Industrial Policy, Competition Policy and Reciprocal Control Mechanisms

A preliminary assessment of the use of conditionalities in late-industrialising economies and lessons for regulators

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1 Introduction

The extent to which governments get involved in steering their economies differs from country to country. The role of the government in supporting and regulating private firms is determined by the nation's historical background, its political and philosophical disposition, the stage of economic development, the comparative advantages and disadvantages of industries in the country, and various other factors (Matsushita, 1996). It is within this complex and multifaceted environment that the state develops and implements policies that encourage the broadening of the base of economic activity and deepens the level of economic participation of its citizens.

Many of today's developed countries have used some form of industrial policy when they were still catch-up economies (Bairoch, 1993; Chang, 2002 & 2007; Reinert, 2007). This is so particularly for the United States of America and the United Kingdom who have conventionally been viewed as exemplars of free-market and free-trade policies but were in fact the pioneers of protectionism via infant industry promotion and a variety of other industrial policies. Di Maio (2008) captures this well when he says that the industrialisation experience of developed countries shows that industrial policy; rather than being the antithesis of market economic, is a "permanent feature of the constitution of markets". Indeed, the Asian Tigers come from a long lineage of countries that have made use of state support to advance the industrial capabilities of their economies (Chang, 2012).[1]

In spite of the increasing acceptance that industrial policy is core to economic development, there still exists scepticism over its application to poorer developing nations, particularly in Africa. All African countries - including those with an abundance of natural resources and a relatively high level of income per capita such as South Africa - still need a greater deepening of industrial activities that involve getting the prices right (or deliberately getting the prices "wrong")[2] and establishing the conditions that encourage the successful implementation of state supported industrial programmes. According to Chang, this is not a matter of choice, but a matter of imperative if these countries are to become globally competitive (2012).

Developing countries currently operate in a global policy environment that is very different from how it was two or three decades ago. In particular, there has been a tendency to discipline national economic policies through multilateral, regional, or bilateral agreements. These disciplines enforce restrictions on developing countries that limit their ability to conduct certain

[1] The term the "Asian Tigers" refers to the economies Hong Kong, South Korea, Singapore and Taiwan.
[2] In "*The Rise of the Rest*" (2001) Alice Amsden argues that government intervention to distort exchange rates and interest rates (i.e. getting prices wrong) encouraged local production and export.

forms of industrial policy. Industrial policy tools have thus had to evolve in response, and to remain on the table as a prominent feature of the levers that are fundamental for economic and structural transformation (Rodrik, 2004). In this context, it is all the more important to understand the policies and tools that ensure the success of industrial policy.

A review of the literature on successful industrialisation programmes acknowledges that while government support is justified in the presence of market failures, it cannot ensure competitiveness and efficiency by itself. Instruments that work to "discipline" firm behaviour in the interest of competitiveness and efficiency, *a la* Amsden's "reciprocal control mechanisms" are required (Amsden, 2001). Reciprocal control mechanisms (RCMs) are essentially conditions attached to state support (subsidies and incentives) which ensure that firms that receive such support 'reciprocate' through appropriate investment behaviour and performance.

This paper is interested in ways in which industrial policy can promote competitive rivalry. This is explored through a review of the literature that contemplates the complementarities between competition policy and industrial policy. We are particularly interested in evaluating the use of RCMs in East Asian economies as one seemingly effective example of creating rivalry and encouraging competitiveness. We also explore the sectors in which these measures are perhaps less helpful in encouraging competitive outcomes. In those sectors, we evaluate whether competition policy has a more concrete complementary role to play to encourage rivalry. Finally, we try to unpack the success of the use of RCMs in East Asian Tigers[3] to understand whether there are any lessons we can learn from a competition policy perspective. The paper concludes with some suggestions for future research.

2 Understanding the complementarities between Industrial and Competition Policy

Competition and industrial policies develop from the economic, social or political forces playing out at a particular point in time. While industrial policy exists in various forms in nearly all economies across the globe, competition policy is not as pervasive. Nonetheless, competition policy is rising in importance, especially among developing countries where it is seen as an important tool for breaking up concentrated markets and encouraging firm entry and economic diversification (UNCTAD, 2009).

The term "industrial policy" is used casually in newspapers, journals, and academic writing, but has never been ascribed an official definition. Krugman and Obstfeld (1994) have defined it as "an attempt by a government to shift the allocation of resources to promote economic growth." Buigues and Sapir (1993) refer to industrial policy as "the set of measures applied by governments to deal with the process of structural adjustment associated with changes in comparative advantage." Essentially, a working definition of industrial policy would incorporate the idea that it involves state support to firms or sectors and that is designed to correct for market failure or to affect the allocation of resources in the interest of greater economic

[3] The term "East Asian Tigers" refers to the late-industrialising economies Taiwan, South Korea, Hong Kong, and Singapore.

diversification. It includes measures to deal with externalities, anticompetitive structures and conduct, promotion of economies of scale in production, encouraging the growth of new (infant) industries and expanding investment in research and development to build dynamic capabilities. This tentative and workable definition of industrial policy should suffice (Matsushita, 1996).

Some commentators believe that industrial policy and competition policy are naturally at odds. It is true that industrial policy can have a profound impact on market structure and can distort competition. The need to establish globally competitive firms has often been used to justify giving industrial policy precedence over competition policy in this way (CUTS, 2003 cited by Brooks). However, we believe that this tendency to polarise the two types of interventions rather than emphasize the common ground between them is unhelpful. The complementarities and tensions between competition policy and industrial policy is indeed oft-explored terrain (see for example Roberts, 2010; Fox, 2007; and Evenett, 2005). This paper does not intend to cover this ground anew and will not reassess these tensions and complementarities. Instead, it starts from an appreciation of the convergence in the objectives of competition policy and industry policy with respect to advancing country competitiveness, encouraging economic diversification and transforming ownership in the interest of a less concentrated and more efficient economies.

In fact, one could rather argue (and quite convincingly so) that competition considerations should be incorporated into industrial policy if it is to be successful in the long term, and particularly in a context where broadening participation in and transforming the structure of an economy are important goals alongside economic growth. In a developing country, where capital is constrained and market sizes are small, it can be argued that there is only room for few firms to operate so that they may achieve economies of scale and compete in global markets. However, this promotion of "national champions", without giving room for smaller business entrants to participate in the market, may lead to highly concentrated market structures, low levels of dynamism and innovation, and high barriers to entry which undermines competitiveness in the long run (UNCTAD, 2009). Conditions that 'mimic' competition and encourage efficiency would be useful in such instances. Crucial to the success of the East Asian Tigers was exactly this ability to tie government support and intervention to the establishment of disciplining mechanisms to ensure that economic outcomes were in line with carefully considered performance targets (Amsden, 2001; Chang 1996).

The use of export targets as a condition for state support in East Asian economies (explored further below) can be understood as a tool to achieve such competitive discipline. The more a company exported, the higher the chance it was to receive cheap, long-term loans as well as tariff protection for its sales in the local market. These stipulations created aggressive competition among Korea's big business groups at a time when the appearance of heavy industries was dampening competition at the sectoral level (Amsden 1997). If a targeted firm in Korea failed to perform, it ceased being subsidized as illustrated by the high turnover among Korea's top ten companies between 1965–85 (Kim 1993).

This principle of "reciprocity" (i.e. firms receive support in exchange for certain behaviour or performance) operated in almost every industry in Korea. In electronics, for instance, ''the question could be asked why the chaebol-affiliated enterprises did not confine their business to the domestic market where they could make large profits without difficulty. The primary reason was that the government did not permit it. An important Korean industrial policy for electronics was protecting the domestic market. In return for protection of the domestic market, the government required the enterprises to export a part of their production (Sato 1997, p. 413 cited by Amsden 2001:151).

In summary, the literature shows that industrial policy can be broadly understood as the proactive behaviour of the state to support targeted sectors, with the idea that this would lead to the development of these sectors. Government selects certain sectors to support based on a belief that they have strong linkages to other sectors and will promote long-term development. However, incentives offered to firms in the short-run can potentially subdue the degree of competition between firms, similar to the way that intellectual property rights in the form of patents can serve to restrict competition in the short-term. In the long-run however the protection of these rights can have the ability to encourage greater competition and innovation from incumbents and rivals, if managed carefully. In general then, tying competition principles to industrial policy instruments can encourage competitiveness in the long run even if it appears to be side-stepped in the short-term (Roberts, 2010).

We take the idea of complementarity in the objectives of industrial policy and competition policy further by evaluating the extent to which competition principles are, or could be, incorporated more explicitly into industrial policy. In particular, we are interested in how competition can be used in a manner similar to the use of reciprocal control mechanisms (RCMs) to monitor, assess and encourage competitiveness and efficiency of state support. The point is to tease out elements of competition and industrial policy that speak to their mutually reinforcing capabilities. The concept of reciprocal control mechanisms, and the manner in which the East Asian Tigers applied them, is briefly discussed below.

3 The concept of reciprocity and industrialisation: A review of conditionalities in East Asia

The nature of competition varies historically, both in theory and in practice. The competition of the First Industrial Revolution was characterised by perfectly competitive markets and free trade. At the time of the Second Industrial Revolution, the nature of competition had shifted towards rivalry among capital-intensive, oligopolistic businesses. By the end of the twentieth century, its focus had switched from product to capital markets (Hikino, 1997). At the time of the growth of LIC's, there existed no conceptual categories to define the type of market discipline to which ''the rest's''[4] leading industries had to adhere to. This was suggested by the complex explanation given for the success of Korea's automobile industry by the first president of Korea's economic think-tank, the Korea Development Institute:

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[4] This term is synonymous with late industrializing economies. It is coined by Amsden(2001) in reference to the following countries: China, India, Indonesia, South Korea, Malaysia, Taiwan, and Thailand in Asia; Argentina, Brazil, Chile, and Mexico in Latin America; and Turkey in the Middle East.

> *''It is true that the success of the Korean automobile industry was achieved by private initiatives. But it is also true that the success could hardly be attributed to market competition per se. Korean automobiles faced severe competition in the export frontiers. However, it was not market competition that simulated the industry to grow strong enough to venture into the world market. I am not arguing that market competition was useless. Rather, I would like to point out that the environment was provided in which the private sectors' creativity and responsibility could be maximized''*
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> (Kim 1997, pp. 39–40).

The "environment" to which MahnJe Kim makes reference includes the use of reciprocal control mechanisms, with their associated conditionalities and performance standards. The Korean automobile industry did not export for approximately 20 years after it initially began to assemble trucks and cars. However, the commitment to build export capabilities was built into the design of industrial policy. So too were efforts to establish a network of local parts and components manufacturers. The direct negative effects of a concentrated automobile manufacturing sector were warded off by the threat of new entry and price surveillance (Amsden, 2001).

The World Bank issued a major study of the East Asian experience in 1993 that indicated that the success of East Asian countries depended on three essential prerequisites. Firstly, the interventions addressed problems related to the functioning of the market, that is, they addressed market failures. Secondly, market interventions arose out of sound policies. Thirdly, their success was dependent upon the ability of governments to develop and monitor the relevant economic performance criteria related to the interventions; in other words, to create economic contests (Chang, 1996; Amsden 2001). These prerequisites imply that the institutional context within which policies are implemented is just as important to their success or failure as the policies themselves (World Bank 1993:vi). An UNCTAD (1998) report echoes these findings:

> *"Some factors contributing to success were selectivity in protection and incentives (necessary to ensure efficient resource allocation between technologies involving substantial learning costs and simpler activities), conditionality related to technological mastery and export performance, the institutional and administrative capacity to implement such policies and maintain some insulation from rent-seeking pressures, and inter-firm rivalry"* (our emphasis)

3.1 ***Individual country experience***

The following countries have been key exemplars for late industrializing economies and the policy possibilities for industrial and economic development. The manner in which industrial policies have been framed and implemented outside of free market and free trade policies have played a crucial reminder to developing economies on the various ways in which the state and business can cooperate.

3.1.1 South Korea (Republic of Korea)

In the Republic of Korea, trade protection, selective credit subsidies and export subsidies were the most commonly used industrial policy instruments. Amsden (2001) highlights the importance of the "carrot-and-stick strategy" used by the government to implement industrial policies. This took the form of putting in place performance standards in exchange for the provision of state subsidies.

Another important strategy in Republic of Korea's development experience is the intentional creation of large private conglomerates, the chaebols, which controlled a significant part of economic activity (UNCTAD, 2009). The creation of 'chaebols' as national champions was important for South Korea during the initial stages of industrial development because it allowed for achievement of economies of scale; a prerequisite for attaining global competitiveness. The Korean government intended for the chaebols to be able to compete on world markets not for a lack of domestic demand, but due to the fact that their development strategy was distinctly export-orientated, and industrial change needed to work towards this goal (Amsden, 1991). Competing on export markets would incentivise the chaebols to investment productively and operate efficiently.

In a measure of the success of this approach, the literature reports significant differences in the prevalence of rent-seeking and patronage between countries who followed import substitution industrialisation and those who were export-oriented like Korea. Under an import substitution policy, government protection and favours were critical for the profitability of businesses. Under an export-oriented policy, however, firms had to compete in foreign markets. Although various forms of favours and subsidies assisted firms to compete in foreign markets, productivity and competitiveness became much more important. In order to allow for export promotion, the government had to discipline the chaebols with favours based on export performance rather than clientelistic criteria (Mo and Weingast 2009).

In a recent assessment of the effect of these policies on the current level of competitiveness in South Korea, it had this to say about its industrial policy *"… (it) seems to be an effective policy… when a country with little resources and small domestic market is in its early stage of industrialization. However, as the economy gets bigger and more complex, a government-oriented strategy that promotes national champions may deepen monopolistic market structure, create inefficiencies and have other adverse effects (UNCTAD, 2009)."* This statement identifies an important temporal dimension of state support – today's champions can be tomorrow's dominant firms, and different interventions may be required to ensure competitive discipline.

3.1.2 Taiwan

The experience of Taiwan is rich in the extensiveness of industrial policy measures related to competition. The government predominantly encouraged mergers in sectors that were struggling. Wade (1990) has found elements of a free market economy in the type of industrial strategy used. The government promoted cooperation and the establishment of long-term relationships between buyers and sellers, and in some cases instructed firms in certain sectors to merge, for instance in PVC and synthetic fibres industries (UNCTAD, 2009).

Taiwan's ability to set professional standards for government elites made it difficult for interest groups to establish private connections with government. Hence, performance standards were not only attached to firms but also to Taiwanese government officials. If firms or industries can show that their ability to meet performance conditions are being restricted by corrupt officials, they had a second channel of recourse (Wade, 1993: 158).

During Taiwan's import substitution phase, firms were able to lobby the government into granting them an exception to the import substitution policy but only when they could prove the import was necessary. The government would make sure that the firm is aware of what local supplies are available and once it is satisfied that the producer is well-informed, it generally will not stop the import. The government would allow for exceptions if a firm made the case that they needed to import materials otherwise their international competitiveness would be compromised, either because specific material was not made in Taiwan or was of lower quality, or the cost of inputs would be greater than world market prices, (Wade, 1993: 153). During the transition to export oriented industrialisation, export performance was used as a basis for judgment. A firm's request would be seen more favourably if it had a good export record. Thus, firms would be compelled to enter export markets or if they already were not already in the export market, trying to find ways to export more to build up credit with the state (Wade, 1993: 156)

3.1.3 Concluding thoughts on reciprocal control mechanisms in industrial policy in East Asian economies

This section has shown that RCMs were a vital mechanism by which to discipline firms targeted for state support in the East Asian countries. These mechanisms encouraged competitive and efficient outcomes despite otherwise skewed incentives associated with protection.

The Korean example has also shown that there is presently a greater reliance on competition policy to break up the concentrated markets and discipline the large firms left by its particular forms of industrialisation. We would like to explore whether the East Asian experience recounted here can provide key lessons about how to develop the synergies between competition and industrial policy in the interest of greater country competitiveness. We derive some of these key lessons from the use of RCMs in East Asian economies and apply these lessons to South Africa.

4 RCMs: lessons for exploring the competition/industrial policy interface

In the preceding sections, we explored the use of RCMS in the industrialisation experience of the East Asian Tigers. While industrial policy clearly selected, protected, and supported 'national champions'; the efficiency-enhancing benefits of competition remained in the forefront; whether these were simulated by RCMs or through competition policy in the latter years.

We believe the RCMs are interesting for two reasons. The first is because they offer valuable lessons in effective policy implementation that are applicable to present day industrial policy practitioners and competition practitioners alike. Secondly, RCMs exist right at the interface between competition policy and industrial policy; smoothing any tensions that exist between the two by introducing aspects of pro-competitive behaviour and competitive rivalry into "protected" industrial sectors.

The rest of this paper explores these two areas of interest more closely. It identifies some practical lessons we can learn from the efficacy of RCMs in the East Asian industrialisation experience. We apply these lessons to some competition cases in South Africa. In selecting the case studies, we also explore those areas of overlap between industrial and competition policy that are less "smooth": that is, concentrated sectors that once received state support, but presently use their entrenched market power in an anticompetitive manner.

4.1 *Lessons from RCMs for effective industrial and competition policy*

4.1.1 Pre-empting 'abuse'

The first key lesson from the use of RCMs in the East Asian industrialisation process is that RCMs pre-empted how (or whether) support would lead to inefficiency, corruption, or complacency. Competition policy, on the other hand, is largely designed as a responsive mechanism; investigating and prosecuting anticompetitive abuse after the fact (*ex post*). Though the South African competition authority has made some positive moves towards improving responsiveness to industrial priorities (such as more rigorous sector prioritisation on the basis of developmental objectives) competitive rivalry is not sufficiently *designed into* industrial policy in a pre-emptive manner (Roberts, 2010). In the case studies below, we emphasise the value of doing this more effectively.

4.1.2 Being innovative and self-reflective

In the example of the East Asian Tigers, industrial policy focused on establishing new firms and acquiring new capabilities; doing so within a changing trade policy environment. When World Trade Organisation rules prevented export promotion, the East Asian Tigers had to develop new tools, acceptable within the WTO regime, that could achieve their industrialisation objectives (Seguino, 2014). This requires rapid learning and continuous re-evaluation of priorities and performance. Regulators and policymakers must build the institutional capacity to monitor progress consistently and critically in order to execute their mandate effectively. The extent to which this is reflected in the current competition and industrial policy in South Africa is explored below.

4.1.3 Clear, measurable, achievable and objective (evidence-based) goals

Reciprocal control mechanisms were clear, measurable targets. They operated within a logical and coherent industrial policy structure to which all economic agencies agreed. Consistent engagement between state actors and private sector players (at very senior levels) ensured that the targets were achievable and ensured that the state enjoyed a high degree of embedded autonomy (Amsden, 2001). Additionally; not only were targets clear but so were lines of responsibility; firm executive and civil servants responsible for particular sectors were held accountable for firm and sector performance respectively.

4.1.4 Time-bound, with built-in sunset clauses

State support was not everlasting RCMs introduced clear end dates and clear transition arrangements. In our case studies, we evaluate what happens when there are clear end dates, but no clear transition arrangements. That is, we are particularly interested in the problems that arise when even time-bound state support results in entrenched gains. It seems that the effects of past industrial policy and subsequent privatisation decisions, for example, hamstring current industrial policy in South Africa.

4.1.5 Demonstrable capabilities

Much of the development literature about the period of rapid East Asian industrialisation emphasises the professionalization of government bureaucracy; which may be shorthand for the credibility and embeddedness of the state. The state set targets, monitored performance and took the necessary action to punish or reward frims. Though this observation seems rather trite; the importance of demonstrating the ability and the willingness to take difficult enforcement decisions is worth emphasising. Effective enforcement and proportionate sanctions (or remedies) encourage compliance.

5 Reciprocal control mechanisms and competition: a closer exploration of the use of RCMs in South Africa

In this section, we tie the lessons learnt from the use of Reciprocal Control Mechanisms in the Asian Tigers to industrial policy experiences closer to home. We focus on experiences within South Africa.

This section starts with a brief evaluation of the industrial policy framework in South Africa. We then explore some key sectors more closely, evaluating the extent to which RCMs are, or could be, used in those sectors. In tandem, we evaluate whether there is a complementary role for competition law to capture the benefits, and limit the costs, of state support. This assessment covers both enforcement and advocacy tools available to competition authorities. The present analysis focuses only on South Africa, but the conclusion contemplates areas of future research on a regional scale.

5.1 *The industrial policy framework in South Africa*

South Africa’s industrial policy is coordinated within a multi-departmental policy framework by the “Economic Sectors, Employment and Infrastructure Development (Cabinet) Cluster” (GCIS, 2014). At a policy level, the National Development Plan 2030, New Growth Path and National Industrial Policy Framework constitute the pillars of the state’s industrialisation, development, growth and transformation plans. The Department of Trade and Industry (**the dti**) develops operational blueprints to guide the implementation of industrial policy and releases these annually as an “Industrial Policy Action Plan“(IPAP). Each IPAP is a rolling three-year plan that sets out detailed policy actions and goals for the next three-year period. South Africa is presently in its sixth IPAP iteration, IPAP 2014/15 – 2016/17 (IPAP6).

5.1.1 To what extent are RCMs generally incorporated into industrial policy plans?

For our analysis, it is important to understand what monitoring and evaluation mechanisms **the dti** puts in place to evaluate the effectiveness of its industrial programmes in fostering efficiency and competitiveness. In IPAP6, the Minister mentions that **the dti** monitors key IPAP programmes, and commissions "major impact evaluations at regular intervals by independent, expert service providers" (DTI, 2014). However, in an acknowledgment (albeit veiled) of the fact that ongoing monitoring, early detection, and effective course correction remain a challenge, IPAP6 identifies "the imposition of stronger performance requirements and *quid pro quos"* as a critical *new* initiative (our emphasis).

A similar trend is evident when we explore the stated role of competition policy within the industrial policy framework. Though IPAP6 contemplates an explicit role for competition policy external to the work of **the dti**, it does not practically integrate competitive rivalry or increasing competitiveness into the industrial policy framework (Qobo, 2013; Hanival & Rustomjee, 2008). In their review of the first 15 years of post-Apartheid industrial policy, Hanival & Rustomjee (2008) find that firms that have been offered incentives over this period (and before) have not been held to clear accompanying conditionalities or performance standards. Instead, the state has put a great deal of trust into what Roberts (2010) has termed "moral suasion" coupled with a heavy reliance on increasing productivity through liberalisation. Indeed; beyond the identification of "setting stronger performance requirements" as a new initiative, IPAP6 sets no clear performance targets for the sectoral interventions and it proposes, nor does not indicate how these targets will be developed over IPAP's three-year cycle. The use of RCMs is thus not well developed in the South African industry policy framework

5.1.2 Does IPAP contemplate introducing competitive rivalry in other ways?

In IPAP6, as in IPAP5 before it, there is a section dedicated to the role of competition policy in encouraging dynamism in the economy. The section contains certain practical, implementable recommendations such as, for example, identifying the sectors the Commission should focus its enforcement activities on over the next three years.[5]

IPAP6 is less clear when it comes to encouraging competitive rivalry. Though it makes well-considered and important recommendations in this respect; it does so at a theoretical level and without due urgency. For examples, IPAP6 sets the following important goal: *"establish stronger conditionalities for large firms related to competitive conduct*". IPAP5 contained exactly the same goal. While this may indicate continuity in industrial policy, it is concerning that the goal is again set over the entire IPAP horizon with no interim targets or any indication how (or whether) these conditionalities will be set. This lack of detail may lead to policy paralysis over the IPAP6 period too. From our review, it is clear that the promotion of

[5] IPAP recommends that the Commission focus on three areas: (1) concentrated input markets such as carbon, stainless steel, aluminium, chemical polymers, fertilisers, (2) monopsonistic buyers of strategic inputs, and (3) expensive goods and services provided by both the public and private sectors. These sectors have been chosen within the broader context of IPAPs sector focus. See IPAP6, page 54 for a description of these focus areas

competition and competition policy are seen as stand-alone activities, rather than behavioural changes that can (and should) be incorporated into industrial policy.

5.1.3 Sectors that require competition interventions: steel products and the plastics value chain

IPAP6 cites the price of steel products and products in the plastics value chain as a binding constraint to competitiveness in the South African manufacturing sector. In particular, **the dti** identifies the *"prevailing practices of import parity pricing and excessive profit-taking"* in the steel and plastics sectors as a critical concern that requires more concerted action by the competition authorities (DTI, 2014:29). As solution, (and in a further show of the artificial distinction drawn between industrial policy and competition) **the dti** proposes that the Competition Act be reviewed to enhance the powers of the Competition Commission to (1) ensure competitive outcomes, (2) initiate complaints in the broader public interest, and (3) to monitor and enforce compliance.

These sectors; hereafter referred to as "steel" and "plastics", are interesting from both an industrial policy and competition policy perspective. They share a common history of state support, and demonstrate the lasting effects thereof and are both worth considering in somewhat greater detail. Neither sector is new to competition enforcement. From both, we learn similar lessons about the insufficiency of competition policy as a lone tool to enhance competitiveness.

5.1.4 A brief review of excessive pricing in steel

The South African steel manufacturing sector is dominated by the single steel producer, ArcelorMittal South Africa (Ltd) ("Mittal"). Mittal was originally established in 1928 as a state-owned company called ISCOR (the South African Iron and Steel Corporation) to produce iron and a range of steel products. It was converted into a public company in 1989. (Lewis, 2008).

In 2007, Harmony Gold Mining Company Limited ("Harmony") lodged a complaint of excessive pricing of flat steel products against Mittal and Macsteel International Holdings BV (Macsteel) at the Competition Tribunal.[6] The case centred around Mittal's practice of selling its steel at import parity prices and preventing resale of lower-priced flat steel, in the domestic South African market.

At this stage, some historical background is necessary. When Mittal (Iscor at the time) was still owned by the state, its prices were regulated and were set on a cost-plus basis, increasing annually at the inflation rate. When the inflation rate increased dramatically in the 1990s, imports entered the country and local prices were increased to import parity levels (Competition Tribunal, 2007). This was reasonable and consistent with industrial policy goals of supporting a local 'champion' at the time. However, import parity pricing effectively became the status quo and continued after privatisation. In its assessment of this practice, the

[6] Harmony initially lodged a complaint with the Competition Commission who non-referred the matter. Harmony then self-referred the matter to the Tribunal.

Competition Tribunal found that Mittal's import parity pricing mechanism, combined with the contractual obligations it imposed on steel trader Macsteel not the resell lower priced steel in the domestic market, did constitute an illegal exploitative practice.

We now turn to the aspects of the case that are most pertinent at this current juncture – the remedies imposed by the Tribunal and the Tribunal's discussion around the appropriateness of a pricing standard. In Mittal, the Tribunal resisted deciding what an "appropriate" or "non-excessive" price would be; arguing that pronouncing on this would approach price regulation, which would be outside the ambit of competition authorities (the function rests more readily with sector regulators) and contrary to the objects of the Competition Act. Instead, it imposed a combination of an administrative penalty and a behavioural remedy that prevented Mittal from restricting the resale flat steel in the domestic market.[7]

Importantly, the Tribunal was somewhat less cautious about proposing a pricing remedy in a subsequent excessive pricing case brought by the Competition Commission of South Africa against Sasol Chemical Industries Limited (SCI). We provide a brief review of the SCI case before highlighting the importance of this difference in approach and linking it back to the success use of RCMs.

5.1.5 A brief review of the SCI case

As mentioned above, the plastics value chain actually bears some similarities to the story of flat steel products. For example, **the dti** identifies the high cost of inputs into the plastic conversion industry – particularly the high cost of polymers[8] - as a major constraint on the competitiveness and growth of the plastics sector (IPAP6, 2014). The high costs of polymers is partly attributed to import parity pricing in polymers; a concern that **the dti** asked the Competition Commission to investigate a possible exploitative abuse.

The Commission initiated an investigation of excessive pricing in the polymers market against Sasol Chemical Industries (SCI), a subsidiary of previous state-owned company, Sasol Limited. In its investigation, the Commission found that though SCI had very low production costs for polymers and exported approximately half of its polymers, it still managed to extract an import parity price from local consumers. South African polymers prices were in fact 41 - 47% higher than the prices at which SCI sold the same products in Western Europe. The investigation also showed that SCI's practice of import parity pricing had a dampening effect on the growth of the plastics manufacturing sector. The matter was referred to the Competition Tribunal for adjudication in 2010.

The Competition Tribunal found in favour of the Commission, ruling that SCI had indeed charged excessive prices for polymers. The remedies, and how they compare to the Mittal case, are particularly interesting for our present discussion. In addition to imposing n

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[7] We note that this case was eventually settled out of court and the contravention was never confirmed, nor remedies implemented.

[8] The specific products at issue are purified propylene and polypropylene, collectively referred to here as polymers.

administrative penalty, the Tribunal also imposed a forward-looking behavioural remedy that would directly reduce the future price of polymers. Specifically, the Tribunal ordered Sasol to price its product on an ex-works basis and not to discriminate between the prices it charges various consumers.

5.1.6 <u>What do the Mittal and SCI cases reflect about our understanding of the effective use of RCMs?</u>

The evolution in the Tribunal's approach to excessive pricing remedies is a useful reflection of the lessons we drew from the effective use of RCMs in the industrialisation experience of East Asian economies. In particular, lessons about clarity in objectives, pre-empting the (strategic, rent seeking) responses of firms and setting clear, measurable, an evidence-based targets would support the imposition of a clear pricing remedy in an excessive pricing case.

The inherent logic of RCMs would indicate that the cautionary approach of Mittal is insufficient; a dominant firm (in an uncontested and incontestable market) will not easily vary their pricing behaviour based solely on the deterrent effect of a possible administrative penalty. Where it is possible to continue to extract rents from dominance, remedies must contemplate that it will continue to do so.[9] A pricing remedy, such as the one imposed in SCI mitigates these concerns effectively, and in a manner that can be monitored easily.

It is important to note that in the Mittal case, the Competition Tribunal made the very strong statement that we were dealing with an *"uncontested and incontestable"* market – the likelihood of competitive entry is remote (Competition Tribunal, 2007). Assuming that such a firm would price at a competitive level, or would be concerned about the threat of entry, ignores the incentives it faces. How then, should competition policy approach this? In this case, there is a need for the competition authority to provide clarity about a price that more readily reflect efficiency, and for having the power to enforce compliance with such a price. Though some argue that price regulation is anathema to competition law, this response takes heed of Motta and de Streel's warning that:

> *"Competition rules cannot be applied in newly liberalised markets in exactly the same way as they have been applied in 'normal' sectors because the market structures and the risks for competition are substantially different"* (Motta & de Street, 2003)

Another way in which the SCI case takes us a lot closer to understanding how competition policy can play a role akin to that of RCMs used by South East Asian countries is in the Tribunal's implicit acknowledgment of the importance of reciprocity. In the SCI judgment, the

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[9] In a clear show of how insufficient reliance on moral suasion in these markets may be, we note the following quote from a Sasol representative in response to a report that the Minister of EDD is revising the Competition Act to improve the Commission's powers to prosecute excessive pricing: "*South Africa's joining the World Trade Organisation in 1995 took us forward to opening the economy to compete internationally, with prices being brought in line with international prices. Regulating prices to below gate price, is unlikely to lead to building long-term competitive industries."* It is curious that a firm would see the purpose of trade liberalisation as increasing the market (pricing) power of firms. From Business Day, 2014, *Patel reworks Competition Act against excessive pricing.* Available at http://www.bdlive.co.za/business/2014/08/11/patel-reworks-competition-act-against-excessive-pricing. Last Accessed: 14 March 2015.

Tribunal paid significant attention to the benefits that accrued to SCI as a result of past state support. Though the protection may have passed, the benefits have been retained and firms such as SCI (Sasol) and Mittal should still be required to invest in promotion of competition and enhancing the competitiveness of the South African economy. This “price control” remedy is effective, evidence-based, objective, and easy to measure – factors that made RCMs successful tools.

6 Conclusions and Recommendations for future research

This paper emerged from an interest in exploring the complementarities between industrial policy and competition policy. In reviewing the industrial policy literature, the use of RCMs to introduce competitive rivalry into industrial policy emerged as particularly interesting. We then explored why this is so; and whether the lessons from RCMs could be incorporated into competition policy in sectors where industrial support has left concentrated and uncompetitive markets. In this concluding section we draw these lessons out more clearly.

We believe that the approach of identifying tools that work in one policy space (RCMs in industrial policy for instance) and drawing lessons from these for regulators in associated sectors (competition policy in this instance), as a useful practical exercise. It also of why it is critical to tease out complementarities, rather than conflict, between various policies. When we focus on the tensions, we will miss opportunities to learn. Important, lessons that can be drawn from this review are summarised below.

6.1.1 Coordination

The success of RCMs were predicated on a common understanding of the industrial policy goals within the broader framework of economic development in the East Asian states. This coordination holds an important lesson for competition policy, which must locate its priorities and allocate its investigative resources in the most productive manner, where productivity refers to selecting sectors and conduct that have the most linkages to, or impact on, related sectors of the economy. In South Africa aspects of coordination are happening in a fairly “isolated” manner. The Competition Commission of South Africa does prioritise its work and focuses on key sectors but does not necessarily do so in a consultative manner (beyond evaluating official policy documents).

It is clear that there are significant opportunities for closer collaboration. In one example, the International Trade and Administration Commission of South Africa, for example, recently increased the ordinary customs duties for a variety of poultry products; a sector in which there have been significant competition concerns in the past. Implementing this protection without using it as an opportunity to extract pro-competitive conditions is somewhat disappointing (see Tregenna and Kwaramba, 2014 for a review of this decision). This would have been an apt opportunity to leverage the common experience of various regulators in the sector in the interest of a more competitive poultry sector.

6.1.2 Clarity

The targets and objectives of RCMs were always clear. Additional clarity in the application of competition enforcement principles may be beneficial. From both the Mittal and Sasol

Chemical Industries cases, explored above, it has become clear that import parity pricing inefficient, state-supported, and excess supply markets will attract competition scrutiny. The behavioural remedy imposed in the SCI case also goes some way to defining what constitutes less exploitative pricing behaviour. Though these definitions will change as market structure changes and competition enforcement evolves, the additional clarity brought from referring these case and developing case precedents assists in changing firm behaviour. The lesson for competition authorities is that you establish clarity and credibility through practice.

6.1.3 Strengthened monitoring and evaluation

Competition authorities must become stronger not only at monitoring compliance with remedies and conditions attached to mergers and enforcement findings, but must become experts on constantly evolving corporate strategy and behaviour. This is particularly important in the regional context. Many large firms operate in a number of countries within the SADC region, yet competition and industrial policy remains largely national in focus. This leaves competition authorities at risk of not understanding the full extent of anticompetitive behaviour. Regional convergence in competition enforcement may be the ultimate long-term goal, but at present, agencies can leverage existing tools and build networks of inter-agency cooperation to understand these regional dynamics. Nationally, market inquiry provisions allow agencies to conduct broad inquisitorial studies into how competition works in a particular sector. Should similar sector inquiries be initiated across countries at the same time, it may become easier to understand the regional competitive dynamics at play, as well as the competitive dynamics in other countries that have an effect within particular national borders.

6.1.4 Course-correction

RCMs were reflective and responsive to economic policy, social conditions, and firm strategic behaviour. There is a similar need for reflection and flexibility in competition policy and in the manner in which it relates to industrial policy. For example, the difficulty of successfully prosecuting abuse of dominance cases in South Africa is well known. Though South Africa's two most recent industrial policy action plans suggest that the Competition Act will be revised to improve the Commission's ability to prosecute abuse of dominance and levy penalties for all first offences, it is unclear when this will happen or what the provisions will change. Similarly, addressing potential restrictions of competition in oligopoly markets (particularly where none meet the presumptive thresholds for dominance) have been difficult.

The 'complex monopoly' provisions in the Competition Amendment Act, no 1 of 2009 attempts to remedy some of these challenges by making it simpler to initiate an investigation into complex monopoly conduct and providing for the prosecution o*f unconscious* parallel conduct in an oligopolistic market. However, these provisions have still not been enacted since they were assented to in 2010 and it remains unclear when they will come into effect.

6.1.5 Oversight

The professionalization of the civil service accompanied the use of RCMs in late industrialising countries. This improved the ability of state officials to set target, monitor performance, and direct firm behaviour. Investing in the capabilities and resources of competition authorities and other regulators may seem like a simple suggestion; but it remains a shortcoming and must thus be highlighted (Tregenna & Kwaramba, 2014).

Additionally, the close relationship between professional civil servants and private sector firms in the implementation of RCMs is worth contemplating. Competition authorities could consider whether it would be feasible to second officials from competition authorities to the Boards of monopoly producers, particularly those that were previously state-owned and have fallen foul of the Competition Act. This would be contentious; but it could be argued that unlikelihood of competitive entry makes it unlikely that this would have a chilling effect on competition. This would mimic the East Asian Tigers' practice of close cooperation between state officials and firms, and would have similar benefits in terms of understanding corporate incentives and behaviour.

6.2 *Areas for future research*

This paper has largely focused on the use of RCMs as a way to bridge the gap between state support and competition. The lessons learnt from this analysis have been applied to South Africa and only to sectors where previous state support, and current lack of reciprocal control mechanisms, necessitate intervention by competition authorities. In conclusion, we identify the following areas of potential future research:

6.2.1 <u>The design of RCMs:</u> The design of effective RCMs that can be incorpoaretd in current national industrial policy frameworks to encourage competitive rivalry and prevent future concentration,

6.2.2 <u>Regional perspectives:</u> Firms do not operate within national borders. As firms expand their focus regionally (and internationally), what must industrial and competition policy do to keep apace? Further research should be conducted on how governments unlock regional markets, explore regional value chains, and ensure that such cross-border industrial projects introduce competitive rivalry, and

6.2.3 <u>Institutional perspectives:</u> RCMs as an industrial policy tools has been the major focus area in this paper. Are these additional institutional, or governance, lessons to be learnt from the way in which other governments are organised to enhance policy convergence?

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