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Making markets work: Can you compete with the elite?

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'The close relationship between governments and big business in developing countries can work against the competition that is needed to ensure growth and poverty reduction.'

Business can be a force for good in development. It plays a huge role in driving the economic growth that is needed to reduce poverty, and create jobs and wealth. But the objective of business is to make a profit, and this does not always guarantee good economic results. Markets needs to be disciplined through competition and/or regulation to ensure they deliver growth and poverty reduction.

The benefits of competition

When people talk about the benefits of competition, they usually talk about reduced prices, improved choice and quality for consumers, greater efficiency, and incentives to innovate which contribute to growth. This is all true, but the benefits of competition are much broader than this. Competition plays a fundamental role in determining the impact of business on the economy, the allocation of resources between consumers and business, and the balance of power between business and the state.

A lack of competition that results in higher prices and higher profits, implies a transfer of resources from consumers to the owners of the companies that produce the goods. In other words, a transfer of resources from the poor to the rich.

Competition and competition policy – and here it is defined quite broadly to include all policies affecting competition, including trade policy, regulation, privatisation, industrial policy, and competition law – play a crucial role in disciplining business, and preventing excess profits and unfair business practices designed to keep out new entrants. The existence of a good competition policy framework allows new firms to enter the market, and helps to create a level playing field between firms, which is important for attracting investment and developing the private sector.

The extent of competition is crucial in determining the impact of globalisation on development, where large multinationals with considerable market power are entering small underdeveloped economies which desperately need the products, investment capital, and know-how that they bring, but which want to avoid the repatriation of excess profits, and the unfair suppression of domestic business. Thus sound competition policy is an important accompaniment to globalisation and liberalisation processes, to ensure that developing countries achieve the expected benefits.

Competition also helps to challenge the dominance of the economic 'elite' that is so often observed in developing countries, where well-connected or closely allied politicians and business people cooperate to extract the economic rents from productive activity, at the expense of society as a whole. This is one of the main reasons why economic growth does not always result in poverty reduction.

Competition allows new entrants to gain a foothold and gives them the opportunity to undercut or outcompete the incumbents, undermining the cosy relationship enjoyed by the few, and reducing the power of cronyism and the returns to corruption. So competition plays an important role in creating economic opportunity for new firms, contributing to private sector development and enabling more people to engage in markets and contribute to economic growth.

Competition, collusion or collaboration?

Fieldwork for a current ODI research programme shows that, in many instances, the existence of an economic elite itself prevents the development of competition as it may weaken their dominant position. What is often observed in developing countries, especially in sectors dominated by large firms, is a very close relationship between business and government, and it is this relationship that often seems to make or break a company's success, rather than a process of competition.

The relationship can often become one of mutual advantage. Sometimes a close relationship involves explicit part or full ownership of business by the state, or ownership by individual politicians or their relatives; sometimes it is achieved through corrupt business dealings; sometimes it is a way for government to meet its own electoral objectives. It can often result in a greater degree of involvement and intervention into business decisions by government. For example, there may be some formal

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arrangement whereby government influences or sets the price at which business sells its produce, or businesses may simply be requested by governments to hold prices down at certain times e.g. when there is a shortage, when prices would otherwise normally rise.

Or governments may expect large businesses to meet other objectives e.g. providing employment and services, such as housing, medical clinics, or even schooling to employees and their families. Government may lean on businesses to make goods available at discounted rates to favoured customers or for government procurement projects. And of course, large businesses are often a major source of tax revenue for the Government, especially where they can take a share of excess profits being made in the absence of competition.

Businesses may have little choice but to meet these requirements. If they do not, there are many ways that governments can make it difficult for them to survive, for example through arbitrary enforcement of regulations, or through effecting long delays in the authorisation of essential imports through customs. But by establishing themselves as a helpful partner of government, businesses may also secure themselves advantages, such as a degree of protection from competition, through import barriers, or through reduced government support for new market entrants. Thus competition itself becomes a bargaining chip in a power game between government and business, as these examples show:

- One company in Sub-Saharan Africa claimed that they were asked by government to provide their product at discounted rates to a new foreign company in another industry that the government was trying to establish in the country. They claimed that when they refused, their punishment was the government licensing of a new entrant to compete with them, thus undermining what had been a long-standing monopoly position.
- Sugar mills in some sub-Saharan African countries face frequent price intervention by government, which has sometimes caused them financial difficulties, resulting in underinvestment which has reduced their efficiency and pushed up costs significantly. But in return they have enjoyed significant protection from imports until now. Prices in such countries have become uncompetitively high though, which is bad for poor consumers and which makes the sector very vulnerable to liberalisation, as neighbouring countries produce sugar much more cheaply.

That big business needs government support in order to survive may also help explain why developing country governments often play quite a proactive role in attracting new, foreign firms to enter particular markets – actively wooing potential investors, often with inducements such as tax holidays, protection from competition, or discounted prices of inputs. This may be needed because the markets in poor countries are unattractive without the additional inducements that governments can provide (e.g. infant industry protection). But in some instances it may be that without clear government commitment and support for a new venture, market entry will not happen, even where there appears to be profit potential.

In principle the influence of government over business could have advantages, e.g. where free market competition delivers undesirable outcomes which need to be managed, or where government uses its power to encourage firms to operate in a way that contributes more to development, or to constrain monopoly pricing in the absence of effective competition. Indeed, some Asian countries seem to have developed very successfully on the basis of strong government intervention in markets. The evidence suggests, however, that there are significant risks that such influence will be misused for rent- seeking purposes and that it will often result in poor economic decision-making. To the extent that this strategy relies on and perpetuates a lack of competition, it can have long term costs for the sustainability and competitiveness of the sector.

Fighting vested interests

This close relationship between government and business creates very strong vested interests opposed to pro-competition (and pro-growth) reforms, as incumbents will oppose policies which may undermine their advantaged position. The best way to tackle vested interests who oppose reform, is to establish and facilitate coordination amongst other interest groups who stand to gain from reform. This includes consumers, both household (who can be mobilised through consumer groups) and industrial, who may gain considerably from lower priced inputs (e.g. confectionery companies can lobby against a lack of competition in sugar production). It also includes potential new entrants to the market, who can make their voices heard through business associations.

If these groups can be mobilised to lobby effectively for reform, this can help to offset the political pressure to maintain the status quo. Competition authorities can play an important role here, in coordinating such groups, publicising the issue and providing evidence of the benefits of reform. Donors can also help support the development of constituencies for reform, by building the evidence base on the benefits of competition, working with civil society to develop a culture of competition, and supporting the establishment of effective competition authorities.

Achieving a sound framework for competition is difficult, and beset by vested interests, but it is crucial to ensuring that markets work to deliver growth and development.

Written by Karen Ellis, ODI Research Fellow (k.ellis@odi.org.uk). ODI is conducting a multi-year research project, investigating the impact of government policy on competition, and the impact of competition on market outcomes, in five developing countries. The results will be published later this year.

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