti-competitive effects when it increases market concentration and makes market entry even more difficult. There are two types of merger activities:

a) Horizontal mergers – When two competing firms merge, the level of market concentration increases, thus, increasing the likelihood of collusion between these firms. For example, FTC denied Staples and Office Depot's merger because it proved that it could save consumers USD1.1 billion over five years (source: www.ftc.gov/bc/compguide). FTC may make certain exceptions by requesting for special post-merger conditions; for example, Worldcom was allowed to merge with

17 Richard J. Gilbert and Michael L. Katz, 'An economists' guide to US versus Microsoft', Feb 2001, page 12
18 UNCTAD, 'Model law on competition', The intergovernmental group of expert meeting on competition law and policy (1999), page 21

MCI, on condition that it divest its internet bandwidth business unit to avoid over-concentration within this market.

b) Vertical mergers – Normally covers mergers that involve firms in a buyer-seller relationship because the new entity may harm competition by refusing free access for other players to a particular component or channel of distribution. 'Under the ***theory of vertical foreclosure (bottleneck problem)***, vertical integration by incumbent suppliers can be used to deny access by entrants to trading partners in upstream and downstream markets[19]'.

**Price Discrimination** is said to occur when businesses attempt to charge different prices for the same product or service. FTC invokes the Robinson-Patman Act for these kinds of conduct, which hurts competition because it gives 'favoured customers an edge that has nothing to do with the superior efficiency of those customers. However, price discriminations are lawful, particularly if they reflect the different costs of dealing with different buyers or result from a seller's attempts to meet a competitors prices or services[20]'. UNCTAD's model law for competition details out the various types of price discrimination, which may be deemed illegal

a) Personal discrimination – *'Haggle-every-time':* dealing common in bazaars and private deals, *'Size-up-his-income':* pricing related to the customer's purchasing power, frequent for doctors, lawyers, and members of the professions, *'Measure-the-use':* even if marginal costs are low, charge larger customers more (large dominant computer, software and copier manufacturers are known to have used this strategy).

19 Roger Alan Boner and Alan Krueger, 'The basics of antitrust policy, A review of ten nations and the European communities', World Bank Technical Paper No. 160, page 16
20 Extract from 'Promoting competition, protecting consumers: A plain English guide to antitrust laws' from http://www.ftc.gov/bc/compguide.htm

b) Group discrimination – *'Kill-the-rival':* predatory price-cutting aimed at driving out a competitor, *'Dump-the-surplus':* selling at lower prices in foreign markets where demand is more elastic (common for drugs, steel, TV sets and other goods), *'Promote-new-customers':* common with magazine subscriptions, luring new customers, *'Favour-the-big-ones':* volume discounts are steeper than cost differences (frequently in utilities) *'Divide-them-by-elasticity':* common in utilities.

c) Product discrimination – *'Pay-for-the-label:* The premium label gets a higher price, even if the good is the same as a common brand, *'Clear-the-stock':* sales which are commonly used to clear inventory but which may also destabilise consumers and competitors if resulting form false advertising, *'Peak-off-peak-differences':* prices may differ by more or less than costs do, between peak-hour congested time and slack off periods (nearly universal with utilities).

(Source: F. Machlup, The political economy of monopoly, Baltimore, 1952; W. Shepherd, The economics of industrial organisation, Englewood Cliffs, 1990).

To access the pro or anti-competitive nature of discrimination, the competition authority will evaluate the legality of the practice with reference to its economic effects on the relevant markets and to the position of the operators in those markets. In many jurisdictions, vertical restraints are subject to the rule-of-reason approach[21].

21 UNCTAD, 'Model law on competition', The intergovernmental group of expert meeting on competition law and policy (1999), page 24