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Understanding Competition in Hong Kong

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The proposition that competition in the market benefits the consumer is widely accepted. This is the rationale for enacting antitrust laws and fair trade acts to foster competition in the marketplace. Unfortunately the accumulated evidence shows that these laws and acts have not accomplished their objectives; even worse, they have often thwarted competition, reduced economic efficiency, and damaged consumer interests.

This undesirable state of affairs stems from a fundamental misunderstanding of the process of market competition, which economists are now beginning to rediscover. Since antitrust laws and fair trade acts were put in place more than a century ago, the economic view of competition has changed dramatically. If Hong Kong were to establish a competition policy, it is important to avoid well-known mistakes of the past. An appreciation of the best economic ideas on competition policy will be useful.

Sources of Monopoly Power

The rationale for government intervention to foster market competition assumes that the unregulated economy is monopoly prone. An implicit requirement for this view is that firms can develop and maintain monopoly power without any substantial aid from the government. This self-sufficiency theory sees market concentration as an important inhibitor of competition from within the industry, and large capital requirements, intensive advertising, and "predatory" pricing are viewed as important obstacles to competition from outside. This view has dominated the economics profession since 1925.

Yet, prior to 1925 and since the time of Adam Smith, economists have always viewed monopoly power as the derivative of government intervention into the market. The interventionist theory considers factors emphasized by the self-sufficiency theory to be relatively unimportant sources of monopoly power so long as the government does not use its coercive power to create and police legal barriers to competition. This viewpoint suggests that the regulation of transport, the enforcement of licensure, the control of prices, the legal restrictions imposed on entry and on the use of competitive tactics, the granting of franchises, and the creation of public monopolies are the origins of more serious monopoly problems.

Such a view has been revived since the 1970s, and I believe that this is by far the most important source of monopoly power in Hong Kong.

These two theories lead to very different views as to how we should cope with monopoly power. Should we try to reduce the degree of government intervention, or should we try to restructure industries and to modify the competitive tactics used by firms? Those who advocate the self-sufficiency theory will answer this question by seeking more intervention, while those who see the source of monopoly in government intervention will seek to limit the role of government in the economy.

Self-Sufficient Natural Monopoly

Natural monopoly is the textbook case of self-sufficient monopoly. Scale economies alone explain why monopoly power can be maintained in the face of competition from rivals. The standard policy response to natural monopolies is to regulate their behavior through schemes of control that set rates of return, price caps, etc. More recent theories have questioned the need and wisdom for such regulation.

The "theory of contestable markets" argues that the existence of monopoly profits encourages entry from potential rivals. This threat imposes sufficient discipline on the incumbent to refrain from using monopolistic pricing so as to make entry unattractive to potential rivals. This argument is particularly strong in the case of multi-product natural monopolies where rivals can enter niche markets; telecommunications provide an important example of this.

The "theory of competition for the field" argues that would-be natural monopolists, none of whom have yet entered the market, could compete for the right to serve the market, and the market would be one in which each rival would adopt the best technology if elected to serve the community. Competition for the field would encourage firms to give up monopoly profits and induce them to set prices more competitively.

Both theories argue that even natural monopolies face competition in subtle ways that compel them to set prices competitively in much the same way as a competitive firm. The commonly presumed link that exists between pricing behavior and market structure is therefore severed. If markets are contestable, and fields can be competed for, then even natural monopoly firms may cease to behave as monopolies.

The Market Concentration Doctrine

The textbook theory also presumes that the further away real markets are from the atomistically competitive structure, the more likely the industry is to set price monopolistically. However, there is no reason to presume that existing firms in a concentrated industry are not rivalrous. Furthermore, competition can come from outside the industry. How existing and potential rivals can be kept from competing without some government-provided restrictions on competition has never been answered adequately.

Empirical testing of the market concentration doctrine has relied on a search for a correlation between industry structure and profit rates. Professor Joseph Bain confirmed the correlation for the U.S. in a study published in 1951. Subsequent studies, however, have shown that, once account, advertising expenditures, and capital requirements are taken care of, the correlation between concentration and profit rates no longer existed.

It has been argued that the intensive use of advertising and capital constitutes a self-created barrier to new entrants and preserves an existing firm's market power. But this makes little sense if all firms are free to compete equally in advertising and capital spending. By contrast, government-imposed restrictions on advertising and capital requirements are often effective barriers to entry. For example, restrictions imposed on advertising by the tobacco industry and the medical profession penalize new entrants.

Nevertheless, the logic of much of antitrust and fair trade policy in the U.S. and elsewhere is derived from the market concentration doctrine. In effect, these have unwittingly prevented firms from exploiting scale economies, have lowered productivity, discouraged entry, and reduced competition.

Interventionist Monopoly

The key to sustained monopoly power is the ability of an industry to restrict or retard the expansion and utilization of productive capacity. Government can offer to industry much greater powers of coercion to accomplish this end than can be supplied by industry itself. It can restrict competitive entry through the use of licensure and certificates, which, by convenience and out of necessity,specifically penalize prospective entrants.

An investment by an industry to obtain government aid to monopolize, say through regulatory restrictions, is likely to yield much more control than the investment of the same sum without the aid of government. First, to the extent that a private agreement among firms to restrict output is likely to succeed, a firm would find it profitable to remain outside the agreement; the firm could then expand its output to take full advantage of any higher prices brought about through the private efforts of other firms. Second, excess profit from

cartelization would attract entrants who are not parties to the agreement and threaten the stability of the cartel.

The purpose of public regulation of industry is to protect the consumer. It is often assumed that intentions and consequences will coincide. A contrasting and increasingly accepted view put forth by George Stigler in 1971 argues that the consequence of public regulation of industries has been to advance industry interests at the expense of the consumer. Stigler's logic is compelling: Public regulation of industry substitutes economic decisions with political choices that reflect the relative strengths of organized groups. Industry incumbents, especially large ones, have the greatest stake in the outcome of public regulation and are willing to devote considerable resources to ensure that their interests are protected. The incentives of consumers, impartial outsiders, bureaucrats and politicians to defend the public interests are typically no match for industry incumbents. The outcome of political choice, for those in democratic societies, almost always favors industry rather than the consumer.

The evidence accumulated through research raises increasing doubts about self-sufficient sources of monopoly and increases our estimate of the importance of government regulation to protect industries from competition. This is not to suggest that the search for private conspiracy should be abandoned, but that much more attention should be devoted to governmental interventions.

Competition in Hong Kong

Any assessment of the state of competition in Hong Kong has to be highly preliminary, given the limited amount of empirical research on the subject. For this reason, the formulation of policy at the present stage has to rely more on adopting an appropriate approach to the problem. In other words, one has to identify the primary source of Hong Kong's monopoly power: self-sufficiency or interventionist.

Monopoly power will not be found in Hong Kong's manufacturing industries, which are highly competitive, since firms have to compete in the world market. Even the quota-determined textile and garment industries are highly competitive because the government prudently allocates transferable export quotas on the basis of historical performance of existing firms. Since these quotas can be freely transferred on the open market, there is no barrier to entry, and market power does not develop.

Monopolies, if they exist, are to be found in the services sector. An advocate of self-sufficient monopoly would focus his attention on highly concentrated industries. He will be surprised to find that average firm size and market concentration have been falling over

time in most Hong Kong industries, with the possible exception of the retail trade business, where franchised stores and supermarkets have grown rapidly. Allegations have been made that some of their pricing and sales strategies appear to reflect market power. Economic theory does not support such allegations. Incumbent firms do not have an exclusive right in deploying such strategies. Any new entrant is free to imitate and to further innovate. Supermarkets, department stores, and other retail outlets often have vast economies of scale due to their inventory, distribution, and information management systems. The decline of the neighbourhood "mom and pop" store is a universal phenomenon reflecting the growing economies of scale in this industry that has nothing to do with market power. Furthermore, the profits of franchise stores also reflect returns to investments made in establishing brand names.

There are obvious areas in the service sector that are severely inflicted by inadequate competition, and they all have to do with government intervention. These include (1) government monopolies, (2) cartels, (3) licensing, (4) government franchises and regulations.
(1) Government monopolies include postal services, water supply, and the like. Railways and mass transit systems, however, have to compete with other forms of private transportation services. Certain security services, like fire and correctional services, are provided monopolistically by the government in Hong Kong. By far the most important government monopolies are in the social services that provide health, housing, and education. These areas, which are likely to take up more and more resources over time, are plagued with problems arising from the lack of competition.

The Hospital Authority is a near monopoly provider of hospital services, controlling some 90 percent of hospital beds in the territory. The Housing Authority provides housing to some 50 percent of domestic households. The dominance of the state in these sectors has created enormous inefficiencies and inequities and is the source of much popular dissatisfaction. Some of these issues have been investigated in two separate studies commissioned by the HKCER.

In education, government and aided schools constitute 87 and 75 percent of all primary and secondary schools. Aided schools are not strictly government operated, but since more than 90 percent of their funding come from the government, they are heavily regulated to the point that they are almost indistinguishable from government schools. The monopoly of the state in education is reinforced by policies that prohibit local private schools from charging higher tuition fees to improve the quality of schooling. This limits the ability of private schools to compete effectively against aided and government schools. Unless greater competition is introduced into education, the quality of education will inevitably decline even as we pour more money into the system.

(2) The best known government-supported cartel is banking. Under the Interest Rate Agreement, the cartel sets deposit rates that are binding on all banks. Banking appears to be highly profitable because of the larger differential between deposit and loan rates. Some of these cartel profits are dissipated through non-price competition, for example, through over-branching. Since the cartel does not restrict entry, competition among existing banks, and from potential entrants, is still present. In the long run, the cartel arrangement does not make banking appreciably more profitable, but protects the market position of banks with large deposit bases. But since banks are forced to compete on economically-inefficient non-price measures, society as a whole suffers.

(3) Licensing is a pervasive form of regulation and its most pernicious effect is to facilitate cartelization. The most damaging economic effects are in the area of occupational licensing. The most obvious ones are in the medical and legal professions. The medical cartel is especially powerful because of its ability to control entry and maintain cartel discipline through, for example, admission privileges to hospitals, bans on advertising, and the self-disciplinary powers of the Medical Council.

Over the past decade, licensing arrangements have expanded rapidly to many occupations. Malpractice and accidents cannot be entirely prevented in any line of business, but they have been turned into opportunities to lobby government for interventions. While this may improve the standard of services provided, it also means higher prices and less competition. It is difficult to imagine how Hong Kong can emerge as a high value-added service center if its professions are highly cartelized.

(4) A variety of private services operate under either government granted franchises that restrict entry, or government-imposed schemes of control to regulate profits and prices. These include telephone and telecommunications, broadcasting, television (terrestrial, satellite, cable), aircraft maintenance, air cargo terminals, air terminals, container terminals, buses, and minibuses. The presence of large scale economies has often been the justification for granting franchises. But this is odd since natural monopolies do not need franchise protection if entry is not feasible given demand conditions. The case of power supply in Hong Kong illustrates the point: Entry into the power industry has not occurred even though existing companies have not been granted a franchise.

Franchises should be limited in scope and confined to those areas that exhibit large scale economies. Some franchised industries produce a great variety of heterogeneous products and services, not all of which are characterized by large scale economies, and these should be supplied competitively. Regulation of natural monopoly franchises is a challenging task in the

best of circumstances because outsiders, including regulators, simply cannot possess the same information that is available to the monopolist producer.

The regulatory problem is particularly difficult in industries where technological advances are rapid so that new products and services are introduced continuously and production costs fall rapidly. Franchises granted in an earlier period become an obstacle to competition; telecommunication services is a case in point. What is even more important is that the changing technological landscape alters the way industries should be structured in order to produce efficiently. The Murdoch plan to acquire HK-TVB shares was stalled by anachronistic regulations in the Television Ordinance. This prompted Murdoch to acquire a majority shareholding in STAR-TV, a satellite broadcaster, where regulations have yet to be formulated and cast into legislation.

The transportation system is characterized by a rich variety of organizational forms. Passengers are served by railways and mass transit systems that are independently incorporated organizations with 100 percent government equity holding. Private firms operate tunnels, ferries, trams, buses, and minibuses under franchises granted by government. Taxis and maxicabs operate under licensing arrangements. International air travel is governed by air service agreements, and the government maintains a policy on permitting only one local airline to fly on one route. All forms of passenger transportation are heavily regulated with respect to fares, routes, entry, or some combination of the above. Studies about the economic consequences of government intervention in this area are few and badly needed, but surely it does not require a great deal of imagination to realize that government regulations retarded the entry of maxicabs in the 1960s and the introduction of Citybus in the 1990s.

Conclusion

Liberalization of many regulated industries and professions, and privatization or corporatization of government-provided services, will do much to enhance competition in many areas of Hong Kong's growing service economy. It would be a serious mistake if our efforts to promote competition in Hong Kong should be directed at preventing market-driven mergers and acquisitions, prohibiting firms to adopt competitive pricing and marketing strategies, and forcing markets to become artificially less concentrated.

One should not be surprised that in a small city economy like Hong Kong’s, the level of market concentration will necessarily be high in some industries. What one must guard against is using the coercive power of government to erect barriers to entry, limit competition, protect cartels, and preserve monopolies. The fact that average firm size and market concentration have been falling in most industries in Hong Kong over time should convince

the advocates of self-sufficient monopoly that there is no reason to presume that the markets in Hong Kong are monopoly prone, except in those areas where there is government intervention.

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