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Seth Sacher
Federal Trade Commission

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I. INTRODUCTION

It may seem obvious that good trade policy can promote competition. That is, by opening up a domestic economy to increased trade, additional competitive pressures may be placed on domestic producers, thereby decreasing domestic market power and improving industry performance in the form of lower prices, production that is more efficient, and more innovation.

On the other hand, although it may appear less obvious, good competition policy can be a means for fostering good trade policies. A competitive domestic economy, as enhanced by appropriate competition policies, can be a good defense against protectionist sentiments. In other words, robust competition enhances domestic prosperity and international competitiveness, which are conducive to political conditions supportive (or at least less obstructive) of freer trade. Indeed, this note argues that the benefits of good trade policy for good competition policy may be overemphasized, while the benefits of good competition policy for good trade policy may not be fully appreciated.

II. INTERNATIONAL TRADE AND DOMESTIC COMPETITIVE PERFORMANCE

Trade economists often note that one of the major benefits of a more open economy is increased competition for a domestic market. For example, Douglas Irwin states:

> There is much better, *indeed overwhelming*, evidence that free trade improves economic performance by increasing competition in the domestic market. This competition diminishes the market power of domestic firms and leads to a more efficient outcome…Firms with market power tend to restrict output and raise prices, thereby harming consumers while increasing their own profits. With international competition, firms cannot get away with such conduct and are forced to behave more competitively.[2]

Such a claim seems rather strong in light of much of the industrial organization literature and recent antitrust enforcement experience where three or four significant competitors are commonly found to be sufficient to ensure a workably competitive outcome. For example, consider the work of Bresnahan & Reiss ("BR").[3] BR studied how the average quantity sold per

[1] Economist, US Federal Trade Commission, Washington, DC 20580, ssacher@ftc.gov. The views expressed in this paper are solely those of the author and do not represent the views of the Federal Trade Commission or any individual Commissioner. Tim Hughes, Paul Zimmerman, Malcolm Coate and Douglas Herman provided helpful comments and suggestions. Remaining errors are my own.

[2] DOUGLAS IRWIN, FREE TRADE UNDER FIRE, at 49. (Emphasis added.) *See also* BHAGWATI, IN DEFENSE OF GLOBALIZATION, at 77.

[3] Timothy F. Bresnahan & Peter C. Reiss, *Entry and Competition in Concentrated Markets*, 99 J. POLITICAL ECON. 977 (1991).

firm varies as the number of firms in a market changes and draw inferences from this regarding the competitiveness of a market.

Assume only one firm serves a town and the population of this town is 3,000. It may appear that in order to support two firms, a town would need a population of 6,000. However, if the first firm is charging monopoly prices, it may take more than an increase in population of 3,000 to support a second firm. This is because the entrant may have less power to set price and thus needs more sales to cover its fixed costs. Thus, BR argue, if one observes that the average quantity sold per firm does not significantly change as the number of firms in a town increases, then pre-entry pricing is at competitive levels since entrants do not appear to be affecting strategic behavior. BR study five industries (druggists, tire dealers, doctors, dentists, and plumbers) in a set of small towns and find that generally price is at competitive levels whenever there are three or more significant rivals within a particular town.

Modern antitrust enforcement would appear to be roughly commensurate with such findings. For example, the staff of the U.S. Federal Trade Commission ("FTC") was able to identify the number of significant competitors in 898 markets involved in horizontal mergers in which enforcement actions were taken between 1996 and 2011.[4] Of these, 802 (89 percent) would have reduced the number of significant competitors to three or less. The recent increases in the levels of concentration required before competitive concerns arise in the *U.S. Department of Justice and Federal Trade Commission Merger Guidelines*[5] also appear to roughly correspond with such findings.

Thus, only in highly concentrated industries with less than three or four significant competitors is international trade generally likely lead to a significant improvement in performance.[6] For industries that already have at least three or four significant competitors, based on findings like those of BR, international trade should not have a substantial impact on market performance. What is the source of this apparent contradiction between the findings of trade and industrial organization economists?

One answer may be methodological. Largely, the trade result appears to rely on regressions of price-cost margins on proxies for import competition or trade protection, usually looking cross-sectionally across industries at a point in time.[7] Because of various methodological issues, students of industrial organization have long questioned such an approach.[8] For example,

[4] U.S. Federal Trade Commission, *Horizontal Merger Investigation Data, Fiscal Years 1996-2011*, January 2013 at 12. *Available at* http://www.ftc.gov/os/2013/01/130104horizontalmergerreport.pdf.

[5] U. S. Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines*, August 19, 2010 at 18-19. *Available* at http://www.ftc.gov/os/2010/08/100819hmg.pdf. .

[6] Opening up an economy to international competition can improve performance if foreign firms have a fundamentally superior cost structure to domestic firms. However, this does not appear to be the kind of performance improvement referred to by Irwin in his statement above.

[7] For a survey of this literature, *see* Norman Lee, *Market Structure and Trade in the Developing Countries, in* TRADE POLICY INDUSTRIALIZATION AND DEVELOPMENT: NEW PERSPECTIVES (Helleiner, ed., 1992).

[8] E.g., *see* Michael Salinger, *The Concentration-Margins Relationship Reconsidered*, 287 BROOKINGS PAPERS ON MICROECONOMICS 1990 (1990).

actually measuring marginal costs in order to obtain price-cost margins is difficult and mismeasurement can seriously bias results.[9]

Another possible source of the contradiction is context. Much of the trade literature focuses on less developed economies while the industrial organization literature tends to focus on more developed ones. Consequently, what the trade literature largely may be observing may not be a strict "numbers" effect in the sense that an increased number of competitors makes coordination or other anticompetitive effects less likely. Instead, what international trade may really be doing in the context of less developed economies is upsetting some kind of domestic "cronyism" or corruption.

In this case, rather than challenging competition-softening practices or tacit collusion among domestic firms, government officials may turn a blind eye or even facilitate such practices, particularly if some set of business owners has particularly close ties to the government. The more anonymous entry in the form of international trade may have a greater destabilizing effect on such arrangements than domestic entry, which may merely involve entry by another member of the "club."

This suggests that while an international trade policy that is more open to increased trade may be a complement to domestic competition policy, the degree to which that is the case may be situation specific. This is not to say that increased trade cannot be beneficial in developed economies, only that its impact is likely to be limited to more concentrated industries.[10] Thus, while international trade can make a difference in the performance of some industries, generic claims about the impact of international trade on overall market performance should be made carefully.

As noted above, industrial organization scholars have generally moved away from broad cross-sectional studies in terms of considering the relationship between market performance and concentration. One alternative approach is the case study method. A number of recent studies have used case studies of mergers to elucidate the relationship between concentration and price. Many of these studies use a difference-in-differences approach, which is generally held to be less fraught with methodological issues relative to pure cross sectional or time-series approaches.[11] This case study approach might also help further elucidate the relationship between trade and

[9] For a critique of the typical price-cost margin used in such studies, *see* Franklin M. Fisher, *On the Misuse of Accounting Rates of Return to Infer Monopoly Profits,* 82 AMER. ECON. REV. 18 (1987). Other methodological issues include the endogeneity of many of the structural variables and issues in market definition, which can lead to mismeasurement of key variables such as seller and buyer concentration.

[10] There are clearly exceptions. For example, up through 1968 the American steel industry exhibited remarkable pricing discipline despite being relatively unconcentrated until import competition forced a general reduction of price-cost margins. Some observers also point to import restrictions in the U.S. crude oil industry as the source of downward price rigidity in that industry between 1945 and 1973. However, the cartelized prorationing system, under which Texas producers in particular were required under state and federal laws to restrict their supply also played a crucial role. Thus, this example more likely falls under the "crony" upsetting effects of international trade rather than strict deconcentrating effects. (*See*, F. M. SCHERER & DAVID ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE, 3rd, 1990 at 292.)

[11] E.g., *see* Michael Vita & Seth Sacher. *The Competitive Effects of Not-for-Profit Hospital Mergers: A Case Study,* 63 J. INDUS. ECON 69 (2001).

market performance, perhaps by focusing on a single market where there has been a significant change in trade policy.

III. THE BENEFITS OF GOOD COMPETITION POLICY FOR GOOD TRADE POLICY

Overall prosperity may contribute to a political climate that is more hospitable to free trade. As noted by trade theorist Jagdish Bhagwati:

> [t]he pace at which trade liberalization takes place is likely to be higher the greater the economic prosperity and state of overall employment when liberalization is attempted. Trade liberalization therefore has traditionally proceeded faster in times of prosperity than in time of distress.[12]

For example, if workers displaced by imports can more easily find jobs, there is less likely to be strong mobilization by this segment against free trade. Indeed, the Smoot-Hawley tariffs provide well-known evidence for the proposition that bad times are more likely to generate protectionist policies.

Clearly, both competition policy and trade policy contribute to prosperity. Freer trade accomplishes this through a number of factors, including allowing countries to benefit from their comparative advantages, allowing for greater scale economies by expanding the extent of the market, increasing the amount of choice, and increasing productivity. Although increased productivity may result because of increased competition, it also occurs because trade enhances the diffusion of new technologies.

Competition also drives prosperity. For example, in 2004, McKinsey Global Institute completed a 12-year study of 13 developing countries to find out what makes some countries rich and others poor and found that productivity was the most important factor.[13] What drives productivity? The study examined labor, capital formation, corporate governance, education, competition, etc., and found the most important factor was competition.

In addition to prosperity, it can be argued that international competitiveness can contribute to a political atmosphere more conducive to open trade policies. When countries see their domestic producers as unable to compete on a level playing field with others, this often leads to protectionism. Good competition policy can be a key factor in fostering international competitiveness.

As noted by Michael Porter:

> Few roles of government are more important to the upgrading of an economy than ensuring vigorous domestic rivalry. Rivalry at home is not only uniquely important to fostering innovation, but benefits the national industry. Firms that do not have to compete at home rarely succeed abroad.[14]

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[12] *See* Bhagwati, *supra* note 2, at 270.

[13] *See*, WILLIAM LEWIS, THE POWER OF PRODUCTIVITY: WEALTH, POVERTY, AND THE THREAT TO GLOBAL STABILITY (2004).

[14] MICHAEL PORTER THE COMPETITIVE ADVANTAGE OF NATIONS at 584 (1990). Additional papers finding a positive relationship between competition, competition policy, and economic growth & development are summarized in OECD, *Competition policy and economic growth and development* (2002). *Available at* http://www.oecd.org/daf/competition/prosecutionandlawenforcement/1845998.pdf.

For example, Porter considered the Japanese market. He found that Japanese industries with strong domestic competition were also its most successful "world-beating" industries. Examples included cars, motorcycles, cameras, video recorders, and musical instruments. Japanese industries with weak domestic competition had little or no international success. Examples included construction, commodity chemicals, and paper.[15]

Increased domestic competition leads to increased international competitiveness through a variety of mechanisms. Thus, increased competition leads to increased productivity. This, in turn, leads to cheaper goods, increasing international competitiveness. Further, increased competition spurs innovation. Innovation leads to either higher quality goods or completely new goods (or both), which also leads to increased international competitiveness.

Good competition policy can also enhance trade by helping to ensure foreign entities are able to compete on a level playing field for domestic customers. Thus, if foreign producers feel they do not have fair access to a domestic market, this can lead those firms (and other sympathetic entities) to create pressures to retaliate by having their own domestic markets closed to sales and investment. Consequently, authorities charged with monitoring various exclusive vertical practices, such as exclusive dealing or conditional rebates, which may be used by dominant firms to exclude competition—whether it be foreign or domestic—should keep this in mind. Proper attention to such practices may not only enhance domestic competition, but may create more harmonious trade relations as well.

Further, authorities should continue to be vigilant when dominant firms attempt to use trade policies to buttress market power. Indeed, there is evidence that antidumping legislation has been used to enforce cartels. For example, in 1989 U.S. producers of ferrosilicon formed a cartel and reduced output. The lower output was used to prove injury and justify the imposition of antidumping duties against five foreign competitors. When Brazil started exporting ferrosilicon in place of the others, their producers were invited to join the U.S. cartel. When they refused, they were also hit with an antidumping case.[16] Again, not only is such behavior potentially harmful to domestic competition, it also increases the risks of retaliatory trade actions. Competition agencies can play a key role in many economies by promoting market-oriented trade reforms through their advocacy functions.

Perhaps somewhat paradoxically, increased competition can increase international competitiveness by increasing expenditures on imports as well. Many trade theorists have noted that increased imports actually lead to increased exports. Thus, consider the following sequence: Increased competition leads to goods and services being available to consumers at lower prices. These lower prices mean that consumers have more income available to spend on other goods and services, which creates demand in other sectors, including import sectors. In order to purchase more goods from foreign countries, domestic consumers will have to purchase the foreign currency. In response to the increased demand for the foreign currency, the relative value

[15] *See also* Mariko Sakakibara & Michael Porter, *Competing at Home to Win Abroad: Evidence from Japanese Industry,* 83 REV. ECON. & STATISTICS 310 (2001) (finding that local competition pressures dynamic improvement that leads to international competitiveness).

[16] *See* Richard J. Pierce, *Antidumping Law as a Means of Facilitating Cartelization,* 725 ANTITRUST L.J. 67 (2000).

of the domestic currency will fall. This will dampen the domestic demand for the foreign good, but increase the foreign demand for domestic goods, thereby increasing exports. That higher imports are correlated with higher imports is a regularly observed trade phenomenon.[17]

Increased exports can also lead to increased diversification in the nature of exports, which can also lessen resistance to freer trade. Thus, as a nation becomes more competitive internationally, it does not simply mean more trade in the same goods, but trade also tends to expand more rapidly in goods not previously traded or only traded at low levels. Such export diversification can lessen the harmful consequences of export price shocks as a lower percentage of workers may be in industries that are harmed by the shock—thus weakening forces resistant to international trade.

V. CONCLUSION

In sum, proponents of freer trade should be cautious in using arguments regarding increased domestic competition to buttress their case, particularly in more developed economies. Similarly, antitrust practitioners should be cautious in applying the findings of the trade literature in defending specific practices or transactions. This is not to say that, in cases of concentrated industries, increased international trade cannot promote better market performance, only that such arguments should be applied expeditiously and without a broad stroke.

On the other hand, the benefits of good competition policy for good trade policy may be underappreciated. Good competition policy, by promoting a robust domestic economy helps create conditions that are conducive to good trade policy. Thus, robust competition enhances domestic prosperity and international competitiveness, which are conducive to political conditions supportive (or at least less obstructive) of freer trade. Further, good competition policies can lead to harmonious trade relations and help create exchange rate conditions conducive to increased trade. When shaping competition policies, policymakers would be prudent to consider these additional effects.

[17] E.g., *see* Irwin *supra* note 2 at 82-86.