Institut Européen
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European Institute
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Regionalism, Competition Policy and Abuse of Dominant Position

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Working
Paper
98/W/01

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Typeset and printed by the Publications Service, EIPA, the Netherlands.

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Regionalism, Competition Policy and Abuse of Dominant Position*

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May 1998

Abstract

Co-ordination of competition policies within regional trade agreements (RTAs) seems desirable, especially within deeper forms of regional integration. This contributes to a healthy and stable regional trading system. We argue, however, that regional competition policies should be carefully elaborated not to neglect efficiency considerations linked to economies of scale/scope within a regional liberalisation program, in particular, in the case of dominant positions. We also suggest that, in the short term, a less stringent approach to competition policy should be adopted in RTAs among developing countries where market failures may be due not only to imperfect competition but also to credit and labour market constraints.

(JEL F13, F15, L40)

Key Words: competition policy, regionalism.

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* We gratefully acknowledge helpful comments by Emmanuel P. Mastomanolis, Petros C. Mavroidis, Jaime de Melo and Aad van Mourik. An earlier version of this paper was prepared for the CEFIR-EIPA conference on *Competition Policies and Regional Integration* held in Montevideo on the 8-10 September 1997. The views expressed here are those of the authors solely and do not necessarily reflect those of the institutions to which they are affiliated.

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1. INTRODUCTION

Recent years have experienced simultaneously the globalisation of the world economy, illustrated both by the conclusion of the Uruguay Round Agreement, and the resurgence of regionalism, with the deepening and widening of the European Union (EU), the creation of the North American Free Trade Agreement (NAFTA) and the Common Market of the Southern Cone (MERCOSUR), among others. Trade liberalisation tends to enhance the competitive climate within and among countries. Indeed, by lowering its trade barriers, a country opens its market to foreign competitors. Such increase in market access is likely to break up oligopolistic structures in the domestic economy. In many respects, trade policy and competition policy can be considered as substitutes to the extent that they are two policy instruments affecting market openness and market structure.

However, trade and competition policies are only imperfect substitutes, except perhaps in the case of small open economies, where competitive pressure from foreign suppliers may suffice to yield a high degree of competition in the domestic market. Some authors have also argued that theoretically there is a case for trade liberalisation and competition policy to be complements. Indeed, the *topsy-turvy* principle of implicit collusion argues that anything that makes a market more competitive (as trade liberalisation) may actually result in more collusive behaviour by firms. The idea is that as the market becomes more competitive, firms will try to enter into strategic agreements to keep their profit level at a sufficiently high level. There is some evidence in the EU, NAFTA and MERCOSUR that such a phenomenon has occurred during the integration process (see Hodara, 1992 for example). The reinforcement of dominant position within regional trading blocks may call for a cautious approach to regional competition policy. Section 2 of this paper develops some of the problems related to the abuse of dominant positions and its legislation.

If it is not clear whether an international competition policy agreement is needed in a forum such as the World Trade Organization (WTO), there is a stronger case for the introduction of a regional competition policy authority within regional integrating areas. In particular, in the case of deep forms of regional integration such as customs unions and common markets, the need for a common competition policy approach is stronger. The reason is that regional integration reinforces the arguments in favour of a common competition policy whereas many of the arguments against an international

approach to competition loose their significance (or vanish) in the case of regionalism. This point of view is developed in Section 3.[1]

Section 4 discusses the case for a regional approach to competition policy in the presence of abuse of dominant position. However, we call for a less stringent approach in the case of regional integration process among developing countries which should be closer in spirit to the US legislation on abuse of dominant position (Section 2 of the Sherman Act) than to the EU legislation (Article 86 of the EU Treaty). The reason is that the focus of EU competition is rather on competition *per se* rather than on efficiency (see Turnbull, 1996, and Jebsen and Stevens, 1996). In developing countries where market failures may not only be due to imperfect competition but also to asymmetric information, credit constraints and labour market shortages, competition policy should provide for efficiency considerations. Section 5 contains some concluding remarks.

2. ROLE OF COMPETITION POLICY AND ABUSE OF DOMINANT POSITION

Contrary to other fields of economic policy, there is no general consensus on the definition of an appropriate competition policy. Unlike trade policies, which can be ranked according to their impact on welfare, the merit of various competition rules depends more on the objective of the political authorities, as well as on the cultural and historical specificities of each nation. Nevertheless, in spite of the variety of competition policies favoured by countries, some general common features can be identified. In particular, competition rules recognise the possible inefficiencies arising from imperfect competition. Everybody will agree on the main purpose of competition rules: to prevent anti-competitive behaviour by controlling collusion, mergers, and abuse of dominant position. The basic insight is that monopoly power, by increasing prices and reducing the supply of goods (or services), generates inefficiencies in production and loss of consumption, hence reducing social welfare (the so-called dead-weight loss). It is also assumed to create managerial inefficiencies (also called X-inefficiencies) and to stimulate rent-seeking activities (in an attempt to capture rents that a monopoly power generates) that may be costly to society.

In this paper we will focus more specifically on the regulation of abuse of dominant positions. By *dominant position* we understand the faculty to

[1] For a more extended treatment of arguments for and against an international competition policy agreement, see Bilal and Olarreaga (1997).

create obstacles to efficient competition in its own market. By *abuse of dominant position* we understand the use of this faculty.

Laws on abuse of dominant position (like in Canada, the US or the EU, for instance) are concerned with exclusionary practices such as vertical restraints (e.g., exclusive purchase or supply agreements) and predatory pricing. In fact, three broad categories of abusive behaviour can be identified:

- *foreclosure behaviour*, whereby the dominant incumbent prevents the entry to the market of new competitors (e.g., exclusive dealing arrangements);
- *predatory practices*, whereby a dominant company attempts to force its competitors to exit the market (e.g., predatory pricing); and
- *exclusionary conduct*, whereby a dominant company uses (and abuses) its market power to discriminate between its suppliers or buyers, thus gaining an unfair advantage in order to extract abnormal rents (e.g., tying and bundling treatment of competitors).

Note that in practice the distinction between these three categories may blur as an anti-competitive behaviour by a dominant firm (such as refusals to deal or any other exclusionary conduct) may prevent entry and/or force exit and/or lead to unfair treatment of competitors.

In principle, competition policy aims at avoiding not market power per se, but the abuse of a dominant position. The basic idea is that competition law should not penalise efficient firms which have established a dominant position in their market due to their better performance compared to their competitors. The objective is rather to insure the potential access to the relevant market and to guarantee 'fair' competition (see Wood, 1995). The contentious issues then are first to determine which behaviours constitute an 'abuse' of market power and how to promote competition without penalising successful enterprises which would experience a dominant position.

Arguably, competition policy is beneficial only if it increases economic efficiency. In the presence of economies of scale, however, concentration of firms with larger market shares may lower production (and selling) costs and hence prices. Hence, under some circumstances, less competition may be welfare improving. The problem is that efficiency effects are difficult to quantify. Besides, oligopolistic market structures are often conducive to reduced supply and higher prices. Consequently, strict enforcement of basic

competition principles, preventing any restriction on competition (regardless of efficiency considerations), may turn out to be a good 'rule of thumb' to insure the prosperous economy.

However, market share is not a correct indicator of market power for at least three reasons. First, the definition of the relevant market is not clear when there is high substitutability in consumption. This is illustrated by the case *United States v. E. I Du Pont de Nemours & Co (Cellophane)* quoted by Wood (1995). If the relevant product market was 'all flexible packaging material', then Du Pont's share was only 20%. But if instead the relevant product market was just cellophane, Du Pont had 75% of the market. Second, small market shares may be consistent with market power. Indeed, this would be the case when several small firms collude to control a market. For example, 10 firms with 10% of the market each may collude to charge monopolistic prices. Obviously there is a limit to this given the free-rider problem when the number of firms increases in a collusive agreement, as in any other co-operative agreement (see Olson, 1965). Third, large market shares may be consistent with low market power. Indeed, potential entry may significantly reduce incumbent firms' market share as underlined by Contestability theory. For firms with large market share, the presence and nature of barriers to entry is a much more useful guide to policy than the market shares themselves (see Kuhn *et al.*, 1992).

Thus, crucial to the proper implementation of monopolisation law (in particular assessment of dominance) is a thorough analysis of entry barriers since a firm may not exercise significant market power over time in the absence of barriers to new entry in the relevant market.[2] However, all too often the issue of entry barriers is undermined in monopolisation laws. For instance, the common practice in US and EU competition laws suggests that while most efforts have been devoted to determine the relevant market and to assess market power (usually in terms of market share), little (or at least not enough) attention has been paid to entry barriers. This is particularly true in the case of the EU as argued by Harbord and Hoehn (1994) who indicate that in the application of Article 86 of the EC Treaty on the abuse of dominant position, the 'primary indicator' of dominance is market shares while the level of entry (and exit) barriers is only a 'secondary indicator'.

Another proxy for market power sometimes used is the level of profits. The idea is that firms with high levels of profits are abusing their dominant

[2] Barriers to entry can be of three types: artificial (introduced by government regulation or trade associations), natural (linked to the production technology, scale and scope economies) and strategic (set up by firms to deter entrants, through over-investment or loyalty bonuses for example).

position. A legislation that implicitly or explicitly forbids high profits levels may have unexpected effects. Indeed, if the competition authority is to regulate the abuse of dominant position by imposing a profit ceiling, then firms will have serious incentives to artificially inflate costs. This in turn provokes misallocation of resources. Competition authorities, when regulating, should keep in mind that firms react strategically to competition rules. More importantly, as already mentioned, high profits may simply reflect greater efficiency from a firm with a competitive edge (see Demsetz, 1974).

To summarise, competition policy as any other government policy should include efficiency considerations. If competition policy on abuse of dominant position tends to focus on firms' market share rather than on strategic barriers to enter the market, then efficient firms may be penalised. This will give the wrong incentives to firms which will try not to become too large (in terms of market share) rather than to try to produce more efficiently.[3] This could be particularly important in developing countries where market failures are due to important factor market distortions. Clearly, if a firm has a dominant position due to credit constraints in the domestic market, the first best policy is not to prevent the 'abuse' of dominant position by the incumbent firm but to correct for the credit shortage that will in turn allow for entry by new firms.

3. REGIONAL INTEGRATION: A CASE FOR HARMONISATION

While there is a broad consensus on the desire to prevent anti-competitive behaviour, the globalisation of the economy has raised the question of the desirability of an international approach to competition policy.[4] If countries feel concerned about international competition, they can rely on two different approaches. The first approach rests on trade policy measures. For instance, governments could rely on trade liberalisation and favour foreign direct investments to promote competition. They could also use existing trade rules or introduce some competition principles into trade policy measures, a process consistent with the WTO system (see Bacchetta, Horn and Mavroidis, 1997; Hoekman and Mavroidis, 1994; Messerlin, 1996; and Petersmann, 1993) . The alternative approach is based on competition rules, in which case there are three different options (see Mattoo and Subramanian, 1997, for a similar proposition). First, governments can rely on a co-ordinated application of national competition laws (e.g., positive

[3] The recent 'sauvetage' of Apple by Microsoft may be seen by some as an example.

[4] Bilal and Olarreaga (1997) have outlined some of the main arguments in favour and against an international agreement on competition.

comity agreements). Second, countries can harmonise their national competition laws following international guidelines. Finally, the highest degree of collaboration would be an agreement on international competition laws, which entails of course a notion of supranationality.

A discussion on the optimal international design to tackle competition issues goes far beyond the reach of this paper (see Giardina and Beviglia Zampetti, 1997; Mavroidis and van Siclen, 1997; Nicolaides, 1996; and Petersmann, 1996). Instead, we focus our attention on a related question, namely: Does a regional trading agreement (RTA) give member countries further incentives to adopt a common competition policy? Our answer is yes. The basic argument is that the co-operative element embodied in an RTA fosters the incentive by member states to adopt a common approach to competition policy and it alleviates some of the impediments to a common competition policy.

To the extent that the purpose of an RTA is to guarantee (or simply promote) the free movement of goods and services, and more generally an open market, within the region, a common competition policy is desirable. That is, if member countries are willing to achieve a common market, as it has been the case for the EU for instance, then competitive business practices must prevail within the integrated market. The full benefits of internal free trade can be enjoyed only if internal trade barriers are not substituted by other forms of restrictive practices (such as market-sharing or price fixing agreements, for instance).[5] A natural example is the case of countries that have harmonised their foreign investment and trade policies to avoid a prisoner's dilemma situation in trying to attract foreign capital. In spite of this harmonisation, they may well end up in a non-co-operative equilibrium by trying to attract foreign firms through their competition policies (race to the bottom or to the top; it does not change the argument). Therefore, benefits from harmonisation of other policies may be jeopardised by the non-harmonisation of competition policies.[6] This consideration seems

[5] In this respect, the objective of market integration is a key element in the EU competition policy, Article 86 of the EC Treaty on abuse of dominant position stipulating that "Any abuse by one or more undertaking of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market insofar as it may affact trade between Member States" (emphasis added). See also the extended discussion by Forrester (1997).

[6] Harmonisation may also reveal to be extremely costly. What may seem abusive in one country is not necessarily considered so in other countries (Marceau, 1994). To illustrate this, think of the telecommunication sector: universal service through a monopolist may be seen as extremely important in one country with a large share of rural areas whereas it may be irrelevant in highly urbanised countries. Moreover, as suggested in Bacchetta et al. (1997), harmonisation of competition policies does not solve for the externality problem. To solve for this, some sort of inter-governmental approach or supra-national agency has to be set.

to have been the driving force behind the development of the EU competition policy.

Moreover, for trade liberalisation to be fully effective countries must renounce, or at least significantly reduce, the recourse to contingent protection measures (i.e., antidumping (AD), countervailing duties (CVD) and safeguards measures).[7] Arguably, in principle some trade measures, such as AD rules, can be maintained in a free trade zone. For instance, this has been the case for the European Agreements between the EU and the Central and East European Countries (CEECs), and to some extent for NAFTA and MERCOSUR. Economic theory suggests that AD measures could be justified in case of predatory dumping (as a second-best instrument, though).[8] It is well recognised, however, that predatory dumping seldom occurs (if ever) and that AD rules serve as a protectionist device relying on 'fair' trade rhetoric (see Finger, 1993). As a result, the benefits of an RTA could be ripped off by an active use of AD and CVD rules against partner countries. In consequence, RTAs which intend to create an effective internal market must forbid the use of contingent protection against partner countries. The prospect of a removal of the threat of AD/CVD measures has also proved to create a strong incentive for countries to enter an RTA (as in the case of the Canada-US Free Trade Agreement and the European Agreements, although both Canada and the CEECs failed to obtain a waiver against AD/CVD actions from the part of the US and the EU, respectively).

Besides, AD measures entail anti-competitive biases. For instance, AD measures distort competition by targeting usually the most efficient foreign supplier (see Petersmann, 1993). Moreover, as the complainant must generally be representative of the industry (at least 25% of the domestic industry in the case of EU AD rules), AD is an instrument only available to firms with a dominant position or to coalitions of domestic firms wishing to limit competition. Finally, measures resulting from an AD complaint are often of a collusive type (price or quantity undertakings, AD duties which have to be reflected in higher selling prices, etc.).[9]

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[7] A recent example of mutual commitment to avoid the use of AD measure in an FTA is the signature of the Chile-Canada free-trade agreement.

[8] Predatory dumping is defined as the selling of goods(in a foreign market) at a price below (domestic) production costs (i.e., dumping), so as to drive (foreign) competitors out of the market, leaving the dumping company in a monopoly situation. Note that to be meaningful, the dumping firm must be able to recover its losses from dumping once it has become a monopoly. Hence, predatory dumping requires not only that the dumping firm forces its competitors to exit the market, but also that market barriers exist so as to prevent potential entry from new competitors.

[9] For a discussion on the anti-competitive nature of AD measures, see Messerlin (1990, 1996), Hoekman and Mavroidis (1996), and Veugelers and Vandenbussche (1996).

In consequence, the free movement of goods and services and the integration of economies call for: (i) a strict control (and preferably a ban) on trade barriers, and (ii) the prevention of anti-competitive behaviour. Both objectives can be more easily achieved by the adoption of a common competition policy. That is, if trade liberalisation and globalisation of economies underline the need for a co-ordinated policy against practices restricting competition, then complete free trade and a deeper economic integration, as experienced by RTAs, only reinforce the arguments in favour of a common competition policy.

In parallel, many of the arguments against an international approach to competition loose their significance (or even vanish) in the case of regionalism. Indeed, successful RTAs inevitably entail the existence of common rules, the creation of common institutions, the delegation of authority to supranational instances, and more generally the development of a co-operative framework among member countries. Of course, a crucial aspect here is the degree of regional integration. Six forms of economic integration, ranked in increasing order of integration, can be identified (see Winters, 1991):

- *Preferential Trade Areas (PTAs)*, where member countries agree to levy reduced, or preferential, tariffs on partner countries (such as the Britain's Commonwealth Preference System);[10]
- *Free Trade Areas* (FTAs), where trade barriers between partner countries are abolished, but each member country determine its own external (i.e., non-FTA) trade barriers (e.g., NAFTA);
- *Customs Unions* (CUs), where intra-union free trade prevails and a common external trade policy is adopted by member countries (e.g., MERCOSUR);
- *Common Markets*, which are CUs with further provisions to facilitate the free movements of goods, services, and factors of production, and the harmonisation of trading and technical standards (e.g., the European Community, the European Economic Area);
- *Economic Unions*, which provide for additional harmonisation in general economics (e.g., fiscal policy, monetary co-operation/union, etc.), political, social and legal policies (e.g., the European Union);
- *Political Unions*, which are the ultimate form of economic integration (e.g., the US).

While PTAs and FTAs do not require inter-governmental institutions since each member country remains fully in charge of its own policy, CUs and

[10] The creation of new preference trade areas is forbidden under the GATT/WTO system.

higher forms of economic integration do involve a delegation of sovereignty, and thus an element of supra-nationality, as at least external (i.e., non-CU) trade policy is the result of a common decision by member countries. Arguably, countries that enter RTAs which entail a joint decision mechanism (on external trade policy for instance) are more likely to be willing to extend this common approach to other fields of economic activities, such as competition policies.

Various institutional designs to co-ordinate competition policy can then be envisaged. The simplest form is a regional agreement setting general principles for competition but with no common enforcement procedures. Although such agreements are supposed to indicate the good will of member countries in the implementation of competition policies, they usually lack any practical meaning. Such competition clauses can be found in NAFTA and in a diluted form in the Canada-Israel FTA (see Hofley and Gudofsky, 1997).

More significantly, regional agreements can include co-operative provisions. This is the case for instance under the Europe Agreements between the EU and CEECs and under the Australia-New Zealand Agreement (ANCZERTA). The integration of competition policy in FTAs can be quite far reaching, and include exchange of information, positive comity, and even harmonisation of competition rules and procedures, as in the case of the EU-EFTA agreement under the European Economic Area. In general, however, competition policy in FTAs remains under the control of national authorities. Co-operation takes the form of formal recognition of partners competition policy, co-operation between national competition authorities and harmonisation of objectives and procedures.

CUs and deeper regional agreements can generate more integrated co-operation mechanisms. In particular, common decisions can be adopted following common rules on competition. Provided standard procedures set at the regional level are respected, competition policy can be implemented at the national level. An important condition for the credibility of the common competition policy is the presence of an effective enforcement mechanism. In this respect, several institutional frameworks can be envisaged. First, a judicial approach can be adopted whereby national competition procedures have to conform to common rules. A regional tribunal then must be put in place to insure full compliance with the union competition law.[11]

[11] In the EU, such task is performed by the European Court of Justice.

An alternative is to rely on either national or regional independent competition authorities after harmonisation of competition rules. Independence of the agency in charge of competition is crucial to prevent the capture of competition policy by political and business interests. Note that an independent body at the regional level, being less prone to be influenced by strictly national interests, is more likely to retain its autonomy over competition policy than a national authority. However, even a regional independent competition authority is not completely immune from private and public pressures, especially in union-wide cases. Besides, it is simply not possible for a union agency to handle all competition cases affecting member countries. It would create organisational difficulties (i.e., the development of an administrative 'monster') and information problems (i.e., local authorities are often more apt to gather information about local firms and market environment).

Hence, the solution probably rests on a two-tier system. Independent national agencies should deal with practices that restrict only national competition, provided that national anti-competitive behaviours do not generate externalities on other member countries' agents. A regional independent competition authority should tackle union-wide competition issues.[12] In any case, these 'independent' authorities must operate in a transparent way and must be subject to close public scrutiny and judicial control to insure their strict compliance with regional competition policies.

A third possible structure to oversee regional competition policy centres on the direct political involvement of member countries. That is, a regional political authority can be set to determine and enforce competition policies. Member countries could designate their own representatives in this regional political body, in the spirit of the Council of Ministers in the EU. This framework can prove particularly useful to co-ordinate competition policies since each member country's interests are represented. However, the efficiency of the decision process crucially depends on the voting system adopted by the regional political body. In short, a unanimity procedure is most likely to preserve the status quo, limiting the scope for both the adoption and enforcement of common competition rules.

A combination of these three institutional structures seems desirable. Common competition principles embodied in rules and procedures should be adopted by national governments. This could be done by a regional political body which should accept ultimate political responsibility for the

[12] Note that this system does not correspond to the EU approach. In the EU, authorities in charge of competition are not strictly independent (in particular at the national level). Moreover, national competition authorities deal with anti-competitive practices that affect mainly their market (a set of thresholds being defined in the EC Regulation) , irrespective of the potential externality effects on partner countries.

decisions taken. The implementation and enforcement of competition policies should be left to either national independent authorities in the case of national anti-competitive behaviour with no externality effects, or to regional independent competition authorities otherwise. Finally, compliance to common competition principles should rest on a common judicial process (for instance with a regional court of justice overseeing competition matters).

This type of regional structure may be of particular relevance for small countries engaged in RTA with larger countries. If it is true that small economies may have no need for a competition policy authority if they are relatively open, as was the case for Hong Kong and Singapore, they may actually need to introduce some legislation if engaged in regional integration agreements with larger countries. Indeed, discriminatory trade preferences may bring the need for some competition policy authority, especially if countries engage in a CU where the common external tariff is set at a higher level than the pre-union tariffs of the small country. This is the case for Paraguay and Uruguay in MERCOSUR (see Olarreaga and Soloaga, 1997). Note that in this case, small countries will certainly benefit more from a supra-national authority than an inter-governmental approach where their bargaining power is relatively small. Use of extra-territoriality clauses also seems constrained in the case of small countries engaged in RTAs with large countries for the same reason.[13]

To sum up, regional economic integration provides additional incentives for the adoption of a common approach towards competition. First, a common competition policy helps to the realisation of an internal common market, in particular to insure the free movement of goods and services within the region. Second, the existence of a common institutional framework may facilitate the determination and implementation of common competition policies. The degree of co-ordination and harmonisation between national competition policies depends on the existing degree of integration in the union.

[13] This may explain why Argentina, Paraguay and Uruguay have argued for the creation of a supra-national authority within MERCOSUR, as reported by Di Biase (1997).

4. REGIONALISM AND ABUSE OF DOMINANT POSITIONS

Regional trade liberalisation, by lowering prices, stimulates competition. Although this leads to higher regional demand and supply, it also contributes to lower profits, forcing less efficient firms to exit the market. Firms that survive this competition process increase their market share which allows them to further exploit economies of scale (see Harris, 1986; Sleuwaegen and Yamawaki, 1988; and Smith and Venables, 1988). Hence, trade liberalisation in oligopolistic markets can generate a welfare improving concentration effect (i.e., an increase in firm scale) with lower prices and lower average costs (provided there is no market segmentation).[14]

In this case, as argued in Section 2, a competition law focusing solely on market power could have a negative welfare impact if it were to prevent the full exploitation of economies of scale by firms (or mergers) whose market share would exceed a threshold value.[15] So, the potential welfare gains from economies of scale in RTAs may induce a loose interpretation of competition rules.

In parallel, several factors may reinforce the tendency towards market concentration and full exploitation of economies of scale in an RTA. First, regionalism refers to an internal trade liberalisation process only, whereby external barriers to trade remain in place. Hence, domestic firms can take full advantage of economies of scale in a protected internal market (i.e., without having to face extra-union competition). It follows that strictly regional trade liberalisation can be conducive to a more oligopolistic structure of the internal market than the one that would prevail if regionalism were accompanied by multilateral trade liberalisation. Therefore, the potential for abuses of dominant positions are greater in the case of regionalism, suggesting that the need for an effective competition policy are greater than in the case of multilateralism.

Second, the dynamics of the creation of an internal market also facilitates, and in some occasion even induces, collusive behaviour. The reasons are twofold: internal survival and external competitiveness. At the internal level, some firms may find themselves too weak to survive increased

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[14] The Cecchini Report estimated the potential welfare gains from economies of scale for production resulting from completion of the EC internal market to around Ecu 60 billion, i.e., 2.1 percent of EC total GDP (see Cecchini, 1988).

[15] Although other factors are considered, the EU practice based on Article 85 (on mergers and collusive behaviour) and Article 86 (on abuse of dominant position) suggests that a dominant position requires a market share above 25 per cent (see Graper, 1994; and Neven et al., 1993).

internal competition as a result of regional trade liberalisation. In order not to exit the market, such firms may choose to enter collusive agreements or to merge so as to benefit from new opportunities for economies of scale arising from the creation of an internal market. Hence, not only some firms grow as the result of internal trade liberalisation (as indicated at the beginning of this Section), but firms may also collude or merge to generate efficiency gains so as to survive in the internal market. In both cases, this may raise concerns about the potential deviation from competitive practices which would reduce social welfare.

Considerations of external competitiveness may also trigger mergers, collusive behaviour and abuse of dominant position. A reason is that one of the prime objectives of RTAs is often to strengthen domestic industries. By promoting internal competition, RTAs intend to increase the international competitiveness of domestic firms. Competition is viewed as the best driving force for efficiency improvement. Thus, a firm able to compete on the domestic market is more likely to succeed when facing international competition.[16] However, efficiency gains are also generated by economies of scale. Thus, the concentration effect associated with the creation of the internal market can enhance the international competitiveness of domestic firms. The prospect of capturing larger shares of the foreign market may lead some domestic firms to adopt anti-competitive behaviour and abuse their dominant position in the internal market. To prevent such anti-competitive outcomes, a strict enforcement of common competition principles is recommended.

In sum, if RTAs boost competition, they also create greater opportunities for economies of scale and hence abuse of dominant positions (resulting from concentration and collusion effects) in oligopolistic markets than a multilateral trade liberalisation process would.

It is important to note that the danger of anti-competitive behaviour and abuse of dominant position in the internal market also increases the risk that internal competition policy be captured by interests groups (in particular the large firms and mergers benefiting from new opportunities for economies of scale) and serves strategic objectives.

The situation is slightly different for RTAs among developing countries, such as MERCOSUR, where there exist already important adjustment costs for firms due to internal (and external) trade liberalisation. This may give incentives for firms to behave more collusively, obviously decreasing the

[16] For further explanation on this line of reasoning see Porter (1990).

short run benefits from trade liberalisation. However imposing too strict a competition policy in such RTAs may induce a significant additional burden on firms already struggling to adjust. The potential risk is a loss of support from these adjusting firms for the reduction of trade barriers which could ultimately derail the whole liberalisation process. Besides, capital constraints, labour market shortage or information asymmetries, common in developing countries, could prove to be more important barriers to entry than market power by incumbent firms. To penalise an incumbent firm with a large market share in this case is by far not the first-best policy. Government intervention to introduce more flexibility in factor markets would be more appropriate. This is not to say that basic principles of competition should not be put in place. But a less stringent approach to competition policy in the short run may be envisaged when countries engage in trade liberalisation programs.

5. CONCLUDING REMARKS

As regional trading agreements have spurred world-wide, the question of whether there is a need for a regional agreement on competition arises. We have argued that there is a case for a regional approach to competition policy, especially in the case of deep forms of regional integration such as customs unions.

Internal trade liberalisation within regional blocs allows for economies of scale and restructuring of the internal market which drive inefficient firms to exit the market. This in turn leads to a more concentrated market structure which is consistent with efficiency and welfare gains. Thus, a cautious interpretation of legislation on the abuse of dominant position is suggested so that firms are allowed to undertake the necessary adjustment costs linked to the internal trade liberalisation. In particular, legislation on the abuse of dominant position should focus more on strategic entry barriers rather than on market shares.

This is particularly relevant in the case of regional integration agreements among developing countries where market failures are not only due to imperfect competition but also to externalities or other barriers to entry resulting from factor market distortions such as credit constraints, labour shortages or information asymmetries.

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