International developments

Japan's competition policy: current and future issues

The following article outlines progress toward reforming Japan's competition policy. It is an edited version of a speech by Professor Akira Goto, an economist at Hitotsubashi University, who spent two months at the Australian National University in August and September 1999. Professor Goto is a member of various committees set up by Japan's Fair Trade Commission (FTC) including the Committee on Chapter Four of Anti-monopoly Law. As a member of the Prime Minister's Regulatory Reform Committee he chairs a group dealing with competition policy reform.[1]

Chapter Four of the Japanese Anti-monopoly Law deals with holding companies, stockholdings by large companies and financial institutions, interlocking directorates, and mergers and acquisitions. Most of these regulations are related to the concept of **aggregate concentration** that refers to concentration in a whole economy, not in a specific, single market. Section 9, sub-section 9.2 and s. 11 of the Anti-monopoly Law prohibited the establishment of a holding company, and placed a limit on the stockholdings of large firms and financial companies. The committee on Chapter 4 recommended that a holding company should not be banned and the law was changed in 1997 although some restrictions remain. I will discuss these restrictions later.

Through my work on the Regulatory Reform Committee, I am, in effect, trying to reform Japan's Anti-monopoly Law from the outside. Reforming the Anti-monopoly Law differs from reforming other regulations such as those controlling transportation. Regulatory reform of the transportation sector essentially means abolishing old, unnecessary regulations that had protected the industry at the expense of consumers. In contrast, anti-monopoly law especially its enforcement, should be strengthened because the discipline imposed by a competitive market becomes more important as deregulation proceeds. It is of vital interest to maintain competitive, well-functioning markets so these and not government will discipline industries. Of course there are provisions in the Anti-monopoly Law that are outdated and should be removed, such as those in Chapter 4 on aggregate concentration.

Japanese economy and competition policy

To begin, I will briefly outline the historical developments of Japanese competition policy. The Japanese competition law is called the Anti-monopoly Law, and was introduced in 1947 by the Allied Forces as an integral part of the 'economic democratisation policy'. Other important measures of this policy included land reform and labour reform. Anti-monopoly law was introduced to maintain competitive markets and prevent the resurgence of zaibatsu, which was considered responsible for the war, and was dissolved as a part of the economic democratisation policy package.

The Anti-monopoly Law has been changed several times. The original Anti-monopoly Law

1 For more detailed information on competition policy in Japan, see *Competition Policy in Japan*, Akiro Goto and Kotaro Suzumura (eds) Tokyo University Press (English version is forthcoming from Oxford University Press).

was stringent, especially toward companies combining. For instance, it prohibited companies from owning other companies' stocks. This turned out to be unrealistic because individuals were not wealthy enough to buy stocks previously owned by zaibatsu stockholding companies, zaibatsu families and the companies that belonged to the same zaibatsu. Therefore, this section has been changed and companies gradually allowed to own other companies' stocks. Still, stockholding companies were prohibited until 1997. Former zaibatsu firms tried to maintain their ties without using a holding company, mainly through mutual stock holdings and thus becoming a keiretsu. However, one should keep in mind that the term keiretsu is not well defined.

In the 1950s and 1960s, competition policy had been relatively weak while industrial policy was vigorously promoting mergers to create big companies that could compete with larger foreign firms, and providing various forms of legal cartels such as rationalisation cartels and recession cartels.

The oil crisis of the 1970s ended the Japanese economy's double-digit growth, and consumer prices increased sharply. People panicked and started to stockpile daily items such as toilet paper. This series of events created strong anti-business sentiment. General trading companies were especially targeted as they were seen to be manipulating supply of these goods. The Government was pressured to do something about it and various new laws were introduced. Among them were the new restrictions on the stockholding of large firms and stricter restrictions on stockholding of financial institutions. This is the first time the Anti-monopoly Law was amended to strengthen it. However, it should be emphasised that the change in the Anti-monopoly Law at that time was largely a response to a sharp price increase and was conducted in the midst of anti-big business sentiment. In retrospect it appears there was a mismatch between policy objectives and policy tools.

In the late 1980s, trade conflict between Japan and its trading partners, especially the United States, intensified. This reflected Japan's large trade surplus. The cause of this large trade surplus, in turn, was largely a macro-economic factor, namely oversaving. Nevertheless it led many trading partners to scrutinise the openness of the Japanese economy. Trading partners demanded that Japan should strengthen its competition policy so foreign firms could access the Japanese market. This and other factors led to various measures to strengthen competition policy in the 1990s. The amount of surcharge on cartels has been increased; new, strict guidelines on distribution were announced, and many legal cartels previously exempted were made illegal. The number of personnel at the FTC was increased. In particular, the Bureau of Investigation of the FTC expanded from 129 people (28 per cent of total FTC staff) in 1989 to 236 people (44 per cent of total) in 1996. Some of these measures had been already taken, or recommended by academics, but it would not have occurred without pressure from trading partners, notably the United States.

Aggregate concentration and its regulation

As mentioned earlier, aggregate concentration refers to the concentration not in a single, specific market but within an entire economy. The issue of aggregate concentration occurs as firms are diversified over multiple markets. In pre-war Japan, zaibatsu, that is, large conglomerates, engaged in various activities, including, banking, manufacturing, mining, and importing and exporting. The paid up capital of the four major zaibatsu was about one quarter of the total economy.

Section 9 of the Anti-monopoly Law had prohibited the establishment of holding companies. In addition, the stockholdings of large non-financial companies and financial companies had been restricted under sub-section 9.2 and s. 11.

This type of regulation of aggregate concentration in competition law can be seen only in Japan and Korea.

The reason for regulating aggregate concentration is therefore largely historical. The Allied Forces considered zaibatsu responsible for the war. Because of pre-war zaibatsu, development of a middle class, which was said to be essential for democracy, was hindered and the wealth of the nation was in the hands of a few. Thus, they were dissolved. One of the main aims of the Anti-monopoly Law was to

prevent the resurgence of zaibatsu. As holding companies were considered to be the headquarters of zaibatsu, it became illegal to create such companies.

In 1997 this part of the Anti-monopoly Law was amended and only holding companies likely to cause 'excessive concentration of economic power', were banned. Sub-section 9.2 on the stockholding by large firms was relaxed to promote restructuring of companies and creation of venture firms. It was decided to maintain s. 11 but it was to be discussed along with other legal framework related to the financial sector. In March 1998 the Law on Bank Holding Company was enacted.

Background of the amendment in 1997 was as follows. First, there was a strong need to restructure companies both in the financial and manufacturing sectors as the recession deepened and became prolonged. Financially troubled firms tried to merge with one another to survive. Other firms tried to sell their unprofitable divisions. However, under the Japanese employment system in which job security is important, radical restructuring is not easy. The Business Federation as well as the Ministry of International Trade and Industry argued that holding companies can provide a convenient vehicle for restructuring and an alternative organisational architecture.

Second, the environment has changed. A half-century has passed since the war and the first enactment of the Anti-monopoly Law. Various institutions have been established to ensure democracy. And competition is increasingly global. Under these circumstances, the need to prohibit holding companies seems to have disappeared.

Two theoretical points should be considered when discussing whether the regulation of aggregate concentration is necessary. First is the relationship between democracy and aggregate concentration. As mentioned earlier, regulations on aggregate concentration were introduced because a high aggregate concentration was considered detrimental to democracy. However, we do not have enough evidence to conclude that this is so. The relationship between the degree of aggregate concentration of a country and democracy of that country is not straightforward. One can find a country with high aggregate concentration and democracy at the same time. There are several studies on the relationship between income distribution and democracy, but the result is inconclusive. If high aggregate concentration was considered detrimental to democracy because high aggregate concentration inevitably leads to highly unequal income distribution as maintained by the Allied Forces after the war, we have to say that that relationship is not confirmed by these studies.

However, sometimes, as in Japan right after the war, and in developing countries today, social and political institutions that support democracy, such as freedom of speech, fair election, regulation on political donations and education, are not well developed. Then regulation of aggregate concentration can be adopted as a second-best way to achieve democracy.

The second theoretical point to be considered is the relationship between aggregate concentration and economic efficiency. The relevant issue in economics is the strategic behaviour of multi-product firms and its efficiency implications. This includes cross subsidisation and predatory pricing, reciprocal dealing, and multi-market contact. The welfare implication of these strategic behaviours is ambiguous. Efficiency can be hindered or promoted by these practices depending on circumstances and conditions. Therefore, it is difficult to argue that aggregate concentration should be regulated on efficiency grounds. First, the relationship between strategic behaviour mentioned above and the degree of aggregate concentration is not straightforward. Second, the welfare implication of these strategic behaviours is unclear. And third, it can be checked at the individual market level with the existing Anti-monopoly Law when inefficiency occurs because of the strategic behaviour of multi-product firms.

I recommended that the Fair Trade Commission lift the ban on holding companies. They were reluctant. The first draft of the amendment of s. 9 was still very restrictive and proposed to allow holding companies only as exceptions. However, after much discussion inside and outside the Diet, holding companies were finally allowed, although some restrictions remain.

Current and future problems

There are four main issues affecting competition policy in Japan: globalisation, technological progress, deregulation and new economic thinking.

Globalisation

In many industries, the market is becoming increasingly global. This creates new problems for competition policy. One of the problems is how and who should deal with international mergers and alliances between companies. This problem is essentially a procedural one that can be solved through cooperation between competition policy authorities of different countries. Japan's Fair Trade Commission is now preparing a cooperative agreement with the United States, and it will be finalised this Fall.

The more difficult problems caused by globalisation are those that lie at the nexus of trade issues and competition policy. It is widely recognised today that a regime of free trade complements domestic competition policy. To achieve free trade, trading partners must have effective competition policy, and to maintain competitive domestic markets, international trade and investment play an essential role.

The difficulty that arises from the complementary nature of competition policy and international trade is the spillover effect. That is, the competition policy of one country affects not only the welfare of that country but also that of trading partners. There are two ways this can happen. Either ineffective competition policy of a country makes anti-competitive behaviour of domestic firms possible, and this hinders market access by foreign firms or the competition policy authority of a country treats domestic firms and foreign firms differently.

In the first case, foreign firms do not necessarily lose, while domestic welfare usually declines. For example, a cartel reduces the welfare of consumers. But high prices caused by the cartel creates opportunities for foreign firms to enter. Thus it is in the interest of the country to strengthen its competition policy.

A foreign country can deal with spillovers in several ways. It can use another country's competition policy and demand the investigation by that country's competition authority. If its own markets are affected, it can use its own competition policy including applying the policy extraterritorially. However, we should be careful because extraterritorial application can be used unfairly, for instance to shift rents from foreign firms to domestic firms. In the second case, if market access is hindered by the discriminatory application of competition policy by foreign government, the WTO can be used. To solve these problems, international cooperation in competition policy, including with the WTO, is extremely important. The issues that should be discussed include prohibition of government sanctioned cartels, prohibition of export and import cartels, and equal treatment of foreign and domestic firms under competition policy.

Another important issue is the abuse of anti-dumping measures. This certainly reduces the competition in the market of the importing country, and often reduces the welfare of an exporting country as well. Anti-dumping measures have been used by developed countries to stop low-priced imports from developing countries. It is used extensively by the United States, European countries, Canada and Australia. However, in recent years, developing countries have started to use anti-dumping to protect their domestic firms as they reduce their tariff and non-tariff barriers. Anti-dumping now poses a serious threat to free trade. One way to deter protectionist use of anti-dumping is to make it consistent with the treatment of predatory pricing in competition policy.

In competition policy, predatory pricing is restricted to the cases in which dominant firms force the exit of competitors, and the reference price is average variable cost as a proxy for marginal cost, not full cost. If the criteria applying to anti-dumping measures are changed and predatory pricing criteria used, there will be a more restrained use of anti-dumping measures.

Technological progress

Technological progress or innovation is increasingly seen as the critical factor for 'competitiveness' of companies or nations. On the assumption that some element of

monopoly is needed for companies to invest in research and development, competition policy has been practically relaxed in many countries. For instance, cooperation in R&D among companies is allowed in most countries today. However, collusion or monopoly is not the prerequisite for innovation. It is true that some sort of mechanism that enables companies to appropriate the fruit of their investment in R&D is needed. But that does not necessarily require a monopoly or collusion. It is often the case that competition promotes innovation. In any event, it is important to keep in mind that innovation does not always require relaxation of competition policy.

A related issue is the association between intellectual property protection and competition policy. As Japan is moving rapidly to so-called pro-patent policy, finding the right balance between intellectual property protection and competition is increasingly important. Another increasingly important issue arising from technological progress is network externality. In brief it seems that the recent Microsoft case suggests that the dominant position of Microsoft might be achieved not only through network externality but also through such traditional strategic behaviour as raising a rival's costs and bundling. The problem of monopoly from network externality per se might not be so serious or persistent.

Deregulation

Past efforts at deregulation in Japan saw significant progress in many areas. In telecommunications, Nippon Telegraph and Telephone was privatised in 1985 and broken up into two regional companies and a long distance company under one holding company last month. In the energy sector, importation of refined petroleum products such as gasoline was liberalised in 1996, and the wholesale stage of the electricity industry was deregulated. Deregulation at the retail stage is proceeding. There was a new entrant in the domestic airline industry, leading to significant reduction of airfares. In the retail sector, the Large Scale Retail Store Law that restricted the establishment of large retail stores was relaxed, leading to new openings for discounters of such goods as electrical appliances and liquor. Financial sector reform also made significant progress, including the deregulation of interest rates, foreign transactions, and entry restrictions into the securities business by commercial banks.

Ongoing large-scale deregulation means that an increasing area of economic activities is now disciplined by market forces instead of government. Therefore it is of vital importance for the Japanese economy to maintain a competitive market. Certainly, international competition plays an important role in maintaining competition, but is limited to certain industries. The role of competition policy is of critical importance.

New thinking in economics

Economists are now concentrating more on the strategic behaviour of firms and its welfare implications with the help of game theory. The result is that many things are possible depending on the conditions. It is difficult to derive simple per se rules from these analyses. For instance, cartels are per se illegal in most countries. However, from a theoretical stand point, it is not difficult to think of cartels that promote efficiency. Of course, simple rules are important from the point of administrative cost containment, but everything falls into the rule of reason category from the economic theory point of view. It is a challenge for the FTC to incorporate these new developments in economic thinking and, at the same time, maintain an efficient operation.

All of the problems mentioned above indicate that the role of competition policy is increasingly important, and at the same time, difficult. To maintain effective and transparent competition policy, an innovative approach and more resources for competition policy authority are needed.