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## International Trade Aspects of Competition Policy

Sadao Nagaoka

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Competition policy has emerged as one of the high-priority policy issues in East Asian economies. Japan has strengthened its competition policy substantially in the 1990s, largely in response to U.S. demands in the Structural Impediment Initiative (SII) talks of 1989–90, but also within the overall context of regulatory reform. Both Korea and Taiwan have also substantially strengthened competition policy in recent years.<sup>1</sup> Competition policy has emerged as an important policy issue in regional and multilateral contexts too. The action agenda adopted at the APEC Osaka meeting of November 1995 calls for the establishment of appropriate cooperative arrangements among the competition policy authorities of the APEC economies.<sup>2</sup> A working group on trade and competition policy was established in the World Trade Organization (WTO) in December 1996, to study issues relating to the interaction between trade and competition policy.

These developments reflect the increasing perception of policymakers that private anticompetitive behaviors may continue to constrain “market access,” even when official barriers created by border measures have come

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1. The Korean Fair Trade Commission became an independent administrative agency in 1994. Taiwan enacted the Fair Trade Law in 1991 and established an enforcement agency (the Fair Trade Commission) in 1993.

2. It envisages, among other things, strengthening cooperation among the competition policy authorities of the APEC economies with regard to information exchange, notification and consultation, and development of nonbinding principles on competition policy or laws in APEC.

down.<sup>3</sup> In fact, the most important motivation for including competition policy on the agenda of the next round of WTO trade negotiations seems to be market access concerns. However, there has been little economic analysis of how private anticompetitive behaviors can act as trade barriers.<sup>4</sup> In fact, there seems to be much confusion as well as unwarranted views in this area.

This paper addresses how competition policy is and is not important for international trade. In section 2.1 I conduct a simple economic analysis of international spillovers of anticompetitive behavior. In section 2.2 I briefly review the recent development of Japanese competition policy, emphasizing its international aspects. In section 2.3 I evaluate priorities for international cooperation in competition policy based on an assessment of the importance of international spillovers of competition policy. Section 2.4 concludes.

## 2.1 International Spillovers of Anticompetitive Behavior

International concern has grown at the possibility that anticompetitive behavior by the private enterprises of trading partners harms trading opportunities. This section assesses how trade cartels, domestic cartels, mergers, and vertical restraints can affect foreign countries through international trade. I omit a discussion of monopolization, including predatory pricing.<sup>5</sup>

### 2.1.1 Trade Cartels and International Cartels

Trade cartels restrain international transactions.<sup>6</sup> They include export cartels, import cartels, and international agreements for dividing up national markets. Restriction of international trade reduces global supply and welfare and simultaneously harms the interests of trading partners.

This point is illustrated by figure 2.1 in the context of an export cartel and quantity competition. We assume here that national markets are segmented. In figure 2.1,  $q$  represents the exports of a home country and  $q^*$  the supply of the import-competing industry of a foreign country. An export cartel among the home firms shifts the reaction curve of the home

3. See, e.g., the economic report of the president of the United States for 1994 (Council of Economic Advisers 1994), as well as the report of the Group of Experts of the European Commission (1995).

4. Exceptions are Bliss (1996) and Levinsohn (1996). See also Scherer (1994).

5. Mergers and vertical restraints are, however, major means of monopolization. An extensive theoretical and empirical literature on dumping generally suggests that predatory pricing is a rarely used business strategy, in spite of many accusations (see Nagaoka 1995 for a review of the recent literature).

6. When a trade cartel is used as a means to prevent free-riding on joint investment for trade promotion, it can lead to the expansion of international trade (see Dick 1992). Here we focus only on "naked" trade cartels, the objective of which is to improve the terms of trade by limiting trade.

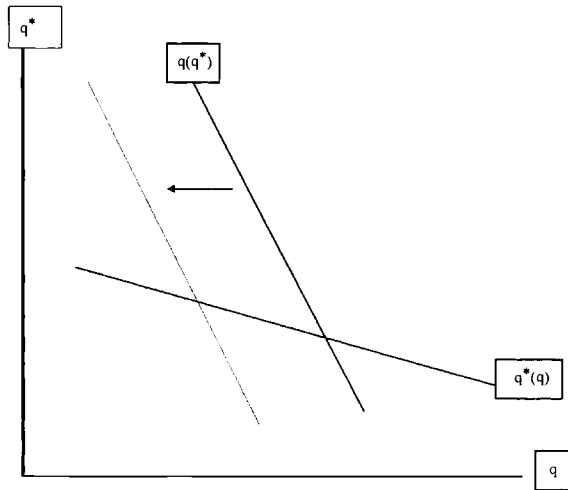


Fig. 2.1 Economic effects of a cartel

country inward, so that the output of the foreign firms expands ( $dq^* > 0$ ) and the market price  $P$  rises ( $dP > 0$ ).<sup>7</sup> The welfare change of the foreign country is given by

$$(1) \quad dW^* = (P - c^*)dq^* + (q^* - q_H^*)dP,$$

where  $W^*$  is the welfare of the foreign country,  $c^*$  is the cost of production of the foreign industry, and  $q_H^*$  is the consumption of the foreign country. Because of this cartel, the foreign country, on the one hand, loses due to terms-of-trade deterioration since it is an importing country ( $q^* - q_H^* < 0$ ), but on the other hand, it gains due to the rent-shifting effect for the foreign industry ( $(P - c^*)dq^* > 0$ ).

The net effect of the cartel for the foreign country, however, is always negative as long as the export cartel is voluntary since the exporters engage in the cartel only if it is profitable for them, while global welfare is reduced by the cartel unless the marginal cost of the exporters is substantially above that of the foreign industry.<sup>8</sup> That is,

$$(2) \quad dW^* = d(W^* + \Pi) - d\Pi < d(W^* + \Pi) < 0,$$

where  $\Pi$  is the profit of the home country exporters and  $W^* + \Pi$  is the sum of consumer surplus and producer surplus at market equilibrium in the foreign market. Thus a voluntary export cartel is clearly a beggar-

7. Whether the price goes up or not depends on the slope of the reaction curve of the foreign country. However, when the home firms foresee that the price will drop as a result of an export cartel, they will not engage in such a cartel.

8.  $d(W^* + \Pi) = (P - c^*)dq^* + (P - c)dq = (P - c)(dq + dq^*) + (c - c^*)dq^*$ .

your-neighbor policy since the home country where such a cartel originates always gains and the foreign country loses.<sup>9</sup> There exists a negative international spillover of nonenforcement of competition policy against export cartels. Identical conclusions apply to import cartels.

When export restraint is a part of an international agreement among firms for allocating markets among themselves, all countries can lose. This is most clear in the following symmetric case, where the home and foreign countries are the same size, and each country has one firm with a common production cost. In this case the firms can achieve a monopoly outcome by each completely refraining from exporting to its competitor's market. The welfare of both countries declines due to constrained supply, while both firms gain.

It is important to note that the abolition of export cartels does not necessarily improve welfare, given the presence of contingent protection, to the extent that such cartels are used to prevent the use of contingent protection. In particular, antidumping measures can result in stronger restriction of trade since the duties ordered are often prohibitively high. As shown by a recent U.S. International Trade Commission report (1995), antidumping measures often result in very large reductions in exports or in their complete abolition, so that the trade-restraining effect of such measures can be much larger than the monopolistic reduction of exports.<sup>10</sup> Thus reform of antidumping measures is necessary to ensure that the international restriction of export cartels leads to welfare gains.

### 2.1.2 Domestic Cartels and Mergers

#### *Domestic Sales Cartels and Production Cartels*

When domestic and foreign markets are segmented, domestic firms can collude to raise their sales price in the domestic market by restricting only their sales in the domestic market. Since the price in the domestic market is not linked with that in the foreign market, the domestic sales cartel does not affect the equilibrium in the foreign market if the marginal cost of production is constant. With such a cartel, the foreign country does not suffer a reduction in import supply, while it can expand its exports. Thus the foreign country's welfare definitely improves as a result of the sales cartel in the domestic market.

When domestic and foreign markets are integrated, domestic firms have

9. An involuntary cartel can reduce the profits of its members due to expansion in supply by outsiders (see Salant, Switzer, and Reynolds 1983). Such an outcome is very likely in the case where competition is Cournot, strategic substitution holds, and outsiders have significant market share.

10. The fact that an export industry typically dislikes antidumping measures imposed on itself also suggests that the export restrictions imposed by antidumping measures are stronger than profit-maximizing restraint of trade.

to reduce sales in both domestic and export markets in order to raise their sales price. Thus the effect of such a cartel can be analyzed as the effect of a production cartel among domestic firms. Now we can interpret figure 2.1 as representing the global market. When the home country is an importing country and the foreign country is an exporting country ( $q^* - q_H^* > 0$ ), it is clear that the foreign country gains from the cartel among firms in the home country. It gains both from terms-of-trade improvement and from the rent-shifting effect for its firms, as is clear from equation (1).

On the other hand, when the home country is an exporting country and the foreign country is an importing country ( $q^* - q_H^* < 0$ ), a cartel among the home firms worsens the terms of trade of the foreign country, while the rent-shifting effect is positive for the foreign country, as in the case of an export cartel. The welfare of the foreign country is likely to decline especially when its firms are not efficient (high  $c^*$ ).<sup>11</sup>

The above analysis shows that the international spillover from a domestic cartel tends to be positive. It can be negative only when the foreign country is a net importing country and its import price arises substantially. On the other hand, a domestic cartel harms the home country, and international trade tends to amplify this effect when markets are segmented or it is an importing country, since it invites deterioration in its terms of trade.

In spite of this clear result, policymakers often believe that a cartel abroad harms the interests of the home industry, since cartel profits are used to promote the cartel's exports. According to this "profit sanctuary" story, high profits gained by a domestic cartel are used to subsidize exports, or in other words, the cartel forces domestic consumers to cross-subsidize exports. This view is not supported by economic analysis. Domestic industry is not going to spend profits gained in the home market for export promotion unless such an act is profitable by itself. Profits in the domestic market may provide the means for artificial export promotion but not its motivation, so that a firm does not cross-subsidize consumers in one market using profits from another market.<sup>12</sup>

In the case of import protection, protection may promote exports, not by providing the means for cross-subsidization, but by strengthening competitiveness (Krugman 1984). Import protection shifts the global expenditure pattern in favor of the home industry, encouraging its efforts at cost reduction and learning while discouraging those of the foreign industry. However, in the case of a cartel, the exact opposite is the case. Contrary

11. High production costs for the foreign firms cause greater dependency on imports as well as low profit margins for the foreign firms.

12. Cross-subsidization may be relevant in a regulated industry, where the regulator allows the regulated firm to set its price based on its costs. In such an industry the regulated firm has an incentive to use the assets of the regulated business to expand into unregulated markets because the private cost of such activity is zero.

to the case of import protection, a cartel shifts the market away from the home industry to the foreign industry (see fig. 2.1). Consequently, cost reduction in the home industry slows while that in the foreign industry accelerates. Thus a domestic cartel is not a substitute for import protection in this regard at all, and in fact, it tends to reduce the home industry's competitiveness.

### *Mergers*

Mergers among home firms have spillover effects on the foreign country similar to those of a combination of domestic and trade cartels, if we ignore for the time being their potential efficiency effects. This is because a consolidated firm will have more market power in both domestic and export markets and will restrict sales in each market. Thus a merger hinders exports and promotes imports if its efficiency effect is small, as pointed out by Bliss (1996). As for welfare, a merger in the import-competing industry of the home country increases the welfare of the foreign country. A merger in the export industry of the home country worsens the terms of trade of the foreign country and so can harm its welfare when foreign competing firms have high costs.

A competition policy authority typically will not allow a merger between firms if the merger creates a significant market power in the home market. Even when efficiency defenses for mergers are considered, as in the United States, a merger that will produce a firm of significantly greater market power will be approved only if it is expected to have a strong efficiency effect that can dominate the price-raising effect. Thus the regulation of mergers under competition policy tends to reduce (and can reverse) their negative as well as their positive international spillover effects.

### *Downstream and Upstream Effects of Cartels and Mergers*

Domestic cartels in such business service sectors as international transportation and international communications, which support international trade, have a definite constraining effect on international trade because they raise the cost of such trade. Similarly, cartels among distributors in a specific industry will raise the consumer price of that industry, which in turn will reduce demand for both domestic and foreign goods in that sector. The effect of these cartels on the foreign country is just like that of tariffs on its exports (or export duties on its imported goods). Foreign downstream industry suffers from terms-of-trade deterioration and a decline in the amount of trade.<sup>13</sup> Thus, even if the effect of such a cartel on the foreign industry in a horizontal relationship with the domestic indus-

13. The home country can also lose because the monopoly transportation, communications, or distribution firm can raise its price beyond the level of the optimal tariff, ignoring the effect on domestic consumers and producers.

try is positive, its international effect may be negative if its effect on downstream foreign industry is significantly negative. Similarly, a domestic cartel can have a negative international effect if its negative effect on upstream foreign industry, such as foreign component suppliers, is large.

### 2.1.3 Vertical Restraints

Vertical practices may affect international trade both by constraining interbrand competition and by reducing intrabrand competition. We discuss the two cases in turn.

#### *Interbrand Competition*

Vertical restraints by incumbent domestic firms may constrain entry and growth by both foreign and domestic suppliers when they are used to increase the costs of entering and doing business in the market.<sup>14</sup> Such business practices as exclusive dealing, vertical integration, and refusal to deal may be used for such objectives. Foreign firms will suffer sales losses due to such anticompetitive practices by incumbent domestic firms. However, vertical restraints by incumbent firms are also used to increase the efficiency of supply.<sup>15</sup> It is important to note that vertical restraints by incumbent firms always reduce “market access” by a new entrant, whether such practices reduce cost of supply by incumbent firms or increase cost of supply by new entrants. When the main effect of vertical restraints is to reduce the cost of supply by incumbent firms, global welfare tends to rise, even if foreign firms suffer competitive losses.

Thus it is important to distinguish anticompetitive vertical restraints from efficient ones. Market structure plays a critical role in that regard. In particular, the following three conditions must be simultaneously present for the strategy of raising a rival’s cost to be a credible profit-maximizing strategy, as pointed out by Ordover and Saloner (1989), among others. First, the foreclosing firm must have significant market power. Like predatory pricing, engaging in exclusionary practices is costly for the foreclosing firm. Thus, in order for the payoff of an exclusion strategy to be positive and to exceed that of an entry accommodation strategy, the firm must have a profitable market that can be protected from competition. Second, the foreclosing firm must be willing to pay more than the foreclosed firm in foreclosing the market. Otherwise, the foreclosure will be blocked or undone by the targeted firm. Third, the supply of the foreclosed resource

14. Vertical restraints may be used strategically to raise a rival’s cost, in particular for exclusionary reasons (see Ordover and Saloner 1989; Ordover, Saloner, and Salop 1990; Tirole 1990).

15. Vertical restraints can be efficiency increasing in various ways (see Katz 1989). They facilitate smooth information flow across related parties and enable its efficient use. They also encourage investment by controlling ex post opportunism. They help internalize vertical or horizontal externalities such as double marginalization and free-riding on investment in reputation.



must be inelastic. Competitive output markets make the first two conditions unlikely to hold, while competitive input markets make the third condition unlikely to hold.

### *Intrabrand Competition*

Vertical restraints such as territorial restraints may be used to price discriminate among national markets. Although the output effect of price discrimination can be positive, especially if such price discrimination is necessary to induce a firm to serve each national market, international price differentiation per se is welfare reducing. The welfare cost due to international price differences becomes larger as such differences become larger. Therefore, competition policy measures that prevent the emergence of a high degree of international price differentiation can be welfare improving.<sup>16</sup> Such measures include regulation of the strength of territorial restrictions imposed on distributors by a producer and prohibition of a firm from interfering with parallel imports or reverse imports.

The welfare impact of price discrimination on a foreign country depends on whether the firm sets a higher price abroad than at home, which in turn depends on consumers' willingness to pay and the degree of competition abroad relative to those at home. If a firm discriminates in favor of foreign consumers, the foreign country tends to gain from such business practices. The benefit of a lower price to its consumers tends to dominate the losses of competing firms. Thus international price discrimination can have a positive international spillover.

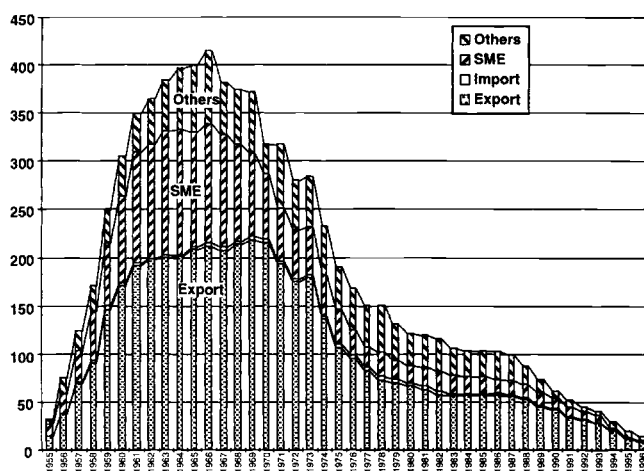
## **2.2 Recent Development of Japanese Competition Policy**

### **2.2.1 Trade Cartels and International Division of Markets**

Trade cartels that are approved by the Ministry of International Trade and Industry under the Export and Import Transaction Law<sup>17</sup> are exempt from the application of the Antimonopoly Law of Japan. Export cartels have accounted for more than half of the exempted cartels in terms of numbers (see fig. 2.2 and table 2.1). The number of trade cartels, however,

16. However, there may be good cases for price discrimination for goods embodying a large amount of R&D expenditure and among markets with significant differences of income. In the former case, price discrimination may be useful for expanding the areas for technology application, given low marginal cost, and the profits gained from price discrimination tend to encourage R&D (see Hausman and Mackie-Mason 1988). In the latter case, prohibiting price discrimination has the significant danger that the firm will choose to abandon the markets with lower incomes.

17. The law was enacted in 1952. Its objectives are to prevent unfair export transactions and to establish orderly export and import transactions. Unfair export transactions include infringing on intellectual property rights in importing countries and giving false indication of origin.



**Fig. 2.2** Number of cartels exempted from the Antimonopoly Law

*Note:* Import is indicated by the area between small and medium-size enterprises (SME) and export.

**Table 2.1** Number of Cartels Exempted from the Antimonopoly Law in Japan

Type of Exempted Cartel	1 April 1991	1 March 1997
International trade		
Export	30	4
Import	1	1
Associations of small traders	3	0
Recession or rationalization	0	0
Small and medium-size enterprises	10	0
Fishery	4	4
Transportation		
Coastal shipping	1	1
Barbershop and other services	1	1
<b>Total</b>	<b>50</b>	<b>11</b>

*Source:* JFTC (various years).

*Note:* Regional cartels in the same product are counted only once.

has declined substantially over time. As of March 1997, the number of trade cartels was five, of which four were export cartels.<sup>18</sup> The significant reduction in trade cartels reflects, first, a general reduction in the scope of exempted cartels. The Japanese government has reduced the scope of

18. The four export cartels covered textiles (quantity) to certain destinations, ceramics (design), and pearls (quality). The single import cartel covered silk products imported from China.

exemptions since the latter half of the 1980s within the context of regulatory reform. Regulatory reform has gained new momentum recently. In 1995 a cabinet decision was reached that exempted cartels be abolished in principle by the end of FY 1998. Accordingly, the exemptions for import cartels, associations of small traders, and domestic cartels for export restriction were abolished in 1998.

Second, the recent reduction in trade cartels also reflects the prohibition and phaseout of voluntary export restraints (VERs), as agreed in the Uruguay Round. Export cartels were an important means of implementing VERs and export restrictions under the Multi-Fiber Arrangement. According to a Japanese Fair Trade Commission report (JFTC 1991), preventing trade frictions was the main objective of two-thirds of export cartels (twenty out of thirty) in 1991.<sup>19</sup>

Trade cartels that are not approved by the government are violations of the Antimonopoly Law, even if they do not directly affect the home market. Recently, the JFTC caught such a case: the cartel coordinated by an industrial cooperative to fix the domestic wholesale prices as well as the export prices of its member's products.<sup>20</sup> Moreover, participation in international cartels per se is also prohibited by the Antimonopoly Law.<sup>21</sup>

## 2.2.2 Prohibition of Cartels and Regulation of Mergers

### *Prohibition of Cartels*

The Japanese government has also strengthened its enforcement of the Antimonopoly Law against cartels by increasing the administrative surcharge on firms engaged in cartels, by more actively invoking the procedure for criminal prosecution, and by strengthening its investigative capacity (see table 2.2). The administrative surcharge was increased significantly in 1991. As a result, the surcharge on a manufacturing firm participating in a cartel was raised from 2 percent of its sales to 6 percent of its sales.<sup>22</sup> The average annual surcharge levied from FY 1991 to FY 1995 after the increase was 4.5 times as much as that before the increase if we exclude FY 1990, during which the cement industry was subject to a very large surcharge, and 2.2 times as much if we include that year. Criminal prosecution has been more frequently invoked. There have been four cases

19. Countervailing an import monopoly was another objective (seven out of thirty cartels).

20. In 1994 the national mosaic tile industrial cooperative was ordered by the JFTC to stop the practice of price fixing in both markets and was levied a surcharge.

21. One major case uncovered by the JFTC was an international cartel between Japanese synthetic fiber producers and European competitors in 1972, which agreed on the complete restraint of exports to each other's market as well as on quantity ceilings and minimum export prices for other markets, excluding that of the United States.

22. The surcharge of 6 percent is levied for up to three years of sales, with exceptions for retail businesses (2 percent), wholesale businesses (1 percent), and small and medium-size firms (3 percent with a further exception of 1 percent for distribution businesses).

**Table 2.2 Antimonopoly Enforcement against Cartels in the 1990s**

	Fiscal Year							
	1990	1991	1992	1993	1994	1995	1996	1990–96
Number of cartels acted against	13	19	30	24	21	24	15	146
Total surcharge (billion yen)	12.6	2.0	2.7	3.6	5.7	6.4	7.4	40.4
Criminal prosecution	0	1	1	0	1	1	1	5

*Note:* In addition to the legal measures for injunction and for levying surcharges, the JFTC issues warnings and provides guidance in cases where not enough evidence can be found to establish violation of the Antimonopoly Law. In FY 1995 alone the JFTC issued five warnings and sixteen guidances with respect to suspected cartels (twelve against price cartels and twelve against bidrigging).

from FY 1990 to FY 1995, compared with no cases in the 1980s.<sup>23</sup> In addition, legal exemptions from the Antimonopoly Law have been significantly streamlined. In particular, it was decided in March 1998 that the Antimonopoly Law would be amended within three years to abolish exemptions for recession cartels and rationalization cartels.

Table 2.3 shows, by industry and by customer, the number of cartels as well as the size of surcharges levied on members of cartels that were subject to legal sanctions by the JFTC from 1989 to 1995. In terms of industrial sectors, the manufacturing industry accounts for 31 percent of the cases and 60 percent of the surcharges. The construction industry accounts for 36 percent of the cases and 24 percent of the surcharges. The service and distribution sectors account for the rest. The government and other public bodies were the customers in more than half of the cartel cases. Bid rigging was the dominant form of cartel for public procurement contracts, and the construction industry contained the main offenders in bid rigging.<sup>24</sup> In the case of private customers, price cartels were the dominant form of cartel. Cartels in the manufacturing sector accounted for about half of the cartels selling to private customers.

#### *Regulation of Mergers and Acquisitions*

The JFTC has been relatively restrictive against mergers and acquisitions, although the new Merger Guidelines of 1999 indicate a significant liberalization of JFTC policy. A 25 percent domestic market share used to be regarded as a critical line with regard to the necessity of close scrutiny of competitive conditions. The market definition used by the JFTC has been either the national market or a regional market within Japan. Although it does consider imports in the evaluation of competition, the JFTC has never used the global market as the defined scope of the market. It has not approved the efficiency defense for mergers either.

Table 2.4 shows the domestic market shares of merged firms for the largest merger cases from 1985 to 1995. In most mergers the market share of the postmerger firm did not substantially exceed the 25 percent market share line. In three cases mergers that achieved more than 30 percent market share were approved; however, the circumstances were exceptional. In one declining market demand and low entry cost were judged to justify the

23. The only major case that led to criminal prosecution before the 1990s was that of a cartel in the oil-refining industry in 1974.

24. We can point out three reasons why bid rigging has been prevalent in Japanese public procurements. First, government organizations are much less concerned with cost minimization than they are with the smooth implementation of the budgeted projects. Second, defection from a cartel is much easy to detect in the case of government contracts because the government is obliged to disclose publicly the winner of the bid. As the theory of cartel stability suggests, a high detection rate of defection helps to maintain a cartel. Third, until the recent choice of open tendering, tenders had been invited only from nominated bidders.

**Table 2.3 Japanese Cartels by Industry, Type, and Customer, FY 1989–95**

Industry	Public Procurement (number of cases)			Private Procurement (number of cases)			Total Cases	
	Bid Rigging	Price Cartel	Others	Bid Rigging	Price Cartel	Others	Number <sup>a</sup>	Surcharge <sup>a</sup> (billion yen)
Manufacturing	14	2	0	1	25	0	42 (31)	19.7 (60)
Distribution	4	0	0	0	9	1	14 (10)	2.5 (8)
Construction	48	1	1	0	0	0	50 (36)	8.0 (24)
Service and others	11	1	0	0	14	5	31 (23)	2.5 (8)
Total	77	4	1	1	48	6	137 (100)	32.7 (100)

*Source:* Author's estimate based on JFTC (various years).

*Note:* The numbers of cases for which surcharges were levied up to the end of FY 1995 are 37 for manufacturing, 10 for distribution, 37 for construction, and 23 for service and other industry.

<sup>a</sup>Numbers in parentheses are industry percentages of totals.

**Table 2.4** Market Shares of Major Horizontally Merged Firms, FY 1985–95

Market Share	Number of Cases
Less than or equal to 20%	11
Less than or equal to 25%	6
Less than or equal to 30%	3
More than 30%	3
Unknown	2
Total	25

*Source:* JFTC (various years).

*Note:* This table covers only major horizontal cases having the national market as market, as reported in the JFTC annual reports. When the JFTC examines several layers of markets, this table adopts the broadest market.

merger. In another a joint venture between the leading Japanese beer maker and a large foreign beer maker was approved because of regulatory restrictions on the expansion of liquor shops in Japan, and only for ten years.

Moreover, when the market share of the postmerger firm was expected to exceed the 25 percent line substantially, the JFTC often asked the merging firms to take measures that would limit their market power as a precondition for approval. For example, in 1995 the JFTC asked one chemical company undertaking consolidation to divest its shareholding in the joint production company. It asked another chemical company undertaking consolidation to liquidate its joint sales agreement with a foreign, potentially competing company.

### 2.2.3 Vertical Restraints

#### *Overall Regulation*

Vertical restraints have been regulated in Japan mainly under the unfair trade practices section of the Antimonopoly Law because it covers a range of business practices wider than attempted monopolization. Unfair trade practices can cover such business practices as resale price maintenance, joint refusal to deal, below-cost sales and price discrimination, exclusive dealing, and territorial restriction. Similar to the policy practices in the United States or the European Union, such conduct as exclusive dealing is not illegal *per se*. Legality in Japan depends on how “influential” the party requiring such a contract is as well as on how much such a practice constrains the business activities of competitors. Major exceptions in this respect are resale price maintenance, joint refusal to deal, and sales substantially below cost, which are illegal in principle, irrespective of the market position of the firm engaging in these activities. Focusing on distribution, the JFTC issued detailed guidelines on distribution and business practices in 1991, as a direct outcome of the SII talks.

**Table 2.5** Unfair Business Practices Subject to JFTC Action, FY 1991–95

Type of Unfair Business Practice	Number of Cases
Resale price maintenance	20
Requirement or exclusionary contract	24
Business interference	5
Abuse of stronger bargaining position	2
Other	7
Total	58

Source: JFTC (various years).

Note: Actions include warnings, where violations were suspected but not enough evidence was obtained. The above numbers do not include unfair practices conducted by business associations that were subject to JFTC action.

Table 2.5 shows recent JFTC actions according to type of unfair business practice. Resale price maintenance accounts for one-third of the cases. Requirement or exclusionary contracts, such as exclusive dealing, account for another third. Sales restriction in international licensing can directly affect international trade. The JFTC acted in two international licensing cases in 1995, where there were agreements between Japanese firms and a Taiwanese firm that restricted sales by the Taiwanese firm in Japan even after the expiration of the licensing contract.

### *Exclusive Dealing*

Exclusive dealing between manufacturers and distributors in Japan has sometimes been regarded as a market access barrier.<sup>25</sup> One of the main issues in the recent automobile trade dispute is the “closed” distribution system in Japan. In Japan all nine automakers have developed their own distribution networks, and most dealers specialize in selling the automobiles of a particular automaker. Consequently, multiple-franchise dealers have been almost nonexistent, except for those arranged by Japanese automakers themselves.<sup>26</sup> Similarly, the central competition policy issue in the recent film dispute was the relationship between the largest Japanese film producer and its first tier of wholesalers. These seven distributors currently sell only the films of this maker.<sup>27</sup>

25. In addition, Tilton (1996) points out that refusal to deal has often been used to restrain imports by Japanese firms in the basic material industry, although refusal to deal per se is not illegal.

26. The situation has been similar in Europe, where most dealers have single-franchise agreements with major automakers. In contrast, around 30 percent of dealers had multiple-franchise dealerships in the United States in 1989, although single-franchise dealers were dominant in the United States too until the 1960s.

27. On the other hand, the second tier of wholesalers, who buy films from the first tier of wholesalers for resale to small retail shops, do not specialize in handling a single brand (JFTC 1996).



Exclusive dealing contracts, when required by an influential firm,<sup>28</sup> are deemed an unfair business practice in Japan when they make it difficult for competitors to find alternative distribution channels. For example, the exclusive dealing contract required by a firm that possessed two-thirds of the domestic market was judged by the JFTC to be an unfair business contract. As for the automobile industry, the JFTC guided the two largest Japanese automakers to abolish the clause requiring exclusive dealing in distribution contracts in 1979. In 1991 all domestic automakers decided to abolish the prior consultation clause for distributors in selling other makers' models, in response to the JFTC's guideline on distribution. Thus producers who have relatively large market shares cannot bind distributors with contracts that bar them from dealing with competitors in Japan.<sup>29</sup>

From an international perspective, it is not the case that Japanese competition policy has been more favorable to exclusive dealing requirements by producers. In the United States the efficiency-improving nature of exclusive dealing is recognized, so that such practices are likely to be treated as illegal only if a firm with significant market power exercises them.<sup>30</sup> In Europe block exemptions have authorized exclusive dealing in automobile sales and other industries.

### *Parallel Imports*

In the application of Japanese competition policy, not only resale price maintenance but also nonprice vertical restraints, which directly reduce price competition among distributors, have been deemed illegal without regard to the market position of the firm. Consequently, such conduct by sole import agents as asking foreign suppliers to take measures to close supply channels to parallel importers has been deemed to be a violation of the Antimonopoly Law. In recent years the JFTC took up several cases in this field involving imports of tablewares, pianos, and bags.

## **2.3 Implications for International Cooperation in Competition Policy**

### **2.3.1 Welfare Measures**

In considering international cooperation in competition policy, the critical issue is what welfare measure is to be used in evaluating private anti-

28. An influential firm as defined by the JFTC is a firm with more than 10 percent of the domestic market or a firm ranked in the top three in terms of market share.

29. The use of financial measures with an exclusionary effect, such as highly progressive rebates, is also being restricted in Japan.

30. In addition, market definition in the United States is often broader than in Japan. Two United States courts recently ruled that the largest film producer in the United States does not have market power despite its dominant market share in the U.S. market because the market was judged to be global. Consequently, the two consent decrees issued by the U.S. Fair Trade Commission, which had restricted such distribution practices as selling private-label film and requiring exclusive dealing, were lifted.

competitive practices. The appropriate measure is global welfare, and global output as its surrogate. A particular business behavior is anticompetitive domestically if it reduces the domestic supply of an industry. Similarly, a particular business behavior is anticompetitive internationally if it reduces the global supply of that industry.

Why should a global welfare criterion be used instead of a national welfare criterion? National welfare implies the adoption of different standards of competition policy with regard to anticompetitive behavior in the home market versus that in international markets or with regard to the behavior of foreign firms versus that of home firms. One example of such a policy is prohibiting cartels in the domestic market while allowing them in export markets. Another example is regarding any business practices in foreign markets as anticompetitive if the exports of home firms are constrained.

Such discriminatory application of competition policy has two major problems. First, it may undermine domestic standards. The historical evolution of the principle of competition policy from protecting competitors to protecting competition can be negatively affected. Second, when a foreign country adopts a similar policy, the national welfare of both countries can decline, just as optimal tariff policy is in fact not optimal given similar foreign behavior. The use of competition policy as a rent-shifting policy is self-destructive in these senses.

The guiding principle for securing consistency with global efficiency is to establish national treatment in the application of competition policy for domestic and foreign firms as well as for domestic and foreign consumers. Currently, national competition policy does not necessarily respect this principle, and the danger exists that political pressure to use antitrust policy in order to expand market access can further widen the gap.<sup>31</sup> National treatment has several important implications:

1. Extension of home competition policy to export cartels.
2. Prohibition of import cartels. Exceptions, however, may be granted in cases where the import cartel is formed as a countervailing device against an export cartel.
3. Application of the same competition policy standard to foreign and domestic firms. In the case of extraterritorial application of competition policy, the same standards will be used for foreign firms as for home firms.

Once national treatment is established and substantive standards for competition policy are agreed upon internationally, each economy will be

31. The U.S. government is authorized by the Congress to apply its antitrust law in an extraterritorial manner to foreign business practices that hinder the export expansion of U.S. firms (Foreign Trade Antitrust Improvement Act of 1982). It has not yet been clarified whether in applying this provision the U.S. government has to meet the same antitrust standards as those applied to domestic firms or whether it can use separate standards just for the purpose of export expansion.

willing to delegate the enforcement of competition policy to the country that can most efficiently investigate and enforce corrective actions, which would typically be the country where firms are located. It will thus encourage the development of a division of labor in enforcing competition policy, avoiding duplication and inconsistency in enforcement efforts.

### 2.3.2 Priorities for International Cooperation

High priority for international cooperation in competition policy could be given to the regulation of private anticompetitive conduct that has negative as well as large international effects. As discussed in section 2.2, trade cartels, including international cartels, do have negative international spillovers. The degree of spillover depends on the international market power of the cartel. The same thing applies to mergers that create international market power. In contrast, domestic cartels per se do not have substantial negative international spillovers.

As for vertical practices, what should be addressed are *efficiency-reducing* vertical practices. The degree of spillover depends on whether the market foreclosed by a firm is large in the international context. For both horizontal practices and vertical restraints, it is clear that a larger economy has more responsibility for controlling the anticompetitive behavior of its firms and for keeping its markets competitive. Firms located in a relatively small country are less likely to have international market power. Moreover, it is a time-consuming process to develop effective competition policy institutions (see Scherer 1994). Thus, international agreements on cooperation in competition policy may be framed so that differential treatment can be provided to small developing countries.

## 2.4 Conclusions

Competition policy, including its absence, can have important international spillovers. However, the recent focus on competition policy from a “market access” perspective can be misleading. The anticompetitive behavior that can have the most clearly negative international spillover is an export cartel. Export cartels, however, do not constrain market access. Moreover, export cartels or similar export-restraining arrangements were often used in the past to ameliorate trade frictions. Pure domestic cartels tend to improve market access and harm primarily the country that tolerates such arrangements, although when a domestic cartel is in a vertical relationship with international trade it can restrain international trade and reduce foreign welfare too. Vertical restraints can constrain market access and can have negative international spillovers. However, we have to distinguish efficiency-reducing vertical restraints from efficiency-improving restraints.

The Japanese government has substantially strengthened its competition policy in the 1990s, especially in its drastic reduction of cartels ex-

empted from the application of the Antimonopoly Law, including trade cartels, and in its enforcement against cartels. On the other hand, Japanese competition policy used to be fairly restrictive toward mergers and acquisitions, and Japanese policy toward vertical restraints has not been significantly different from that in the United States. The recent change toward stronger enforcement of competition policy, especially against cartels, should be highly beneficial to the Japanese economy. But on the other hand, it is not clear whether this policy change can have a substantial impact on market access.

In promoting international cooperation in competition policy, it is important to have national treatment as the guiding principle, in order to avoid the danger of using competition policy as a means for rent shifting. Priority in international cooperation could be given to controlling the anticompetitive behavior of firms with international market power.

Although this paper has focused on competition policy in a narrow sense, it is very important to recognize that many WTO issues remain, the resolution of which would contribute much more to the development of competitive markets than will cooperation in competition policy itself. Unrestricted international trade and investment will make markets more competitive, so that sustaining cartels and other anticompetitive behaviors will become more difficult. A major issue in this regard is the reform of antidumping rules. Although antidumping measures have sometimes been defended by their proponents as substitutes for competition policy abroad or as transitory measures while markets remain nonintegrated, both the guiding principles as well as the actual practices of antidumping measures are widely divergent from those for competition policy interventions. The second area is the introduction of domestic and foreign competition into public utility industries, such as electricity, where vertically integrated firms used to supply monopolistically in many countries. The third area is the reform of government procurement agreements. Currently, only a limited number of WTO member countries participate in the WTO agreement on government procurement. Furthermore, the experiences of many signatory countries, including Japan, suggest that public procurement is vulnerable to bid rigging. Thus there is a substantial efficiency gain from more competition in this area too.

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## Comment      Anne O. Krueger

In this paper, Sadao Nagaoka makes two important contributions: first, he analyzes competition policy and the ways in which such anticompeti-

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tive behavior as cartels, vertical restraints of trade, and predatory pricing can affect the welfare of home and foreign countries. Second, he then considers how Japanese competition policy has evolved in recent years.

I have little to add with regard to the first contribution, as Nagaoka's analysis covers the main issues nicely. He does point to two facts that must be borne in mind in considering competition policy: (1) predatory pricing has been relatively rare internationally except when governments themselves have undertaken policies that permitted it, and (2) even when governments break up export cartels (which should be to international, as well as national, advantage), other governments have then exercised their antidumping regulations in ways that have rendered the potential welfare gains nugatory. As an example of the first case, consider the United States, which has prohibited the formation of domestic cartels but encouraged the formation of export cartels. As an example of the second, Nagaoka notes that VERs were encouraged by importing countries and led to the formation of export cartels, especially in Japan. When the VERs were removed and the Japanese government broke up the export cartels, there were suits by importing countries on grounds of antidumping at the reduced export prices. If one considers the extent of anticompetitive behavior in international markets in the past several decades, however, there is little doubt that government-imposed anticompetitive behavior through VERs was a major source of welfare loss.

The discussion of the evolution of Japanese competition policy is also very useful. It is an irony of history that the United States, after World War II, sought competition policy in Germany and Japan in order to keep German and Japanese industries weak! Especially in light of the importance modern regulatory theory places on maintaining competition, this earlier thinking is quite remarkable.

One point that Nagaoka alludes to, on which I would have liked to have heard more, is the role of international trade in bringing about more competition. It seems self-evident that opening domestic markets to foreign competition greatly increases competitive pressures on domestic firms. Likewise, exporters selling in third markets almost surely (except in the case of international cartels) face more competition than they would selling in protected domestic markets. In terms of dealing with integrating competition policy among countries, I would therefore conjecture that there was less urgency to worrying about market shares of national markets for exporters than for producers in home markets (where the presence of foreign competition would obviously reduce the share of domestic producers). Yet most discussions of market shares seem to focus on shares of national markets held by domestic firms: does not this practice require amendment?

I would like to close by endorsing another point made by Nagaoka: that is, it is important that any international competition policy use national treatment as a guiding principle so that it cannot be used as a means for

rent shifting. Nagaoka correctly urges attention to areas where firms have international market power and correctly notes that restricting the abuse of antidumping regulations would probably do more to improve the competitive environment than can possibly be achieved by coordination of competition policy. Would that this message could be received and understood by politicians!

## **Comment**      Chong-Hyun Nam

I enjoyed reading Nagaoka's paper and think it makes a nice companion piece to chapter 1, by Roger Noll. While Noll's paper deals with broader issues of competition policy, including regulatory reforms, Nagaoka's paper focuses on narrower issues, such as cartels, mergers, and vertical restraints.

I have only a few comments to make. Beforehand, however, I think it may be useful to ask again why competition policy has recently emerged as a prominent agenda for a future round of multilateral negotiation at the WTO, and what we can expect from it. I do not know exact answers to these questions, but I can think of a couple of reasons why the subject of competition policy has gained momentum in recent years.

One is based on the fact that despite continued liberalization of trade-restricting border measures under the GATT system during the postwar period, its expected effect on trade expansion has not been fully realized in some countries. Many have argued that this is largely due to anticompetitive nonborder measures that have worked in these countries as a deterrent to market access for foreign exporters, and Japan has been frequently named as supporting evidence for their argument. They indicate that Japan's import-to-GDP ratio is the lowest among the OECD nations, about half of that for the United States, while the discrepancy between Japan's current and purchasing-power-parity-based income is the largest among the OECD nations in both absolute and relative terms. I suspect, therefore, that the main impetus behind the recent competition policy drive is U.S. and EU frustration at failing to penetrate the Japanese markets that are alleged to be the most open at the border among the OECD nations. There seems to be an expectation that once anticompetitive domestic regulations and business practices—including closed distribution systems—are lifted from Japan, that country can provide the world with vast and unexplored markets. I am not sure what kind of quantitative importance may be attached to this sort of belief, but I do think the wel-

fare gains to be reaped from a global competition policy can be sizable, especially when regulatory reforms are included in it.

Another reason for the recent prominence of competition policy is the fact that the so-called unfair trade rules currently in operation under the WTO system are utterly inadequate from the viewpoint of competition. They tend to discourage competition rather than promote it. At present, trade-related competition policies under the WTO system are reflected in antidumping and countervailing duty rules. These rules, however, are fraught with so many flaws both in theory and in practice that they have been heavily abused, most notably by the United States and the European Union. Replacement of these rules by an agreed upon global competition policy, or an agreement to use national treatment for importers, would significantly reduce trade friction and the potential for protection through antidumping measures.

Now let me turn to a few comments on some specific conclusions in Nagaoka's paper. First of all, I am puzzled by Nagaoka's conclusion that the recent competition policy drive is "misleading" in that it is focused more on market access concerns than on export cartels, arguing that export cartels deserve greater attention because they have the most clearly negative international spillovers. There is no doubt that export cartels distort trade, incurring economic costs, but it seems to me that they are not likely to be quantitatively significant compared to the economic costs associated with other anticompetitive domestic measures. Given a relatively open and competitive world trading system, as we have today, there seems to be little room left for trade cartels to exploit. Thus it seems to me that improving market access on a multilateral, reciprocal basis should and would be a major concern of the competition policy drive, and for good reason.

I am also troubled to understand Nagaoka's conclusion that domestic cartels are likely to increase market access with positive international spillovers. It may hold true in his simple model, but not in reality in general, I suppose. To be realistic, domestic cartels are unlikely to survive long unless they are protected from import competition by the government. In this circumstance, domestic cartels are likely to generate negative international spillovers instead because import protection limits market access for foreign exporters. But there can be cases in which domestic cartels come into being under natural import barriers or under some sort of domestic "regulatory capture," if I may borrow terminology from Noll's paper. Service industries such as distribution, transportation, communications, or finance may belong to such a category. A global competition policy including regulatory reforms seems to be most wanted in these circumstances because services are increasingly becoming internationally tradable goods these days.

Finally, I wonder whether we will ever be able to design and achieve a



comprehensive global competition policy that can be accepted and administered by individual nations with diverse economic structures, histories, and customs. But if we could have one, the most important beneficiaries would likely be small, outward-oriented developing countries, which would enjoy improved market access as well as fewer threats from administered protection. In this regard, contrary to Nagaoka's conclusion, I think any differential treatment toward developing countries in making a global competition policy is neither necessary nor desirable. We know all too well how the special and differential treatment provided to developing countries under the GATT system eventually disserved the interests of developing countries.