

## A Not-Entirely-Free Economy Needs Some New Rules

By Simon Pritchard

In the 1970s, economist Milton Friedman was at the vanguard of an intellectual challenge to the prevailing Keynesian orthodoxy of big government and corporatist policies to correct “market failure.” His television documentary, *Free to Choose*, lionized a vibrant Hong Kong, which had kept faith with nineteenth-century laissez faire traditions and largely kept government out of private business. The currency was freely convertible, wages and prices were unregulated, officials had minimal influence over the allocation of private capital and the market’s animal spirits ran free.

The government basked in its paragon status and for most of the next twenty years few outsiders were rude enough to point out that a brutally competitive internationally-traded goods sector, mostly in manufactures, sat uncomfortably with a domestic economy typified by cartels and collusion. Because Hong Kong got the big things right, it could afford to coddle its domestic industries with exclusive operating franchises and reject antitrust action. That view changed in the mid-90s, but it has taken a decade for serious discussion to begin on introducing a comprehensive competition law. In June this year the government is scheduled to release its thinking on adopting legislation after a one-year study by a task force led by the financial secretary. Without committing himself, Chief Executive Donald Tsang has indicated a willingness to adopt a new competition regime.

Hong Kong has historically adopted a piecemeal approach to competition control. In most situations private companies face no legal sanction for fixing prices, limiting supply and entering market-share agreements – activities deemed hard-core cartel activity in most jurisdictions. Most industry regulators have no remit to manage issues of dominance or monopoly. Instead, a matrix of overlapping agencies monitor competition on a “sector-by-sector” basis: banks are subject to prudential regulation with competition-policy elements; bid rigging on public sector contracts is illegal but not in the private sector; property developers, contractors and sales agents are subject to almost no competitive restrictions; natural monopolies such as the power utilities since the 1960s have been subject to agreements regulating their returns; bus and rail companies must seek government approval before altering passenger fares yet the monopoly piped-gas provider faces no tariff controls. Port operators’ blanch at divulging the most basic operating data, while import monopolies across Hong Kong’s land border benefit from an opaque licensing system. The odd-couple in this mix are the telecommunication and broadcast sectors, both of which are governed by specific competition laws, empowering oversight agencies to regulate their behavior, dominance issues and ownership changes.

The idea of competition regulation sits uncomfortably with Hong Kong’s business dominated polity. The civil service prizes its “flexibility” in tackling industry-specific issues and has a visceral dislike of universal, rules-based mechanisms. Functional constituency legislators, representing individual trades, are elected with a predictable remit to oppose antitrust proposals.

In 1996, this axis vigorously opposed a recommendation by the Territory's quasi-governmental Consumer Council to introduce a competition law aimed at countering entrenched domestic cartels and restrictive practices. Instead, the government created an advisory body – the Competition Policy Advisory Group (Compag) – that was chaired by senior officials but lacked powers to investigate private companies or deliver sanctions. A 1998 statement of principles by the group claimed Hong Kong, being a small externally orientated economy, had no need to enact an all-embracing competition law. Its broader argument was that Hong Kong excelled in most other metrics of economic freedom – low taxes, small public expenditure, secure legal and property rights, sound money, open trade and tight regulation of credit, labor and business - and hence should be treated differently. The specter of Hong Kong's nimble business sector being suffocated by excess regulation and frivolous law suits has been raised in defense of the status quo.

Despite such protestations, recent criticism by economic bodies such as the International Monetary Fund and the World Trade Organization stung an administration which prizes its status in such clubs. Most Asian economies have anti-trust statutes and even Singapore, a long time opponent of economy-wide competition regulation, is in the process of legislating. Ironically, China's proposed antitrust law could directly impact Hong Kong interests such as port operators due to their dominance in many Eastern seaboard ports. The Chinese Ministry of Communications in April this year threatened to impose fines on shipping operators, such as Hong Kong's Orient Overseas Container Line, unless they stopped coordinated increases in terminal handling charges – a levy estimated to add 35 billion yuan (about US\$4.3 billion) to Chinese exporters' transport costs.

But the trigger point for Hong Kong's present competition policy review was heavy local criticism that the administration had collusive ties with local tycoons, whose conglomerates dominate property development, utilities and the biggest supermarket chains. In particular, former Chief Executive Tung Chee-hwa faced heavy criticism from progressive politicians and the generally conservative business sector for granting lucrative projects such as the Cyberport high-technology park to close former business associates. In response, big business groups sense change, as shown by the Hong Kong General Chamber of Commerce subtly shifting its position from implacable opposition to an antitrust law to apparent agnosticism.

Functional-constituency legislative council members predictably remain to be convinced and, in May this year, they voted down a motion brought by the democratic grouping calling for legislation. Donald Tsang's political calculus seems to be that an activist policy will win popular public support and deliver a tangible policy success ahead of his anticipated 2007 election via an electoral-college system that, while containing only 800 members, at least has heavy representation from small business interests that don't belong to any cartels. International pressure for legislation receded when competition policy – along with other so called “Singapore issues” – were dropped from the Doha round of WTO negotiations. But the administration dislikes its isolated position on a policy stance increasingly regarded as a basic totem of economic modernity. Fears have also been raised that other states may seek to exert extra-territorial jurisdiction over Hong Kong companies and individuals in the absence of comity agreements.

Lastly, there is also a slowly dawning realization among local elites that antitrust law would deliver tangible benefits to an economy that still faces embedded high costs and competitive

threats from centers such as Shanghai (financial services) and Shenzhen and Guangzhou (producer services). The ad hoc approach looks to have reached its practical administrative limits given the specialized nature of competition policing and politicization of basic economic decision-making. Officials increasingly accept the argument that a single antitrust agency is best qualified for the role. And it has escaped no one's attention that exposing the Territory's telecommunications sector since the mid 1990s to explicit de-regulation, backed by a competition law, has resulted in massive consumer choice and some of the world's lowest service prices.

Economists favor competitive markets because they produce an optimal allocation of resources, allowing consumers to buy their desired quantity of product at a clearing price achievable by the most efficient producers. Cartels disrupt this process typically by manipulating supply or more directly by artificially inflating prices. Internationally, such behavior is increasingly equated as simple theft from consumers with criminal sanctions to match. In Hong Kong, such a consensus on the "evil" of price fixing and collusion is only slowly emerging. The debate is hamstrung by a lack of data to verify the economic costs imposed on the wider economy and welfare losses to consumers. The Consumer Council has outlined multiple cases of prima facie abuse, and simple international price comparisons of sectors subject to cartelization indicate many local dominant players earn excess returns.

For example, the Council found that between 2000 and 2002 Wellcome and ParknShop - the dominant two supermarket chains with an approximate 70% market share - upped average prices by 3.6% cent during a period when general retail prices fell 5.6%. In a representative case of an industry group regaining pricing power through concerted action, a noodle-makers trade association last year advertised in local newspapers saying it had agreed with suppliers to increase prices by up to 20%. A widespread system of retail price maintenance has product suppliers dictate to retailers a minimum price they must charge consumers. In 2000, the French supermarket giant, Carrefour, withdrew from Hong Kong after just four years, having been blacklisted by suppliers for selling products below the minimum agreed re-sale prices.

High street abuses garner most public attention, but cartel activity is usually most pernicious in basic industries typified by homogenous product offerings. Property development is concentrated with a handful of firms, with four accounting for up to 70% of new flat sales. The 1997-2002 deflationary down turn saw smaller players exit the market while big firms led a successful lobbying effort, forcing the government to jettison its subsidized homes-for-sale program and scrap all restrictions governing their right to retail new flats before actual construction, a normal practice in Hong Kong. Since late 2002, the government's land policy has swung back to explicitly crimping supply of new development land and keeping prices high, a feature of Hong Kong's political economy inherited from colonial days but arguably supported by property interests.

More explicit instances of hard-core cartel activity are seen in the construction and building materials sector where collusive behavior is considered endemic. Bid-rigging on public sector contracts may be illegal, yet a group of building contractors was last year cleared by a court of criminal behavior on a public housing contract due to insufficient evidence. They had established a front company to co-ordinate bids; each paid a "membership fee" of HK\$500,000 and split HK\$55 million (about US\$7.1 million) of excess profits. The judge found no evidence of anything other than "sharp business practice."

It seems likely that Donald Tsang will propose some change to the territory's competition regime. Softer options include an expansion of Compag's role, giving it investigative powers and authority to name and shame offenders. This approach would satisfy local business interests but not garner widespread popular support. It would be at odds with both international developments and mainland policy as Beijing inches toward a comprehensive antitrust law.

International experience suggests that a successful competition regime requires an independent authority, backed by statute. Barrister and Civic Party legislator Ronny Tong argues the body should have full investigative powers over companies and their professional advisers. Among other powers, it should have the power to prosecute, apply for injunctions and fine offenders. The Consumer Council states that exemptions should be strictly controlled and time-limited. The authority should announce block exemptions, based on public interest issues, rather than allow companies to apply individually. It should be noted that big Hong Kong firms have won exceptions from non-statutory stock exchange listing rules after aggressive lobbying campaigns.

Competition law started by regulating company behavior and has expanded in advanced jurisdictions to managing issues of dominance and market concentration. At a minimum, legislation would need to tackle hard-core cartel activity such as price fixing, bid rigging and agreements to divide market share. So called "vertical restraints"—such as retail price maintenance, exclusive dealerships and tied sales—must also be tackled in any credible regime.

Regulating vertically integrated industries such as port services, trucking and food importation is complicated by the fact that mainland and Hong Kong companies run seamless operations on both sides of the land border. Such jurisdictional issues are not unique to competition policy; they vex securities regulators in both Hong Kong and the mainland. Local business opposition to the Telecommunications competition law has been concentrated on an amendment regulating mergers and acquisitions activity.

Whether a first stage competition law should contain provisions for regulating abuse of collective dominance and control of takeover activity is open to question. A number of local competition law advocates argue for a two-track approach with an initial law focusing on tackling bad behavior. The Consumer Council has stated concerns that forcing an immature competition authority to tackle complex takeover cases at its inception would overburden the agency and bring the new policy into disrepute. That may be a political bargain that local business groups are prepared to make rather than face forced divestiture of business units due to excess dominance.

Much has changed since Milton Friedman elbowed his way past Hong Kong's teeming market traders, preaching free-market home truths to American television viewers. These days, facing the competitive pressures of globalization and a rising tide of consumerism, most modern economies have embraced market-friendly policies and made antitrust rules a key plank of their reforms. Arguably, Hong Kong never was the *laissez faire* paragon heralded by U.S. free market thinkers and think tanks [rather, it served a useful didactic purpose in furthering their own ideological views], but the acclaim certainly helped its officials maintain the status quo.

But as Hong Kong matures into a potentially alert, high income economy, facing complex policy choices, the old model of sector-by-sector discretionary competition regulation looks untenable. Consumers won't wear the rip-offs and, as the biggest locally-based firms extend their operations seamlessly into China, the resulting business arrangements make an internationally-proven, rules-based competition system the most logical way forward. ■

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