

# **Industrial and Competition Policy: Conflict or Complementarity?**

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Developing countries in Asia debate the following policy question: Should we allocate scarce resources to promote competition and thereby procure resulting efficiency gains, or would we do better to favor selected sectors viewed as contributing most to a particular set of desired, long term, developmental goals? Making the distinction between these two choices obscures the fact that the two can be complementary.

For a developing country with limited capital, it is sometimes argued that its small market size can only support a few domestic firms if those firms are to achieve sufficient economies of scale to compete in world markets, and to use the benefits of that competition to stimulate other domestic sectors. Even though promotion of such “national champions” is likely to impact negatively on the economy as a whole, hopes for their success at the global level have been used to justify giving industrial policy precedence over competition policy (CUTS 2003). At the same time, industrial policy has been criticized as contributing to rent seeking, barriers to market entry, and protection of incumbent firms.<sup>1</sup>

Whereas competition policy is generally viewed as supporting the allocative and technical efficiency of economic activity on the basis of equality of opportunity to participate in markets, industrial policy supports dynamic efficiency in achieving favored outcomes through allowing or supporting an advantaged participant. An inherent potential tension is therefore perceived between the two types of policy and concerns arise that enforcement of competition policy may limit the policy space necessary for achieving the goals of industrial policy, even though competition policy is not inherently opposed to large firm size. Whether this tension manifests itself as overt incompatibility or in a form that strengthens the interaction of

competition and industrial policies depends on the details of their design and objectives.

### **Industrial vs. Competition Policy**

Some form of industrial policy has been used in all modern economies; it has been most apparent in the context of East Asia's rapid growth in recent decades. The defining characteristics of industrial policy are subject to debate and disagreement. Generally, industrial policy aims to ensure that selected industries or sectors with positive linkages or spillover effects to productivity in other parts of the economy obtain the chance to heighten their contributions. Industrial policy is frequently implemented in ways in which the chosen economic agents have a market advantage over competitors (including producers of substitute products)—an advantage they would not have in the absence of that policy. For example, Noland and Pack (2003, 10) define industrial policy as

“ an effort by a government to alter the sectoral structure of production toward sectors it believes offer greater prospects for accelerated growth than would be generated by a typical process of industrial evolution according to static comparative advantage. ... Credit directed at specific sectors with below-market interest rates for long-term and working capital, sectorally differentiated profit taxes, subsidized electricity rates, research and development subsidies, control of the entry and exit of firms, export targets, and highly differentiated tariffs and nontariff barriers are all forms of industrial policy. Japan, Korea, and [Taipei,China] used most or all of these instruments as well

as others for varying lengths of time and at different intensities.”

Industrial policy may operate through factor markets, product markets, or influencing international trade and investment, as it alters rivalry between firms. It may be designed to accommodate short run goals such as greater employment, foreign exchange earnings, or improved income distribution, but the emphasis is ultimately on long term growth and development. In turn, faster growth may lead to greater competition.

Economic development requires structural transformation, but since new activities take advantage of existing capabilities (such as particular labor skills) that were developed for other activities, structural transformation is path-dependent. Coordination failures may limit the ability of markets to identify and achieve the most socially beneficial long term development path of activities. “Unless purposeful action is taken to move towards new activities, countries may not be able to overcome the market failures that affect the process of structural transformation. Seen in this perspective, industrial policy is a central part of any development strategy” (Hausmann and Rodrik, 2006, 37). The unequal treatment administered by industrial policy is then justified by gains in economies of scale and efficiency. Moreover, Rodrik (2004) cites Taipei, China as an example where industrial policy acted *in anticipation* of changes in comparative advantage, contributing to a more efficient growth trajectory.

While competition in markets yields efficiency benefits, industrial policy can fill in the gaps in a developing market economy by coordinating markets where developments in one market depend on developments in another, by ensuring provision of public goods

(infrastructure, education, etc.) that raise productivity of inputs and are complementary to the market, and by maximizing the net benefits of other externalities. However, claims that those industrial policies that constrained rivalry were central to East Asian development, and that such measures were effective, have been discredited by empirical research (see Evenett, 2005, for a summary).

Within markets, competition policy aims to ensure that an economy experiences the greatest potential net benefits from the efficiency induced by rivalry in contestable markets. Competition policy includes competition law, which is generally crafted to prevent abuse of market dominance and to facilitate ease of market entry. Particular focus is normally given to restrictive practices and behavior, and to mergers and acquisitions. Competition policy also includes competition advocacy, which in a narrow sense strives to make sure that the formulation of other policies considers factors impinging on competition in markets. In a broader sense, competition advocacy fosters development of a competition culture, and various means for expression of consumer interests.

Areas of possible conflict between industrial and competition policies include the relevant time frame and effects of foreign entry to the market. Within the realm of competition policy, there may be tension between short run and long run objectives (Brooks 2005). Dynamic efficiency and many of the inventions and innovations that drive it rely on protection of intellectual property rights (IPRs). While patents, copyrights, trademarks, registering of Internet domain names, and other forms of IPR protection restrict competition in particular markets in the short run, they may promote it in the longer run as the resulting temporary monopoly rents provide incentives for new and improved products or services to compete with existing ones. Given the importance of IPRs in the modern economy, long term

implications of anticompetitive behavior have led to more nuanced applications of competition policy.

In early periods after its introduction, competition policy commonly helps new and smaller producers to compete on a more equitable basis against larger and more entrenched suppliers. In later stages the focus tends to broaden to account for a wider range of consumer choice and consumer protection interests, as well as those of producers. This may occur through changes in the emphasis of implementation or through new legislation (as recently in India). Similarly, industrial policy aims to promote dynamic efficiency first for the selected economic agents and second for the economy as a whole, where the efficiency should be interpreted in terms of achieving the designated long run socioeconomic goals at minimum cost, measured in present value. The greater emphasis on long term focus in industrial policy suggests that competition policy should be designed flexibly to accommodate industrial policy.

In their dynamic interaction, the balance between competition and industrial policy may change over time with different emphases at different stages either by design or by circumstance, particularly in economies in transition. Jiang (2002) argues that the People's Republic of China's industrial policies have undergone three stages of development: (1) from the late 1970s to the mid-1980s, the industrial policies promoted competition; (2) from the mid-1980s, the industrial policies limited competition; and (3) since the mid-1990s, industrial policies have both promoted and limited competition.

Competition with foreign firms adds an extra dimension to the balance between industrial and competition policy objectives. The entry of foreign firms into the domestic market usually increases competition, at least in the short run. To the extent that foreign entrants bring new managerial or production techniques and

technology; access to international supply chains, markets, and finance; and benefits to domestic consumers, labor, and suppliers of other inputs, they tend to be viewed favorably. An exception is generally when the entry takes place through mergers or acquisitions that increase market concentration. If the increased concentration leads to abuse of a dominant position in the market, competition policy may be called upon to restore efficiency.

From the perspective of industrial policy and its goals, foreign entry is often viewed with much greater suspicion, in part because it is less subject to control by domestic authorities. Foreign direct investments are often subjected to performance requirements to ensure that their operations conform to domestic policy goals and support, rather than diminish, the operations of domestic firms. It is common to find that

“an advocate of industrial policy could be a keen supporter of measures to bolster competition between domestic firms while simultaneously seeking to shelter them from foreign competition. ... industrial policy of the ‘sheltering’ type tends to work better when intense rivalry between domestic firms spurs them to improve productivity and performance—a finding that calls for a strong competition law enforcement to complement certain national industrial policies” (Evenett 2005, 68).

In the case of Korea, support for the *chaebol* was tempered by measures to ensure they competed intensely against each other in the domestic market. Similarly in Japan, support was for oligopolistic rivalry rather than single national champions.

## **Industrial and competition policy**

The perceived conflict between industrial policy and competition law is more apparent than real. Industrial policy is less likely to achieve satisfactory results when it is not accompanied by active enforcement of competition policy, as illustrated by the case of Korea. Where tensions exist, competition law can be drafted and implemented to accommodate challenges. Similarly, measures to promote the aims of industrial policy need not interfere heavily with competition in markets. Some notable measures to support growth and achieve social goals may include public expenditures on infrastructure and education, strengthening of property rights to support invention and innovation, deepening of capital markets, and creation of an investor-friendly business environment.

Evenett (2005) offers five suggestions for how competition law is, or can be, designed or implemented to minimize adverse impacts on industrial policy:

1. government actions are not actionable under many competition laws;
2. developmental objectives can be explicitly incorporated in national competition laws;
3. application of competition laws can take into account dynamic as well as static efficiency considerations;
4. exemptions, exceptions, and exclusions from competition law can be allowed, and mechanisms to create future exemptions included. For example, “national interest” or “public interest” clauses can be included in competition policy for flexibility.

5. a governmental body can have authority to overrule a competition decision in cases where the ruling would work against national development priorities.

Each of these suggestions has pros and cons. The basic approach is to ask: Which instruments of industrial policy directly conflict with the application of competition policy? Are there any equally effective alternatives? To ensure transparency, applications of exemptions or exclusions should be based on publicized rules and open to public hearings, as well as subject to regulatory oversight.

Similarly, an industrial policy environment that is designed to maximize informational benefits and to limit rent-seeking costs should follow the principles of open architecture, self-organization and transparency, without predetermination of which sectors or activities will directly benefit (Hausmann and Rodrik 2006).

Experiences with industrial policy, and the desires for its goals, have been shaping the debate over competition policy in Asia. Most countries in the region have found, or are finding, ways to accommodate efforts to achieve those goals in their design and implementation of competition policy. Competition policy, which places greater weight on short term concerns but is increasingly considering longer term effects, and industrial policy, with its generally converse weighting, appear to be converging in their goals. As a result, more and more countries are finding that carefully crafted, industrial and competition policies can be mutually reinforcing.

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<sup>1</sup> This policy brief does not propose to assess the merits of enacting industrial policy, but rather to consider its interactions with competition policy when both are implemented together, and characteristics of those policies that may make their interaction more effective.