The Changing Composition of FDI to the Poorest Nations and the Need for a Competition Culture Supported by Regulatory Institutions and Openness

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Summary

Like their wealthier counterparts, the poorest developing economies saw their share of foreign direct investment (FDI) in the form of mergers and acquisitions (M&A), and privatizations rise in the late 1990s. To be sure, greenfield investments still dominated overall FDI inflows, but certain sectors (notably utilities) saw considerable M&A by overseas firms. Without in any way diminishing the potential benefits of overseas takeovers and participation in privatization deals, policymakers need to be aware of—and take action against—the possible deleterious effects that can occur when foreign investors exercise market power against domestic consumers and producers.

A first line of defense is to ensure that domestic barriers to entry remain as low as possible. A second line of defense—which is particularly powerful in tradeable sectors where the distribution channels are not all owned by manufacturers—is to have no policy-induced impediments to trade. A third line of defense is an open FDI regime, which allows other overseas investors to chase profitable opportunities. Unfortunately, bitter experience has taught is that sometimes these three lines of defense are not enough—and that carefully calibrated interventions to support a competition culture are needed. The widespread adoption of competition laws in developing world in the 1990s suggests that this lesson has been learnt. Moving from legislation to legal implementation is the next challenge—and provides the final line of defense against the persistent exercise of market power, be it by foreign or domestic firms.

This note is organized as follows. The next section documents the changing mode of entry of foreign investors into the poorest developing economies in the late 1990s, and discusses some of the rationales for this change. The second section outlines the issues raised by the rise of M&A and privatization activity in the light of existing literature on firm behavior in developing economies. In this section I discuss the beneficial role that openness can generally play in attenuating the market power of foreign investors. The key words here are "generally" and "attenuate," not "always" and "eliminate." Remaining significant exercises of market power can be tackled by competition policy, whose rationale is discussed in section three. In the latter section I also review the growing body of evidence on the beneficial effects of such laws. In addition, the linkages between competition policy, regulatory policy, and privatization are discussed—and brought alive in the fourth section by an overview of the recent analyses of telecoms reform—perhaps the most prominent sector where all of these issues intersect. The fifth section contains policy recommendations and concluding remarks.

The changing composition of FDI to the poorest nations

As is well known, total FDI inflows to the forty nine nations the United Nations classifies as the Least Developed Countries (LDCs) rose sharply through the

1990s (see Figure 1).[1] In 1990, these inflows were less than US $1bn. By 1999, those inflows stood at approximately US$5bn. Although the latter number is only a very small percentage of world FDI inflows[2], for some countries (such as Liberia, Angola, Lesotho, Zambia, Vietnam, and Mozambique), these inflows exceeded 30 percent of gross domestic fixed capital formation in 1999 (UNCTAD 2001, Figure 3.)

INSERT FIGURE ONE HERE

What is less well known is that in recent years the share of FDI that take the form of cross-border mergers and acquisitions in LDCs has risen, reaching nearly 20 percent in 1997. One important component of this cross-border M&A are privatization sales that involve a foreign firm acquiring (at least part of) a formerly domestic state-owned company (see Figure 2). In fact, of the largest 50 cross-border M&A transactions in LDCs during 1987-99, (by value) 42 percent were attributable to privatization (see Figure 3). Foreign investors appear to have a greater appetite for purchasing state-owned and domestic private firms in LDCs than in the past.

[1] The following three criteria are used by the UN to determine which economies are classified as "Least Developed:" (i) a low income per capita (typically $800), (ii) weak human resources (as measured by the Augmented Quality of Life Index) and (iii) a low level of economic diversification (as measured by an Economic Diversification Index), see UNCTAD (2001).

[2] Empirical studies on FDI flows point to the following explanations for the LDC's inability to attract much overseas investment: political and economic instability, corruption, small local market size, poor logistics, transport, and telecoms infrastructure, and large distances from global poles of economic activity. Overviews of such findings can be found in Graham (2000) and Moran (1998, 2001).

INSERT FIGURES TWO AND THREE HERE

In addition, the top 50 cross-border M&A deals were concentrated in seven LDCs—Zambia, Myanmar, Senegal, Uganda, Guineau, Cape Verde, and Mozambique—suggesting that getting the right policy environment for M&As and privatization is especially important for these developing economies (see Figure 4.) Finally, in LDCs such M&As are concentrated in resource extraction, telecoms, and other utilities (see Figure 5).

INSERT FIGURE FOUR HERE

The shift towards M&A and privatization reflects a number of factors—and perhaps the most obvious one is the greater willingness of governments in LDCs to sell off previously state-owned firms. This, in turn, reflects expectations that privatization would strengthen incentives to cut costs, improve productivity, efficiency, customer selection and service, as well as to provide revenue for cash-strapped governments (Megginson and Netter, 2001). Recognition that foreign takeovers can improve managerial efficiency and firm performance also eroded state resistance to cross-border M&As, although this remains a sensitive issue in many economies. Furthermore, the desire to avoid incurring substantial fixed costs associated with setting up distribution networks and alike may account for the shift towards M&A and away from greenfield investments, especially in the service sector. And, the opening up of the latter is in large part

due to the signing of the General Agreements on Trade in Services (GATS) in the Uruguay Round multilateral trade agreement (Hoekman and Kostecki, 2001).

INSERT FIGURE FIVE HERE

The impact of inward M&A: towards a balanced calculus

In principle, inward M&A can offer many of the benefits to LDCs that greenfield investments can, such as technology transfer, access to overseas capital for expansion, improvements in managerial technique, and greater opportunities to market goods abroad. However, the two modes of entry differ in one important respect: inward **acquisitions** initially leave unchanged the number of suppliers located in the recipient economy, whereas greenfield investment typically increases the number of such suppliers.[3] In a wide range of circumstances, increasing the number of firms enhances competition for customers, resulting in lower prices and higher quality or service. Unless a cross-border takeover results in more aggressive pricing behavior, then the shift away from greenfield investments may well come at the expense of forgone potential price reductions for consumers. What is more, a **merger** between an existing foreign firm and an existing domestic firm reduce the number of companies supplying the market which, in the absence of cost efficiencies brought on by the merger itself, will

[3] A wrinkle is when a foreign firm stops exporting to a nation and sets up a greenfield site to supply the same market. The effective number of firms supplying the nation stays the same, even though the production location has changed.

tend to result in higher prices for consumers.[4] This suggests that both inward mergers and acquisitions are less likely to result in price reductions than greenfield FDI.

Even when inward M&A does result in more aggressive pricing, the consequences need not be benign. A foreign investor may want to drive some—or even all—domestic firms out of the market, subsequently enhancing the market power of those firms that remain. This practice—known as predation—effectively involves charging consumers lower prices in the near term (reducing profits), attempting to induce shakeout, and subsequently raising prices (to earn supra-normal profits.) Enunciating the analytical difference between this strategy and more healthy price competition (based on actual cost reductions) is easy, differentiating them in practice is much more difficult (Lott, 2000). Even so, recognizing that predation may occur should be borne in mind in any assessment of the effects of inward M&A.

Foreign investors may engage in other anticompetitive practices, such as collusion, cartelization, and vertical restraints. The first two practices involve tacit or explicit agreements between firms in the same market to raise prices, to fix output or market shares, or to limit investment. Over time, more evidence of such practices in and outside developing economies has come to light (see, for example, Levenstein and Suslow, 2001). For example, Pakistan's Monopoly

[4] The classic analysis of the tension between cost efficiencies and market power enhancement in mergers was presented in Farrell and Shapiro (1991).

Control Authority recently took steps against cartels in such diverse economic activities as ghee, sugar, cement, and cellular phones.[5] Vertical restraints involve agreements between (or sometimes ownership of) firms in different markets, where the objective is to leverage market power in one market into another market (Viscusi, Vernon, and Harrington, 2000). These can include, for example, agreements by distributions not to sell rivals' or new entrants' products—thus erecting a larger barrier to entry to the market.

Three lines of defense against anticompetitive practices…

Policymakers have several lines of defense against anticompetitive corporate practices which, it should be noted, can be carried out by domestic firms too. The three lines discussed below are important components of the domestic business environment, and are valuable for other reasons that those described here. The first line of defense is to have the lowest possible barriers to entry by domestic firms, subject to meeting minimal registration requirements. The number, complexity, and cost of administrative regulations should be reassessed to see if they are not (perhaps unintentionally) curtailing entry into domestic markets. Cross-country evidence suggests that the time and financial costs of meeting entry requirements varies considerably across developing economies (see Table 1). For example, in Madagascar it takes 152 hours to comply with all the requirements to establish a business in that nation's capital. And, in Senegal a

[5] See "Monopoly Control Authority to check monopoly in ghee, cement," downloaded from http:/DAWN.com.

prospective businessperson must spend the equivalent of 1.23 percent of that nation's GDP per capita on application fees and alike. The large variation in costs presented in this Table suggest that there is considerable room for improving entry conditions in the poorest economies (Djankov and others 2001).

INSERT TABLE ONE HERE

The second line of defense, which is of importance in markets with internationally tradeable goods and services, is to have low or no trade barriers. Keen importers can spot international price differentials, and if firms located in an open economy try to raise prices too much, then importers can begin to supply those economies' markets too. Thus, imports can tame market power—a finding that is supported evidence in many developing economies (see, for example, Harrison 1994, and Levinsohn 1993, Tybout 2000, and Hoekman and others, 2001).

Of course, not all markets can be subject to import discipline, and so the third line of defense is to have an open FDI regime. If incumbent firms in an economy raise prices so much that overseas firms now perceive a profitable investment opportunity, then domestic market power may be attenuated through this channel too. As discussed earlier, the downward pressure on prices is likely to be greatest when the overseas investment takes a greenfield form, rather than M&A. Another caveat is that poorer nations, by definition, have smaller markets and—if sunk costs of entry are high (as they can be in certain utilities)—may be able to

support indefinitely only a small number of incumbent firms. Nevertheless, these three lines of defense—which maximize opportunities for domestic and foreign entry—go a long way to mitigate the concerns about foreign investors exercising market power.

Towards a competition culture

But do these three defenses go far enough? Perhaps not. A recent econometric study found that the manufacturing sectors of certain Least Developed Countries are highly uncompetitive. It has been estimated that Nigerian and Zimbabwean manufacturing firms were able to raise prices above marginal costs by over 50 percent. The situation is much worse in Sri Lanka, where on average her manufacturing firms charge prices three times their marginal costs—which indicates such firms are under little competitive pressure (Hoekman and others, 2001).

Here it also is instructive to quote from the judicious conclusion of a recent comprehensive survey of manufacturing firm behavior in developing economies:

"To summarize, because of institutional entry barriers, labor market regulations, poorly functioning financial markets and limited demand, the industrial sectors of developing countries are often described as insulated, inefficient oligopolies. To date, however, there is little empirical support for this characterization. Turnover is substantial in the countries that have been studied, unexploited scale economies are modest, and evidence of widespread monopoly rents is lacking.

The above notwithstanding, it would be foolish to conclude that market power is a non-issue for developing countries. Turnover studies and cross-plant studies of profitability give one a general sense for the extent of competition, but they cover

a limited and perhaps unrepresentative set of countries. Further, they are unlikely to detect isolated pockets of non-competitive behavior.…Finally, many developing countries have privatized natural monopolies during the past decade, and where efficient regulatory agencies have not sprung up to oversee them, non-competitive practices may arise. Careful case studies that collect detailed price data and monitor behavior of the individual players are probably the only means through which convincing conclusions about these problems can be reached." (Tybout 2000, p. 27)

This highlights the need for a fourth—and final—line of defense: competition policy. The objective of this policy is to better allocate a nation's resources, often by attacking entrenched market power which tends to restrict output below competitive levels. This can be done by investigating proposed mergers, and by breaking up cartels and restrictive arrangements between manufacturers and their distributors. Such actions also lower prices, which make goods and services more affordable to the poor. Like visits an operating theater, competition policy enforcement need only be rare, selective, and—as the quotation above suggests—based on a careful examination of the matter in hand. The latter is especially important as officials will need to sort out which explanation best accounts for observed market outcomes, and to take action only if the balance of the evidence suggests that anticompetitive practices are important. Developing the capacity and expertise to accomplish this task with take time but, as discussed below, some LDCs are off to a promising task.

The need to ground competition policy decisions in thorough economic analysis is illustrated by the following example. South African Breweries International (SABI) has deliberately sought to expand its presence through Africa. Through

numerous mergers and acquisitions, it now supplies over half of African consumers' beer purchases (see Figure 6, *Business Africa*, 2001a). A recent acquisition included the purchase of the Madhavi group's stake in Nile Breweries, a firm that supplies an estimated 60 percent of the Ugandan market (*Business Africa* 2001b). The central question is whether these, or potential future, acquisitions will enhance SABI's market power, enabling it to raise prices and earn supra-normal profits. As Figure 7 makes clear, profits earned per liter of beer sold vary considerably across African markets—with margins typically higher in markets where SABI holds a leading market position. These differences may be entirely due to benign reasons (such as cost differentials brought about by superior SABI managerial technique), and the task of the authority implementing the competition policy would be to discern whether observed profit levels reflect benign or anticompetitive underlying causes.

INSERT FIGURES SIX AND SEVEN HERE

The 1990s saw the number of jurisdictions that had enacted competition laws exceed 70 (Palim, 1998). As Table 2 makes clear, this spread is evident too in Central and Eastern Europe and the constituents of the former Soviet Union. What is also strikingly apparent is that nations continue to reform these laws, fine tuning them to their own development needs. Another interesting finding is that most of the FDI into these countries appears to have gone to economies where competition laws have been enacted the longest. To the extent that competition

laws help stabilize the business environment and discourage anticompetitive practices against other firms, these laws may themselves serve to attract FDI.

This growing emphasis on competition policies to enhance resource allocation in an era of integrating markets is supported by a growing body of academic research. Hayri and Dutz (1999) have shown that, even after controlling for the height of national trade barriers, countries with more active policies towards fighting monopoly power tend to see their economies grow faster. In a study of Eastern European and other transitional economies, Dutz and Vagliasindi (1999) found that enhanced enforcement (not merely enactment) of competition policies facilitates the growth of higher productivity firms in an industry—that is, inefficient firms cannot be cushioned by the profits acquired through the exercise of market power. In evidence that is of direct relevance to economies which have not enforced these laws before, Symeondis (1999) showed that greater competition (which leads to lower prices) and shakeout in U.K. industries followed a decision by the British authorities to stop condoning restrictive practices. This evidence—plus the history of European Commission competition policy enforcement (see Gerber, 1998 for a excellent historical account)—reinforces the case for bolstering competition enforcement even during eras of falling trade and investment barriers and integrating markets. For, as European experience has shown, firms respond to greater competition by rationalizing their operations, often through cross-border mergers and acquisitions (Sleuwaegan, 1998).

Similar restructuring can be expected as poorer nations integrate further into the world economy and open their economies to overseas investors.

INSERT TABLE TWO HERE

The experiences of developing countries in implementing competition policy provide important lessons for policymakers too.[6] First, what can be feasibly expected of a competition policy enforcement agency depends in large part on the stage of development. Lack of administrative capacity is clearly one concern—which can be remedied by bilateral and international training efforts—and calls for more proscribed objectives and procedures.[7] For example, poorer nations that are more open to international commerce can probably adopt weaker enforcement standards than landlocked standards—intervening, say, when a proposed merger exceeds a higher threshold market share.

A second lesson is not to overburden competition policy with objectives that other policies may be better able to attain. For example, the aims of Zambia's competition policy include stimulating innovation, bringing about a fair distribution of income, and reducing unemployment (Basant 2001). Arguably, more effective policy instruments exist for securing each of these objectives. Worse still, with multiple objectives enforcement decisions may give prominence to one objective

[6] For a study of competition law and enforcement in seven Commonwealth countries see Basant (2001). De Leon (2001) is another recent contribution that reviews the experience in Latin America.

[7] For two recent surveys of enforcement capacity in developing countries see American Antirust Institute (2000) and World Bank (2001).

over another in a given case—and then the reverse in another. When this happens the private sector receives mixed signals, and competition policy enforcement makes the business environment more—not less—stable. The best path is to assign competition policy the task of maximizing consumer welfare by attacking monopoly power, leaving other objectives to policy instruments better suited to meet those goals.[8]

The third lesson is to recognize the primacy of competition policy principles over sectoral regulation. That sectoral regulators have issued rulings which contravene the objectives of competition policy authorities is not a theoretical curiosum. Tanzania has faced this problem with disagreements between her Communications Commission and her Competition Tribunal. In revising her laws towards sectoral regulation, Tanzania is now expected to clarify these agencies' respective responsibilities and it is envisaged that the Competition Tribunal will act as the final arbiter in disputes with sectoral regulators (Basant 2001). This kind of solution, along with independence for competition policy authorities, helps ensure that the competition culture infuses sectoral regulation too.

[8] An implication is that competition policy should not be used to promote the development of "special" or "strategic" industries. It is difficult to see how competition policy enforcement could be a central plank in a strategy to eliminate market failures that prevent infant industries from growing. Typically, factors such as lack of access to credit and financial markets are a far more important concern.

Competition policy and privatization: Lessons from telecoms reform

The growing role of privatization in attracting foreign investors to LDCs—especially in larger transactions—was alluded to earlier. The interface between privatization policy and competition policy provides another case where the objectives of the latter can be inappropriately subverted. One sector where this is glaringly apparent is in telecommunications. Recent research has pointed to the considerable growth benefits of getting the right policy framework in place for this sector. Economies that "fully" liberalized their telecoms sectors saw their income per capita grow by approximately two percent per annum faster than those nations who did not (Mattoo and others, 2001).

Wellenius (1997) documents the various interests that conflict over telecoms privatization. And, one of the more important groups are government treasuries who often seek to maximize revenues from such asset sales by deliberately offering the purchaser the exclusive right to supply national or international calls. Offering these rights effectively creates private monopolies (to replace the state-owned firm), which can be expected to exploit their market power at their consumers' expense. Wallsten (2000) studied the effects of such exclusive arrangements in developing economies, and his principal results are reported in Figure 8. To be sure, privatization receipts are higher when exclusive rights are granted. In his sample, granting the sole right to supply international calls increased privatization receipts by over 350 percent! Of course, the cost is borne

by the customers who use telecoms services less or not at all. One measure of how much less is the number of mainlines served. As the lower panel of Figure 8 makes clear, exclusive arrangements have detrimental effects over the long term. Even after four years such arrangements reduce mainlines by over a quarter, compared to telecoms operation who did not have such a cozy arrangement and faced actual or potential competitive pressures.

INSERT FIGURE EIGHT HERE

Adopting a pro-competitive perspective also influences the manner and sequence of desirable telecoms liberalization. Such reform includes a number of key choices including whether to allow foreign equity stakes, whether to privatize an incumbent state telecoms provider, and whether to allow competition in either local or long distance telephony. Table 3 summarizes the extent of telecoms reforms in 40 poorer nations during the 1990s.[9] As an indicator of the potential for further reform, by 1999 only 10 nations had foreign equity shares in their telecoms operators and only nine nations permitted competition in either local or long distance calls. In an era where the telecommunications infrastructure is one of the foundations of a competitive more knowledge-based economy, this lack of reform is especially worrying as it creates another factor that increases the disparities between rich and poor nations over time.

INSERT TABLE THREE HERE

[9] This table was constructed from the database reported in Fink and others (2001).

Given the numerous dimensions upon which to reform their telecoms sector, a natural question to ask is which steps should be taken first? Two metrics by which to measure policy reform in this sector are the number of mainlines supplied (per 100 people in the population) and the number of mainlines supplied per telecoms employee. On these metrics Fink and others (2001), in the first systematic study of which sequence of telecoms reform boosts performance the most, found that introducing competition in local telephony before privatization offered the most gains (see Figure 9). Such a move raised the number of mainlines supplied to be population by 25 percent and the number supplied by each telecoms employee by 40 percent. Their results also imply that privatizing telecoms operators before introducing competition in this sector is ill advised. Perhaps this is because privatization creates powerful incentives for the new private sector owner of the telecoms company to lobby or make investments so as to undermine the competitiveness of any subsequent entrants to this sector. These findings reinforce the main message of this section, namely that adopting a pro-competitive perspective—a competition culture, if you will—offers best prospects for maximizing the gains from initiatives such as privatization and attracting foreign direct investment.

INSERT FIGURE NINE HERE

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Ensuring that the benefits of growth are enjoyed by consumers, poor or otherwise, is one of the benefits of adopting institutions that support competitive and open markets. Recent research points to a much more qualified view of the benefits of foreign direct investment, and the appropriate policies for such investment. For example, the claim that foreign investments generate spillovers has been called into question—which is significant as such spillovers provide the externalities-based rationale for promoting inflows of foreign direct investment.[10] Worse still, assessments of the net benefits to developing countries of FDI after tax and subsidy inducements have been made suggest are particularly worrying. For example, Moran (1998) reviewed dozens of FDI projects finding that the cost of FDI sweeteners in many cases exceeded the economic benefits of overseas investment. These findings are as applicable to Greenfield FDI as they are to foreign mergers and acquisitions. This note has gone one step further and argued that, in the context of the least developed economies, foreign investments and privatization measures can create persistent pockets of market power. Such power has no part in a pro-poor development agenda, and aligning competition policy and sector-specific regulatory enforcement efforts to tackle the resource allocations distortions created by firms is becoming increasingly important for developing economies during this era of global integration.

[10] See the thorough overview of the research into spillovers in Hanson (2001).

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