

## A Consensus for Hong Kong's Competition Policy?

Leonard K. Cheng

While almost everyone agrees in principle that free and fair competition is crucial to Hong Kong's continued economic success, there are rather divergent views on whether there is adequate competition and whether there are in fact anti-competitive business practices in specific sectors of the economy. As a result, there are different opinions about the kind of competition policy Hong Kong should adopt and the kind of institutions that are needed to implement the policy.

In the following, I would attempt to put the different points of view on competition policy in perspective. In doing so, I would argue that beneath the apparent disagreements and conflicting views, we can actually find a large common ground if extreme positions caused by misunderstanding or motivated by one-sided self-interest are ignored. In short, a consensus exists and is a reasonable point of departure for formulating a workable competition policy for Hong Kong.

### Are There Anti-Competitive Practices?

In the debate on Fair Trade Policy in Legco on 17 February 1993, many legislators found themselves on diametrically opposite sides of the issue. At one extreme, some argued that everything was fine and nothing had to be done about trade practices and government regulation of public utilities. From their perspective, even the banks' Interest Rate Agreement, the newspapers' coordination of price increases, and the insurers' premium-setting are acceptable practices because the parties involved allegedly compete fiercely in non-price dimensions such as service quality.

At the other extreme, some members argued that the economy was saddled by all kinds of anti-competitive practices that were harmful to consumers. From their perspective, every twist and every turn were unfair, and a Fair Trade Commission was needed to root out these socially undesirable practices.

To a lesser degree, a similar polarization of opinions seemed to appear at the Academic Forum on Competition held at the City Polytechnic of Hong Kong on 12 May 1993. Apparently, neither side managed to convince the other side. But was the issue really one of black against white, or good against evil?

Hong Kong has achieved the status of a newly industrializing economy, but like many less developed economies, her consumers' interests have often been shortchanged, though seldom completely ignored by her government. As she becomes more developed, consumers are increasingly asserting their rights. However, it is easy to go too far in the opposite direction. In addition to obvious self-interest and misunderstanding, some of the extreme positions reflect a populist inclination on the part of politicians and voters. Big and powerful enterprises become a target of criticism, regardless of whether these enterprises have indeed engaged in unfair and anti-competitive practices.

For instance, in the discussion of public transportation, media commentators often demand better quality (such as higher frequency, better service, and air-conditioning) but oppose higher prices to accompany the desired quality

improvement. They demand unprofitable routes to be run as a service, but oppose passing the resultant losses to other routes in the form of higher prices. They complain about congestion during peak hours but lament peak-load pricing to reduce congestion. To the extent that the issues were over-shadowed by one-sided self-interest, meaningful solutions would be hard to find.

Hong Kong's free trade policy is by itself an excellent component of a competition policy. It is tempting to infer that as a result domestic producers must be forced by foreign suppliers to behave competitively, but such an inference would be wrong because many goods and services are non-tradables. Examples of non-tradables include real estates, retailing, transportation, and public utilities. The most significant characteristic of these goods and services is that international price arbitrage is weak, and prices in segmented local markets are determined by local conditions rather than by the discipline of a well integrated world market. Thus, in spite of her free trade policy, Hong Kong is still in need of a competition policy.

### Competition Policy and Level Playing Field

For some advocates of a comprehensive competition policy, the most important purpose of such a policy is to ensure a level playing field for every participant of economic transactions. One way to achieve this objective is to enact sweeping laws, such as those in the U.S., to prevent the playing field from being tilted unless uneven terrain can be justified on special grounds. Due to the nature of production and distribution technology, over time many exemptions have been granted. As a result, the original appeal of a comprehensive approach, namely, that a competition policy can be based on simple principles, is seriously weakened.

For other critics of Hong Kong's existing competition policy, the policy's purpose is to keep the playing field from becoming too much out of balance and to tackle clearly anti-competitive practices and abuses of market powers as they arise. This approach is clearly more conservative and less ambitious, but equally valid in ensuring satisfactory functioning of the markets. It may err in the direction of being too lenient to anti-competitive practices and being too late in remedying the situation, but sweeping legislation can err in the opposite direction of being too hostile to creative business activities.

How important is a level field to individual business and to the overall operation of the economy? Legco member Mr. Chim Pui-chung offered an interesting view. He believed that there was never fair treatment by the Government, which took care of the economic and political interests of British companies, major foreign investors, and franchised companies. In spite of this, many indigenous entrepreneurs still prospered and became tremendously successful.

*(Continued on page 4)*

---

(Continued from page 3)

### **Anti-Competitive Practices**

It is self-serving to argue that even overt price-fixing is socially desirable, but paranoiac to view every trade practice involving several producers through a lens of conspiracy. Since many of the business practices alleged to be anti-competitive or unfair have been studied in great details in the developed countries, Hong Kong should learn from their experience and does not need to reinvent the wheel.

Banks, newspapers, insurance, and certain professional groups are known to fix prices collectively. These practices should be prohibited except under extraordinary circumstances. The fact that fixed prices have engendered fierce non-price competition is not a defence for price fixing because the resultant price-service combination is distorted and thus socially undesirable. Another practice that might be prohibited is restraint on competition through territorial agreements.

In industries that are dominated by a small number of firms, for example, private housing development, there is a distinct possibility of firms reaching an understanding to refrain from competition or even achieving covert price agreements. Some firms may serve as price leaders while others follow. From the point of view of social welfare and efficiency, covert price agreements are as bad as explicit price-fixing, but they are difficult to identify and outlaw.

Some practices are socially unacceptable in principle, but hard to find in the real world. For example, predatory pricing is a phenomenon in which a firm sets its price below its cost of production with the intention of driving out its competitors and subsequently charging a monopoly price. One might come up with isolated examples under unusual conditions, but predatory pricing is empirically uncommon. The most important reason is that even if existing competitors are successfully driven out of business, it is almost impossible to prevent new or the same firms from entering the market when the predator begins to set a high monopoly price.

In many cases, what on the surface looks like predatory pricing is really industry rationalization whereby inefficient firms get "shaken out" by the efficient ones. Some consumer advocates argue for the need to keep small firms alive even if they are less efficient than the larger firms. But if the combination of low price and little variety offered by corner grocery stores, for example, cannot compete against that of higher price and greater variety offered by large supermarkets, then clearly consumers regard the former combination as less desirable than the latter. Consumers' interests do not coincide with the mere existence of alternative suppliers. Even in the United States, its competition policy has been designed only to ensure adequate competition, not to protect specific producers!

There are other trade practices that have come under attack by consumer advocates due to the latter's lack of understanding of the economic rationale behind these practices. Resale price maintenance, tie-in sales, and exclusive dealings in general can be justified in terms of economic efficiency considerations and can be harmless. They are usually efficient ways of dealing with multi-stage production and distribution, economies of scope (i.e., reduction in cost due to a wider range of

products), and quality uncertainty inherent in many goods and services.

"Unfair trade practice" is a value-loaded term, and there is a danger that fair trade regulations may be used by inefficient firms to harass successful market leaders, especially under the present atmosphere when politicians are tempted to garner votes through populist appeal. "Fair trade" should mean free competition with no artificial entry barriers erected by incumbent firms to lessen competition. Politicians, academics, and commentators seem to have recognized that in general market dominance is the result of greater efficiency on the part of the dominant firms, and should not be a cause for government intervention.

However, if market dominance is the result of artificial entry barriers, then government measures may be needed to dismantle the barriers and to encourage entry. As an example, preemptive patenting by Xerox and its aggressive patent suits against potential entrants had made entry into the plain paper copier market impossible until the U.S. Federal Trade Commission forced Xerox to license its key technologies to its potential competitors at nominal prices.

As another example, to help overcome entry barrier erected by the huge costs of setting up and maintaining a long-distance telephone network, American Telephone and Telegraph was forced to lease its lines to its competitor MCI at reasonable prices. That is to say, from the point of view of social welfare, it may be desirable to modify the business landscape when it is too much out of balance, even if the landscape is not the result of artificial and preemptive entry barriers.

### **Concentration of Market Power**

In a free enterprise system, merger and acquisition serve useful and legitimate purposes. They are a means of achieving inter-firm synergy, diversification of risk, economies of scale and scope, and of weeding out incompetent management. In a market that is already highly concentrated, however, merger and acquisition would also lead to further concentration of market power and thus monopolistic behaviour.

Hong Kong has no anti-trust legislation or even guidelines for merger and acquisition. Perhaps as a result, cross-holding seems to be rather common. As market structure and ownership structure have impact on firm behaviour and the efficacy of the market, this development could be a serious cause of concern in sectors that are already characterized by a high degree of concentration. In comparison with the anti-competitive practices discussed above, concentration of market shares and ownership is potentially more difficult to resolve.

### **Regulation of "Natural" Monopolies and Oligopolies**

Given Hong Kong's size and industrial composition, "natural" monopolies and oligopolies primarily mean public utilities such as public transportation, radio and television broadcasting, telecommunication, gas, and electricity. In these sectors, heavy capital investment is needed and the size of the market does not justify more than a small number of suppliers. As a result, entry is often controlled by the Government through the award of franchises in order to exploit the economy of scale. In accordance with their special

(Continued on page 5)

(Continued from page 4)

privileges, the franchised companies are regulated by the Government to ensure that consumers enjoy good services at reasonable prices. In addition, in a progressive society, consumers expect to get a share of the benefits of technological improvement in these sectors.

In some sectors, for example, electricity, the firms achieve their monopoly position without government franchises, but mainly due to a large efficient scale, learning benefits, and adequate capacity expansion to keep up with increasing demand. In these cases, regulation is warranted even if the Government is not the cause of monopoly.

The recent move by Government regulatory bodies away from rate of return regulation (and the accompanying detailed regulation of business operation) but toward price cap regulation has been blindly criticised by some politicians. However, it represents an improvement over the earlier approach because it creates an incentive for the utilities to reduce cost, provided that the quality of services does not suffer as a result.

Enhanced competition reduces the need for regulation. When the size of Hong Kong's market for these goods and services expands sufficiently, or when production technology reduces the minimum efficient scale, new competition should be introduced through the award of additional franchises. And that seems to be what the Government is doing.

#### **Comprehensive versus Piece-Meal Approaches**

Many advocates for a fair trade policy argue for a comprehensive competition policy, a position taken by Governor Patten in his October speech. There are several dangers about this approach. First, it might require a large bureaucracy to enforce the policy. Second, the policy might go too far and stifle investment incentives. Third, society might be entangled in an endless web of litigations if individuals can initiate suits in the expectation of multiple damage awards.

A step-by-step, piece-meal approach, in contrast, is in danger of developing regulations over time that are complicated and inconsistent. Not unlike the comprehensive approach, there is also danger of abuses on both sides, with producers abusing their market position but inefficient producers and disgruntled consumers abusing the process to harass innocent producers. Nevertheless, such abuses of the system by consumers and inefficient producers must be more serious under a comprehensive approach than under a piece-meal approach since the former entails not only corrective measures, but also preventive measures as well.

I find the approach of the Government as reflected by the view of the Secretary of Trade and Industry Mr. T.H. Chau to be rather sensible. That is, one should look at the evidence with regard to the state of competition and alleged unfair trade practices in particular sectors, assess the adequacy of existing regulations and pro-competitive policies, and if necessary consider alternative remedial options, including new legislation and new institutions.

The Hong Kong Government is perceived to be reluctant to intervene in business dealings, especially through introducing laws to govern business practices. However, to the extent that she wishes to have credible reports on trade practices and the

impact of these practices on competition, any agency in charge of producing such reports must be able to access critical firm level information to determine if there is evidence of anti-competitive practices. If the required information is not already in the public domain, then it seems that there are no alternatives to providing legal power to the investigative units, and the Government some how must bite the bullet.

#### **Institutional Arrangement**

In the Legco debate on Free Trade Policy, some legislators expressed doubts about the Consumer Council's expertise and capability to play a central role in Hong Kong's competition policy. In addition to the question of ability, which might be relatively easy to overcome, there is a more fundamental problem. If the Consumer Council's main objective is to advance consumer interests in general, then it should not be the only party to shape competition policy. What we need is a body that represents consumer interest and producer interest in a balanced fashion. Moreover, for a free enterprise economy to achieve technological progress and dynamic efficiency, innovators have to be rewarded with temporary monopoly profits. It is questionable whether the Consumer Council is in a credible position to take into account these various conflicting considerations.

If the adopted approach to competition policy is piecemeal rather than comprehensive, then a possible institutional arrangement is to set up Ad Hoc Committees to report on the state of competition, including findings about anti-competitive practices, in specific sectors and to make recommendations to the Government. Among others, these committees should include consumer representatives to articulate consumers' interest, business representatives to provide information about the nature of production and supply technology and the logic of specific business practices, and economists to analyze market structures and the effects of business regulation.

There is no denial that the executive branches of the Government are already performing some of the functions of the proposed committees. For example, in the case of regulating the transportation sector, the Transportation Department and the Economic Services Branch can be expected to work with other relevant units to perform analyses on which policy decisions are based. The major differences between the existing practice and the proposed arrangement are that the committees' approaches would be more systematic and their findings and recommendations would be under closer public scrutiny.

#### **Conclusions**

Hong Kong has an evolving policy with regard to the award of franchises, de-franchising, and regulation of franchised public utilities. In addition, there are also industry-specific Commissions and regulatory agencies. However, she has yet to develop a systematic competition policy. As a result, consumer interests might have been slighted in specific areas. An important responsibility of the Government is to gradually rectify the situation without letting the consumer movement go too far.

I believe that the gradual and cautious approach taken by  
(Continued on page 2)

**Leo K. Cheng**  
(Continued from page 5)

the Government is sensible. A detailed and objective study must be done before the severity of any alleged anti-competitive trade practice can be assessed and policy actions can be recommended. Given the step-to-step approach, it seems that Ad Hoc Committees are a more suitable vehicle than the Consumer Council or the Governor's Business Council to provide the inputs necessary for the institution of a competition policy. To take the first step, however, it seems that the