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The Interaction amongst Trade, Investment and Competition Policies

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THE INTERACTION AMONGST TRADE, INVESTMENT AND COMPETITION POLICIES

OECD Trade Policy Working Paper No. 60

by Csilla Bartók and Sébastien Miroudot

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ABSTRACT

The report focuses on the complementarities between trade, investment and competition policies and analyses how policy coherence can be promoted in these three important areas that shape incentives for firms and individuals to be more productive and for markets to be more competitive. It also deals with the potential inconsistencies or tensions that may arise between trade, investment and competition reforms and how to ease them. It shows that specific policy goals can be achieved while maintaining an open and pro-competitive environment. Overall, the analysis highlights the role of governments in providing the right incentives to facilitate the adjustment to the internationalisation of production and the important synergies between policies that can be exploited to promote growth. It is not only the case in contestable markets but also in the context of market failures where pro-competitive policies can address specific distortions and mitigate the adverse effects of reforms. The report includes the results of a survey collecting the experience of policymakers on complementarities between trade, investment and competition policies.

Keywords: Trade, investment, competition, policy coherence, synergies, supply-side, pro-competitive, market failures, distortions, reforms

JEL: F1, F2, L5

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EXECUTIVE SUMMARY

As trade reforms interact with several other economic policies, policy coherence is critical. Trade, investment and competition policies shape the incentives for firms and individuals to be more productive and for markets to be more competitive. This report focuses on the mutually reinforcing relationship between these three supply-side policies in the context of the internationalisation of world production.

There are synergies between trade, investment and competition policies in the sense that gains emerging from one policy area are enhanced by reforms made in the two others. Trade liberalisation generates higher gains when markets are competitive and the movement of capital is free. FDI decisions are made on the basis of efficiency considerations and interactions with domestic producers are more likely, with potential technology spillovers, when trade is liberalised and competition enforced. Successful development strategies, as exemplified by the experience of Chile or Ireland, have been built on such synergies. The experience of the EU is also interesting in illustrating the combination of trade, investment and competition reforms to promote economic efficiency in a common market.

The gains from pro-competitive reforms have been also recently emphasised in a series of research papers, inside and outside OECD, assessing the impact of trade, investment and competition reforms on growth and welfare. Cross-country differences in income per capita and productivity are partly explained by differences in product market regulations, as defined by the market access provided to foreign products and foreign investors, as well as the way competition is enforced. Explaining economic growth requires taking into account how competitive markets are and how liberal the investment regime is, in addition to looking at the openness of the trade regime.

While there are complementarities between trade, investment and competition reforms, one may wonder to what extent the policies can also be substitutes, as their objectives often overlap. In particular, the role of trade and investment liberalisation in enforcing competition can lead one to think that in some cases the competition pressure from imports and foreign investors could be enough to discipline the market and prevent domestic producers from exercising any kind of market power. There are indeed disciplining effects from trade and investment liberalisation and small open economies like Hong Kong or Singapore have achieved economic efficiency without a general cross-sector competition law.

However, it is only when markets are contestable that trade and investment liberalisation have significant disciplining effects on competition. Barriers to entry or exit, important sunk costs or networks effects might prevent foreign products or companies to reach domestic consumers and the removal of trade and FDI barriers has no impact on competition. Anti-competitive behaviours can occur on such markets and need to be addressed by competition authorities. Some of these barriers to entry are however related to the structure of markets and cannot always be eliminated through competition law or policy.

For these sectors where there are market imperfections and which are regulated, the question is therefore to what extent the synergies described in the report still exist and can be useful to improve economic efficiency. The liberalisation of trade and investment in the telecommunication sector proves that positive results can be achieved by exposing sectors to foreign competition. In some cases, asymmetric regulations help new entrant firms when they maintain a good balance and motivate new entries instead of overly protecting them. In other infrastructure and utility sectors, like energy, trade and investment policies cannot alone play their full role. In such cases, the proper functioning of the remaining policies is the key.

While the complementarities among trade, investment and competition reforms in regulated sectors do apply when markets are not contestable, they disappear on markets where, rather than market imperfections, it is strong protective policies prevent reaping the full benefits of trade and investment liberalisation. These policy implications create situations where the interactions between trade, investment and competition no longer promote efficiency and growth and can lead to resource misallocation and lower productivity. This can be illustrated with many examples where industry interests in sectors deemed strategic for the government lead to altered trade or investment policy provisions through high tariff barriers, quotas, high domestic taxes, unfair trade remedy measures, export monopolies or prohibition on foreign ownership to such extent that it is detrimental for the immediate competitors in the sector or other industries connected to these markets.

Depending to what extent these measures are exploited the results can vary, allowing for either a handful of small competitors or their full disappearance. Thus, under restrictive trade or investment policy measures the role of competition policy is to play an active role and contribute to the open discussion of the restrictive measures applied. When broadly used with credible enforcement, competition policies can deter anticompetitive practices of foreign and domestic firms and can effectively substitute for various trade instruments that aim to re-establish fair competition. Such policies can be implemented along with the phasing out of restrictive trade policies and restrictions on foreign investment and ownership.

As provisions on trade, investment and competition are now commonly found in regional or bilateral trade agreements, it is interesting to look at the motivation behind the inclusion of such provisions and to what extent it is related to the synergies described so far. There is a rationale in including investment and competition provisions in these agreements in the context of international production networks and global value chains. Dealing with trade and FDI allows a comprehensive treatment of barriers that can distort firms' decisions and create economic inefficiencies by disconnecting domestic companies from international markets. The competition mechanisms in RTAs that can deal with barriers represented by anti-competitive practices also offer reassurance to foreign companies that in the end may enhance trade and investment incentives.

When negotiating or implementing RTAs, policymakers may have different objectives. There is for example historically a difference between investment rule-making in bilateral investment treaties and in recent regional trade agreements that include investment provisions. However, there is no identifiable conflict between the objectives of policymakers, as RTAs take into account both the protection and liberalisation dimension of investment policy. For trade and competition policymakers, mutual understanding is crucial, in order to provide a coherent policy environment for both foreign and domestic companies, since the mandate of the competition authority and its basis for action are given by the national competition law and not by the trade agreement.

Overall, the analysis highlights the role of governments in providing the right incentives for firms and individuals to facilitate the adjustment to the internationalisation of world production. There are important synergies between trade, investment and competition policies that can be exploited to promote growth. It is not only the case in contestable markets but also in the context of market failures where pro-competitive policies can address specific distortions and mitigate the adverse effects of reforms. Only extreme cases of policy failure where strong protective strategies are pursued lead to inefficient outcomes with no benefit from the interaction between trade, investment and competition policies.

Results of the questionnaire sent to trade, investment and competition policymakers of OECD countries, indicate that countries are well aware of the synergies between trade, investment and competition policies and that policymakers are increasingly working together to address these issues.

INTRODUCTION

1. Trade, investment and competition policies are among the main supply side policies that can promote market efficiency and lift productivity growth. While the interactions between trade and investment, on the one hand, and trade and competition, on the other hand, have been previously examined¹, there are few studies that deal at the same time with trade, investment and competition reforms. As these three policies shape the incentives for firms and individuals to be more productive and for markets to be more competitive, it makes sense to study them together.

2. The relationships between trade and investment, and trade and competition, were discussed at the WTO following the 1996 Ministerial conference of Singapore. These two “Singapore issues” were dropped from the Doha Development Agenda negotiations in July 2004. Nevertheless, investment and competition disciplines are increasingly incorporated into regional trade agreements². These agreements are good examples of the interaction among trade, investment and competition policies and of the rationale for policy coherence among them.

Policy coherence

3. Policy coherence has been recognised as an important factor to promote sound public policies. As trade reforms interact with several other economic policies, coherence of trade policy with other policies is critical and the relationship between trade and investment policies on the one hand and trade and competition policies on the other hand has been the focus of increasing attention.

4. Policy coherence can be defined as the capacity to produce consistency among different policies and to promote mutually reinforcing policies across government departments and agencies. In the case of trade, investment and competition, the objectives of the three policies are similar: to improve economic efficiency and promote economic growth. Policy coherence therefore aims at creating synergies between reforms that can spur policy change through mutually reinforcing mechanisms. However, potential tensions or inconsistencies may arise among trade, investment and competition policies when they depart from their main purpose of economic efficiency and follow other objectives, or when policymakers do not share the same conception or approach towards economic efficiency and growth. There are also market imperfections that can create situations where one of these policies is inoperative and to a certain extent the two others can fill the policy gap and serve as substitutes.

1. The interaction between trade and investment policies has been studied in different OECD projects and recently in the context of the Policy Framework for Investment (OECD, 2006a). The complementarities between trade and competition policies have also been addressed in several OECD studies, in particular in the programme of work of the Joint Group on Trade and Competition. For example, in COM/TD/DAFFE/CLP(98)98/FINAL and OECD (1999).

2. See COM/DAF/TD(2005)3/FINAL on trade and competition, and TD/TC/WP(2005)40/FINAL and COM/DAF/INV/TD(2006)/40 on trade and investment.

5. The reason why policy coherence is of a greater importance today in the area of trade, investment and competition lies in the changing nature of world trade and world production. International trade and foreign direct investment have been growing faster than output over the last two decades. Trade in services and FDI in services have increased, an evolution related to technological progress. With new information and communication technologies, more services are tradable.

6. Because many services can be outsourced or offshored, it is also possible for firms to change the way they produce. Since the mid-1980s, the internationalisation of world production has occurred through new organisational forms and strategies where firms fragment their production in different countries and create global value chains in a vertical specialisation framework. But this second change is also related to trade and investment liberalisation and the fact that tariff barriers have been substantially reduced. Firms can choose the location where they produce on the basis of efficiency considerations. When both trade and FDI are liberalised, firms can also choose the best strategy to serve foreign markets, in particular whether they should export or create a subsidiary in the foreign market. The internationalisation of world production and new strategies of multinational enterprises (MNEs) have therefore important implications for policymakers and there is a need for greater policy coherence and a co-ordinated treatment of trade, investment and competition issues.

Defining trade, investment and competition policies

7. This section briefly defines the three policies and presents their main objectives. It should be kept in mind that countries have sometimes different approaches to defining the objectives of these policies and how they are enforced or implemented. When relevant for the analysis, some of these differences are highlighted below, but the description remains general (and as such may not always hold for specific countries).

Trade policy

8. Trade policy can be simply defined as “any policy affecting international trade, including especially tariffs and non-tariff barriers”³. It refers to the policy framework, laws, regulations and international agreements that control foreign trade. One characteristic of trade policy is that by definition it is an “international” policy which is to a certain extent “negotiated” with other countries or agreed upon in international organisations (such as the WTO) but can also be exercised unilaterally. In a broader sense, trade reforms can be understood as institutional changes with a significant impact on economic behaviour, resource allocation and relationship with the rest of the world as trade liberalisation changes production patterns and prompts the integration of countries into the world economy.

9. The objectives of trade policy are summarised in the first column of Table 1. The main objective of trade policy is to maximise the nation’s welfare through increased economic efficiency. A first best outcome would be according to economic theory a maximisation of global welfare through free trade (i.e., the removal of all barriers to trade). In the absence of global free trade or when market imperfections exist, the maximisation of domestic welfare can take other avenues through the use of trade policy instruments and measures to achieve a “second best” outcome. Trade policy can depart from its economic efficiency objective when as a supplementary objective it aims at serving specific national interests and increasing income of specific groups to the detriment of others.

3. Alan Deardorff’s glossary of international economics.

Investment policy

10. Although investment policy can deal both with domestic and foreign investment, the focus here is on foreign investment. In this narrower sense, investment policy can be understood as encompassing any regulation or law that encourages or discourages international investment. International investment includes FDI, other capital movements, and the operations of multinational enterprises.

11. The objectives of investment policy are presented in the second column of Table 1. Attracting investment is generally the main objective of investment policy and is done by liberalising FDI but also by providing protection to investors or incentives. The creation of a sound investment environment is crucial. But investment policy can also be more defensive and limit the foreign ownership in the domestic economy. The promotion of investment and corporate responsibility are also common features of investment policy. As it is the case with trade policy, investment policy measures are often found in international agreements, including bilateral investment treaties (BITs), double taxation treaties and regional trade agreements (RTAs).

Table 1. The objectives⁴ of trade, investment and competition policies

Trade policy objectives		Investment policy objectives		Competition policy objectives	
<p><i>Main objectives:</i></p> <ul style="list-style-type: none"> • Maximising the welfare (real income) of a country <ul style="list-style-type: none"> • Improving market access for domestic firms • Promoting productivity growth • Facilitating the integration of the economy into global markets. <p><i>Supplementary objectives</i></p> <ul style="list-style-type: none"> • Serving particular national interests • Revenues for the government (tariffs) • Macroeconomic balance 	<p><i>Associated objectives:</i></p> <ul style="list-style-type: none"> • Free trade, trade liberalisation • Static gains from trade: consumer & producer surplus <ul style="list-style-type: none"> • Dynamic gains from trade 	<p><i>Main objectives:</i></p> <ul style="list-style-type: none"> • Enhancing the contribution of international investment to growth and sustainable development • Improving the investment environment and attracting investment • Liberalisation of capital movements <p><i>Supplementary objectives</i></p> <ul style="list-style-type: none"> • Increasing domestic investment • Protecting certain sectors • Promoting social benefits and fight against poverty • Supporting SME linkages 	<p><i>Associated objectives:</i></p> <ul style="list-style-type: none"> • Local diffusion of technology and knowledge • Protection of investors • Transparency • Liberalisation of FDI 	<p><i>Main objectives:</i></p> <ul style="list-style-type: none"> • Maintenance of competitive process/markets and free competition • Lessening the adverse effect of government intervention in the marketplace • Prevention of abuse of economic power • Achievement of economic efficiency <p><i>Supplementary objectives</i></p> <ul style="list-style-type: none"> • Protecting small business, preserving the free enterprise system and maintaining fairness and honesty • Balance between efficiency and economic-social policy objectives 	<p><i>Associated objectives:</i></p> <ul style="list-style-type: none"> • Allocative and dynamic efficiency to be encouraged • Improving access and opening markets • Consumer protection

Competition policy

12. Competition policy can be defined as “the set of policies and laws which ensure that competition in the market place is not restricted in a way that is detrimental to the society” or “in a way to reduce economic efficiency” (Motta, 2004).

4. The Main objectives cover the policy objectives that are shared by most countries. Associated goals are usually related to the main goals, however not pursued by most countries. Supplementary objectives do apply in a handful of countries and are objectives that should be followed primarily.

13. The objectives of competition policy are more closely related to the second version of the definition given above. In general, competition policy aims to achieve greater economic efficiency in order to increase welfare of the society through competition law enforcement and advocacy to make markets freer and more open. Therefore, it takes measures that promote competitive market outcomes, structures and behaviours. On the other hand, competition policy may cover measures that are country-specific. This implies that there is more than one policy variation, according to how the policy is defined beyond the economic efficiency argument and/or whether certain sectors are subject to sector-specific rules and treated outside the competition law. Beyond the domestic features, various international forums deal with competition matters, like OECD or ICN. Bilateral agreements on competition policy have also contributed to increased transparency, better understanding of competition policy measures and supported companies dealing with multi-jurisdictional merger filings.

14. Looking at Table 1, there are obvious similarities in the objectives of the three policies. A common objective is to improve economic efficiency and to promote growth and sustainable development. These policies aim at increasing domestic welfare and facilitating the integration of the domestic economy in global markets. As supplementary objectives, these policies also pursue social benefits, the alleviation of poverty and the mitigation of adverse effects from economic change on specific groups of the population..

15. In the case of services, there is an overlap between international trade and investment policies as the liberalisation of Mode 3 trade in services is covered by the WTO General Agreement on Trade in Services (GATS) while services benefit from the protection provisions found in international investment agreements. Since the mid-1990s it is also common to find rulemaking on many kind of investment (in services and non-services sectors) in regional trade agreements. In the rest of the document, we often refer to “trade and investment” policies because it is not possible to clearly disentangle them.

16. However, Table 1 also points out possible conflicts in the objectives of trade, investment and competition policies. These conflicts can be “internal” as some of the supplementary objectives listed are sometimes not fully compatible with the main objective of economic efficiency and increased growth. But tensions may also appear between the three policies when improving welfare in an area may be in conflict with the achievement of objectives in another area. For example, decisions on mergers can reduce market access of companies. Another example would be the conflict between certain types of incentives given to companies to attract their investments and trade agreements, as some of these incentives could have a trade-distorting effect.

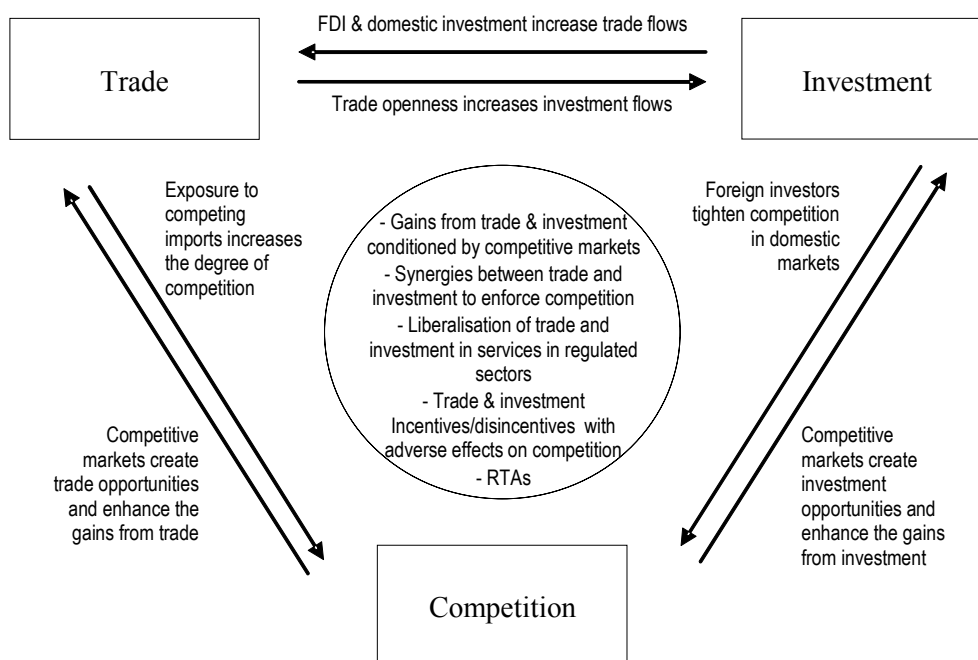
17. A last comment is that in the trio formed by trade, investment and competition policies, competition policy can be seen as being of a different nature as it focuses on the functioning of markets while trade and investment policies deal with international flows (flows of goods and services on the one hand and flows of capital on the other hand). However, it would be a mistake to regard competition policy as a “domestic policy” and trade and investment policies as only of an “international” nature. Competition authorities look at the broad picture when assessing the degree of competition on a market and take an international perspective. Moreover, trade and investment policies can be pursued with purely domestic goals.

A brief description of the interactions between trade, investment and competition policies

18. The interactions among trade, investment and competition policies can be illustrated through the diagram presented in Figure 1. It describes the positive and mutually reinforcing relationships between outward-oriented trade, investment and competition reforms. Trade openness has been found to be consistently correlated with higher investment rates. Trade and investment tend to be complements rather than substitutes in the context of open economies.

19. Competitive markets create opportunities for trade and investment and enhance the gains from trade and investment liberalisation. Uncompetitive markets can attract foreign companies to the extent that they can have a dominant position in domestic markets, thus creating rents. FDI can also be justified by tariff-jumping motives. However, these situations will not lead to lower prices and spillovers in the domestic economy. It is thus the (long-term) gains from trade and investment liberalisation that result from competitive markets rather than FDI inflows or imports.

Figure 1. The relationships between outward-oriented trade, investment and competition reforms



20. The intersection between trade, investment and competition policies should be precisely defined. It is the area in the middle of the above diagram. It covers:

- The way competitive markets create trade and investment opportunities as well as enhancing the gains from trade and investment when there is a positive interrelationship between trade and investment.
- The role of trade and investment policies in enforcing competition *together* through the facilitation of the entry of foreign firms in domestic markets.
- The liberalisation of trade and investment in services in sectors where regulatory reforms are needed to create a competitive environment.
- The use of investment and trade incentives or disincentives to attract foreign companies or to prevent them from entering the market with potential adverse effects on competition.
- The negotiation and implementation of regional trade agreements in which trade, investment and competition provisions are combined to facilitate trade and economic integration.

21. This study highlights the important synergies between trade, investment and competition policies that can help countries to increase their income through coherent reforms. It aims at building a better understanding among stakeholders in the area of trade, investment and competition.

22. Section 1 describes the gains that can be expected from trade and investment liberalisation in the context of competitive markets and how the synergies between the three policies covered in this report can enhance productivity and growth. Through case studies and results from empirical analysis, the section shows that complementarities between reforms are key to successfully increase income per capita and benefit from a closer integration in the world economy. While Section I focuses on complementarities, Section II explores the substitutability between trade and investment liberalisation and competition enforcement. It has been argued that trade and investment reforms alone can create a competitive environment. The section analyses to what extent this statement is true and help to understand that if there is some overlap between the three policies they are nonetheless all important to achieve economic efficiency.

23. More complex is the case of regulated sectors examined in Section III. While it seems that market imperfections prevent trade and investment liberalisation from fostering competition, the section shows that they can nonetheless contribute to greater competitiveness and efficiency. The need for specific and adequate regulatory measures should however be acknowledged in such sectors. In Section IV, trade and investment policies that favour certain domestic industries or foreign investors are analysed. Trade and investment policy restrictions often redistribute the gains between various sectors and within the society, or alternatively between domestic and foreign companies. As these policies can decrease the competition pressure, Section IV looks at different ways of avoiding welfare-decreasing outcomes.

24. Lastly, Section V deals with regional trade agreements that incorporate investment and competition disciplines. It analyses the rationale for introducing investment and competition provisions in RTAs as well as issues that can arise among trade, investment and competition policymakers when negotiating trade agreements. A final section concludes and discusses policy implications of the synergies described in the report. Annex I also includes the results from a survey conducted with OECD trade, investment and competition policymakers that highlights how they take into account policy complementarities.

THE INTERACTION AMONGST TRADE, INVESTMENT AND COMPETITION POLICIES

I. Enhancing the gains from trade and investment through pro-competitive reforms

25. There are important gains from trade and investment reforms that have been exemplified by the rapid increase in per capita income in many emerging economies that have pursued outward-oriented development strategies aiming at a close integration into the world economy. Studies attempting to elucidate the relationship between trade openness and growth or foreign investment and growth have however encountered difficulties in identifying robust relationships⁵. One reason is that these studies were until recently limited to separate analysis of the link between trade and growth or investment and growth, without taking into account policy complementarities.

26. What is often missing is a comprehensive view of pro-competitive reforms that can account for the synergies between trade, investment and competition policies. In particular, the competitive environment, which is a precondition for trade and investment liberalisation to translate into higher per capita income growth, is often overlooked. This section sheds light on the synergies between trade and investment liberalisation on the one hand, and competition enforcement on the other hand, with examples of successful “policy mix” boosting growth.

a) The synergies between trade, investment and competition reforms that promote growth

27. There are synergies between trade, investment and competition reforms because the combined impact of these policies on economic efficiency and income growth can be higher than the sum of their individual effect. These synergies can also be understood as complementarities, as reforms in one area would not have their positive impact in the absence of concomitant reforms in the two other policy areas. For example, gains from trade liberalisation in terms of lower prices for domestic consumers can be “confiscated” by anticompetitive practices on markets that allow firms to exercise market power. Similarly, opening the market to foreign investors will not benefit consumers if a domestic monopoly is replaced by a foreign monopoly. It is only when domestic markets are competitive and foreign companies have market access that a higher degree of competition can lead to higher productivity and higher income.

28. A first observation is that gains from both trade and investment reforms rely on competitive markets and are reduced when markets are not competitive enough, as a consequence of the market structure or of anti-competitive behaviour.

29. Gains from trade reforms are generally subdivided into two categories: static gains and dynamic gains. Static gains result from the reallocation of resources in sectors where the country has a comparative advantage. Following the opening of trade, countries start to produce new goods or services and to shift resources from import-competing sectors to export sectors. These mechanisms rely on competitive markets. Higher relative prices in sectors where there is a comparative advantage attract companies into these markets. Higher wages and higher returns on capital then explain the movement of the labour force and capital into these sectors. Uncompetitive markets prevent the reallocation of resources towards the

5. See Nordås *et al.*, 2006 for a review of these studies and a discussion of their methodologies and shortcomings.

more efficient sectors and deprive consumers from their most immediate gain in trade reforms, which is a reduction of prices in import-competing sectors.

30. Dynamic gains from trade are also related to competitive markets. To begin with, a source of increased productivity and higher growth is the intensification of competition on product markets. There is first a selection process, where only the most productive firms can stay on the market while the less productive ones are forced to exit. This process leads to an increase in the average productivity of sectors opened to foreign competition. But to remain competitive in the market, individual firms are also encouraged to increase their productivity and diminish their costs, by reducing inefficiencies or improving their technologies. In addition, the pressure of competition prompts firms to source their inputs from more efficient producers and optimise their scale of production. Therefore, all kinds of dynamic gains from trade, whether they are related to technology upgrading, scale economies or competitive incentives are based on price signals that require competitive markets.

31. The same can be said regarding foreign direct investment and its potential positive impact on growth. FDI benefits the host economy when there are interactions between domestic and foreign companies and when there are incentives for technologies and know-how to be shared. The degree of competition on the host market influences the type of FDI that is attracted. High tariffs are likely to attract “tariff-jumping” FDI motivated by a desire to bypass border barriers. Uncompetitive markets encourage market-seeking investment where foreign companies are interested in extracting rents from the domestic market. The combination of border protection and weak competition enforcement is the worst case scenario, especially if there are barriers to entry that enable a foreign company to enjoy a monopoly in the domestic market. It is when trade and investment liberalisation are pursued in competitive markets that resource-seeking and efficiency-seeking investment are the dominant type with potential productivity spillovers for the domestic economy.

32. It is important to specify the type of competition that is considered in the above synergies and in the relationship between trade and investment liberalisation, competition enforcement and growth. Competitive outcomes encompass a broader range of situations than the “perfect competition” described in microeconomic theory. The gains from trade for example apply to trade in varieties and intra-industry trade as well as inter-industry trade, although only the later would be theoretically possible under “perfect competition”. Although it is beyond the scope of this paper to characterise the synergies between trade, investment and competition policies under different market structures, it should be pointed out that a monopolistic or oligopolistic competition would replicate most of the relationships and mechanisms described above, as long as markets remain contestable⁶.

33. Moreover, the competition considered here should be understood in a broader sense than a large number of buyers and sellers and a free-pricing mechanism. Introducing new products in the economy, new varieties of existing products, quality upgrades and new technologies is part of the creation of a competitive environment⁷. In that sense, competitive markets are not only the concern of competition authorities who enforce antitrust laws and control mergers, but also the concern of trade and investment policymakers. Trade and investment liberalisation, together with competition enforcement, can promote the entry of foreign products and companies leading to dynamic productivity gains.

34. For this kind of competition to occur, a specific role is assigned to multinational firms as they organise international trade. When “export-platform” or “efficiency-seeking” FDI can be attracted in a country, MNEs play an important role in developing trade. MNEs import new inputs and expand the

6. Markets are contestable when the entry in the market is free, there is no sunk cost and the best technology /best inputs are available to all companies. See Baumol *et al.* (1982).

7. See Baumol (2002).

network of suppliers in the host economy. They also export inputs or final goods and help the country to get access to new markets. Recent literature has emphasised the importance of fixed costs and barriers to entry to international markets. MNEs can assist recipient countries in overcoming such barriers and high fixed costs. Their presence benefits both the “intensive margin” of trade (an increase in the quantity of imports and exports of existing goods and services) and the “extensive margin” of trade (exports and imports of new goods and services).

35. The production of new goods and services has a direct impact on growth as recent research suggests that there is unconditional convergence at the product level⁸. When a country starts to export a product, it converges to the global productivity frontier for this individual product at a quite rapid rate (5% a year). Diversification and the extensive margin of trade (newly traded goods and services) are therefore key in the catching-up process of emerging economies.

Box 1. Pro-competitive reforms: the case of Chile

In the late 1970s, Chile's economy faced a number of economic reforms aimed at increasing growth and efficiency. Before this period, Chile had pursued a policy of import-substitution aimed at protecting local firms from international competition. Chile provides an interesting example of pro-competitive trade policies, first with the implementation of a uniform tariff in 1977 and then with the network of RTAs negotiated with its main economic partners at the end of the 1990s.

A uniform tariff consists in applying the same MFN rate to all products. It has several advantages. To begin with, it introduces no distortion as no product is favoured over the others. Hence, the allocation of resources between different productions is not biased and an efficient outcome is achievable despite the tariff. Another advantage is that the administration is less prone to lobbying and rent-seeking activities. Of course, domestic companies are still protected by the tariff and there is a welfare loss associated to it, but the welfare loss is minimised. From a trade policy perspective the uniform tariff seems a very good idea. However, from a competition perspective, the uniform tariff has both advantages and disadvantages. A positive aspect is that as previously mentioned a domestic monopoly is less likely to be protected by exceptionally high tariffs. But the uniform tariff still allows companies to extract rents and imports are prevented from fully exercising their disciplining effect on all markets. A non-uniform tariff is more likely to have pro-competitive effects (Moraga-González and Viaene, 2003). For example, if a RTA removes completely the tariff for a few foreign producers, there are companies that can compete on a level playing field with domestic producers and the threat of competition can make the market contestable.

Chile managed to avoid the negative impact of the uniform tariff on competition in domestic markets through two complementary policies. First, a relatively liberal investment regime was introduced and as a consequence Chile was one of the main recipients of FDI in Latin America. A liberal investment regime can create the pro-competitive effect of the non-uniform tariff in the context of a uniform tariff if foreign companies can access the domestic market through FDI. At the end of the 1990s, Chile also started to negotiate RTAs with many partners (including the US, the EU and Korea) in a strategy of “additive regionalism”, thus allowing a significant number of foreign companies to fully compete with domestic producers. In addition, Chile progressively reduced the uniform tariff rate, which is now relatively low (6% since 2003) and amendments introduced to the Chilean competition law in 2000 suggests that competition authorities may become more important players in providing efficiency.

Irrazabal and Opromolla (2006) provide evidence on the impact of trade policy changes in Chile. As emphasised by recent theories on firms' heterogeneity (for example Bernard *et al.*, 2005), productivity increased in the manufacturing sector and the less productive firms had to exit the market. There was a reshuffling of resources from less to more efficient producers. Chilean firms are now able to source intermediate goods from different countries and to sell goods to a different range of markets. With the influx of new plants, the behaviour of incumbents changed (the pro-competitive effect) and productivity increased in both the tradable and non-tradable sectors.

Source: Corbo (1997), Moraga- González and Viaene (2003), OECD (2004), OECD-IADB (2004) and Irrazabal and Opromolla (2006).

8. Hwang, (2006).

b) Country examples and empirical studies on the gains from trade, investment and competition reforms

36. The synergies that were presented in the previous section are not merely conceptual. There are many examples of countries that successfully enhanced growth through trade, investment and competition reforms. It is interesting to take the example of Chile (Box 1) and Ireland (Box 2), as these countries often illustrate a successful “trade strategy” for the former and a successful “FDI strategy” for the latter. In fact, the experience of these two countries is based on consistent policies in the area of trade, investment and competition, exploiting the synergies that were previously described. The uniform tariff of Chile would not have been as efficient in promoting growth without an investment policy that allowed foreign companies to establish and helped to mitigate the adverse effects of the uniform tariff on competition. Similarly, Ireland would not have managed to continuously attract new investors without the trade liberalisation that followed its entry into the European Community and the less distortive investment incentives that were put into place to comply with EC rules on competition.

Box 2. Pro-competitive reforms: the case of Ireland

Ireland has been exceptionally successful in attracting FDI and developing a long-term business relationship with multinational enterprises (MNEs). As a consequence, Ireland has been one of the fastest growing economies in the world over the last decade. The country illustrates the kind of synergies that can be exploited to increase trade and FDI in a competitive environment.

It is in the mid-1950s that the country moved from high rates of tariff protection and prohibition of FDI towards a policy of free trade and direct encouragement by multinational enterprises (Buckley and Ruane, 2006). This move culminated in the process of joining the European Community in 1973. There were several types of incentives for MNEs to locate in Ireland (including financial support and tax holidays). While FDI from other EU countries and in particular Germany was important, Ireland started to attract extra-EU investors, and in particular US investors. The country was attractive for companies seeking to establish production bases within the Common External Tariff area and Ireland became an export platform. Investment was encouraged in high-tech sectors by giving higher rates of financial assistance in these sectors. The approach was project-based to identify enterprises with the highest potential.

In the 1980s, the investment policy evolved in response to MNEs and limitations set by the EU on the use of incentives to attract companies. The original tax holiday and grants were replaced by trade-neutral supports such as a low corporate tax rate (for all companies) and grants only for training and R&D. This new policy was less costly and removed some of the financial distortions previously observed. Economic policies also became more rational and pro-competitive, in particular at the request of MNEs (for example the Irish government obtained in the 1990s a two-year derogation from deregulating the telecoms market, but had to do it earlier under the pressure from the electronics and software sectors). It is in the 1990s’ new investment regime that FDI flows have increased, in a more competitive environment. The EU Single Market and reforms in other EU countries were beneficial for “export platform” FDI as it was now possible for MNEs established in Ireland to serve all the EU market.

Today, MNEs account for almost half of the manufacturing employment. Clusters have been developed in two key high-tech sectors (electronics and chemicals/pharmaceuticals). The approach in the electronics sector was to attract key investments, benefiting from the pro-MNE reputation of the country and its network of relationships with MNEs. The strategy was to build the electronics sector both vertically and horizontally to generate agglomeration economies through shared input markets (in particular highly skilled labour) and product linkages. Ireland succeeded in attracting the two key global enterprises in microprocessors and software, Intel and Microsoft. In the computer products segment, Ireland attracted Dell, Compaq, Gateway and Hewlett-Packard. Once these key industrial leaders were established, dozens of smaller enterprises came into the market, a textbook case of “clustering”.

Source : Barry (2004), Buckley and Ruane (2006), Rae *et al.* (2006).

37. The European Union itself is an interesting example of regional economic integration based on synergies between trade, investment and competition reforms to create a “common market”. Box 3 explains how competition policy in the EU interacted with trade and investment. Competition policy was

first designed to contribute to the establishment of a customs union and then evolved concomitantly with the deepening of trade and investment reforms. The aim of the Treaty of Rome and its subsequent amendments is precisely to enhance growth in the EU area through the synergies between trade, investment and competition reforms and as such the EU experience provides interesting insights into these synergies.

Box 3. Competition policy in the EU: interaction with trade and investment

The basic principles of the competition policy of the European Communities were laid down first in the Treaty of Rome. Agreements distorting competition, abuse of dominant position, rules on public undertakings and exclusive rights of states as well as state aid rules were the basic targets of competition policy to ensure fair competition among companies and to avoid distortion on the common market. Soon, after the signature of the treaty, Council Regulation No. 17 guided the enforcement and the implementation of antitrust rules. Competition rules were first designed to contribute to the achievement of the main objective of the treaty: the creation of a customs union. The free movement of capital was also foreseen in the treaty based on the progressive abolishment of restrictions on the movement of capital and discrimination based on nationality.

The Treaty of Rome has been amended on several occasions. The basic objectives and principles on competition law have not changed over time, and the application of competition rules have been extended to some economic sectors not covered before. The Single European Act gave competition policy a broader scope through the regulatory reforms in the services sector. After the customs union had been achieved; the free movement of goods and services also evolved, being supported by rulings of the Court of Justice. The Court clearly defended the common market as a legal concept against preferential national treatment.

The regulatory reform initiated by the Single Market programme opened up public tenders for services, like telecoms, energy and transport, previously inaccessible to players from other Member States. As part of the reforms, a greater emphasis was put on capital liberalisation. While it was acknowledged that capital was moving more freely among Member States than in the 1970s, regulations and directives contributed to further dismantling of the remaining barriers on capital. The free movement of capital was accompanied by new EC competition policy rules, including on the assessment of mergers of European dimension.

Over the past two decades competition policy has unquestionably been consolidated through the increasing number of cases and court judgements, and with the increased number of sectors exposed to competition policy. The increased capital movements and the ongoing regulatory reforms bringing national markets together have led to an increasing number of mergers notified to the Commission from 1994 onwards.

Source: Jones & Sufrin (2004), Ehlermann (1992), EC Treaties, Dausen (1985)

38. The gains from trade, investment and competition reforms can actually be empirically measured in cross-country studies. While studies in the past have focused on the link between trade and growth, FDI and growth or competition and growth⁹, a new research trend seeks to explain the combined impact of reforms in the area of trade, investment and competition. Such analysis has been recently conducted at the OECD (see Box 4).

9. Regarding the relationship between competition and higher growth, the literature is less extensive, but there are also several studies investigating the productivity gains induced by competition. As it is the case with trade or investment, it is important to make a distinction between the economic outcome and the policies that may determine it, in this case between competition and competition policy. Studies generally find a positive impact of more competitive markets on growth. However, it is more difficult to link competition policy enforcement to growth (see for example Dutz and Hayri, 2000). A recent note by the Secretariat submitted to the Competition Committee provides a review of the literature on the relationship between competition policy and economic performance (see DAF/COMP(2007)2).

39. There are several interesting findings in the analysis summarised in Box 4. First, it is very relevant to look at the joint impact of trade, investment and competition reforms. An index of pro-competitive reforms explains more significantly cross-country differences in trade flows (once distance, GDP and a number of countries' characteristics have been accounted for) than a variable that would catch only trade reforms (Miroudot *et al.*, 2007). It confirms the existence of synergies between trade, investment and competition reforms.

Box 4. Quantitative studies on the gains from pro-competitive reforms

In a series of papers, the Economics Department of the OECD has analysed the benefits of liberalising product markets and reducing barriers to international trade and investment in OECD countries. An overview of this work can be found in OECD (2005). The Product Market Regulation (PMR) indicators used in these studies are based on a broad survey of economy-wide and industry-specific structural policy settings, covering a comprehensive range of regulatory barriers to competition (see Nicoletti *et al.*, 1999 and Conway *et al.*, 2005 for a description of the PMR indicators). Barriers to foreign trade (tariffs and non-tariff measures) and to FDI (indicators on FDI restrictions from Golub, 2003¹) are also used to assess the impact of reforms.

The gains from reducing competition-restraining regulations, cutting tariff barriers and easing restrictions on FDI to "best practice" levels in the OECD area are quite substantial. The study indicates that such reforms would lead to gains in GDP per capita up to 4 to 5 per cent. Product market regulation in the non-manufacturing sectors has also been investigated in Conway and Nicoletti (2006), covering business services and the energy sector, but no assessment of potential gains from services reforms has yet been provided. Another report (Conway *et al.*, 2006) also looks at how productivity convergence is affected by anti-competitive product market regulations. Cross-country differences in product market regulation can partially explain the observed divergence of productivity in OECD countries.

Miroudot *et al.* (2007) extend the analysis on the impact of pro-competitive reforms to developing countries. An index of pro-competitive reforms is created for 82 countries over the period 2001-2005. This index is then used in a variation of the gravity model to test the relationship between pro-competitive policies and the volume of trade. A robust result is that countries with less competitive markets trade less than their counterparts. The model points out that if the average index in developing countries was at the same level than in high-income OECD countries, exports from developing countries would be on average 30 per cent higher and imports 36 per cent higher. Moreover, this increased trade would have a positive impact on growth, raising income per capita by up to 10 per cent for countries that are far from best practice levels in terms of trade, investment and competition reforms.

1. The OECD's FDI regulatory restrictiveness index has been recently updated and extended, see Koyama and Golub (2006).

40. Not only do these studies point out complementarities between trade, investment and competition policies, but they also explain cross-country differences in productivity and income on the basis of how such complementarities are exploited¹⁰. While all differences in productivity cannot be explained by the lack of competition or proper regulation, "a chain is only as strong as its weakest link". It may be the case that, because of complementarities and linkages, a weak policy in one of the three areas will have a detrimental effect on growth. The synergies between trade, investment and competition reforms should thus not only be seen as potentially mutually reinforcing effects.

10. Conway *et al.* (2006) point out that cross-differences in product market regulation explain part of the differences in income in the OECD area. Complementarities between trade, investment and competition policies are also acknowledged in the literature on trade and growth through the inclusion of interaction variables that are necessary to find a positive and economically significant impact of openness on income per capita. Chang *et al.* (2005) study the role of policy complementarities and how they affect the trade openness and growth relationship.

II. The role of trade and investment reforms in enforcing competition

41. Section I has emphasised the complementarities between trade, investment and competition reforms. There are complementarities because reforms in one of the three policy areas can reinforce the impact of reforms in the two others. One can however wonder if the three policies can also act as substitutes. As there is an overlap between the objectives of trade, investment and competition reforms, the three policies can appear to be to a certain extent “redundant”. This section explores the possible substitution of trade and investment liberalisation for competition policy.

42. As previously indicated, trade and investment liberalisation can tighten competition in domestic markets. Foreign products and foreign investors compete with domestic products and companies and as they are new entrants on the market they are likely to put pressure on prices to gain market shares. Taking into account the fixed cost of penetrating new markets and the variable trade costs, these foreign companies are also likely to be more efficient than domestic producers. Otherwise, they would not enter the market. Hence the tighter competition provided by foreign companies, as compared to domestic firms (for which the entry and exit is less costly). Even if domestic producers are more efficient (in sectors where the country has a comparative advantage), imports and FDI can have a disciplining effect, as a threat if domestic firms are tempted to exercise their market power.

a) The disciplining effect of trade on competition

43. The role of foreign producers in strengthening competition in domestic markets has been studied mostly in the case of increased imports following trade liberalisation and is known as the “imports as competitive discipline” hypothesis (Box 5). Imports create a harsher competition and encourage rivalry among foreign and domestic firms. The impact is not limited to lower prices, quality upgrading is also expected as well as the production of more varieties as firms specialise in different market segments to mitigate the increased competition.

Box 5. Empirical studies on the relationship between import penetration and competition

The “imports as competitive discipline” hypothesis has been empirically tested in several studies that confirm the positive impact of trade liberalisation on competition enforcement. These studies generally test the relationship between import penetration and some measure of the degree of competition in the domestic market, such as the market concentration or price-cost mark-ups (i.e., the difference between the price of a good and its cost).

Studies looking at the changes in mark-ups when countries liberalise trade find a negative relationship between trade openness and mark-ups, implying that when the pressure from competing imports increases, firms are less likely to price above the marginal cost and have to renounce to rents associated to their market power. Levinsohn (1993) studies the impact of the removal of import protection in the Turkish manufacturing sector in 1984 using firm-level data for the period 1983-1986. He shows that in sectors where protection has been reduced, mark-ups have decreased. In a control group of sectors not liberalised, mark-ups are on the contrary increasing. Roberts and Tybout (1996) have similar results for different time periods and different sectors in a series of empirical studies covering Chile, Colombia, Mexico and Morocco.

While it is a robust finding that mark-ups fall with import competition, some issues are left unresolved (Erdem and Tybout, 2003). The recent literature on firms’ heterogeneity has explored in more details the complex relationship between industry structure, sunk costs, entry and exit of firms. It is still difficult to empirically identify the mechanisms that link import competition to efficiency.

44. Exports can also have positive effects on competition but the mechanism involved is different. Trade liberalisation can increase opportunities on export markets and more firms can reach the efficient scale of production. The number of firms in export markets can increase with a positive impact on

competition, including in the domestic economy where more products (or varieties of products) are available.

45. The substantial impact of trade on competition can lead small open economies to regard competition policy as partly superfluous. Hong Kong and Singapore have strongly debated the usefulness of a general cross-sector competition law (beyond specifically regulated sectors). These two economies have the most open trade and investment policies. However, Singapore has introduced a competition law in 2004 following the negotiation of RTAs (with partner countries requiring such a law) while Hong Kong has announced in March 2007 that it would begin work on the drafting of a cross-sector competition law (Cheng, 2007).

46. While imports can have a disciplining effect on domestic companies, it should be stressed that the competitive pressure is not as important as when it comes from other domestic firms. Foreign goods or services are generally imperfect substitutes to local products and thus domestic companies enjoy advantages. Empirical studies find that measures promoting rivalry among domestic firms have a more consistent impact on firm restructuring than trade liberalisation (see Brooks and Evenett, 2004). The role of importers should also be analysed when considering the extra competition resulting from imports.

b) The impact of FDI on competition

47. Although it gets less attention, foreign direct investment has also a market disciplining effect. As noted above, the effect can even be regarded as stronger than in the case of imports, as foreign companies established in the domestic market can have access to local inputs and tailor their production to meet local needs and tastes. Their products and services can be better substitutes to domestic production than imports.

48. For a long time, foreign investment was regarded as being rather detrimental to competition with foreign firms trying to gain market power in the host economy¹¹. The impact of FDI on competition depends on the motivation underpinning foreign investment and on the characteristics of the host economy.

49. When FDI is motivated by high barriers to trade and when competition enforcement in the host economy is weak, multinationals can invest to establish a dominant position in the host market and to enjoy rents. In empirical studies focusing on developing countries, there is sometimes a correlation between FDI and market concentration or FDI and higher profitability¹². This result is not apparent in studies on developed countries and in the more recent studies. The reason is that FDI is now mainly motivated by access to new markets in a competitive environment and by the fragmentation of production to achieve higher efficiency.

50. Market-seeking FDI has the higher positive impact on competition as foreign firms directly compete with local companies on the domestic market. “Export platform” FDI or “efficiency-seeking FDI” also exerts a disciplining effect to the extent that competition exists with domestic producers and that part of the production is sold in the host economy.

51. While both greenfield FDI and mergers and acquisitions can play an important role in boosting competition, there is a difference in the sense that greenfield investment adds new productive capacities while M&As can reduce the number of firms in the market. One possible outcome of increased

11. Since the seminal work of Kindleberger in 1969 presenting FDI as the result of oligopolistic competition, FDI has been associated with imperfect competition. It is no longer true with recent theories of multinational firms and foreign investment where investment is more of the “efficiency-seeking” type and results from organisational choices to produce internationally.

12. For example in Lall (1989). See Yun and Lee (2001) for a review

concentration is a higher profitability for incumbent firms and some studies have found a difference in the impact of greenfield and M&A FDI on price mark-ups.¹³

52. An illustration of how mergers and acquisitions can lead to less competition is provided in Box 6. It highlights the need for both trade and investment liberalisation, since higher concentration through M&As is less likely to lead to uncompetitive outcomes when the market is open to trade. Moreover, the example of the Korean vegetable seed industry emphasises that the level of competition that exists in the market before the FDI, as well as the enforcement of competition policy, also matter. It highlights that investment liberalisation alone cannot create competition.

Box 6. Investment liberalisation alone does not lead to higher competition: the Korean vegetable seed industry

At the end of the 1990s, there were about 50 seed-producing companies in Korea. After the financial crisis in Asia, three of the main Korean companies (Hungnong, Choon Ang and Seoul Seed Co.) were acquired by foreign multinationals; two of them by the Californian firm Seminis Vegetable Seeds Inc. At this time, the seed industry was exempt from the application of the *Monopoly Regulation and Fair Trade Act* and the different mergers that took place were not screened by the Korean Fair Trade Commission (KFTC). With its two subsidiaries, Seminis reached a market share of 45%. As Seminis was also the main importer of seeds in Korea, imports had no pro-competitive effects.

An analysis of the vegetable seeds market reveals that for several vegetables prices were declining until 1999 and increased substantially in 1999 or 2000 (after the mergers took place). In 1999, the KFTC investigated a resale price maintenance incident involving Hungnong (one of the two companies controlled by Seminis). The case established an effective dominance in the vegetable seed market for the company with the possibility of fixing prices in certain segments.

The case illustrates that mergers and acquisitions can lead to concentration that does not increase economic efficiency or benefit consumers with lower prices and thus reduce the degree of competition in the host economy. This is not automatically the outcome of M&As. First, there was already a trend towards consolidation in the Korean vegetable seed market, where 5 top companies had already an important market share before the mergers. Then, the mergers that resulted in higher concentration were not submitted to merger control and the combined effect of efficiency gains and losses were not assessed. Lastly, imports were also prevented from playing their positive role on competition enforcement.

Source : Yun and Lee (2001), Chang and Jung (2005).

c) To what extent can trade and investment liberalisation enforce competition?

53. The question has been asked whether trade and investment liberalisation alone can substitute for competition policy. When in 1982, Baumol, Panzar and Willig emphasised the concept of “contestable markets”¹⁴, the point was made that the concentration of a market or the absence of competitors was not enough to characterise this market as non-competitive and to prompt some action from competition authorities. As long as the market is “contestable”, that is if there are no barriers to entry or exit, incumbent firms are forced to price at the competitive level. If these firms price above average cost (and thus earn an abnormal profit), new firms can enter the market to take their share of this extra profit (through a “hit and run” strategy).

13. Using plant-level data for manufacturing industries in the UK, Maioli et al. (2006) find that greenfield FDI reduces price-cost margins, whereas acquisition-FDI is found to have a positive impact on margins. This suggests that there is indeed more concentration in markets where FDI has mainly taken the form of mergers and acquisitions.

14. The concept of contestability can be traced back to the work of John Bates Clark in 1887 introducing the idea of “potential competition”

54. To a certain extent, it is true that “perfectly contestable” markets have no need of competition law enforcement when all barriers to entry and to exit have been removed. However, barriers to entry and exit are not limited to barriers to trade and FDI that could be addressed through trade and investment liberalisation. Trade and investment policies cannot completely replace competition policy. Even when entry is “free” on a market, in the sense that no regulation creates any kind of barriers, market power and dominant positions are still possible. Several cases have been identified:

- The structure of the market can prevent foreign firms from entering the market. The extreme case is the natural monopoly where only one firm can efficiently produce. Domestic or foreign competition is of little avail in curbing the market power of the incumbent company. Such a market needs to be regulated for prices to be brought back to their competitive level.
- Important sunk costs can discourage entry on a market. Sunk costs are costs that cannot be recovered once they are incurred, no matter what happens after. For example, when entering a market, sunk costs include initial investments in equipment that cannot be resold or in research and development that cannot be used for another product or market. Sunk costs discourage entry by making the exit from the market very expensive, as irreversible investments are lost. Lock-in effects and switching costs have a similar impact on entry as sunk costs and are other forms of barriers to exit.
- Last but not least, international (as well as domestic) cartels can operate and prevent competition even when trade and investment have been liberalised. Several OECD studies have highlighted how hard core cartels injure consumers by raising prices and restricting supply (OECD, 2003). These cartels have an important trade-distorting effect. While hard core cartels regroup private producers fixing prices and allocating world market shares, there are also more ad-hoc export cartels fixing prices on specific export markets and not in their domestic market¹⁵.

55. To put it in a nutshell, sunk costs, lock-in effects or switching costs diminish the contestability of markets because they create barriers to entry. And these barriers are not among the ones that are removed through trade and investment reforms. They are related to the structure of markets and firms’ strategic behaviours. Hence the need for competition policy and market regulation. In practice, there are few markets that are completely free from sunk costs or barriers to entry and to exit, but the degree of intervention depends whether the competition rules are violated.

56. While trade and investment reforms can help to enforce competition, the competition authorities that we have questioned also indicate that public policy objectives relating to trade and investment can sometimes ignore or minimise competition concerns (see Annex I). It is acknowledged that measures taken by trade and investment policymakers can have in some cases detrimental effects on competition, for example when erecting barriers to entry of foreign products and foreign investors.

III. Liberalisation of trade and investment in regulated sectors

57. Most regulated sectors are not open or only partially open to competition and are less contestable than other sectors of the economy. On contestable markets, the interaction of the three policies – trade, investment and competition policy– allows, to a certain extent, for smooth substitution amongst the policies. In this section, the aim is to identify how such interaction can work on regulated markets and how the presence of the various policies may lead gradually to the reduction of distortions in regulated sectors.

15 . See Evenett et al. (2006) for a recent assessment.

58. Market imperfections, like low levels of contestability or barriers to entry and exit, can require a different policy design in regulated sectors. In such sectors, competition policy is applied under certain constraints and additional policy measures are introduced to allow for better entry conditions. Usually, markets deemed competitive are separated from incumbent activities (unbundling) and access to networks owned by the incumbent firm is facilitated. The relationship between competitive and regulated markets is defined in regulations. In industries with significant economies of scale, new entrants may find it particularly difficult to break even and reach the optimal operation size, like in telecoms or the computer industry showing high “installed base effects”.

59. While certain market imperfections are supervised by regulatory rules, an open trade or investment environment could complement such rules. For example, trade and investment policies may help to identify the sectors that could be potentially opened to competition or where regulation could be decreased.

a) The benefits of market opening in a regulated environment

60. Certain network industries, like telecommunications (Box 7) provide an excellent example of how market opening through foreign investment contributed not only to more players, but to the introduction of new products, applications and technologies. The creation of competing networks also provided consumers with a greater variety of services and market access.

Box 7. Telecommunication industry: open trade and investment policies

The telecommunications sector has gone through a spectacular de-regulation process: greater liberalisation and increased competition led to full or partial competition in basic services in more than 40 countries of the world. Starting from a monopoly structure even in developed countries, the industry has been able to embrace new entrants as well as new services in the past three decades.

The opening up of markets worldwide has also spurred an increase of mergers and acquisitions. Investments and in particular FDI played a significant role in this sector in 2006 according to the World Investment Report. The report established that South, East and South-East Asia as well as some of the West Asian countries and Latin America profited the most from these capital movements. The report underlines that the liberalisation measures undertaken in the target countries provided a pull to attract new investors. These liberalisation efforts contributed to the growing trend of the industry's consolidation.

When thinking of the economics of the industry, a distinction has to be made between the public network and its operation, the apparatus linked to the network and the services provided over the network. While modern technology increased the capacity of the networks and introduced a set of new equipments, it allowed for a greater variety in its services. Another outcome of the technology change was that the overall output of industry increased and, with the appearance of new services, new providers also appeared and fiercely competed either along more markets or occupying only a few niches. Certain areas remained more closed to competition however. The traditional wire-based local services tended to be managed by a single nation-wide or regional monopolist, usually constrained by regulations to ensure access rights for those without network capacities. New networks based on alternative technologies were also built up with the involvement of both competitors and the incumbent company.

While the International Telecommunication Union (ITU) stated in its World Telecommunication Development Report of 2002 that “*virtually every country has succeeded in improving its telecommunication sector*”, the UNCTAD's ICT development indices show that with stability and consistency the technology leader countries kept their relative position to each other in the country ranking established. Meanwhile some spectacular results could still be mentioned: Nigeria has gone from no digital mobile users in 2000 to over five million in July 2004.

In the light of these changes, on the regulatory side, it has become increasingly important for countries to ensure that they possess the necessary facilities and know-how to efficiently and effectively manage telecommunication competition issues. While in the developed countries antitrust cases and constant regulatory improvement and oversight contributes to service improvements, in many developing countries relatively high service prices might indicate that bottlenecks in the system should be progressively taken care of. A variety of cases show that an open investment environment may allow for new services and providers and that the regulatory oversight in services where bottlenecks and access issues may arise has to be still followed up with great attention.

Source : Armstrong, Cowan and Vickers (1994), Sciadas (2004), UNCTAD- WIR (2006), www.itu.int

61. In certain countries further regulatory features were implemented to reduce the market power of the incumbent player in the telecommunication sector. Asymmetric regulations favouring new market players can push for further restructuring and decrease in market power of the incumbent. Some of these regulations were efficient, others were less so depending on how the trade and investment incentives of the new competitors were structured (Stoyanova, 2007).

62. Some regulatory designs limit the effectiveness of competition policy. To stimulate competition and eliminate unnecessary regulatory burdens, trade and investment policies could be used as supplementary tools. Direct participation of foreign companies, able to become part of the same domestic regulatory framework, can be a very powerful tool for competition and an important element of trade policy as well (Guasch and Rajapatirana, 1994). Especially it should be considered as a strong competition tool, when previous monopoly industries are forced to accommodate new entries (for example in telecommunications, electricity and gas sectors).

63. The role played by an open investment policy was also spectacular in some economies that had placed strict limits on the penetration of foreign capital, like countries in Central and Eastern Europe, East-Asia and Latin America. In these countries liberal investment and trade policies are likely to play a more important role than would traditional competition policies (Campbell et al., 1995). This is all the more so at the early stage of the transition, when the countries lack an established competition culture and the other two policies can take the lead in the economic restructuring.

64. In practice, an open investment regime contributes to the creation of a new ownership structure, where the new entrants/owners together with the incumbent company “redefine” the industry. The role of FDI in the domestic market is however not limited to restructured ownership, it is also a tool for more direct competition with domestic companies. Therefore, it should not be hindered by domestic measures.

65. Trade liberalisation of goods and the increasing amount of cross-border investment requires a greater openness in the financial sector too. Financial systems have direct impact on investment policies and therefore the objectives and the design of regulatory standards can influence significantly the success of cross-sectoral and cross-border transactions.

b) More limited interactions in the presence of strong market imperfections or regulatory measures

66. The aim of competition policy in regulated sectors should be to incorporate under its regime as many areas as possible including those that may have received special legal protection before. This principle is independent of the institutional solution retained. The *OECD Guiding Principles for Regulatory Quality and Performance* in the domain of competition underline that regulatory restriction on competition should be limited and proportionate to the public interest. Periodical review of such regulated sectors may also ensure that costs do not outweigh the benefits of the regulation and that alternative arrangements with less effect on competition may be found.

67. Experiences from the European manufacturing sector in a sample of over 100 sectors (at the three-digit level) confirmed that external imports and imports within the European customs union had a disciplinary effect on price-cost margins, when extra-EC imports played a major role (Jacquemin and Sapir, 1990). Box 8 gives an example from the energy sector, where due to infrastructure bottlenecks trade policy can play a limited role and other policies like investment and in particular competition policy could take the lead if policy design appropriately allows it.

Box 8. Low-import penetration industries and domestic competition

The electricity industry is an example, where cross border trade does not reach more than 10% of exports for some European countries. Thus, companies can engage in competition mostly through foreign direct investment and ensure their direct presence on the target market via their own assets. The utility sector requires large investments; which often allows incumbent companies to keep their hands on the local market. If access to transport and distribution facilities or access to consumer base is not adequate new investors have to face additional risks. Fierce competition in the sector therefore has not been observed in most of Europe with the exception of a few countries and market segments. Low interconnection levels or congested capacities may further restrain trade and increase the size and scale of problems related to potential investments.

A recent case for unsuccessful foreign penetration is the transaction proposed by the German E.ON on the Spanish ENDESA, which ended with a counter bid from Acciona and ENEL in April 2007, a joint offer from Spanish and Italian investors who became the new owners of ENDESA. In commercial terms, the Iberian market is an “energy island”, barely connected to the rest of Europe. Cross-border electricity exports are limited and the interconnection point congested. Direct investments remained moderate. The major principles set out in the European energy directives were supplemented by national provisions to decrease the market power of the incumbent companies. For example, dominant players like ENDESA were forbidden to import electricity through the existing interconnection point.
Error! Reference source not found.

Considering the specificities of the Spanish market, the strategy chosen by E.ON was to make considerable capital investments. Although there were no constraints on foreign investors to enter the market, under a Royal Decree-Law 4/2006 of 27 July 2006 a number of conditions were imposed on the E.ON/ENDESA operation, including the divestiture of important assets. This decree was adopted without the prior approval of the European Commission who cleared merger in April 2006. These domestic measures were strongly criticised by the European Commission and appealed at the European Court of Justice. Under the regulatory uncertainty and determined to put its hand on energy assets, Acciona bought 20% percent of the shares of ENDESA and teamed up with another player, ENEL buying 24.9% of the shares overbidding E.ON’s final offer of February 2007. The peace deal of the three companies in the end allowed E.ON to benefit from the divested assets imposed in the remedy conditions of the Spanish decree.

Source : Case COMP M.4110 E.ON/ENDESA (www.europa.eu); www.europa.eu/rapid/pressreleases (IP/07/427 and IP/06/1649)

68. Sometimes not infrastructure, but regulatory bottlenecks lock out the interaction between the three policies. Once such regulatory measures are removed, the interaction of trade, investment and competition policies are allowed to play their complementary roles. While examples show that trade and investment policies can benefit competition in regulated services, inefficient regulatory outcomes may occur due to both market imperfections and regulatory failures. Market imperfections due to natural (physical and technical) barriers may impose additional burdens on trade and investment. Others, like the weak enforcement of existing competition rules or special regulations may limit market or import penetration. In an ideal case, successful deregulation will reduce the risks of restrictive regulations on trade and investment, and the interaction of the three policies can play a meaningful role to achieve the desired policy aims.

69. Thus, not only innovative regulations can serve to reach a more competitive environment, but also open trade policies or new investments in highly concentrated sectors or regulated industries can bring new product varieties, improve infrastructure, increase productivity through new technologies, know-how and management techniques. Therefore an optimal strategy for governments is to adopt measures that promote competition between local and foreign firms while keeping an eye on the regulatory problems related to non-contestable sectors.

IV. Trade and investment incentives or disincentives with adverse effects on competition

70. This section focuses on cases where trade and investment policies harm competition on local markets or reduce the effectiveness of competition enforcement, allowing firms - whether of foreign or

domestic origin - to seek protection or other special measures. The protection sought may have various impacts such as lower import pressure or decreased penetration of foreign investment. In some cases, protective measures may apply in all three policy areas; in this section however the focus will be on major investment and/or trade policy restrictions.

71. Previously it has been argued that trade and investment policies have similar theoretical points of departure as competition policy, although the immediate goals of the policies may differ. Trade and investment policies seem to achieve their goal when opening previously protected markets or when trade and investment flows increase. Market access issues are in the forefront of these policies. Competition policy may focus on economic efficiencies related to industrial sectors or market power issues. These differences may be complementary and strengthen each other, but also detrimental when they serve specific industry interests.

72. Certain trade policies, like tariffs, behind the border measures, contingent protection measures, or the protection of infant industries through various investment policy measures may be the price to pay for the maintenance of an open trading system offering safety valves in order to support trade liberalisation. The application of these policies if not used appropriately may however lead to controversial outcomes. Some other measures may have a neutral impact on antitrust policies. The Multi-Fibre Agreement served to maintain employment in the Western countries and resorted to a trade policy restrictions, although not reducing the degree of competition in the antitrust sense (Waverman, 1998).

73. The various combinations established between trade openness/restrictiveness and the presence/lack of competition policies in an analysis on trade, investment and competition policies in Latin America bring the following lessons. When broadly used with credible enforcement, competition policies can deter anticompetitive practices of foreign and domestic firms and can effectively substitute for various trade instruments that aim to re-establish fair competition. Such policies can be implemented along with the phasing out of restrictive trade policies and restrictions on foreign investment and ownership (Guasch and Rajapatirana, 1994).

a) Protective trade policies

74. Tariff policies are trade policy measures that can have an impact on domestic competition. High import tariffs applied in defence of new investments can distort competition on the home market. Tariffs can also be used to protect domestic industry (import-substitution industries) or recently established foreign companies. While many share the view that foreign companies look for better conditions, including also concessions for protection, customs privileges and less severe regulatory terms¹⁶, governments are not supposed to offer guaranteed markets for foreign investors. Reducing high import tariffs for those industries where concentration is substantial¹⁷ makes more economic sense. The automobile industry in Central and Eastern Europe offers an example, where the right balance between protection and competition was slowly reached (Box 9).

16 . Flassig (1993) and Fornalczyk (1993).

17 . Hoekman and Mavroidis (1994).

Box 9. Automobile industry in CEEC: large investments and reduced import competition

In the 1990s, the new political prospects as well as their low cost wage structure made the CEEC an attractive target for foreign direct investment. Aiming to introduce higher bargaining pressure on their traditional/ home suppliers, multinational companies found it sensible to penetrate the CEEC markets located not far away from their home industry base. Already at the beginning of 1990s the tariffs applied on Central and Eastern European imports were lower than those on Asian imports and from 1997 duty-free imports originating from EU accession members were also allowed if accompanied by an EU-certificate.

Based on previous co-operation with the CEEC and how they used to organise their sourcing and supply chains with third countries (loose or closed networks) as well as whether they had close or loose ties with their own government, international production groups decided on the strategy to follow in the region. The frontrunner firms were Volkswagen, Fiat GM and Renault; then companies like Ford and PSA, followed by peripheral producers such as Daewoo and Suzuki. Frontrunners were the most interested firms to source from the CEEC and peripheral producers those who focused more on meeting the local content requirements for the EU, while gaining access to these markets.

Governments in most of these countries did not have enough bargaining power, since some of the to be established facilities could have been located elsewhere. First tier production countries (e.g. Czech Republic or Poland) however were exception to this rule. While some of their policies to reduce investors' request deemed successful (e.g. Polish government was able to maintain a balanced position among the car producer companies who settled down in Poland), the governments agreed to restrictive trade policies. The high tariffs on personal car imports kept these markets relatively isolated in terms of imports during the 1990s.

As a consequence, the competition exposure of producing firms in the region was reduced as they were able to avoid fierce competition from import cars. Although the Polish Antimonopoly Office opposed the high import tariffs in the automobile industry in 1991, Poland only progressively lifted import tariffs compared to the other countries in the region, while reaching 0% in 2002, the year in which the accession negotiations were closed. Similarly, the Czech antitrust office opposed the Czech government's proposal of a 19% import tariff on cars (15% for vehicles of EU origin). The high tariff measures got introduced nonetheless and the scepticism of the competition authority had only some "lowering" effects of a few percent. Later on, with the closing of the accession negotiations to the EU most of the remaining protective rules were abolished through joining of the customs union.

Source : van Tudler, Rob and Ruigrok (1998), Hoekman and Mavroidis (1994)

75. A very specific area, where trade and competition policies would promote different policy outcomes is trade remedy measures, such as antidumping. If used excessively or for anticompetitive activities, antidumping can diminish import competition. In such cases, competition authorities have found that the domestic industry where the remedy applies functions less efficiently and in extreme scenarios engages in collusive actions. However, economic research has not fully clarified the real conflict between antidumping and competition policy¹⁸.

76. Some of the research work underlines that antidumping may lead to market coordination and cartels, while others support that outcomes can be multiple. It is claimed that the legal costs of domestic plaintiffs against foreign defenders are in favour of the domestic companies. Few argue that companies using trade remedy measures are much less inclined to enter in illicit actions. Therefore emphasis has been placed on to investigating the industry actions in cases of withdrawn antidumping petitions. Some evidence was found that companies reached cooperative profits afterwards or colluded¹⁹. In countries with strengthened cartel investigations, withdrawn antidumping petitions are also found to lead to pro-competitive outcomes with lower prices and larger imported quantities.

18. de Araujo (2001)

19. Prusa (1992), Zanardi (2000), Taylor (2001), using US data for 1980-85 and 1980-92 or 1990-97 respectively

77. A report commissioned for the Swedish National Board of Trade in 2005 underlined that in terms of antidumping applications there was a shift from developed to developing countries. While in 1990 developing countries introduced less than 20% of the antidumping petitions, today they are responsible for more than 60%. The same applied for measures in force that rose from 4% to more than 50% for the developing countries. The analysis showed that antidumping could become a full barrier to entry if applied by firms with a position close to monopoly. In particular, it was found for India and South Africa that firms that enjoyed a monopoly-like situation in their home markets prior to liberalisation applied for antidumping remedies post-liberalisation. In India for example antidumping petitions were often made by a single domestic producer with a market share above 90%. Older and more recent cases bring examples when trade policy through antidumping measures has changed the competition pressure in some industries (Box 10).

Box 10. Trade remedy measures: various impact on competition

While it is a legitimate trade instrument governed by WTO rules, antidumping measures can in some cases lead to obvious illicit competition practices that are examined under the provisions of the national competition law. This is the case of ferrosilicon cartel in the United States in 1996, where producers fixed price while benefiting from remedies imposed on imports from Brazil, China, Kazakhstan, Russia, Ukraine and Venezuela. A similar investigation on the abuse of dominant position of soda ash producers in the EC showed that antidumping duties could serve as instrument to anti-competitive conduct.

Yet another case has a stronger commercial twist: the sugar dispute between Mexico and the United States. In January 1998, Mexico's antidumping authority determined that imports of high fructose corn syrup (HFCS), a sweetener used in soft drinks imported from the United States was being dumped in the Mexican market threatening the Mexican sugar industry. A countervailing duty on 250,000 tons of HFCS was immediately imposed by the Mexican authorities. The WTO Antidumping Agreement allows dumping duties to be imposed only if injury (or a threat of injury) on the domestic industry is established. Since in two attempts Mexico could not prove that HFCS imports were likely to increase substantially and would have a serious impact on the Mexican sugar industry; the WTO panel sided with the U.S (NAFTA also ruled against the measure). As antidumping duties could not be used, a tariff quota of 148,000 tons on HFCS together with a 20% tax on soft drinks not sweetened with sugar was introduced in 2002.

In the above cases, the domestic consumer or industries seeking cheaper export sources lost out in terms of efficiencies and competitiveness. Antidumping or other similar trade remedy measures may at times reduce competition pressure in certain sectors of the economy.

Source: Bourgeois (1992), de Araujo (2001); <http://www.ustr.gov/>, www.fas.usda.gov/htp/sugar/

b) Protective investment policies

78. Another frequent issue in regulatory practice is the discrimination between public and private stakeholders. Such measures can be taken under the name of trade, investment, or sector-specific policies. As the deregulation process in the service industries proceeds, the role of previous public (or private) monopolies decreases; and as the ownership structure of the industry diversifies, the sector tends to seek less protection from the entry of foreign and domestic private investors.

79. More recent research suggests that public enterprises having closer ties to the government may have stronger incentives than private firms to engage in anti-competitive behaviour or request the imposition of protective/anti-competitive regulations²⁰ in some or even all three policy fields. Such companies also have a better understanding of how the administration works and so their "interventions" are usually more successful than those of others. These government "interventions" have contributed either

20. Sappington, D.E. and J.G. Sidak (2003a and 2003b).

to the slow opening up of certain services sectors, like the electricity and gas sector in Europe or to the maintenance of large-scale public ownership, like in Russia or China, where the public sector swamps private investors and strongly influences economic outcomes.

80. Such cases where the domestic company is close to a monopoly are part of the regulatory background. This can be accompanied by extremely restrictive investment regimes and/ or high barriers to trade hindering the entry of foreign products. These policy inducements add up to strengthen the market power of the domestic firm. The one-player markets are usually adopted for so-called “strategic” sectors. In such cases the domestic regulation has certainly different goals than competition and broader economic policy is less focused on the efficient allocation of resources, but more centred on the protection of strategic assets in domestic hands or social and employment goals.

Box 11. Disincentives on trade and investment: severe market distortion

The case of the Russian gas industry provides an excellent example of a dominant player in the up- and downstream sectors of the industry. Gazprom has a monopoly on all gas exports outside the CIS and is responsible to coordinate the gas export projects in East Siberia. It is a monopoly gas processor in Russia and monopsony buyer of associated gas produced by a handful of independent players. The market share of independent players is about 12-13% (2004). Cooperation therefore is crucial with Gazprom when it comes to pipeline access and exports that in addition are highly taxed (30%).

The gas market thus suffers from more than one regulatory problem. The distribution of revenue (e.g. high export taxes) among the major stakeholders (including the state) lacks transparency. The other problem is that not all producers have direct access to the export markets, so the prices set for European consumers are negotiated by a single gas consortium. Under these conditions, independent companies have little room to manoeuvre. The current market design remains a serious constraint on their incentives. Another question concerns how these companies can become future competitors, under such a regulatory regime.

The prospect for freer market rules is still unclear. While a major step would be to bring domestic prices closer to export prices, but at least close to the long-run marginal cost, another challenge is to reduce the current regulatory restrictions to fewer measures. Curtailing the export monopoly would also contribute to decrease Gazprom's option to threaten the market with decreases in output and price-discrimination. Although the abuse of Gazprom's dominant position has been investigated in several instances, competition policy alone cannot bring about a real relief under strongly distorted trade and investment rules.

Source : Ahrend and Tompson (2004), *OECD Economics Department Working Papers* No. 402

81. Complex policy issues arise as well when competition policy is supplemented by additional measures. Mergers of global impact are another policy area, where competition policy may influence investment decisions. Merging parties (the investing companies) may also be interested in reducing the tight rules of competition and request looser regulations. This issue is all the more important as the number of mega-mergers (deals worth over USD 1 billion) increased.

82. Authorities focusing on multiple goals like social welfare, protection of small businesses or protection of labour force, might overlook the efficiency gains and losses caused by mergers in competition terms. Depending on the size and connections of the company and the importance of the deal, private firms might be inclined to convince the administration of their societal values and debate the outcome of the competition scrutiny and emphasise the positive investment or trade implications of their deal.

83. The removal of excessive trade and investment policy measures in general would allow competition policy to play its role better. In case these policies cannot be called off, competition authorities

may also play a role in reducing distortive measures. Competition offices could also internalise trade and investment policy restrictions²¹ by two means. The first one is to oppose trade or investment policies that are excessively harmful to domestic competition, and use their ability to criticise and push for the open discussion of such policies. The second means for competition policy to intervene is to foster the contestability of markets from the beginning in order to avoid requests later for re-regulation or imposition of protective measures.

V. Regional trade agreements with investment and competition provisions

84. A recent trend in regional trade agreements is the inclusion of investment and competition provisions. For a long time, investment disciplines in international agreements were mainly in bilateral investment treaties (BITs). It is with the North American Free Trade Agreement (NAFTA), entered into force in 1994, that regional trade agreements started to incorporate investment protection provisions usually found in BITs in the framework of a trade agreement liberalising investment in goods and services together with trade (Houde *et al.*, 2007). There are now over 300 RTAs with investment provisions (UNCTAD, 2006). Not all of them have “substantive” investment provisions, but recent agreements tend to incorporate a chapter on investment. Two recent OECD studies have examined the expansion of RTAs with investment provisions and their economic consequences (Leshner and Miroudot, 2006; Houde *et al.*, 2007).

85. RTAs with competition provisions have also proliferated. There are over 100 agreements with competition provisions (UNCTAD, 2005). The OECD study carried out in 2005 analysed 86 of them and identified two families of agreements with a focus either on anticompetitive behaviour prohibited or on cooperation mechanisms between competition authorities (Solano and Sennekamp, 2006). The language can be very different from one agreement to another and more or less binding. There are relatively few studies on the implementation of these provisions, the way they are used by countries and their economic impact (Evenett, 2005 and 2007).

86. While negotiations on investment and competition have been suspended in the current Doha Round and the introduction of multilateral rules on investment and competition in WTO agreements did not advance beyond preliminary discussions²², one can wonder why regional trade agreements now typically include such provisions. Part of the answer lies in the synergies between trade, investment and competition that have been discussed in this report. “Deep integration” agreements that are also called “new economic partnership” or “closer economic relationship” agreements aim at benefiting from the full gains of trade liberalisation that investment liberalisation (as trade and investment are complements) and competitive markets imply. It is especially true in the case of *regional* trade agreements creating an integrated market on a geographical basis. Regional economic integration organisations typically aim at implementing a regional competition policy in co-operation with national competition authorities.

87. Investment liberalisation is also needed in a regional trade area for companies to benefit from scale economies and efficiency gains through vertical integration. New trade theories that take into account firms’ heterogeneity and organisational choices of companies (outsourcing, vertical integration, etc.) highlight the greater gains coming from trade and investment liberalisation than from trade alone (Bernard *et al.*, 2005; Markusen, 2007)²³.

21 . Hoekman and Mavroidis (1994).

22 . A notable exception is the coverage of Mode 3 trade in services in GATS, “commercial presence”. Other WTO agreements have also investment-related provisions, such as the TRIMs agreement.

23 . While the overall welfare gain is higher, the implications for factors income are different (in particular skilled wages versus non-skilled wages).

88. However, the recent trend in the incorporation of investment and competition provisions in RTAs is not limited to regional economic integration organisations. *Bilateral* trade agreements that have proliferated in the last decade also typically include such provisions. The motivations regarding investment are not so different from those described above. In a world economy organised around global value chains and fragmented production across the globe, economies of scale are less related to the creation of a large market of consumers or geographic area. The removal of most tariff barriers on manufactured goods, coupled with an increasing tradability of services, enable companies to fragment their production among a vast array of countries. Distance and geography still matter but regional economic areas are likely to be one piece in the bigger puzzle of global production. In this new context, it makes sense for any economy (small or big) to liberalise trade in services and investment at the same time as trade in goods in order to be part of global value chains (Grossman and Rossi-Hansberg, 2006).

89. The inclusion of competition provisions in regional trade agreements seems justified in view of the fact that anticompetitive behaviour can impede the benefits from trade liberalisation. There are however two additional reasons why competition provisions are now more commonly found in trade agreements. The first one is related to the new organisation of world trade and production described above. In a globalised economy with large economies of scale, MNEs and vertical specialisation, competition authorities need to be more attentive to potential abuses of dominance and imperfect markets. The international nature of production as opposed to the national jurisdiction of antitrust agencies implies the need for co-operation mechanisms between competition authorities and approaches to deal with the international dimension of competition infringement.

90. A second explanation for the proliferation of competition provisions in RTAs is related to the success of trade liberalisation. For those markets that are not competitive enough and can allow for strategic interactions among firms, it is possible to allow domestic companies to preserve their rents in the context of trade and investment liberalisation, by purposely neglecting competition law enforcement. (Cadot et al., 2000). This is an additional motivation to involve competition authorities in the negotiation of trade agreements.

91. Yet one question remains: why it is only at the regional level that investment and competition provisions have been included in trade agreements? The rationale depicted in the preceding paragraphs also applies at the multilateral level. Regarding the concomitant liberalisation of trade and investment, there is even an additional reason to liberalise on an MFN basis or multilaterally. The spaghetti bowl of trade and investment agreements can lead to trade and investment diversion effects with important welfare losses. It is especially true in the case of investment where no multilateral agreement exists and liberalisation provisions have an uneven coverage (OECD, 2007). However, investment and competition reforms are complex and tend to be entangled with domestic issues. They are “second generation” reforms that not all countries are ready to implement.

b) Negotiating and implementing RTAs with investment and competition provisions: are the objectives always the same for trade, investment and competition policymakers?

92. In the case of investment rule-making, both trade and investment policymakers are now compelled to work together, as investment provisions are more often in regional trade agreements than in bilateral investment treaties. There are certainly different objectives for trade and investment policymakers when one compares the provisions in BITs and RTAs. Traditionally, BITs have incorporated mainly provisions protecting investors such as fair and equitable treatment, free transfer of funds, provisions on expropriation (direct or indirect), compensation for losses and the state-investor dispute settlement.

National treatment and MFN treatment were granted only post-establishment²⁴. RTAs have introduced a new dimension in investment rule-making which is the liberalisation of investment, either through the right of establishment, market access or pre-establishment national treatment and MFN.

93. While two “cultures” can be identified and trade and investment policymakers need to deepen their mutual understanding, there is no identifiable conflict between the two approaches. Both investment and trade policymakers aim at attracting investors. The protection of investment and liberalisation of investment are two aspects of investment policy that are likely to positively influence FDI decisions.

94. What is new is the way trade and investment is more than before intertwined in new MNE strategies. Both trade and investment policymakers are confronted with these changes in world production and their consequences on trade and investment rule-making. Conflicts or tensions seem therefore very limited in the area of trade and investment, as long as investment incentives do not lead to trade distortions and uncompetitive outcomes as highlighted previously. That is why RTAs also tend to include provisions on performance requirements for example. But again the objectives of trade and investment policymakers are essentially alike.

95. In the area of trade and competition, the objectives of policymakers are also likely to converge²⁵. For trade policymakers, competition provisions in RTAs are there to address anti-competitive practices that could remove or reduce the benefits from trade liberalisation. Competition disciplines have their rationale in the coverage of “behind the border” trade barriers to achieve a comprehensive set of rules dealing with all dimensions of market access.

96. For competition policymakers, there is a genuine concern in preventing anti-competitive practices from foreign companies in the domestic market. The activities of domestic companies in foreign markets are however not always under scrutiny because of extra-territoriality issues. While there is an equal concern about the even application of competition rules between foreign and domestic firms on foreign markets the extra-territoriality constraints do apply, and the international dimension of competition has to be tackled through co-operation with foreign competition authorities²⁶. But this co-operation can be sought informally or through interagency co-operation agreements. The competition provisions in trade agreements and the co-operation mechanisms that can be found tend not to be used by competition authorities²⁷. When a co-operation agreement between competition authorities exists, it can be the case that it has more effective provisions.

97. The potential interference between trade and competition issues may also explain why co-operation mechanisms on the basis of trade agreements are rarely applied. One issue when competition

24. With the exception of virtually all US and Canada BITs including pre-establishment national and MFN treatment.

25. This section draws on the discussions held at the OECD Global Forum on Trade and Competition (10 February 2006) and more particularly the contribution from Hanspeter Tschäni in the session on competition provisions in regional trade agreements.

26. In the case of investment, one should however note that the company reporting anti-competitive practices has by definition a subsidiary in the market of the partner country. Domestic competition law is relevant and it is not through diplomatic channels involving provisions in a trade and investment agreement that companies will act. National treatment and other protections from the investment chapters in RTAs are likely to be sufficient, as well as state-investor dispute settlement.

27. A survey conducted in 2005 among OECD Members and Observers indicates that competition provisions in RTAs related to co-operation and consultation are not viewed as very useful even though they can be found in many trade agreements. Competition authorities generally prefer to resort to bilateral co-operation agreements or co-operation on an informal basis. See COM/DAF/TD(2005)51.

provisions are in trade agreements is that non-compliance to the provisions becomes a trade issue with potential consequences such as “trade retaliations” or dispute settlement. It would not be in the interest of the Parties to have recourse to such enforcement mechanisms and to link competition decisions to trade interests is also not considered as a desirable outcome.

98. Moreover, as an agreement is the result of a negotiation and countries have different approaches to competition law and policy, the definition of anti-competitive practices in the agreement may create some problems for competition authorities. Trade policymakers have to make sure that anti-competitive behaviours cover the kind of restrictive practices that would reduce trade gains and are similar to trade barriers. The mandate of the competition authority and the basis for its action is given by the national competition law, not by the trade agreement. Hence, competition authorities need to ensure that they can effectively act against anti-competitive practices as set out in the trade agreement.

POLICY IMPLICATIONS AND CONCLUDING REMARKS

99. This report has shed light on the benefits of policy coherence in the area of trade, investment and competition. Many countries have improved their economic performance through the synergies between trade and investment liberalisation and competition enforcement. It is when trade, investment and competition policies converge and aim at economic efficiency by providing the right incentives to firms and individuals that welfare is maximised. It is not a theoretical and abstract outcome, the report has provided both empirical evidence from cross-country regressions and illustrative case studies on the type of gains that can be expected.

100. In the past, trade, investment and competition policies could have been viewed as having conflicting objectives. Export promotion policies have at times aimed at encouraging exports while blocking imports. Tariffs, quotas, subsidies or imports licenses were used to create a wedge between the price of foreign and domestic goods. The consequence was to reduce competition on domestic markets and to grant greater market power to import substituting industries. Distorted regulations were maintained or made overly sophisticated for potential new entrants. Not all countries had a competition law and industrial policies were often used to promote national development objectives.

101. Over the two last decades, both developed and developing countries have moved towards pro-competitive reforms. Developing countries have introduced market-based reforms and reduced the extent of government intervention. Competition laws were adopted and gradually enforced. International trade negotiations and a few successful regional experiences opened the way to more intensified exchanges of goods and services. Regulatory reforms took place in many services sectors. Developed countries also strengthened the intensity of competition in goods and services focusing on remaining trade and FDI barriers and regulatory reforms in network industries.

102. Technological change and the continuation of trade and investment liberalisation have led to the internationalisation of world production, which in turn motivates pro-competitive reforms in order to fully exploit the synergies emerging from trade, investment and competition reforms in an outward-oriented environment. In this new context of international trade organised by MNEs and networks of producers, trade liberalisation has moved from the removal of tariffs and quantitative restrictions to measures addressing “behind the border” trade barriers related to investment, competition and when relevant domestic regulations. Foreign direct investment has been strengthened, in particular in the area of services, and competition policy has evolved to tackle issues such as mergers and the international dimension of competition.

103. As a consequence of the sensitivities related to “behind the border” trade barriers or the more demanding approaches to remove them and to find the right balance between international and domestic regulations, it is in regional trade agreements that the coherence between trade and investment liberalisation, and competition enforcement, has been manifesting itself. Multilateral trade negotiations have shown less inclination to address the main economic changes that have been under way in the manufacturing sector and services industries where trade and investment are intertwined.

104. Some main policy implications of the analysis are the following:

- Countries need to continue to ensure close co-ordination in designing trade, investment and competition policies, especially in sectors where due to barriers to entry or market imperfections the lack of reforms can have detrimental effects on economic performance. The survey conducted among OECD policymakers confirms that countries are well aware of the synergies between trade, investment and competition reforms while recognising that there is room for improvement in co-ordinating policies.
- On contestable markets, open trade and investment policies can lead to fiercer competition and to an increase in the number of firms and products in the market. Trade, investment and competition policies are complements. All of them contribute to reach the best outcome and to increase the gains for society.
- The situation is different in markets with barriers to entry or for regulated industries. The synergies between trade, investment and competition policies are significantly reduced. Trade and investment liberalisation no longer has a pro-competitive effect sufficient to ensure an efficient outcome. However, trade and investment liberalisation can still help. This is the case in particular if regulation is proportionate and adequate in terms of handling the market failures present on the market. Open trade and investment policies can contribute to the entry of new product varieties on unbundled market segments opened to competition or on markets serving or buying from regulated sectors. If regulation is adequate and gives the right remedies to the market failures, then the pro-competitive impact of trade and investment policies could indeed play a meaningful role.
- More difficult is the case where extreme trade and investment policy measures favour “strategic” industries and do not contribute to enhance competition pressure on the market. Milder versions of investment and trade protection may lead to the failure of particular business decisions. Strong protective policies inevitably impede the development of whole sectors of the economy. The overlap between trade, investment and competition policies can be an opportunity for countries to fine tune their policies and to mitigate the adverse effects of reforms that might create distortions or impair economic efficiency. But it cannot accommodate strong protective policies.

105. When policies are not performing, a question is how to put in place a pro-competitive market reform and what kind of policy sequencing would be adequate. Some may think that trade policies may have priority; however the promotion of all three policies should be a goal due to the synergies that link these policy areas. The answer to this question may be somewhat more pragmatic and related to the resources available for such reforms. When deciding about the adequate policy sequence, decision makers should take into account the resources and the policy knowledge and experience available to the country.

106. Sequencing may also start from the simpler policy measures towards the more complex ones. As such, trade liberalisation may start with the liberalisation of goods and simple services and continue with the opening up of sectors subject to market failures (network effects, etc). Similarly, investment policies may first focus on investment promotion and protection and then on liberalisation. Competition policies may first look for the antitrust matters and then settle the main elements for a comprehensive merger policy. It should be stressed however that the synergies between trade, investment and competition policies will only play their role fully when all these reforms are in place.

**ANNEX 1 – HOW SYNERGIES BETWEEN TRADE, INVESTMENT AND COMPETITION
POLICIES ARE DEALT WITH AT THE NATIONAL LEVEL.
RESULTS FROM A SURVEY AMONG OECD COUNTRIES AND OBSERVERS**

A questionnaire was sent to Members and Observers of the Trade Committee to assess how complementarities between trade, investment and competition policies are dealt with at the national level and to collect the experience of policymakers on synergies and issues between these three policy areas. The survey was filled out on a voluntary basis and the Secretariat received 18 responses. The results are summarised below.

Who is in charge of trade, investment and competition policymaking?

Part I of the questionnaire asked countries to describe the government bodies in charge of trade, investment and competition policies and how they achieve policy coherence when dealing with issues relevant for the three policy areas.

As shown in Table 1, the three policies are generally managed by different bodies and individually tend to be shared between different ministries, agencies or departments. Sometimes a rather broad number of services can be involved in the formulation of policies. For example, investment policymakers can be from different ministries or departments according to the sector where the investment takes place. The formulation of trade policy can also be opened to different administrations according to the products concerned.

In a few countries, the same Ministry is in charge of trade, investment and competition policies. In the case of competition, there is however an independent competition authority to implement the policy and take up cases. But the competition authority can also be under the responsibility of this same Ministry. Coordination is certainly facilitated when trade, investment and competition policymakers report to the same Minister.

Another type of organisation places under the same Ministry the responsibility of trade and investment policy (understood as international investment policy), while competition is dealt with in a different government body. It is either the Ministry of Trade or Foreign Affairs (or the Ministry in charge of both trade and foreign affairs) that supervise trade and investment policymaking. Competition policy is then in the hands of the Ministry of Economy, Department of Justice or Ministry of Economic Development (with a competition authority to enforce the competition law). This model reflects the difference between trade and investment policies on the one hand, which are related to “external relations”, and the more domestic-oriented characteristic of competition policy.

A third model of organisation consists in having three different bodies in charge of trade, investment and competition policies. Trade policy is within the Ministry of Trade or Foreign Affairs, investment policy is the responsibility of the Treasury or Ministry of Economy and Finance and competition policy under the supervision of a third Ministry and a competition authority. In this model, there are also several ministries or departments in charge of specific areas but they are different for trade, investment and competition.

Table 2. Government bodies in charge of trade, investment and competition policy

Country	Ministry/agency/department in charge of		
	trade policy	(international) investment policy	competition policy
Argentina	Ministry of Economy and Production (MEP) / Ministry of Foreign Affairs, International Trade and Worship (MRECIC) / Secretariat of Industry, Trade and the Small and Medium Enterprise (SICyPyME)	National Agency of Investment Development / SYCyPyME / MEP	National Commission for the Defence of Competition (CNDC)
Australia	Department of Foreign Affairs and Trade (DFAT)	Department of Treasury	Department of Treasury / Australian Competition and Consumer Commission
Austria	Federal Ministry of Economics and Labour	Federal Ministry of Economics and Labour / Federal Ministry of Foreign Affairs	Federal Ministry of Economics and Labour / Federal Competition Authority
Canada	Department of Foreign Affairs and International Trade Canada (DFAIT)	DFAIT	Competition Bureau
Czech Republic	Ministry of Industry and Trade	Ministry of Industry and Trade / Ministry of Finance / Czech Invest	Ministry of Industry and Trade / Office for the Protection of
Finland	Ministry for Foreign Affairs / Ministry of Trade and Industry	Ministry for Foreign Affairs / Ministry of Trade and Industry / Ministry of Finance / Ministry of Justice	Ministry of Trade and Industry / Ministry of Finance / Finnish Competition Authority
Greece	Ministry of Economy and Finance	Ministry of Economy and Finance	Ministry of Development / Hellenic Competition Commission
Italy	Ministry of International Trade	Ministry of Economy and Finance (MEF) / Ministry of Foreign Affairs / Ministry of International Trade	Italian Competition Authority
Japan	Ministry of Economy, Trade and Industry (METI) / Ministry of Agriculture, Forestry and Fisheries (MAFF) / Ministry of Finance (MOF) / Ministry of Foreign Affairs (MOFA)	METI / MOF / MOFA	Japan Fair Trade Commission (JFTC)
Korea	Ministry of Foreign Affairs and Trade	Ministry of Commerce, Industry and Energy	Fair Trade Commission
Mexico	Ministry of the Economy	Ministry of the Economy	Federal Competition Commission (Comisión Federal de Competencia)
Netherlands	Ministry of Economic Affairs	Ministry of Economic Affairs / Netherlands Foreign Investment Agency	Ministry of Economic Affairs / National Competition Authority
New Zealand	Ministry of Foreign Affairs and Trade	Treasury / Ministry for Economic Development / Ministry of Foreign Affairs and Trade	Ministry of Economic Development / Ministry of Foreign Affairs and Trade
Poland	Ministry of Economy	Ministry of Economy	Office of Competition and Consumer Protection (OCCP)
Slovak Republic	Ministry of Economy	Ministry of Finance / Ministry of Economy / Slovak Investment and Trade Development Agency (SARIO)	Antimonopoly Office
Spain	Ministry of Industry, Tourism and Trade / Secretary General of Foreign Trade	Ministry of Industry, Tourism and Trade / Secretariat of State for Tourism and Trade	Ministry of Economy / Tribunal de Defensa de la Competencia
Turkey	Prime Ministry Undersecretariat for Foreign Trade	Prime Ministry Undersecretariat of Treasury	Competition Authority
United States	Office of the United States Trade Representative (USTR)	USTR / State Department / Treasury Department / Department of Commerce	Department of Justice / Federal Trade Commission

There is no sign that one approach or the other provides a better organisation or has specific advantages in terms of the co-operation that has to take place between trade, investment and competition policymakers. The “geometry” of departments or ministries can vary but there are still different people in charge of trade, investment and competition who have to communicate and to coordinate their actions.

As reflected by the answers to the questionnaire, the key element is the smooth exchange of information, views and national positions and the existence of clear procedures to arbitrate potential conflicts.

General assessment of the way synergies between trade, investment and competition are taken into account

The questionnaire requested countries to provide a general assessment of the way synergies between the three policies are taken into account. Not surprisingly, most countries answered that they are reasonably confident that they sufficiently take into account these synergies.

While one might have expected such answer and even deem the question as naïve, this positive answer is substantiated by the description of the very frequent coordination meetings or consultations between departments, agencies and services (see next section). Also, it is not unusual for policymakers in one area to have to represent the interests of their colleagues or to intervene in another policy area. This is the case in the negotiations of RTAs, when in some countries trade negotiators carry out the negotiation on investment and competition provisions. Another example is the role of investment promotion agencies which also contact potential exporters (as they may become investors).

Some countries also identified weaknesses in their coordination process. First, several countries indicated that there are sometimes conflicting views and that the coordination needs some arbitrages. In such cases, a few countries recognised that they could do more in terms of policy coherence regarding trade, investment and competition. One specific area mentioned, was to involve the private sector. It is acknowledged that in some cases policymakers in charge of the negotiation of international agreements related to these issues are not always in close contact with business representatives or the Ministry in charge of enterprises (and in particular SMEs). This is not the case for all countries, as the Ministry or agency in charge of SMEs is sometimes mentioned as a partner in the trade, investment and competition policymaking.

It is also clear from the answers to the questionnaire that trade, investment and competition policymakers consider the coordination of their policies as very important and recognise the need for policy coherence. Not only do they answer that other policies are important in their area, but they also provide examples.

How is the coordination between trade, investment and competition policies accomplished?

Countries provided a very detailed description of the way they ensure the coordination between trade, investment and competition policies. The process varies from one country to another. In six countries out of 18, there is a specific service dealing with the coordination of trade, investment and competition policies. Some countries also indicate that a specific Ministry or Agency can be responsible for the supervision of these policies, in particular when there are conflicts or when decisions have to be made. Although not in charge directly and specifically for the coordination, this body has the authority to do so or there is some kind of “gentlemen’s agreement” that this body is responsible.

The coordination involves different types of consultations between trade, investment and competition policymakers. Sometimes the choice between these different types is on a case-by-case basis. The following list gives an overview of the different types of consultations mentioned by countries:

- High-level consultations
- Interagency/inter-ministerial consultations on a regular basis where decisions are made by consensus
- Wide-ranging consultations for any new treaty or significant regulatory proposal
- Ad-hoc consultations when appropriate/relevant
- Consultations on an informal basis, opinion sharing
- Binding or non-binding recommendations at the initiative of the Ministry, Department or Agency
- Notifications or reports

High-level consultations or ad-hoc consultations are generally mentioned as the normal process when a specific decision has to be made, a regional trade agreement has to be negotiated or a conflict has arisen that requires arbitration. There are very few countries with consultations on a regular basis, that is with a specific committee in charge of the coordination of trade, investment and competition issues. Consultations can however be requested for any new treaty or regulatory proposal, for example when an impact assessment is made. Informal or ad-hoc consultations seem to be the preferred way in dealing with policy coordination. Many countries also indicate that they are in constant contact with their counterparts in charge of other policy areas (in an informal way).

Generally, the consultation is at the initiative of trade policymakers, in particular when a free trade agreement is being negotiated. Investment and competition policymakers can however initiate the consultation when they have a specific issue related to trade. For example, competition authorities indicate that when competition policy enforcement is obstructed by public policies related to trade and investment, they can issue recommendations to the agencies or ministries in charge. Very few competition authorities seem to make binding recommendations but any issue could be brought forward at a higher administrative level (e.g., the Ministry). It is also interesting to see that several competition authorities monitor (sometimes on a daily basis) bills and changes to legislations proposed by the executive and/or legislative branch. Some competition authorities also mention that they have the opportunity to carry out studies and research on competition and issue reports which can be sent to the government. Through these reports the competition authority can ensure that the competition policy arguments are taken into account.

How are potential conflicts or tensions between trade, investment and competition policies resolved?

Potential conflicts or tensions are resolved through the same co-operation or co-ordination mechanisms described in the previous section. It should be noted that there is always a simple way of solving the matter which is to take it up to the next level of responsibility in the government. Even when no specific mechanism or consultation process is foreseen, a conflict between two bodies within the same ministry is lifted up to the Minister and a conflict between different ministries or departments is sorted out at the next level of government responsibility (Cabinet, Prime Minister, etc.).

However such “conflicts” can precisely be avoided by informal discussions, ad-hoc consultations and then formal consultations at lower levels of policy-making. Many countries indicate that they prefer the informal discussions to prevent conflicts or tensions from happening and to facilitate the decision process. In their answers, countries did not provide specific examples of conflicts or of difficulties they have had in resolving the conflicts.

The role of trade, investment and competition policymakers in the negotiation of regional trade agreements

The last question in the survey was on the role of trade, investment and competition policymakers in the negotiation of regional trade agreements that include investment and competition provisions. There are three different kinds of co-ordination between policymakers:

- The negotiations can be conducted by trade policymakers with only a consultation of investment and competition policymakers before and/or during the negotiations.
- The negotiations can be undertaken jointly by trade and investment or competition policymakers (in their area of competence).
- Lastly, negotiations can be carried out by investment policymakers or the competition authority, in consultation with their trade counterparts.

While these approaches reflect differences among countries, some of them point out that the involvement of investment and competition policymakers in the negotiation depends on the nature of the agreement (and in particular the extensiveness of the investment and competition provisions). Whether trade or investment/competition policymakers lead the negotiation, there is always co-operation between the different ministries, departments or agencies in charge of the three policies. Interestingly, most of the competition authorities who answered the questionnaire mention that they are also consulted on trade and investment issues beyond the chapter or provisions that specifically deal with competition. This is explained by the fact that the trade and investment liberalisation provisions of RTAs have a bearing on domestic competition. Investment policymakers indicate that they are also consulted on competition issues, but they are not directly involved in the negotiation of the competition provisions.

In the case of EU Members States, as trade policy is a competency of the Community, investment and competition policymakers are consulted by their trade colleagues at the stage of the formulation of the national position, which is then fed into the EU position on the issue concerned. Hence they do not directly participate in the trade negotiations. Some countries also mentioned that the negotiation of investment and competition provisions in EU RTAs was relatively new and that the involvement of investment and competition policymakers was evolving. This is true as well for other countries which are not EU Members. Investment and competition policymakers are now more engaged in international trade-related negotiations and have a growing interest in trade issues and how trade agreements affect their policies.

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