

## Competition Advocacy and Regulation

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First of all, I would like to thank the organizers of this APEC/OECD workshop on regulation for having me invited to be a keynote speaker on this second session dealing with competition advocacy.

I will divide my presentation in five parts. In the first I will make a comparison between competition, on one hand, and economic regulation, on the other, as a guiding principle for market players to make their decisions and I will argue that competition is far superior to regulation as a decision making device. In the second part, I address the question: why then regulate? I will give a brief overview of the four basic types of market imperfections which may cause free competition not to lead to optimal social outcomes and which may make regulation necessary in certain circumstances. Next, I will indicate the role competition authorities can play advocating for competition in the design and implementation of the regulatory framework and I describe some of the mechanisms by which competition advocacy can be conducted. In the one but last part I give some examples of competition advocacy in Mexico by the Federal Competition Commission and I conclude my presentation with a brief review of the work done by the International Competition Network (ICN) in the field of competition advocacy.

### Competition versus Regulation

Comparing competition with regulation as a decision making device one should first realize that under competition decision making is decentralized *i.e.* every economic agent decides on his own what to produce, how to produce it and in what quantities, the prices at which he offers his products or services for sale, and many other variables. Moreover, he does so with the information he has available for himself.

In contrast under regulation much of the decision making is centralized. It is the regulator who makes the decisions and it is the regulated entity who has to carry them out. To make the proper decisions *i.e.* decisions to the benefit of society as a whole, the regulator must obtain information from the regulated entity and the latter may have incentives to distort the information he delivers so as to influence the decisions to his own benefit.

Under competition State and government intervention is of a horizontal nature. It does not interfere directly with specific sectors but builds and strengthens the institutions necessary for markets to function efficiently. Among such institutions one may mention: (i) money, (ii) property rights, (iii) contract law and also (iv) the protection of intellectual property and (v) competition law enforcement, among many others. Under regulation, on the other hand, government intervention is vertical; it interferes with specific sectors of the economy and it has often to make choices favoring certain companies to others; *i.e.* picking the winners.

As a consequence economic regulation faces a number of problems which are not there when the market is left free. The first is that regulatory measures must be enforced. As the decision maker is a different person from the one who has to carry them out, the regulator must make sure that the regulated entity does what it is told to do and because compliance is not always fully observable this may not be an easy task. In the second place, there is the information asymmetry between the regulator and the regulated entity which may diminish the effectiveness of the regulator and may cause regulation not to achieve its goals. Third, there is the phenomenon of regulatory capture. That is, even when there is complete information the regulator may not act in the interest of society when it is captured by specific interest groups lobbying with the regulator for the adoption of measures to their own benefit.

Altogether, there are great advantages of competition over regulation as a guiding principle to economic decision making. It is definitely less costly; it is also more precise; there is no danger of regulatory capture; and last but not least, the consequences of making mistakes are mainly felt by the one who makes them. If a regulator, and more generally a public authority, makes a mistake, he is usually not punished himself but the negative consequences are largely felt by the regulated entity, the consumers or others. This makes him less cautious about his decisions than if he would suffer the negative consequences himself. This disciplinary force is much stronger under competition than it is under regulation.

### **Why regulate?**

If competition is so superior to regulation, why then regulate? The reason is that competition does not always work or does not always lead to an optimal allocation of resources in society. This may happen in markets featuring different types of market imperfections and there are four such types, each of which may give rise to significant welfare losses in markets when left unregulated.

The first imperfection is that of *externalities*. The classical example is that of a polluting industry which without regulation causes important negative effects to the population and other economic agents, when left alone. In that case regulation may impose command and control measures limiting the emission of pollutive materials or charge the polluting industries according to the pollution they generate, so bending their incentives away from polluting activities.

The second imperfection is constituted by information asymmetries. Not the type of asymmetries I mentioned earlier between the regulator and the regulated entity but asymmetries between producers and consumers, the former knowing much more about the characteristics of their products, and about the eventual dangers of consuming them, than the latter. In such cases compulsory standards may be imposed upon producers of goods and services in order to protect consumers from their lack of information.

Excessive concentration of market power is another source of market imperfection which may give rise to significant welfare losses. Economies of scale at the supply side or network economies at the demand side may render certain markets natural monopolies which implies that the optimal number of firms to serve the market is just one. In such cases price and quality regulation may be warranted to avoid that monopolists or dominant market players abuse their market power to the detriment of the consumers.

Finally, certain markets when left unregulated may fail to provide a minimum level of service provision considered of public interest. This may particularly be the case in the public utilities such as drinking water, electricity, telephony, etc. Particularly the penetration of such utilities in rural areas or to broad classes of the population may be problematic and some regulatory intervention may be desirable to enhance such penetration. Regulation of such universal service obligations may take many forms, from entrance regulation, through allowing cross-subsidization to outright subsidies.

In order to determine whether such imperfections warrant regulation it is not sufficient to find that the imperfections exist. Almost any market features one or a combination of the imperfections to a certain degree. What is ultimately decisive is whether the welfare losses derived from the imperfections outweigh the costs of the regulation necessary to remedy them. When imperfections are there but their consequences are not all too severe it may be preferable to live with them and not embark upon costly and imperfect regulation. After all, regulation is a sometimes necessary evil.

## Competition Advocacy

Competition advocacy has a long history, definitely longer than that of antitrust policies. Perhaps the greatest advocate of competition was Adam Smith himself who suggested already at the end of the 18<sup>th</sup> century that the forces of competition driven by self-interested individuals, acting on their own, generally leads to socially desirable results, as if those individuals were driven by an “invisible hand”. This makes clear that competition advocacy is not a prerogative of competition authorities and indeed it must be admitted that, today, in most countries there are various institutions in society which advocate for competition to a certain extent.

Still, in this presentation I will confine myself to competition advocacy carried out by the competition agencies themselves and for that purpose I stick to the definition of advocacy provided by the ICN steering group when it gave its mandate to the Advocacy Working Group to study this issue in further detail. According to the ICN:

Competition advocacy refers to those activities conducted by the competition authority related to the promotion of a competitive environment for economic activities by means of non-enforcement mechanisms, mainly through its relationships with other governmental entities and by increasing public awareness of the benefits of competition.

The first part of this definition defines competition advocacy in terms of what it is not. Advocacy is almost everything except enforcement. However, it is not always clear what exactly enforcement is and this may be different from one jurisdiction to another. In most of the older jurisdictions competition law applies exclusively to private agents but in several recent jurisdictions in developing and transition economies competition agencies claim that their law also applies to public authorities, among them regulators. If so at least part of what we have considered advocacy becomes enforcement.

The second part of the definition identifies the two main branches of competition advocacy. The first comprises initiatives undertaken by the competition authority towards other public entities in order to influence the regulatory framework and its implementation in a competition-friendly way. The second covers all activities by competition authorities aimed at raising the awareness of economic agents, public authorities, the judiciary and the public at large about the benefits competition can bring to the society as a whole and about the role competition policy can play to promote and protect competition.

The role competition authorities can play in structuring the regulatory framework is twofold. First, it is to delineate the boundaries of regulatory intervention. It is not always clear where precisely regulation is warranted and regulation may easily overshoot its goal by regulating what in principle could be left to free market forces. To what extent is it necessary to control the entry to taxi services with special permits? Is it not sufficient to procure that taxi drivers have a driving license, have a decent vehicle easily recognizable as such and have no criminal record? Why make the granting of permits subject to the presumed sufficiency of service provision in an area? Why not just leave it to market forces? Likewise, the boundaries of regulation may also move along with technological change. Electricity generation used to be a natural monopoly but with the introduction of combined cycle turbines the minimum efficient scale has become much smaller which may allow for competition in power generation. In such cases, deregulation may be warranted but as regulation, once put into place, may be extremely persistent, not in the least when it protects certain established interests, advocating for competition in such areas may be desirable and the competition authority seems to be a candidate “par excellence” to advocate for the necessary changes.

In the second place, competition authorities may advocate with legislators, rule makers and public authorities in charge of implementing the regulatory measures to make the regulatory framework as competition-friendly as possible and not unnecessarily anticompetitive. As a general rule price measures are more competition friendly than quantity measures and occasionally the simple registration of tariffs may be sufficient to guarantee procompetitive outcomes. Similarly, one may have to weigh the static advantages of compulsory access to infrastructure against its dynamic disadvantages, and competition authorities may have a say in that.

The instruments at the disposal of competition authorities to influence the regulatory framework are manifold. They may participate in the design of legislation, regulation, privatization schemes, etc. through *ad hoc* established parliamentary commissions, interministerial commissions or just by issuing opinions, either upon request or on their own initiative. In such interactions public access to the opinions is a strategic variable that should be carefully monitored. Competition agencies may also participate in the implementation of regulatory measures, such as the determination of interconnection fees in network industries, the installment of trade restrictive measures or mandatory quality standards. There is a wide variety of mechanisms through which the advocacy can be conducted, which varies from one jurisdiction to another.

### **Competition Advocacy in Mexico**

In Mexico competition advocacy is mostly carried and by two institutions. Apart from the Competition Commission itself there is the Commission for Regulatory Improvement (previously the Deregulation Unit) which was already advocating for competition long before the Federal Law on Economic Competition (FLEC) entered into force and the Competition Commission was created, and has always struggled for a procompetitive environment.

The objective of the FLEC is to protect and promote the process of competition and encourage the efficient functioning of markets. Efficiency has been interpreted to mean maximizing social welfare according to a total surplus standard. Apart from establishing a general faculty to issue opinions about existing legislation and regulation, about proposed changes in laws and rules and about administrative acts affecting competition, the FLEC empowers the Competition Commission to emit declarations of market power or of a lack of effective competition which enable regulators to impose various regulatory measures. The Competition Commission can also express that such market conditions no longer persist which obligates regulators to withdraw the regulation to which the original declaration gave rise.

Moreover, the Mexican Competition Commission must also authorize the participation of prospective bidders in tenders for the privatization of State assets or for the granting of concessions. This gives it a strong influence over the design of privatization schemes and concession granting processes. On one occasion, by not authorizing a single prospective bidder in a tender the Commission forced the authority in charge of the privatization of an insurance company (Aseguradora Hidalgo) to redesign the terms of the privatization scheme.

Likewise, the Competition Commission is represented in the Foreign Trade Commission, a body of compulsory consultation before trade restrictive measures such as tariffs, quantitative restrictions, antidumping quota, safeguards, etc. are implemented. Although the Competition Commission has only one out of eight votes and although the Foreign Trade Commission is not the ultimate decision maker in those matters, the representative of the Commission has played an active role as an advocate for competition in this field.

Another important competition advocacy initiative has been the declaration by the Commission of the existence of substantial market power for the incumbent telephone operator Telmex in five relevant markets: the local loop, national long-distance services, international long-distance services, interurban transportation of calls and local access services. This declaration enabled the telecom regulator to impose regulatory measures additional to the ones contained in the already existing regulatory framework and in the concession title. It is still under litigation however.

These are just a few examples of the many instances in which the Mexican Competition Commission has acted as an advocate for competition before various regulatory institutions during the last five years. Many more examples might be given.

### **ICN Work on Advocacy**

Until recently little systematic work had been undertaken about competition advocacy. In the second half of the 1990's the OECD surveyed its members on its advocacy activities but the results received relatively little attention. Only until 2001, with the creation of the International Competition Network, it was decided to set up a special working group to study the phenomenon of competition advocacy in its member countries in a more detailed way. It should be noticed that at that time the ICN had somewhat over sixty members as compared to some thirty members of the OECD. Moreover, the ICN has a strong representation of developing and transition economies which are almost absent in the OECD and where competition advocacy may be even more important than in the developed countries.

In 2002 the Advocacy Working Group launched a questionnaire among its members, asking information about their competition regime and the advocacy activities they carried on. 53 members from all over the world answered the questionnaire and the results were presented in the report "Advocacy and Competition Policy" at the first annual conference of the ICN, held September 2002 in Naples, Italy. The report consists of four sections: an introduction; a conceptual chapter along the same lines as this presentation; the main section summarizing and analyzing the results of the questionnaire and a final section with some conclusions. Until now the report is the most comprehensive study on competition advocacy so far. It is available on the general website of the ICN: [www.internationalcompetitionnetwork.org](http://www.internationalcompetitionnetwork.org).

After Naples the Advocacy Working Group was split up into four subgroups each with its own mandate. The first subgroup was in charge of building an advocacy information center; the second subgroup of studying and analysing different models of advocacy employed in different jurisdictions as well as the legal and other provisions facilitating the advocacy task of competition authorities; the purpose of the third subgroup was to investigate advocacy in regulated sectors (telecom, energy, airlines and professions) and that of the fourth subgroup to propose practical techniques for competition advocacy. The Working Group was chaired by Fernando Sánchez Ugarte, now Chairman of the ICN, and the subgroups were coordinated by myself.

Each of the subgroups has presented the results of its efforts on the second annual conference of the ICN, held last June in Merida, Mexico. Two of them in the form of Websites (the Information Center and the Practical Techniques subgroup); the other two in the form of reports. All the material is available at the aforementioned general Website of the ICN.

At the Merida conference it was decided to discontinue the Advocacy Working Group and to incorporate further advocacy work as a subgroup in the Capacity Building and Competition Policy Implementation (CBCPI) Working Group. The subgroup is now starting up its work with a special focus on advocacy towards regulated sectors in developing and transition economies and on practical advocacy techniques. Finally I would like to mention that the CBCPI Working Group has adopted a checklist approach similar to the one envisaged by the APEC/OECD Co-operative Initiative which will receive further attention in the following sessions of this Workshop.