UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

THE DEVELOPMENT DIMENSION OF COMPETITION LAW AND POLICY

by
Prof. W. Lachmann
(Nuremberg University, Germany)

UNCTAD Series on
Issues in Competition Law and Policy

UNITED NATIONS
New York and Geneva, 1999

Note

- Symbols of United Nations documents are composed of capital letters combined with figures. Mention of such a symbol indicates a reference to a United Nations document.

- The views expressed in this volume are those of the authors and do not necessarily reflect the views of the United Nations Secretariat. The designations employed and the presentation of the material do not imply the expression of any opinion whatsoever on the part of the United Nations Secretariat concerning the legal status of any country, territory, city or area, or of its authorities, or concerning the delimitation of its frontiers or boundaries.

- Material in this publication may be freely quoted or reprinted, but acknowledgement is requested, together with a reference to the document number. A copy of the publication containing the quotation or reprint should be sent to the UNCTAD secretariat at: Palais des Nations, 1211 Geneva 10, Switzerland.

Preface

The basic mandate for UNCTAD's work in the area of competition law and policy is provided by the Conference itself and by the Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices (adopted by General Assembly resolution 35/63 of December 1980), which constitutes the sole universally applicable multilateral instrument in this area, although it is not a legally binding instrument. In the implementation of this mandate, the UNCTAD secretariat prepares studies on different competition issues, services annual meetings of UNCTAD's Intergovernmental Group of Experts on Competition Law and Policy, and undertakes technical assistance and advisory and training activities for developing countries and countries in transition, aimed at assisting them to adopt and effectively implement national competition laws and policies, establish appropriate institutional mechanisms and procedures, and participate effectively in the elaboration of international rules in this area.

At the present time, UNCTAD is quite active in the preparations for UNCTAD X, to be held in Bangkok, in February 2000. Moreover, UNCTAD's Intergovernmental Group of Experts on Competition Law and Policy, when it meets for its second session (7-9 June 1999), will act as preparatory body for the Fourth United Nations Conference to Review all Aspects of the Set of Principles and Rules for the Control of Restrictive Business Practices, scheduled to meet in September 2000.

In addition to this, at the Singapore Ministerial Conference (9-13 December 1996) WTO decided to establish a Working Group on the Interaction between Trade and Competition Policy at WTO, and also decided, *inter alia*, that this Group would draw upon work in UNCTAD and the contribution it can make to the understanding of issues. It further encouraged cooperation with UNCTAD, to ensure that the development dimension is taken fully into account.

To help fulfil these mandates, the UNCTAD secretariat is issuing a series of papers with the aim of providing a balanced analysis of issues arising in this area, and addressed to governmental officials, officials of

international organizations, representatives of non-governmental organizations, business people, consumers and researchers. While the series would best be read as a whole, each study may also be read on its own, independently of the others. The present volume constitutes the first of the series. The main objective in publishing these papers is informative, for background use by delegations, and is part of the process of capacity-building in the broad areas of competition law and policy and competitiveness in globalizing markets. The papers are published under the name of their authors and the views expressed therein do not necessarily reflect those of UNCTAD.

This series of papers has been made possible thanks to voluntary contributions received from the Netherlands and Norway. These contributions are gratefully acknowledged.

Rubens Ricupero

Geneva, May 1999

Secretary-General of UNCTAD

Executive summary

This study examines the implications of the development dimension for competition law and policy. The author suggests that the competition process does not run smoothly or produce optimal results in developing countries, particularly least developed countries, because of several market imperfections or other limits to competition. This would make it particularly necessary for developing countries to adopt and apply competition law and policy. Historical experience, including in countries which are now developed and in newly industrialized countries, has shown that the comparative advantages of today are mostly the results of the successful governmental intervention of yesterday, and that infant industry policies can increase efficiency and competitiveness. However, given the risks of predicting future comparative advantage, of rent-seeking behaviour and of government failure arising from weak institutional capacity, it is difficult to apply such policies in an optimal manner, and Governments' main task should be to create a more favourable environment for competition. This would require an active policy approach, focusing not only on controlling restrictive business practices, but also on enabling enterprises to obtain sustained productivity growth and on developing national and international competitiveness. Also essential would be the provision of such elements as market information, infrastructure, know-how, and human or financial resources (which would involve collaboration between the public and private sectors, or between producers and the educational system), as well as sound economic or other policies. Policy makers should intervene in economic activity or regulate the private sector only in accordance with specified criteria or procedures, and policies and institutional arrangements should minimize rent-seeking, force trade-offs to be faced among different policies, be transparent

regarding costs and communications between Governments and businesses, and continuously review trade protection.

Globalization necessitated international coordination on competition law and policy and trade matters, building upon the United Nations Set of Principles and Rules for the Control of Restrictive Business Practices. The adoption of waivers or exemptions for developing countries in order to permit import substitution could be justified as second-best interim solutions required to compensate for the trade disadvantages arising from their unfavourable conditions and lack of competitiveness, as well as countermeasures against neo-protectionist behaviour in industrialized countries. But such forms of trade protection should be applied selectively, made conditional upon meeting performance standards, transparent, time-limited, degressive, involving minimum discrimination, and constantly reviewed.

CONTENTS[1]

Page

INTRODUCTION 1

I. FUNDAMENTALS 3

II. HISTORICAL OBSERVATIONS 11

III. MARKET FAILURES AND LIMITS TO COMPETITION IN DEVELOPING COUNTRIES 15

IV. THE ROLE OF GOVERNMENT IN FOSTERING COMPETITION 19

V. JUSTIFICATION FOR WAIVERS IN DEVELOPING COUNTRIES 27

VI. FORMS OF WAIVERS (EXCEPTIONS OR EXEMPTIONS) 31

VII. CONCLUSIONS 37

REFERENCES 41

Introduction

The most spectacular performers among the newly industrializing countries (NICs) in Asia did not follow pure policies of free trade but had in general low rates of protection and tried to accept the challenge of surviving in the competitive environment of world trade. The biggest losers, by contrast, can be identified as those countries that continuously followed an import substitution approach in the process of industrialization, which resulted in heavy protectionism. The experience of many developing countries supports the view that in the long run competition enhances competitiveness and development, and in the short run government support of national industries in their quest to be internationally competitive can be crucial.

This is in line with the experiences in the United States, Japan and Europe, where the development process began successfully under heavy government protection (although it was executed in rather different ways). High tariff rates on manufacturing can be observed, for example, in the United States and in Germany in the nineteenth century. We will have to analyse whether this is an indication that nations have to do their homework on competitiveness before they can successfully compete on an international level. We must also ask if competitiveness in the short run can be achieved by an adequate competition policy and law.

What can we conclude as policy recommendations for those countries still remaining in economic backwardness? Should we vote for free trade as a means to enhance competition or is there an existential need to establish a certain degree of competitiveness through protectionism before facing the world economy? Can competitiveness in developing countries be achieved by "pure" competition rules or are there certain deviations that have to be accepted?[2] How should government intervention be designed in order to help industries to become competitive? These questions will be dealt with below.

I. Fundamentals

In the absence of a generally accepted definition of the phenomenon of competition, we will choose a suitable interpretation: competition is the object fostered and protected by competition policy and law. It has to be interpreted as a workable, respectively effective competition which is characterized by a sequence of pushing and pursuing acts of the agents in a particular market. In following their own interests entrepreneurs try to achieve preferential positions by using competitive parameters such as price, quality, delivery conditions, service, marketing and so forth. But any kind of advantage achieved within the sphere of an initiative competitive act will be temporary since it will be abolished by imitating followers. The existing competitive pressures lead to socially desirable market outcomes.[3]

What do we need competition for? Competition is the foundation of an efficiently working market system, which has several advantages over a planned economy. According to Adam Smith, competition is the precondition which protects freedom of decision and action of self-interested individuals from leading to anarchy or chaos but rather to economically optimal, socially fair and desirable market results.[4]

However, the competition process will run smoothly and thus lead to desirable results only if several prerequisites are met, namely:

- Free market entry and exit;
- Freedom of trade and contract;
- An efficient monetary system;
- Protection from restrictive business practices (RBP);
- The existence of positive and negative sanctions; and
- Transparency of the market.

Competition on the consumer side exists when there is a certain responsiveness. Consumers have to:

- Be able and willing to be informed about transparent markets;

- Be free in their decisions;
- Have financial resources;
- React flexibly and quickly to competitive acts and not prefer a specific supplier or good;
- Want to maximize their utility.

Competition on the supply side exists when suppliers:

- Are able to see their chances on transparent markets;
- Are free in their decision-making;
- Strive for profit maximization or loss reduction;
- Possess technical, economic and creative resources;
- React flexibly and quickly to changes in consumers' demand and competitors' actions;
- Are ready to look for success by facing competition, not by using RBPs; or if there is a certain competitive spirit on the supply side.[5]

Where these preconditions are met, competition can work effectively and the competition process fulfils several economic and social functions.[6]

A. *Economic functions*

First of all, competition has to coordinate production and consumers' needs in such a way that in the long run, supplied goods and services will be adequate to the demand. A precondition for optimal coordination is an efficiently working price mechanism which indicates the degree of scarcity of goods. Further, competition has to ensure allocative resource efficiency by combining production factors in a way to attain the utmost productivity. Competition also ensures distributive efficiency; production factors are remunerated according to the value the market bestows on their performance. Since consumers and producers control each other simply by following their own interests, the restriction of economic power is immanent in the process of competition.

These basic economic functions are described as static. They are complemented by some dynamic functions: competition is the driving force behind technological progress. Since innovation of products and production processes is the key to attaining preferential positions within the competition process, every company strives for modernization. Addi-

tionally, companies are forced to adapt their competitive parameters continuously because market conditions are in a never-ending process of change.

B. *Social functions*

Competition also fulfils social functions by opening up opportunities to all market participants: entrepreneurs have the possibility to decide to be solely responsible for the use of their available resources; consumers have freedom of choice between several alternatives; and workers have the chance to change jobs.

However, as mentioned above, these functions can be performed only if certain prerequisites are met. We will thus ask whether this is the case in the developing countries.

First of all, in most such countries the price mechanism is not, or is only partially, intact because of government intervention such as price controls and minimum wages. The neoliberal slogan "getting prices right" thus came into being, which recommends that the State should not tamper with market prices. In many developing countries, the Government gets in the way of free competition by restrictive regulation, whereas an effective competition policy should aim at abolishing all distortional policy measures in order to make room for competitive activities.

Also, we cannot talk about consumers' sovereignty in those parts of the population where basic needs are not guaranteed and the only goal is to survive. Consumers do not possess adequate information; the acquisition of information involves high transaction costs; and the evaluation of information is made difficult by low educational levels. Often enough, the struggle to survive hinders consumers from taking decisions freely; financial resources are missing; and the possibility of obtaining information is hindered by the lack of infrastructure and education.

Progress in productivity is often hampered as well, since the educational level, or technical and business knowledge, is rather low and the productivity of the working force diminished because of malnutrition, disease and the like. In addition, small and medium-sized enterprises (SMEs) in particular lack financial resources because of the lack of credit facilities, face markets lacking in transparency because information and infrastructure are missing, or are confronted with sometimes omnipotent transna-

tional corporations (TNCs). High initial fixed costs frequently build up market entry barriers because marginal revenue is lower than marginal costs. Buying technology and know-how is costly, especially if sophisticated manufacturing technology and management techniques are required and firms are not assisted in covering the high initial costs of importing technology, training the labour force and improving management. Marginal costs may be then greater than the marginal productivity of labour and capital for certain productive activities.[7]

We can thus conclude that most developing countries do not possess a favourable climate for competition to perform its economic functions. Since competition will not appear by itself (liberal view) but needs specific conditions and adequate care, Governments bear great responsibility. In developing countries, where preconditions for a working competition are missing, competition policy and law are even more necessary, not only to face the danger imposed on competition through RBPs—the main problem in developed countries—but above all to ensure a favourable environment for the development of competition and national and international competitiveness.

Competition policy in developing countries has therefore to be seen in a broader context than in industrialized countries. In general it can be defined as any set of government measures aimed at stimulating competition, protecting consumers against monopolies and creating the prerequisites by the competition process mentioned above. Policy areas include control of dominant firms, control of mergers to prevent industries from becoming monopolized, and control of anti-competitive acts.[8] In developing countries competition policy has to comprise the provision of a favourable climate for competition and the development of competitiveness.

Competitiveness can be regarded as the set of skills and qualities required in order to engage in competition. Its object is to gain, hold onto, and expand one's market share.[9] In order to do this producers tend to use RBPs to restrict or eliminate their trade rivals, rather than to face competition by means of lower prices, better quality, innovation, modernization and the like. Since "competition kills competition", which means that competition will not prevail if the market is left alone, competition policy and law are further necessary to secure the nation's welfare gains brought about by national and international competitiveness.

How can competitiveness be achieved? First of all, Ricardo showed that comparative cost advantages among nations determine their gains from trade. Quantity and quality of natural resources build the basis for trading positions, especially in the primary sector. But why was the economic performance of the Republic of Korea so much better than that of the Democratic People's Republic of Korea, or why that of the former Federal Republic of Germany superior to that of the German Democratic Republic? A quick answer would be that wherever market forces were left alone by Governments, competition necessarily led to socially desirable market outcomes. This argument would shortsightedly neglect not only those government actions taken in both successful countries to enhance industrial potential,[10] it would also disregard the historical experience of Japan's success story, where the Ministry of International Trade and Industry was heavily involved in the economy via industrial and trade policies and where in the 1950s and 1960s economic growth was initiated by import substitution and domestic demand, at least until the late 1960s and early 1970s, when the way was paved for the success of an export-oriented strategy.[11]

We can thus carefully conclude that the existence of a free market system by itself can be seen as a necessary but not a sufficient precondition for national and international competitiveness. Government intervention itself is not simply to be condemned. It is the way it is carried out that matters. It can even be an essential ingredient of the achievement of comparative advantages or, ultimately, international competitiveness in the long run.

Trade policy measures in particular have a significant impact on competition in national and international markets. It has been broadly accepted among economists that an international free trade policy is desirable to increase world output and income levels in the long run. However, most economists would also agree that under present conditions, complete freedom of trade would not be desirable. Even if international trade serves to sharpen competition in the domestic market in terms of price, quality and incentives towards innovation and the development of new products and production processes, individual countries might not be ready for it. Thus, although barriers to trade sheltering particular domestic industries may have anti-competitive effects on national markets, they may provide domestic firms with the time needed to increase their ability to compete internationally. Protection of infant industries can therefore be an important component of a growth-enhancing trade policy.

But can such a “time out” really help infant industries to catch up with the developed world? What role does technological progress play in the maturity of a nation’s infant industries or a nation’s economy as a whole? Are developing countries doomed to remain in a position of followers in contrast to the position of active competition applied by industrialized countries? What role can be assigned to the Government in this area?

Most developing countries operate inside a production possibility curve[12] which is backward in terms of technology. Since technical innovation in the developed nations is pushing the technological frontier outward at a rapid rate, the gap with developing countries is widening over time. In order to close the gap new technologies must not only be imported but also learned through the actual production experience. Only through experience can the costs of production be lowered and new technology adapted to local circumstances. This involves the shifting of the long-run average cost curve downward through time. In addition, economies of scale lead to further cost reduction, with firms moving down the long-run average cost curve as the size of the relevant market grows. Thus, the more rapid the market demand is growing, the more rapidly productivity can be increased, costs saved, and investments in new plants, equipment and human capital undertaken. Therefore, the growth of a market, or of demand, is decisive for the growth of productivity.[13]

An import substitution industrialization (ISI) strategy, just as well as an export-oriented approach, can lead to rapid growth in market size by allowing demand for the protected industries to grow faster than domestic consumption. In case of import substitution this happens by means of imports of particular goods being replaced with domestic production and thus no longer available. For most industries the import substitution phase—involving simple, labour-intensive manufactured goods—is needed to precede the outward-oriented development stage in order to lower per unit production costs, become competitive on the level of prices and improve quality to become competitive on the level of quality. Empirical work supports the view that domestic demand and import substitution are important in the first stages of industrialization, with exports becoming important only later on. In the Republic of Korea and Taiwan Province of China, domestic demand and import substitution dominated export expansion as sources of growth in the 1950s and 1960s. These countries even had to subsidize exports in order to allow firms to begin profitably to export commodities that are relatively labour-intensive.[14]

But why did most developing countries fail to make the transition from the import substitution stage to that of outward-oriented development? If the key to economic development for late-developing nations is to catch up with the technological frontier, and the ability to catch up is seen to be dependent on the rate of growth of the market for the specific products, then the main problem can be seen in the small and slowly growing domestic markets which allow a nation only partly to close the technology gap. Export subsidies thus become necessary to close the gap. The difficulty of making the transition from import substitution-induced growth to outward-oriented growth therefore depends on the rapidity with which domestic demand grows. The faster this happens, the lower the cost of transition and vice versa.

However, even if there is a sufficient and growing demand, it is evident that the gap is immense and that closing the technological and overall development gap requires an extreme effort. Yet history is not without some success stories. All of today's developed nations began as late developers compared to England, and a growing number of East Asian countries are successfully surmounting the gap. They used various sorts of protectionist measures to allow selected industries rapidly to accumulate capital, specialize, and learn to use new technologies by taking advantage of fast-growing domestic markets.[15] This supports the view that developing countries do not have to remain in a position of pursuit but have the chance to catch up.

II. Historical observations

Important lessons can be learned by taking historical observations into consideration. A closer look at the economic history of European States reveals that the roots of economic development lay in mercantilism. Liberalism, free trade and competition have been harvested from the seeds planted by mercantilism. During the mercantilistic era Governments tried to improve national competitiveness by placing trade barriers on imports and providing infrastructure and other aid to their infant industries. Government interventions, however, hindered further development. Only after liberalizing the mercantilistic system could high growth rates be observed in many European nations. This observation supports the claim that the comparative advantages of today are mostly the results of successful government interventions of yesterday.

In this context it is instructive to study the outcome of the different policies followed by the United Kingdom and France in the nineteenth century. We often find the thesis that the United Kingdom's extraordinary economic performance was possible only because of its free-trade-oriented strategy, whereas France stayed far behind in its economic fortress. Recent research, however, demonstrates that "free-trade Britain" was no more than a myth. Only in those domains where the country was already competitive was free trade propagated. In all others the economy was protected, with average British tariff rates even higher than those of France. Thus, the myth that the United Kingdom's success was attained under the rule of free trade is based only on those sections of the economy in which a liberal policy was pursued.[16]

A similar picture emerges when we consider the experiences of developing countries with their vastly different performances. Latin America, Africa and South Asia followed a strategy strongly oriented towards protection. They had little or no success regarding their national and international competitiveness, whereas East and South-East Asia successfully built up internationally competitive export industries shielded by infant industry protection. Examples like Japan, the Republic of Korea, Taiwan Province of China and Singapore show the importance of good

timing for the reduction of tariff rates and other protectionist measures, of closing companies with low profitability, and of working towards participation in free trade in general. An important ingredient was an independent and strong Government which was able to go through with painful yet efficient economic decisions. The "visible hand" of Governments has played a major role in all of these countries. A carefully chosen package of interventions paved the way for dramatic economic growth.

It is true that these countries did not achieve growth rates higher than that of Hong Kong, China, with its free trade strategy. However, we are not arguing for government aid and against free trade, but rather for temporary interventions as a potential way to succeed economically.

The poor performance of Latin America in the ISI period 1950 to 1970 and even after the shift to a more export-oriented strategy also demonstrates the importance of "good governance". Not public intervention per se, but the way it was carried out—its inappropriate implementation—has to be held responsible for the poor performance. However, some critics claim that to condemn the ISI strategy as unsuccessful in general is a misleading simplification. According to these critics evidence shows that productivity and competitiveness of large sectors of industry in world markets (temporarily) grew substantially in this period and that manufacturing exports have increased at a fairly rapid pace during the past two decades. The rates of technological modernization and productivity growth were quite significant as well.

There remains some doubt as to the extent to which the ISI strategy in Latin America was really successful. What can be learned from the East Asian economies, however, is that that strategy can represent a decisive stage in the achievement of international competitiveness if it is understood as a short-time preparatory stage focused on expanding export capacities and if Governments are able to recognize the "strategy switch-points".[17]

The implementation of an ISI strategy in many Latin American countries as well as the interventionist action taken by some South-East Asian Governments can be traced back to the infant industry argument: as early as the nineteenth century, Alexander Hamilton (1755-1804) in the United States and Friedrich List (1789-1846) in Germany pointed out the problem that newly developing industries are not yet competitive. List noticed that after periods of war, when British goods in peacetime could again enter continental Europe, German companies had to close down since they could

not compete with the superior British entrepreneurs. Accordingly he advocated the temporary protection of infant industries. Protected by temporary tariffs, the nascent firms could learn by experience, reach their optimum size to obtain significant economies of scale,[18] and in the long run become internationally competitive. It was argued that infant industries operate initially at such a small scale that per unit costs are extremely high, and thus a price that covers such costs will be high relative to industries in developed countries operating on a large enough scale as to bring per unit costs down. To attain an efficient scale of operation, those industries need temporary protection.

The infant industry argument is thus an explicitly dynamic one for temporary trade protection, suggesting that the initial costs of protection will be outweighed by the long-run benefits of increasing competitiveness and participation in international trade. If firms are assisted in covering the initial costs of importing technology, training the labour force, improving management and the like, they may indeed gain higher profit margins, expand the economy's production possibility frontier, and thus increase the nation's welfare in the long run. It is a historical fact that all successful market economies began industrialization shielded by trade protection—the only exception known to this author being Hong Kong, China.

However, the infant industry argument is to be questioned. The many immanent pitfalls suggest that infant industry protection has to be "optimal" in order to minimize market distortions. For example, it is extremely difficult to predict future comparative advantages. Also, rent-seeking behaviour on the part of both entrepreneurs and government authorities is widespread and leads to a waste of resources. This means that such protection should be used very cautiously and in a highly limited manner. The forms of interventions and their effectiveness will be discussed in detail below.

III. Market failures and limits to competition in developing countries

What reasons can be used to justify infant industry protection? The main argument refers to market failures. In poorer nations, market imperfections seem to be legion. Unemployment, differences between rural and urban wage rates, a poorly developed infrastructure, capital market imperfections and so forth—all these problems point to market failures. There is a wide range of literature justifying regulation in case of natural monopoly, externalities,[19] and asymmetric information.[20] We will therefore not focus on those well-known cases but concentrate instead on two areas which are especially important for developing countries, namely, imperfect capital markets and the problem of the appropriateness of knowledge generated by pioneering firms.

Since developing countries do not possess efficient financial institutions (banks or stock markets), it is difficult to draw savings from the traditional sector to finance investment in manufacturing. Low initial profits will be an obstacle for long-term investments. Many investments will not be undertaken unless the Government supports the infant industry. The first best solution would be to overcome the causes of market failure, which means in this case to foster a well-functioning financial intermediation system. If there were no such financial market distortions, and if infant industries were perceived by financial markets as being capable of "growing up", banks would provide the credits necessary for these industries to develop. Financial intermediaries would be able to perceive a future gain if credits were offered long enough to enable the firms to make service payments, having learned from experience. The problem is thus one of resolving market distortions in the financial market, not in the goods market. [21]

As long as financial markets remain distorted, subsidies and any other form of government aid to firms can be looked upon as compensation for trade disadvantages.

The appropriateness argument points to the problem that new industries generate social benefits which far exceed the private benefits, and for which they are not compensated. Should a firm start a new industry it may incur high start-up costs. The pioneer who is not protected against imitators will soon lose high profits to these newly emerging competitors. Hence, certain socially desirable investments will not be undertaken.

In order to overcome this market failure the first best answer would be to compensate pioneering firms for those positive external effects on society. In those cases the necessity for government subsidies or other protectionist measures is evident.

Imperfect capital markets and the appropriateness case are special cases of market failure justification. They may warrant government aid, considering that the first best policy would surely be to overcome market failures by tackling their roots.[22]

In addition to market failures there are other limits to competition in developing countries,[23] such as the limiting capabilities of competition authorities. Bureaucratic systems in most such countries are rarely capable of formulating, implementing or controlling the use of competition laws. The establishment, for example, of a national cartel supervision authority can itself exceed existing capacities in terms of finances and human resources.

There is also a great incentive for politicians to give way to pressure groups in order to be re-elected. Visible short-term actions are thus undertaken and the less obvious disadvantageous long-term implications of protection often ignored. Depending on the “political economic cycle” protectionist measures are highly popular, especially as elections draw near, and in times of macroeconomic setbacks. And since internal difficulties are often blamed on growing competitive imports, there is public sympathy for trade restrictions and subsidies. Competing imports are seen as a threat to jobs and income opportunities in the home industry and not as placing an economic growth-enhancing pressure on domestic firms to adjust to international productivity levels.[24]

This points to another problem stressed by new political economics, namely, the opposition of different pressure groups to economic policy changes that would undermine their interests—in this case the introduction of a national competition law and policy which would control their business practices. Viewed from the international dimension, this means

that in a competitive environment nations or companies using RBPs will gain and the partners will lose. Countries that introduce barriers to trade gain an advantage as long as other nations do not retaliate. But if all countries introduce protectionist measures, all nations are worse off. This situation is known as the prisoner's dilemma (which is studied in game theory). Each Government will be better off if it limits its own freedom of action, provided all other countries follow suit. Such a treaty can make everybody better off. This is the basic argument for international efforts to introduce competition policies and laws and to cooperate in establishing a framework for international trade (e.g. GATT).

With regard to these realities the question arises as to whether developing countries are more prone to market failures and competition-limiting factors than industrialized countries. Looking at the theoretical model of "perfect competition" we find developing countries quite far from this ideal. This model of industrial structure, in which many small firms compete in the supply of a single product, contains several major features which characterize a perfectly competitive industry:

- There is a multitude of firms (buyers as well as sellers), all too small to have any individual impact on the market price. Therefore, marginal revenue equals the price;
- All firms aim to maximize their profit;
- Firms can enter and exit the industry at no cost. Outputs traded are homogeneous and produced without economies of scale;
- There exists complete and free market information and complete market transparency;
- The adaptation to changing market conditions is immediate.

Perfect competition is economically efficient in three ways:

- In the short run, profit maximization ensures that each firm will set its output in a way that its marginal cost equals its marginal revenue. Under the profit-maximization assumption, marginal cost is equal to the price. This is efficient in terms of the allocation of resources because it ensures that no consumer will be deterred from buying something he values at more than what it cost to make;
- In the long run, free entry and exit ensure that new entrants will be attracted to any industry where high profits are made. New entrants

will increase supply and bid down the price until no profit is made—that is, when average revenue equals average cost. Thus no entrepreneur or factor of production earns more than just what it needs to be persuaded into an industry;

- In the long run, perfect competition ensures minimum-cost production since average revenue equals marginal cost and average revenue equals average cost. Marginal cost thus equals average cost, and this is true for the bottom of the average cost curve, the lowest cost point.[25]

In the absence of the above-mentioned conditions, imperfect markets exist and fail to act efficiently. This is the case for all economies, yet it is obvious that developing countries do not even come close to the ideal—for they lack even the most basic information of sellers and buyers about the quality and price of goods. The Government is therefore challenged to make up for the inefficiency of an imperfect market. However, the Government also has other roles to play.

IV. The role of government in fostering competition

Competition is always in danger. Since it is uncomfortable or even threatening, business tries to avoid it. To use a metaphor: competition is not a weed that grows even if left alone; rather it is a cultural plant and needs continuous government attention. As economic experience has shown, competition has to be learned at home if a company is to be competitive in the world market. Hence the Government has to supply a competitive framework. A national competition law and policy can supply a competitive environment to national firms, which can lead to competitiveness on an international level in the long run.

The Government's main task can thus be seen as the establishment of a more favourable environment within an active policy approach. What do we mean by this? A favourable environment must not be confused with one which simply ensures higher profits for companies. Negative real interest rates, downward wage trends and subsidized energy prices favour company profitability. But they cannot be considered suitable elements of a favourable environment which is sustainable in macroeconomic, social or environmental terms.

A passive approach would be the elimination of a restrictive environment, including price liberalization and macroeconomic stabilization; the elimination of protectionist trade policies and arbitrary and unclear industrial policies; the removal of market monopolies; and the modernization and reduction of the civil service. Although necessary measures, they have to be complemented by a more active approach which seeks to create conditions in the environment which did not previously exist, in order to enable companies to compete successfully on a macroeconomically, socially and environmentally sustainable basis.

This includes the provision of elements needed to face competition on open markets, some of the most important being:

- Information on domestic and foreign market conditions, technology, prices, etc.;
- Efficient communication and transport systems;

- Technological and organizational know-how;
- Skilled human resources;
- Improvement of the physical, economic and social infrastructure to support production; and
- Promotion of improved entrepreneurial capacity.

Some of these elements could be developed through collaboration between the public and the private sector, some by strengthening relations between the educational and academic systems and production activities.

Governments must also correct serious market distortions in a way that fosters positive externalities (e.g. technological progress, human resource training) and discourages negative externalities (e.g. any damage to the natural environment). As mentioned above, Governments have to reduce financial market distortions in order to make financial resources available for investment. This could be achieved through sound monetary policies, the reform of the social security system, political stabilization and the like. Private savings could be encouraged via market interest rates in order to raise national savings and investment rates.[26] A well-balanced tax system could provide incentives for (potential) entrepreneurs to engage in investments and further expand their business activities.

In addition, the legal framework must protect both general property rights and intellectual property rights in order to establish a competitive market system. Legal security is also necessary for companies to take efficient long-term economic decisions. Companies will be able to work more successfully and be more prone to invest if they can trust institutions to guarantee stable conditions.

This active approach is itself an ongoing learning process, specific to each country, on the part of the competent institutions and actors of the production sector.[27]

Competition policy is also related to trade policy, the international aspect of competition. One reason for this close relationship is the growing globalization of the world economy. The increased share of exports of all trading nations in total world GDP, which grew from 11 per cent to 20 per cent over the last quarter of a century, is only one indicator of globalization; increasing foreign direct investment (FDI) and financial market transactions can be added as well.[28] The main reasons lie in the acceleration of technological change, or specific technological improvements, which have

led to a reduction of the costs of transportation, communication and information-gathering. This means nothing more than growing international competition.

The implications for developing countries do not only include the need for companies to adjust to technological change and increased international competition but also the need for efficient international competition policy and law. In the light of globalization, national competition policies alone are insufficient to prevent anti-competitive behaviour. International coordination of such problems as market power concentration, ecology, and other externalities has become a necessity and an essential ingredient of a successful competition policy. The Set of Multilaterally Agreed Equitable Principles and Rules for the Control of RBP was an important step in this direction and should be further elaborated. Although today it is merely a set of recommendations, tomorrow this codex could be the cornerstone of an internationally agreed treaty on competition. Part C (iii), "Preferential or differential treatment for developing countries", allows room for the application of waivers.[29]

A widespread problem of trade policy in many developing countries is the persistence of overvalued exchange rates which hamper exports, boost imports and diminish international competitiveness. In this situation Governments often respond with foreign exchange control instead of devaluation, with several negative impacts on economic development. First of all, bureaucrats, not markets, decide—often according to a quantitative development plan—which goods are imported and of what quality and quantity. Since they are in general unable to determine *ex ante* the necessary investments, production and inputs required to reach a specific growth rate, scarce resources are wasted. Secondly, foreign exchange is often allotted preferentially to imports of investment goods which are thus artificially reduced in price. This favours capital-intensive industries and production processes and neglects the most important comparative advantage of most developing countries: a large, low-cost labour force. Thirdly, foreign exchange is not distributed according to the most efficient usage but rather according to bureaucratic rationing systems, personal relations, or even the amount of bribes. This leads to distorted resource allocation on the microeconomic level.[30] According to an empirical analysis of the impact of overvalued exchange rates and exchange controls on the economic growth of developing countries, with growing overvaluation the growth rates of the real GNP and of investment quotas decline, whereas the marginal capital coefficient rises.[31]

Although this advice is unpopular, overvalued exchange rates call for government action in the form of corrective depreciation. Realistic or even short-term undervalued exchange rates (via central bank interventions on the exchange market) can help strengthen export capacity and the diversification of exports and support the development of branches which produce and substitute those imports which had artificially low prices. This is a “natural” form of an ISI process based on the use of comparative cost advantages.[32] Between 1980 and 1985 Japan's low interest rates led to an undervalued yen, which has provided for continued export promotion and import retardation.[33]

Indonesia’s stabilization programme in the years 1966 to 1969 is just one example of the positive impact of depreciation combined with a general liberalization of imports and reduction of government intervention, especially in the form of price controls. The rate of inflation was reduced from 600 per cent in 1966 to 10 per cent in 1969; exports rose from US$ 633 million in 1965 to US$ 1,173 billion in 1970; the annual average growth rate of real per capita GDP rose from 0.8 per cent in the period 1966-1969 to 5.7 per cent in the period 1970-1977.[34] This shows how much government policy can contribute to a favourable competitive environment on the international level.

However, in the past economic literature had to concentrate more on government failures than on successes. Apart from the above-mentioned problems of foreign trade policy, many other government failures, both of omission and commission, can be observed: lack of transparency and accountability in public policy-making as well as excessive government intervention and regulation of economic activities in many developing countries have invited widespread rent-seeking behaviour and corruption. Weak governance and corruption deter domestic and foreign direct investment and have a tendency to lower government tax revenue, thereby contributing to fiscal imbalances and reducing critical public investment in areas such as health, education and infrastructure. Inadequate protection of private property rights and a weak rule of law have often functioned as obstacles to growth. In addition, government investment programmes are sometimes highly inefficient and wasteful. Government public sector deficits, fuelled by public sector enterprise deficits, excessive investment programmes and other government expenditures lead to high rates of inflation, with their attendant effects on resource allocation, savings behaviour and the allocation of private investment. Governments also insisted on nominal rates of interest well below the rate of inflation, with

credit rationing, so that they could supervise credit allocation among competing claimants.[35]

These and other widespread government failures can provide a kind of guidance for policy makers:

- Since no government action is gratis and always affects the allocation of resources, any economic activity in the public sector and any regulation of the private sector should be subject to a specified set of procedures or criteria by which intervention is administered. First, second, and third best policy measures for the attainment of a given objective should be identified, along with the administrative cost, feasibility of the activity and likelihood of political pressures;
- If alternative mechanisms and policies might be able to achieve a given objective, a presumption exists in favour of choosing a mechanism which provides the least scope for rent-seeking. For example, if government subsidies for firms are selective and linked to specific preconditions instead of overall distribution, firms have an incentive to meet the necessary criteria. This leads to the assumption that policies directly controlling private economic activity are likely to be less efficacious in terms of achieving their objectives than those which provide incentives for individuals to undertake the activities deemed desirable for their own benefit;
- It is preferable to choose policies and institutional arrangements that will force trade-offs to be faced in the administration and implementation of policy. A Ministry of Trade (occupied with different tasks, rather than a tariff commission, which would be responsible solely for matters affecting tariffs), would be under the pressure of different constituencies (exporters, protected industries, etc.) and budget restrictions;
- The costs of all policy measures should be transparent so that political pressure has less opportunity to work unseen by the public;
- The domination of specific interest groups can be prevented through open and institutionalized communication channels of a business-government partnership;
- To prevent the persistence of protection, certain mechanisms should be institutionalized. Zero base budgeting, or sunset legislation, should be reviewed as potential budgetary concepts. Policy

> makers should also constantly be reminded that previous decisions may not have been optimal or first best solutions. In the United States, for example, subsidies and other forms of protection are monitored and implemented by the Department of Commerce and the Department of the Treasury. In addition, the United States International Trade Commission conducts trade research investigations for Congress and the Executive upon request, and participates in the process of determining whether United States industries have been significantly hurt by the unfair trade practices of other countries.[36]

However, these proposals are only preliminary answers based on past experience and the little empirical research available.[37]

Examining the concept of "national competitiveness" in greater detail, it must be stressed that it is companies, and not nations, which compete, and thus an economically successful country is one which hosts many internationally competitive firms. Such firms are able to create and sustain competitive advantage against the world's top competitors in a particular field and to do that they need to attain a high and rising level of productivity. Since productivity is the main determinant of national per capita income, it is also the most decisive factor in a nation's standard of living in the long run.[38]

Sustained productivity growth requires the continual upgrading of the economy, i.e. a nation's firms must relentlessly improve productivity in existing industries by raising product quality, adding desirable features, improving product technology, or boosting production efficiency. They must develop the capacity to compete in more and more sophisticated industry segments where productivity is generally higher, and they must also develop the capability to compete successfully in entirely new and sophisticated industries. The following observation, however, should be borne in mind: "No nation can be competitive in (and be a net exporter of) everything. A nation's pool of human and other resources is necessarily limited. The ideal is that these resources be deployed in the most productive uses possible. The export success of those industries with a competitive advantage will push up the costs of labour, inputs, and capital in the nation, making other industries uncompetitive."[39]

The question is, what are the decisive characteristics of a nation that allow its firms to create and sustain competitive advantage in particular fields, the ensemble of which builds up the nation's overall competitive

advantage? How can a nation provide an environment in which its firms are able to improve and innovate faster than foreign rivals in a particular industry?

A supportive environment is one that allows for productivity growth while allowing for a continual upgrading of technological know-how. This can be supported through government-funded research. Germany, for example, has good experiences with joint projects between research institutes and firms, with partial funding of research contracts between firms and universities or with incentives for company research.

Japan, too, offered "administrative guidance" in the form of rationalization cartels. These are industry groups which get together to exchange technology, share research and development, standardize goods production, arrange specialization by enterprises along product lines, make common use of transportation, storage or marketing facilities, etc. Between 1961 and 1973 close to 1,000 cartels per year on average were exempted from antitrust law.[40] Another example of government support, this time in the information field, is the Japanese External Trade Organization, a subsidiary of the Ministry of Trade and International Industry, which operates 80 offices around the world in order to assist Japanese exporters in gathering marketing information and penetrating foreign markets.[41]

It is questionable whether the Government can also play a supportive role in the process of identifying and building up future comparative advantages. Some attempts have been made by economists in the past to identify comparative advantages and to forecast their changes over time. Based on an index of "revealed comparative advantage" (RVA), empirical studies tried to gain insight into the dynamics of the competitive abilities of various industries and to formulate policy recommendations based on the findings. However, further studies will be necessary to analyse whether the gap between theory and empirical application can be closed and whether specific policy decisions should effectively be based on empirical evidence of comparative advantage.[42] If future comparative advantages can be discovered through such analysis, waivers could be used with utmost accuracy.

V. Justification for waivers in developing countries

How can the adoption of waivers or exceptions be justified in developing countries? First of all, as was shown above, those countries do not possess the prerequisites for the competition process to run smoothly and thus for competition to fulfil its economic and social functions. Looking at the aforementioned realities in developing countries—and specifically, the unfavourable conditions for competition, including serious market failures—it is obvious that they have substantial disadvantages for participating in world competition. Since those unfavourable conditions and market failures cannot be overcome in the near future, waivers have to be looked upon as second-best interim aid.

Equals have to be treated equally and unequals unequally. Since developing countries are unequal to developed countries, they need special treatment.[43] Waivers can thus be seen as compensation for their trade disadvantages. They can be granted as temporary adjustment allowances to enable developing countries to participate in world trade as equally matched competitors.

This is in line with a very simple argument for waivers: developing countries need help because they cannot compete under the given circumstances.[44] This might be an unpopular claim which is less likely to meet with approval than the charge that the developed countries are gaining because of unfair trade practices.[45] But open trade is fair trade, and since free trade is not a realistic option nowadays, temporary waivers can—within limits—be considered as an instrument to allow developing countries to engage in international trade.

Especially nowadays, since on the one hand most developing countries have rashly reduced their protective barriers without being competitive on an international level, and on the other hand most industrialized countries are increasingly closing their economies, multilaterally accepted rules of the game (including provisions for the disadvantaged) become all the more important.

Trade theory states that all countries participating in trade, gain (even exploited developing countries). Nevertheless there can be no doubt that the scales fall heavily in favour of the developed countries. Also, free trade is in general to the advantage of more developed countries. Many regional integration attempts have failed because the more advanced economies were the winners of the integration and the weaker ones lost out. Therefore, a precondition for regional integration—which is nothing else but a regional free trade area—is the existence of a mechanism for providing compensation to the potential losers. In this way even economically weak nations can be persuaded to join the integration area.

Developing countries need compensation because they are handicapped in comparison to the industrialized nations. Such compensation can be found in national aid which fosters the competitiveness of national industries. From the neoclassical point of view it can have distortionary effects, yet from a dynamic point of view, and in keeping with new political economic theory, it is necessary in order to win the approval of weaker economies for economic integration meaning free trade. Since the best way to address domestic distortion is through domestic policy intervention, national aid should be favoured.

Finally, waivers in competition policy can be looked upon as countermeasures to the neo-protectionist behaviour of industrialized nations, since various policies of industrialized countries, e.g. the artificial price reduction of exports, lead to competition distortions.

The main argument against waivers to be heard in industrialized countries will probably be that this kind of protectionism will reduce their share of free trade gains. This involves the idea that it is countries, and not firms, which compete with each other, which is not in fact the case. On the company level, success for one firm within a particular market is almost inevitably associated with losses for a rival firm. On the country level, international trade is a positive-sum game, and success for one country usually translates into success for its partners as well (although the gains from trade can be different). All partners now benefit from the availability of new and better products, from larger markets abroad, and/or from more favourable terms of trade.[46] Thus, if waivers do increase international competitiveness and hence participation in international trade, all countries will win in the long run, while industries with low productivity will lose.

In this context it is important to mention that the United Nations Set of Principles does not contain any rules which protect international trade

from government intervention in competition. Since waivers can be seen as part of those interventions, rules should be formulated which contain some minimum requirements for governmental action.

Since developing countries, too, are at times strongly positioned in special markets, and since industrialized countries also have weak industries, it has to be debated whether waivers should be allowed to developing countries as a group of nations (fulfilling special criteria) or—better—only under certain unfavourable conditions. Here some general criteria have to be found which allow temporary protection in the form of restriction of competition without paving the way for discrimination or privileges.[47] Guidelines have to be carefully designed so that infant, and not ailing, industries are supported.

The resistance of many developing countries to opening their markets is understandable in the light of the bad example set by the OECD countries, which keep up non-tariff barriers and at the same time encourage developing countries to abolish them.[48] Economic theory on two-country-models shows that waivers given in the form of export subsidies or import restrictions will increase the country's national income while decreasing the national income of the other country.[49] By this "beggar-thy-neighbour policy" one country keeps up its level of employment, to the disadvantage of the other. This will usually lead to retaliation. The form of waivers will thus be decisive in the reaction of trading partners.

VI. Forms of waivers (exceptions or exemptions)

Economic history, empirical research results, and economic theory cannot provide a final answer to the question of whether the benefits of protection will outweigh or exceed its costs. Since protectionist measures can have adverse effects on the allocation of resources, on the rate of economic growth, and on the evolution of sustainable employment opportunities, the forms of waivers (or exceptions to the rule) are decisive for success. Waivers can take the form of tariffs and quotas, non-tariff measures, and subsidies.

A. *Tariffs and quotas*

In the case of an ISI policy, which basically consists of import tariffs and quotas, but also of foreign exchange controls and other measures, there is a direct increase in the costs to consumers as imports and their local substitutes become more expensive than they would be under free trade conditions. Higher prices, especially higher prices for basic goods, first of all hurt low-income groups in the protecting country.[50] Protectionist tariffs are thus often linked with an income redistribution to the advantage of producers and to the disadvantage of consumers, and even with a change in people's demand patterns.[51]

In addition, the domestic prices of the protected goods amount to artificially distorted price signals if they are raised beyond the level they would reach in the case of free entry of imports and relative to the prices of other goods. This means that incentives are given to concentrate labour, capital and entrepreneurship in the production of those goods. The Government's choice of protected goods and industries will therefore determine whether competitive or uncompetitive industries will be fostered and scarce resources used efficiently on industries with a present or future comparative advantage, or wasted.

Since it is mainly consumer goods that are protected, while imports of intermediate and capital goods are made cheaper for firms, the latter receive preferential treatment. This is tantamount to an income redistribu-

tion in favour of high-income groups. This policy eliminates incentives to improve efficiency for industries which are not privileged.

Tariffs will also push factor costs upwards, so that there is a danger of inflationary pressures and hence a reduction of international competitiveness. Industries which depend on the protected goods as input factors are discriminated against. This especially concerns the export sector. Additional costs of protection via tariffs arise if other countries retaliate, in case of an increase of smuggling activities and if tariff walls hinder the acquisition of foreign technology.

B. *Non-tariff measures*

Non-tariff measures can be defined as "all government actions other than tariffs with a potential trade-distorting impact, including quantitative restrictions, subsidies, government procurement practices, and technical barriers to trade".[52] Some countries frequently use non-tariff measures as a major form of protection usually applied to all trading partners.[53] They are an expression of a more inward-looking development policy and restrain the scope of participation in international trade relations, with all the adverse effects.

C. *Subsidies*

Subsidies can be defined as "government assistance to the development, production, or export of specific goods. Subsidies can take the form of either direct financial support or indirect support through tax exemptions, subsidized loans or loan write-offs, government procurement practices, and subsidies to the production of inputs".[54] They may allow firms to achieve economies of scale without distorting relative price ratios and without altering consumption patterns. In addition, costs for protection are visible within the fiscal budget and thus place constant pressure on the Government to aim for the removal of protection.

Yet there are also some arguments against subsidies. First, they can distort the allocation of resources because of a distorted price mechanism which hinders production factors from moving into areas with higher productivity and hinders the supply of lower-cost products. Secondly, the accuracy with which subsidies are granted to specific industries is limited, since the impact of subsidies can be controlled only within certain limits,

and the target group might enjoy only part of its subsidies. This might, too, lead to a waste of scarce resources. Thirdly, industries which do not belong to the target group and which have to grow and adjust to the market on their own resources are discriminated against. This means that the wrong incentives are given by the Government, which facilitates rent-seeking behaviour and hampers self-sustaining independent attitudes. Fourthly, the Government is usually unable to know its potential comparative advantages in advance.

Although there are some distinct disadvantages to using subsidies as protectionist measures, in the light of the above-mentioned problems of tariffs, especially with regard to the redistribution of income, temporary subsidies should be favoured. Therefore, it has to be considered whether developing countries should receive differential and more favourable treatment on the use of subsidies in international treaties.[55]

If subsidies are envisaged as a form of government intervention it has to be decided whether they should be granted indiscriminately and blankly, or selectively. One argument for the selectivity of intervention (in terms of strategic sectors, products and processes in the different stages of early industrialization) is that it saves on scarce administrative skills and makes it easier to pinpoint the social costs of policies and adjust them in response to changing technical and market conditions. Also, the experience of the successful newly industrializing countries demonstrates the importance of concentrating on some areas with comparative advantages.

On the other hand, we find justified criticism claiming that there are no objective criteria available for deciding on which industries are worth protecting and which are not. Although the above-mentioned RVA index tries to fill this gap, its practicability has to be further analysed. As Hayek said, it would be a “presumptuousness of knowledge” for government authorities to claim trend-setting competence. In addition, selectivity of intervention calls for the influence of pressure groups on economic policy.[56] At the firm level, sectoral protectionism tends to generate x-inefficiencies. In other words, in a restrictive trade policy environment the tendency to savour a quiet life and seek for rents will slacken cost-reducing efforts; efforts to improve organization, marketing and distribution; as well as efforts to carry out product and process innovations and investment in the training of the labour force. Opportunities in the market are missed and the technological catching-up process slows down.[57]

However, whether or not subsidies are granted selectively will not depend on whether they are successful. Many authors indicate that the essential difference between efficient Governments and inefficient ones is not the fact of giving or not giving subsidies to selected industries, because all Governments do this; the efficiency depends, rather, upon the principles that govern the allocation of subsidies. Obviously the same holds true for the adoption of all kinds of waivers.

Therefore, the following policy recommendations should be considered for subsidies as well as for all kinds of waivers:

- Subsidies or other forms of governmental support are necessary only if the private sector would otherwise not engage in business activities;
- Where no performance standards have been imposed upon the recipients of subsidies—i.e. waivers—they were wasted;
- Subsidies have to be granted only for a limited period of time and in a degressive mode so that firms have an incentive to “grow up”;
- If the Government's threats to remove subsidies in time or to remove them for firms not meeting performance standards are not credible, subsidies tend to be ineffective;
- To avoid discriminatory distribution of subsidies maximum transparency is necessary. For example, if the Government is forced to publicize its subsidies it would be under permanent pressure of justification and public control;
- Potential infant industries vary in their need for selective protection, or in other words, promotion;
- Selected firms, industries or branches have to be reviewed constantly. Should additional information surface, or if it can be safely predicted that those industries will not achieve international competitiveness within a reasonable length of time, the initial promotion strategy has to be revised. A control or feedback mechanism has thus to be institutionalized. If mistakes are recognized remedial action has to be taken quickly and future choices have to be considered in the light of past experiences.

- Selective protection should be executed in such a way that the resulting discrimination against all other industries is reduced to a minimum;
- A supranational authority (including all developing countries) in the form of a technology centre could be envisaged to support individual countries in their search for future comparative advantages; offer technological know-how and the advice of specialists; and realize common projects (e.g. bi- or multinational infrastructure projects). Such a concentration of know-how would save scarce resources for all and open up opportunities to “weaker” members of the community. Also, if international instead of national experts were entrusted with the selection of industries, the pressure of national interest groups could be significantly reduced;
- If waivers are granted to all nations they will lose their impact; accordingly, they should be granted carefully and only where necessary. An independent institution should be assigned to establish specific criteria and in this way limit the usage of waivers. Such an institution could also draft regulations to restrict the number of infant industries selected in order to avoid misuse.

The promotion of individual sectors of the economy can be successful only if this leads to their national and international competitiveness. However, some infants never do grow up!

VII. Conclusions

We can draw the conclusion that history and economic theory seem to support the view that at the beginning of economic development (industrialization), companies in developing countries need temporary aid. Free trade is the first best solution in a world of perfect competition. Yet, in the light of the existing disadvantages of developing countries and the reality of existing trade barriers, free trade is insufficient to enhance competitiveness. Governments need to be enabled to give short-term, degressive, limited waivers (second best solution) in order to help their industries become competitive on a national and international level. These waivers must be reviewed continuously. It has to be ensured that the subsidies paid, or any other kind of aid provided, do not continue for too long. Also, the procedure, period of validity and size of waivers must be transparent, so that the recipients are informed and can thus take long-term decisions and have an incentive to "grow up" quickly in order to be competitive. Government protection might otherwise become an incentive for infants to grow up too slowly! Although the theoretical benefits are convincing, there are technical problems in implementing optimal infant industry protection. The institutional capacities of many developing countries are too weak to follow such a policy successfully, and the power of interest groups and danger of rent-seeking should not be underestimated. Hence, wherever possible one should stick to free trade.

Notes

[1] The author would like to thank Dipl.-Vw. Andrea Maria Schneider for her valuable comments and suggestions in preparing this paper.

[2] Developing countries are a heterogeneous group of nations with very different degrees of development. In this article we will concentrate mainly on countries with a very low level of development and low national and international competitiveness.

[3] See Schmidt/Binder, 1996, p. 15.

[4] See Olten, 1995, p. 13.

[5] See Olten, 1995, pp. 15 ff. and Lachmann, 1995, pp. 132 ff.

[6] Competition policy in developed countries nowadays concentrates on the concept of "workable competition" rather than "perfect competition". The economic literature on the infant industry argument, on the other hand, is still based on the neoclassical paradigm (perfect competition). A study on

the interconnection between the concept of workable competition and the infant industry argument is beyond the scope of this paper.

[7] See Lederman, 1993, p. 126.

[8] See Bannock et al., 1987, p. 81.

[9] See Müller, 1995, p. 142.

[10] In the case of the Republic of Korea the State was highly interventionist, with interventions geared towards developing and supporting industry to penetrate foreign markets.

[11] Although the extent to which the MITI contributed to Japan's economic success is highly questionable, there can be no doubt that it actually did contribute.

[12] The production possibility curve can be defined as the graphical representation of output combinations that can be secured from a given set of economic resources.

[13] Technical progress in the agricultural sector can be identified as the major determinant in the growth of the gross national product in many developing countries. The faster productivity and income in agriculture grow, the larger the potential market for domestically produced goods becomes. However, a high degree of inequality of income distribution may hinder the emergence of a national market for relatively simple manufactured goods and lead to a demand structure oriented towards luxury goods.

[14] See Grabowski, 1994, pp. 541 ff. and Fagerberg, 1996.

[15] Ibid., p. 545.

[16] See Lachmann, 1994, pp. 79 ff.; Nye, 1991; and Perrotta, 1991.

[17] See Dietz, 1992, p. 377.

[18] See Grabowski, 1994, p. 537.

[19] "Externalities occur where the benefits to the nation as a whole exceed those accruing to any single firm or individual, so that private entities will tend to underinvest in such areas from the perspective of the nation. Good examples are general education, environmental quality, and some types of R & D that can boost productivity in many industries." Porter, 1990, pp. 620 ff.

[20] See e.g. OECD, 1992, pp. 11 ff.

[21] See Lederman, 1993, pp. 126 ff.

[22] Ibid., p. 127.

[23] As there is ample literature on examples like cut-throat competition, temporary informational monopolies, transparency of market conditions and the like, we will not elaborate further.

[24] See Donges, 1986, pp. 24 ff.

[25] See Bannock et al., 1987, p. 192 and pp. 311 ff.; Lachmann, 1990, pp. 63 ff.; and Neumann, 1987, pp. 27 ff.

[26] Interest rate ceilings which are often observed in developing countries lead to fragmented financial markets and are the major cause for a national savings gap.

[27] See Buitelaar/Mertens, 1993, pp. 64 ff.

[28] See Dahlman, 1994, p. 69.

[29] The discussion of waivers is not a new one. "Hard core waivers" were provided under a GATT decision in 1955. They permitted certain quantitative restrictions to be maintained for a specified period of time. See Kelly et al., 1988, p. 113.

[30] See Escher, 1990, pp. 74 ff.

[31] See Jungfer, 1986, pp. 242 ff.

[32] See Escher, 1990, p. 75.

[33] See Zimbalist et al., 1989, pp. 54 and 58.

[34] See Escher, 1990, pp. 84 ff.

[35] See Krueger, 1990, p. 10.

[36] See Lederman, 1993, p. 130.

[37] See Krueger, l990, pp. 20 ff.

[38] See Porter, 1990, p. 6.

[39] Ibid., 1990, p. 7.

[40] See Zimbalist et al., 1989, p. 56.

[41] Ibid., p. 54.

[42] See Ballance, 1988, pp. 6-24.

[43] It is true that all nations are to a certain degree unequal in terms of resource endowments, political, economic, and social conditions, etc. However, it is evident that financial markets in developed countries such as the United Kingdom and Denmark, for example, function equally well, whereas they do not in developing countries like Cambodia and Ghana.

[44] Low wages, dumping practices, and—compared to developed countries—lower environmental, labour and social standards alone are not sufficient to provide developing countries with the necessary competitiveness in order to engage in free trade. In addition, there is strong resistance from certain special interest groups in developed countries against some of these comparative advantages in developing countries, since they are considered as unfair. As compensation, protectionist measures are demanded in industrialized countries. Further elaboration on the harmonization debate on fair trade is beyond the scope of this analysis.

[45] Unfair trade can be defined as "Trade on the basis of a competitive advantage not derived from 'legitimate' sources. For example, GATT recognizes dumping and trade-distorting subsidies as unfair trade practices". Kelly et al., 1988, p. 114.

[46] See Boltho, 1996, pp. 4.

[47] See von Hahn, 1982, pp. 372 ff.

[48] See Low/Nash, 1994, p. 58.

[49] The results of these theoretical models have to be handled carefully, since they are of only limited relevance.

[50] See Donges, 1986, pp. 17 ff.

[51] See Reichel, 1995, pp. 193 ff. and Lederman, 1993, pp. 126 ff.

[52] Kelly et al., 1988, p. 114.

[53] Ibid., p. 22.

[54] Ibid., p. 114.

[55] The GATT "Subsidies Code" prohibits export subsidies on manufactures. Ibid., p. 37.

[56] See Bardhan, 1990, p. 6.

[57] See Donges, 1986, pp. 18 ff.

References

Ballance, Robert H.
Trade Performance as an Indicator of Comparative Advantage. *In*: David Greenaway, ed., *Economic Development and International Trade*. London, 1988, 6-24.

Bannock, Graham, R. E. Baxter and Evan Davis
The Penguin Dictionary of Economics, 4th ed., London, 1987.

Bardhan, Pranab
Symposium on the State and Economic Development. *Journal of Economic Perspectives*, 4 (3), summer 1990, 3-7.

Bhagwati, Jagdish N.
Free Trade: Old and New Challenges. *The Economic Journal*, vol. 104 (423), 3/94, 231-246.

———
The Demands to Reduce Domestic Diversity among Trading Nations. *In*: Jagdish N. Bhagwati and Robert E. Hudec, eds., *Fair Trade and Harmonization–Prerequisites for Free Trade?* Vol. 1: Economic Analysis, Cambridge and London, 1996, 9-40. MIT Press.

Bliss, Christopher
Trade and Competition Control. *In*: Jagdish N. Bhagwati and Robert E. Hudec, eds., *Fair Trade and Harmonization–Prerequisites for Free Trade?* Vol. 1: Economic Analysis, Cambridge and London, 1996, 313-328. MIT Press.

Boltho, Andrea
The Assessment: International Competitiveness. *Oxford Review of Economic Policy*, 12 (3), autumn 1996, 1-16.

Buitelaar, Rudolf M. and Leonard Mertens
The challenge of industrial competitiveness. *CEPAL Review*, vol. 51, 12/93, 49-68.

Dahlman, Carl J.
New Elements of International Competitiveness: Implications for Developing Economies. *In*: Colin I. Bradford, Jr., ed., *The New Paradigm of Systemic Competitiveness: Toward More Integrated Policies in Latin America.* OECD Development Center Documents, Paris, 1994, 69-95.

Datta-Chaudhuri, Mrinal
Market Failure and Government Failure. *Journal of Economic Perspectives*, 4 (3), summer 1990, 25-39.

Dietz, James L.
Overcoming Underdevelopment: What Has Been Learned from the East Asian and Latin American Experiences? *Journal of Economic Issues*, 26 (2), 6/92, 373-383.

Donges, Jürgen B.
Whither International Trade Policies? Worries about Continuing Protectionism. Kieler Discussion Papers No. 125, Institut für Weltwirtschaft. Kiel, 1986.

Escher, Mónica
Die wirtschaftlichen und sozialen Probleme Lateinamerikas—Eine Untersuchung unter ordnungspolitischen Gesichtspunkten. Bern and Stuttgart, 1990. Haupt.

Fagerberg, Jan
Technology and Competitiveness. *Oxford Review of Economic Policy*, 12 (3), autumn 1996, 39-51.

Gifford, Daniel J. and Mitsuo Matsushita
Antitrust or Competition Laws Viewed in a Trading Context: Harmony or Dissonance? *In*: Jagdish N. Bhagwati and Robert E. Hudec, eds., *Fair Trade and Harmonization—Prerequisites for Free Trade?* Vol. 2: Legal Analysis. Cambridge and London, 1996, 269-331. MIT Press.

Grabowski, Richard
Import Substitution, Export Promotion, and the State in Economic Development. *The Journal of Developing Areas*, 28 (4), 4/94, 535-554.

Grubel, Herbert G.
The Anatomy of Classical and Modern Infant Industry Arguments. *Weltwirtschaftliches Archiv*, vol. 97, 1966, 323-344.

Guerrieri, Paolo
International Competitiveness, Trade Integration and Technological Interdependence. *In*: Colin I. Bradford, Jr., ed., *The New Paradigm of Systemic Competitiveness: Toward More Integrated Policies in Latin America*. OECD Development Center Documents, Paris, 1994, 171-204.

Haberler, Gottfried
Der internationale Handel, 1970. Berlin et al. Springer.

Hay, Donald
The Assessment: Competition Policy. *Oxford Review of Economic Policy*, 9 (2), summer 1993, 1-26.

Hoekman, Bernard M. and Petros C. Mavroidis
Competition, Competition Policy and the GATT. *World Economy*, vol. 17 (2), 3/94, 121-150.

International Monetary Fund
World Economic Outlook—May 1997. Washington, D.C., IMF, 1997.

Johnson, Harry G.
An Economic Theory of Protectionism, Tariff Bargaining, and the Formation of Customs Unions. *The Journal of Political Economy*, 73 (3), 6/65, 256-283.

Katz, Jorge
Industrial Organisation, International Competitiveness and Public Policy. *In*: Colin I. Bradford Jr., ed., *The New Paradigm of Systemic Competitiveness: Toward More Integrated Policies in Latin America*. OECD Development Center Documents, Paris, 1994, 153-170.

Kelly, Margaret, Naheed Kirmani, Miranda Xafa, Clemens Boonekamp, Peter Winglee.
Issues and Developments in International Trade Policy. Occasional Paper No. 63. Washington, D.C., IMF, 1988.

Krueger, Anne O.
Government Failures in Development. *Journal of Economic Perspectives*, 4 (3), summer 1990, 9-23.

Krueger, Anne O. and Baran Tuncer
An Empirical Test of the Infant Industry Argument. *American Economic Review*, 72 (5), 1982, 1142-1152.

_____
An Empirical Test of the Infant Industry Argument. *American Economic Review*, 84 (4), 1994, 1096.

Krugman, Paul R.
The Narrow and Broad Arguments for Free Trade. *In*: *American Economic Review*. Papers and Proceedings, 83 (2), 5/93, 362-366.

_____
Growing World Trade: Causes and Consequences. *In*: *Brookings Papers on Economic Activity*, No. 1, 1995, 327-362.

Lachmann, Werner
Entwicklungspolitik, Bd. 1. Grundlagen. Munich, 1994. Oldenbourg.

_____
Entwicklungspolitik, Bd. 2. Binnenwirtschaftliche Aspekte der Entwicklung. Munich, 1997. Oldenbourg.

_____
Entwicklungspolitik, Bd. 3. Außenwirtschaftliche Aspekte des Entwicklungs-prozesses. Munich, 1994. Oldenbourg.

_____
Volkswirtschaftslehre 1, Grundlagen. Berlin and Heidelberg, 1990. Springer.

_____
Volkswirtschaftslehre 2, Anwendungen. Berlin and Heidelberg, 1995. Springer.

Lal, Deepak and Sarath Rajapatirana
Foreign Trade Regimes and Economic Growth in Developing Countries. *In*: Herbert Giersch, ed., *Free Trade in the World Economy—Towards an Opening of Markets*. Symposium 1986, Tübingen, 1987, 204-235.

Lall, Sanjaya
Building Industrial Competitiveness in Developing Countries. OECD Development Center Studies, Paris, 1990.

Lederman, Daniel
Old and new trade policies. *CEPAL Review*, vol. 51, 12/93, 123-132.

Levinson, James
Competition Policy and International Trade. *In*: Jagdish N. Bhagwati and Robert E. Hudec, eds., *Fair Trade and Harmonization—Prerequisites for Free Trade?* Vol. 1: Economic Analysis. Cambridge and London, 1996, 329-356. MIT Press.

Lloyd, Peter and Gary Sampson
Competition and Trade Policy: Identifying the Issues After the Uruguay Round. *The World Economy*, 18 (5), 9/95, 681-705.

Low, Patrick and John Nash
Der schwierige Weg: Zu einem freieren Welthandel. In: *Forschung und Entwicklung*, 9/94, 58-61.

Mantzavinos, Chrysostomos
Wettbewerbstheorie, Volkswirtschaftliche Schriften. Heft 434. Berlin, 1994. Duncker & Humblot.

Meier, Gerald M.
Infant industry. *In*: John Eatwell, Murray Milgate, Peter Newman, eds., *The New Palgrave: A Dictionary of Economics*, vol. 2. London, 1987, 828-830. MacMillan.

Morris, Cynthia Taft and Irma Adelman
Nineteenth-Century Development Experience and Lessons for Today. *World Development*, 17 (9), 1989, 1417-1432.

Müller, Geraldo
The kaleidoscope of competitiveness. *CEPAL Review*, vol. 56, 8/95, 141-152.

Neumann, Manfred
Theoretische Volkswirtschaftslehre II, 2nd ed., Munich, 1987. Vahlen.

Nye, John Vincent
The Myth of Free-Trade Britain and Fortress France: Tariffs and Trade in the Nineteenth Century. *Journal of Economic History*, 51 (1), 3/91, 23-46.

Organization for Economic Co-operation and Development
Competition and Trade Policies—Their Interaction. Paris, 1984.

———
Regulatory Reform, Privatisation and Competition Policy. Paris, 1992.

Önis, Ziya
The Limits of Neoliberalism: Toward a Reformulation of Development Theory. *Journal of Economic Issues*, 29 (1), 3/95, 97-119.

Olten, Rainer
Wettbewerbstheorie und Wettbewerbspolitik. Munich, 1995. Oldenbourg.

O'Neill, Helen
Globalisation, Competitiveness and Human Security: Challenges for Development Policy and Institutional Change. *European Journal of Development Research*, 9 (1), 6/97, 7-37.

Printed at United Nations, Geneva
GE.99-53213–December 1999–1,130

UNCTAD/ITCD/CLP/MISC.9