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A Neo-Institutional Analysis of Vertical Integration and Its Implications for Antitrust Enforcement in Developing Countries

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SYMPOSIUM

THIRD ANNUAL LATIN AMERICAN COMPETITION AND TRADE ROUND TABLE

A NEO-INSTITUTIONAL ANALYSIS OF VERTICAL INTEGRATION AND ITS IMPLICATIONS FOR ANTITRUST ENFORCEMENT IN DEVELOPING COUNTRIES

*Ignacio de León**

I. INTRODUCTION

Conventionally, social scientists examine the reality of developing countries in order to emphasize the existence of special traits and features in those societies that deserve special attention. The aftermath of this analytical exercise is the development of ad-hoc normative principles guiding policy enforcement. The conclusion, according to which developing countries need "stronger" competition enforcement, is a sub-product of the assumption whereby market failures and resource misallocation is more severe compared to other countries. Asking the question whether some special competition principles should apply to the case of developing countries reveals this analytical bias.

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This paper contends that before examining whether social resource allocation in developing countries is "worse," and whether special competition policy principles should apply to correct the failures, it is important to bear in mind the limitations within which the analysis is made. To begin, the assessment of whether resource allocation is "good" or "bad" is contingent to the existence of an "optimal" resource allocation against which reality can be compared. Is this possible to do in the analysis of real markets in order to draw policy conclusions?

The practical impossibility of ascertaining a standard capable of assessing reality properly, leads to the impossibility of defining whether certain agreements are competitive restrictive or competitive enhancing. This is particularly relevant in the analysis of vertical restraints, where the restrictions on competition are not always considered a welfare loss.[1] As W. Comanor and P. Rey assert, "[t]he foreclosure of firms from upstream suppliers or downstream distributions is a longstanding problem for competition policy. At times, it has been strongly condemned, but in other periods it has been considered primarily efficiency-enhancing and not challenged at all. This vacillating approach towards the problem of vertical foreclosure reflected its uncertain treatment in the economic literature. As this treatment has varied, so have policy standards."[2] Conventional theory appears to have intrinsic epistemological limitations in the assessment of reality, leading to the formulation of erratic normative standards, which are in turn reflected into policy recommendations.[3]

For these reasons, this paper takes an alternative route. Rather than assuming the existence of ad hoc traits arising out of the perceived failures in resource allocation in developing countries, this work attempts to define an alternative positive and normative understanding of the nature of firms and markets, leading to different policy recommendations. This paper argues that the uncertain essence of the business environment where firms interact in the real world force them to adopt business strategies that restrict the "freedom" of those econom-

1. *See* COMPETITION POLICY TOWARDS VERTICAL FORECLOSURE IN A GLOBAL ECONOMY (L. Waverman & W. Comanor eds., 1996).
2. *Id.*
3. *See id.*

ic agents with whom they deal, in order to seize business opportunities which would otherwise remain unexploited, and would lead to a reduction of social welfare. Therefore, the normative conclusions arising from this analysis do not judge market allocations by comparing them against ideal optimal allocations. Instead, they evaluate how conducive institutions are to enabling entrepreneurs to discover new business opportunities, thereby enhancing social welfare. In essence, this equation focuses the policy maker's analysis on the importance of permanent institutional building, rather than on attempting to intervene in markets whenever they do not replicate "optimal" outcomes.

In this paper, I will explore the problems of vertical integration and the emergence of the firm through the lenses of neo-institutional economics. In order to examine these problems, I will use the experiences of the Venezuelan beer, pharmaceutical and cold drinks industries.

II. NEO-INSTITUTIONAL ANALYSIS OF FIRM INTEGRATION.

Organizations are essential to enable entrepreneurs to undertake activities that they cannot pursue in isolation.[4] However, conventional theory does not fully address the economic tenets and implications of this phenomenon. In particular, they do not explain why firms exist at all and how inter-firm division of labor comes about. Instead, it assumes the existence of given production functions that represent the maximum output obtainable from different input combinations.[5] This representation of productive possibilities neglects the roles of organization, knowledge, experience and skills. For a long time, the neo-classical theory of the firm could not render a plausible explanation of the firm, which remained confined to a "black box."[6] Conventional industrial organization regards

4. Organizations are here taken as encompassing any form of inter-firm cooperation among entrepreneuers, regardless of whether they are formalized into explicit arrangements or not. They include a vast array of corporate structures, business practices, and patterns of regular behavior.

5. *See* G.B. Richardson, *The Organization of Industry*, 82 THE ECON. J. 887-888 (1972).

6. Neo-classical theory was never interested in the nature of the firm, which was regarded as a sort of anomaly in the market system, whose emergence did not fit into it basic premises about the interaction between the forces of supply and demand. As recently as 1981, F. Hahn referred to the firm as a mysterious

markets and firms incompatible, the latter being considered a suspicious mechanism whereby entrepreneurs manipulate otherwise efficient market outcomes. Thus, at the most, neoclassical firms are regarded as, "islands of planned coordination in a sea of market relations."[7]

Mainstream theories do not acknowledge how organizations emerge and why, thus hindering a fuller understanding of the causes for the growth of firms, which unquestionably affects the capacity of policy makers to design and implement competition policy.[8] After all, this is a policy that needs an appreciation of the inner reasons why firms grow and compete in a market economy. How firms grow and why are they efficient mechanisms for entrepreneurs to allocate resources in a context of uncertain social relations? What are the implications of this novel analysis to competition policy, particularly in developing countries?

Thus, in this paper I will explore how, under an alternative institutional viewpoint which emphasizes process and change, market arrangements currently prohibited or restricted by antitrust statutes appear to be the very expression of different degrees of co-ordination, the efficiency of which becomes evident in the long-run. In the light of these alternative

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entity. *See* F. Hahn, *General Equilibrium Theory*, *in* THE CRISIS IN ECONOMIC THEORY 131 (D. Bell and I. Kristol eds., Basic Books 1981). The neo-classical theory of the firm does not examine its nature and therefore leaves many aspects in the dark.

7. This expression was coined by G.B. Richardson, following the findings made by R. Coase about the nature of the firm. *See* Richardson, *supra* note 5, at 883; R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA N.S. 380, 386-405 (1937). In this work, Coase argued that firms emerged whenever using the market system in order to obtain inputs is more expensive than planning, due to the existence of transaction costs. These costs of doing business force entrepreneurs to organize production through hierarchy rather than by resorting to market exchanges. However, still in the 1970's, Coase protested for the lack of attention by mainstream scholars to the essence of his insights, arguing that his paper often had been quoted, yet little understood. *See* Coase, *Institutional Structure of Production*, *in* ESSAYS ON ECONOMICS AND ECONOMISTS 5 (1994).

8. More recent studies in the field of industrial organization regard the firm as a structure created for the solution of the incentive problem created by the agent-principal relationship. However, these improvements in the conventional view still present a faulty explanatory basis for appraising the subjective nature of the knowledge held by those interacting within firms and market organizations. *See* N. FOSS, ON THE RELATIONS BETWEEN EVOLUTIONARY AND CONTRACTUAL THEORIES OF THE FIRM (Dep't of Indus. Econ. and Strategy, Working Paper No. 97-4, 1997).

normative standards, we will explore the enforcement experiences in certain, selected Venezuelan industries.

A. The Problem of Co-ordinating Investments in Decentralized Market Settings

Any explanation of market competition and of the reasons why entrepreneurs may be tempted to restrict it through exclusive dealings and other means must begin with the analysis of the essence of the market context where entrepreneurs are required to make investments. Stepping in the shoes of businessmen forces us to consider the elusive environment where investments are made, which is characterized by sheer uncertainty.

To understand the essence of market uncertainty, consider the situation where producers are all hit by an increase in demand. By how much should they increase production? The information found in other firms' investment decisions which would be necessary for calculating optimal investments is not readily available to anyone. Entrepreneurs may conjecture, of course, but these guesses are dependent upon the estimates of other firms, which would seem to lead to infinite regression and sheer uncertainty.[9] The transmission of information is decisive in the functioning of decentralized market systems, because only in this way can entrepreneurs eliminate their uncertainty in part, and co-ordinate their activities successfully. In market economies, individuals are independent of central direction, yet their activities are interrelated by a network of organizations which allow transmission to occur throughout

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9. This is exemplified by Keynes' famous beauty contest. Market knowledge is not only fragmented but also construed on the subjective basis of "expectations" pervaded by sheer uncertainty. Keynes demonstrated in his beauty contest example how mutual expectations lead to the sheer uncertainty that commonly pervades markets and generally, social life. The speculative nature of the decisions market participants adopt in their transactions is similar to a beauty contest whose winner is chosen according to the reciprocal expectations of the deciding judges. In Keynes' example, each judge casts his votes according to what he considers other members of the jury will decide, but since none of the judges possess certainty as to the decisions of the rest, he does not possess an objective fact on which to base his decision either. Each will guess on the basis of everybody else's guessings. Hence, their decisions will inevitably be based on sheer or genuine uncertainty. *See* J.M. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 156 (1964).

the system.[10]

In order to make information available, firms engage in a variety of restrictive conventions, either in contractual form or simply as self-imposed routines.[11] These restrictions provide mutual boundaries aimed at providing some chance of predicting the conduct of other businesses with success.[12] These boundaries also leave open the possibility for businesses to reconsider their respective positions should new problems arise. In this way, parties give tentative assurances about their commitments. Stated differently, organizations enable entrepreneurs a tentative knowledge about the conduct that other economic agents might pursue; the nature of economic organization is thus decisive in encouraging entrepreneurs to invest.[13] Richardson clearly states this point, which is neglected by neo-classical "omniscient" models, "[W]hat commonly fails to be recognized, . . . is that the possibility of forming reliable expectations is not independent of the particular market conditions which define the model employed. [On the contrary] it is the availability to entrepreneurs of this information . . . which is a function of the nature of the particular form of economic organization or system within which they are presumed to operate. [Therefore] the extent to which an entrepreneur can obtain market information can be shown to depend on the nature of the prevailing economic organization . . . ."[14]

Any forecast of future levels of demand is inevitably imprecise, but that does not relieve firms from committing themselves to investments today to meet future demand.[15] Because of sheer uncertainty, firms must develop devices to reduce their uncertainty to a level where they will have sufficient confidence to make investments.[16] This is important for firms because once an investment is made, it is unlikely that the investing firm can withdraw without suffering losses.[17] Hence, managers must be certain that other firms are committed to what they believe are their commitments; in other words, that

10. *See* G.B. RICHARDSON, INFORMATION AND INVESTMENT 30 (1960).
11. *See id.* at 67.
12. *See id.*
13. *Id.* at 29.
14. *Id.* at 29-30.
15. *See id.* at 52.
16. *See* RICHARDSON, *supra* note 10, at 50.
17. *See id.*

their expectations will not be frustrated. As Schumpeter contends, "Enterprise would in most cases be impossible if it were not known from the outset that exceptionally favorable situations are likely to arise which if exploited by price, quality and quantity manipulation will produce profits adequate to tide over exceptionally unfavorable situations provided these are similarly managed."[18] Organizations spring either in the form of self-imposed routines or through contractual commitments ensuring that vital information is generated and passed on to all those involved thus creating such "exceptionally favorable situations."[19]

Firms must know that such favorable conditions will be "there" when the time comes, otherwise, they will refrain from investing.[20] Anticipated knowledge in the form of reliable expectations is essential for establishing the present level of investments that firms are willing to make today to meet future aggregate demand.[21] But such knowledge does not relate to "objective" future circumstances which, after all, are pure speculation; it relates to the subjective perception of the investor that other market participants will have a certain set of beliefs about what the future will bring.

The volume of investments will ultimately depend not so much on increases or reductions in future aggregate demand (a fact that only a prophet could predict), but on the volume of both competitive and complementary investments that each firm hopes others will commit today.[22] Entrepreneurs do not know for sure what these volumes are. Even if they communicated their intentions to the rest, others would have to trust them and align their conduct accordingly. However, trust is not built on mere communication, for entrepreneurs may be tempted to cheat to obtain an advantage.[23] Something else is necessary.

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18. J. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY 89-90 (1942).

19. *Id.* at 90.

20. *See* RICHARDSON, *supra* note 10, at 49

21. *See id.*

22. *See id.*

23. This is the classic prisoner's dilemma situation where some parties seek to gain advantages by cheating the rest. These situations call for intervention to discipline members of the group. *See* A. DIXIT AND B.J. NABELUFF, THINKING STRATEGICALLY (1991). The application of game theory models in the law is explored in D. BAIRD ET AL., GAME THEORY AND THE LAW (1994).

Entrepreneurs speculate about the levels of investment other firms will make in the event of a foreseen increase or reduction in future aggregate demand.[24] For this reason, they must identify the minimum amount of information required, and the different conditions which permit access to it.[25]

The devices which entrepreneurs employ to gather information may take multiple forms, but what they all have in common is that they consolidate the expectations of market participants by reducing their uncertainty to tolerable levels.[26] Note that legal formalities represent a mere additional consideration in the process of building business trust. Explicit arrangements through which price information is made available to entrepreneurs may take several forms which are either structured into formal legal arrangements or not. Thus, the form adopted by organizations does not, in principle, depend on the legal form chosen by entrepreneurs. Rather, it depends on the position that each market actor holds vis-à-vis the rest (both competitors and customers). The goal is to adjust ex-ante to the behavior of other firms in the system in order to minimize possible losses resulting from misleading interpretations of the content of the commitments negotiated.

Such adjustment can take alternative forms, depending on the kind of relationship that the concerned entrepreneur has with the others. It is possible to distinguish between the adjustment that rival firms seek to make with respect to their share in an uncertain future level of aggregate demand, and the adjustment that firms seek with their customers and suppliers to ensure a minimum level of commitment in response to such an uncertain aggregate demand.[27] In this respect, firms may be placed either in a competitive or a complementary relationship.[28]

First, firms may be put into a competitive relationship.[29] In this case, consumers regard the commodities they offer as similar products, or more technically, effective substitutes. Herein, the profitability of the investments of one entrepreneur

24. *See* RICHARDSON, *supra* note 10, at 50.
25. *See id.* at 32.
26. *See id.* at 29-48.
27. *See id.* at 50.
28. *See id.* at 49-87.
29. *See id.* at 30-31.

will be reduced by the investment plans that others implement.[30] Therefore, he will be induced to enter into more or less formal communication with his competitors, to avoid making mistakes on the amount of resources he devotes to production. Underestimating others' capacity or willingness to invest may result in excessive future output and waste for all.[31] At the same time, entrepreneurs are guided by the opportunities in sight to attempt to attain the highest possible level of investments in order to maximize profits. Each entrepreneur will bear an internal tension between following the rule or routine laid down by all, which would give everyone (including him) more certainty, and breaking the rule if that should ensure him a better chance of maximizing profits.[32] Therefore, these agreements and routines do not ensure that entrepreneurs will not violate them (or expect others to violate them) should the particular circumstances dictate it.

Second, firms may be placed in a "vertical" or "complementary" relationship.[33] Here, the profitability of one investment is increased by making another; for example, where the increased availability of one product increases the demand for another, or where the output of one firm provides an input for the manufacture of another. Like firms making competitive investments, those making complementary ones must have information available in order to be encouraged to invest.[34] In other words, the entrepreneur has to determine the minimum amount of information required, and the different conditions that would permit access to it.

In this case, investors need to be sure that other entrepreneurs will commit a minimum volume of complementary investment. Here, the entrepreneur willing to satisfy a predicted demand for the production of widgets by seizing a profit opportunity may require complementary firms to make a minimum investment for the production of some required inputs. However, firms in one industry may not be prepared to expand with-

30. *See* RICHARDSON, *supra* note 10, at 30-31.

31. *See id.* at 50.

32. *See* J. KAISLA, MARKET PROCESS AND THE FIRM: SOME INDICATIONS OF RULE-FOLLOWING AND ENTREPRENEURSHIP UNDER GENUINE UNCERTAINTY (Dep't of Indus. Econ. and Strategy, Working Paper No. 98-17, 1998).

33. *See* RICHARDSON, *supra* note 10, at 31.

34. *See id.*

out the assurance that others will follow suit. Even where no explicit assurance is available, there may be a strong presumption that the necessary investment will take place. In the ongoing process of informational change, entrepreneurs must have access to the information necessary to adjust production to market changes successfully, so as to particularize a general profit opportunity into profit opportunities for each of them. These conditions rest on the premise that everybody else will behave as expected.

In addition, firms may be competitors in respect to one product, and complement each other in respect to another. Firms that were initially competitors in one market may develop some differentiation, making their respective products seem less like substitutes in the eyes of consumers, and eventually not as interchangeable.

Both competitive and complementary investments determine the alternatives with which each entrepreneur is faced. Therefore, their combination encourages the negotiation of alternative corporate arrangements through which entrepreneurs seek to reduce their uncertainty about future market conditions, in particular, to ensure the future volume of investments that other firms may make. In the next section we examine how these arrangements come about.

B. An Institutional Theory of the Growth of the Firm

1. The Firm as an Institutional Instrument to Offset Market Uncertainty

In the context of uncertainty described above, successful coordination of investment plans to reap profits requires the existence of certain natural or contrived restraints on freedom to seize shares in the profit opportunity.[35] Natural restraints differentiate products and markets, thus making it possible for some entrepreneurs to seize profit opportunities by displacing others. They are the result of differing natural conditions imposed on different traders which are the creation of the structural conditions of the market concerned. Natural restraints comprise, for example, restraints on production such as economies of scale in production. It may not be profitable for a new-

35. *See id.* at 69-70.

comer to penetrate an industry if the minimum efficient scale produces additional output sufficient to cause a large fall in price, despite its apparent high levels of profits or low efficiency levels. However, rather than viewing them as entry barriers in the conventional sense of preventing individuals from attaining what is, in any case, an unattainable Pareto ideal,[36] economies of scale are regarded as inevitable limitations on the production possibilities given the state of current technology.[37] In addition, there are also restraints limiting the ability of firms to increase their sales, rather than their output, such as the "goodwill" or reputation of certain firms enabling the attachment of customers,[38] which deserve a similar treatment. Moreover, location or transportation costs may also permit inefficiency or deliberate supply restriction. Similarly, the legal protection afforded to trademarks or brand names may create inevitable difficulties for other firms when placing their competing products in the market. Similarly, albeit to a lesser extent, product variety may dispense some protection, though not much, since the nature of consumer demand changes.[39] Natural restrictions will seldom seriously impede competition. On the other hand, they do not need to make information available. Thus, they cannot guarantee to promote efficient adjustment.

By contrast, contrived restraints are caused by the purposeful action of entrepreneurs that limits the course of action of the contracting parties, and are relevant for the purposes of our normative study.[40] It is necessary to realize that contrived arrangements cannot be considered "restrictions of freedom" as such. Freedom is only obtained when entrepreneurs have alternative courses of action available. In the conventional perspective there is no such freedom. Yet, as this section explains, the very need for seizing business opportunities requires entrepreneurs to "foreclose" the opportunities of others, and to anticipate them in seizing the opportunity open to them. Otherwise they would be impeded from obtaining a competitive gain, and would not be inclined to make investments at all. For this

36. *See id.* at 42.
37. *See id.* at 125-126.
38. *See id.* at 65.
39. *See* RICHARDSON, *supra* note 10, at 55-59.
40. *See id.* at 58.

reason, it is somewhat misleading to think that contrived restraints somehow impede others' courses of action. An opportunity equally accessible to all is an opportunity lost to everyone.

It is important to examine their relationship with the creation of informational conditions appropriate to successful coordination adjustment. Entrepreneurs get the information necessary to invest on the basis of approximations and "educated guesses" based on the conduct of those they interact with (competitors and clients) and the kind of productive activity that they intend to undertake. There are several signals they look for in order to form reliable expectations about the commitments of firms making complementary and competitive investments. For example, they may rely upon the expectation that the status quo of their trading relations will remain unaltered.[41] They may be persuaded that competitors will not make a move unless circumstances change;[42] or that such moves, if they should happen, will follow a pattern.[43] (For example, seeking to enhance production to retain the same market share). Alternatively, they may rely upon a perspective of the feasibility of competitors seizing such an opportunity.[44] If they know that competitors will be unable to seize the opportunity for economic purposes, it will be as if they had never known. Finally, they may rely upon the level of perceived loyalty of their consumers, or of their competitors.[45] To adjust their offers to future demand, entrepreneurs must protect their markets from any undercutting by potential competitors. Consumer loyalty is essential in this calculation. For this purpose, they may develop a differentiated product, based on the reputation or particular attributes of the goods they sell, or on lower transport costs, or on the location of the goods or services they provide. They may also develop a particular "goodwill" which differentiates the quality of the service they provide, as for example, treating loyal customers better, or offering rapid delivery; servicing facilities; policies of special customer treatment, etc. Another strategy may be to maintain prices irrespec-

41. *See id.* at 53-54.
42. *See id.* at 53.
43. *See id.*
44. *See id.* at 57.
45. *See* RICHARDSON, *supra* note 10, at 65.

tive of changes in demand. If prices are flexible, it is not possible to ascertain the magnitude of the demand changes for which producers should plan.[46] In connection to this, waiting lists, advance orders and other similar phenomena arise as a result of price rigidity, but do not necessarily entail inefficiencies; they may well be indicative of future sales.

At times, however, entrepreneurs may have to enter into a variety of more formal restraints of differing strengths and duration, which would restrict their freedom of action. These arrangements may take two forms. First, entrepreneurs may endeavor to secure their individual investments by entering into agreements with their competitors.[47] These arrangements may take the form of price alignment, market sharing agreements, or tacit understandings to avoid ruinous competition in a particular line or product.

Second, producers may increase the security of their individual investments by developing special links with their suppliers or clients.[48] For example, they may enter into exclusive dealings to ensure custom for the entire future period. Where raw materials are involved, it is difficult to develop goodwill or product differentiation. In these cases, it may be better to ensure trade by contracting a quantity of the commodity for sale at a future date and at a fixed price. This is, of course, the rationale justifying most exclusive dealings and vertical restraints.[49]

Organizations adopt their particular shape as a result of the conditions that the markets in which entrepreneurs operate impose on them.[50] They do not necessarily stem from the "intentions" of entrepreneurs to engage in unfair restrictive trade practices. Rather, the choice of these arrangements depends on the level of information they are supposed to convey, which is correlative with the perception that each entrepreneur has of those others (competitors and customers alike) with whom he deals (trusts) and with the complexity of the productive processes involved in the particular activity. In other words, organizational choice is constrained by the length of the

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46. *See id.* at 66.
47. *See id.* at 67.
48. *See id.* at 65-66.
49. *See id.* at 66.
50. *See id.* at 74-77.

relationship (as new circumstances emerge) and complexity of knowledge (as knowledge of other realities encourages the revision of initial plans). Information costs in this subjective sense are therefore essential in shaping the particular organization sought by entrepreneurs. The optimum size of a firm will be determined not so much by the scales of economy associated with any particular operation, but by the number of complementary operations requiring planned co-ordination. The length of time required for productive purposes and the complexity of production are ultimately responsible for the size and shape of inter-firm co-operation. In the following sections we examine these questions in more detail.

2. The Organizational Role of Trust in the Market Process Setting

An effective level of trust between entrepreneurs is essential in encouraging them to make complementary investments. The intensity of commitment which will reveal how willing they are to integrate their activities for the common interest, will depend to a large extent on the length of time that both parties envisage their relationship to last.

In principle, mutual trust depends on the length of time within which both parties are certain about the commitment of the other. As we have indicated above, contractual formality is contingent on the level of certainty and the length of time that parties can foresee it lasting at the present time.

In this context, the form of organization chosen by entrepreneurs will depend on the level of opportunity to frame the conduct of each participant, without losing the flexibility needed to adapt to unforeseen changes. The longer the period envisaged, the more flexible the investment program. But the longer the contract extends into the future, the more likely it is that uncertainty is increased due to unforeseen events. This is also likely to restrain the entrepreneur from modifying his plans to meet unexpected developments. The point will be reached where the greater predictability yielded by contracts does not justify the loss of flexibility involved; for this reason, coordination through market interaction can never be perfect and firms will inevitably engage in forms of vertical integration.[51] The

51. *See* RICHARDSON, *supra* note 10, at 81.

unavoidable imperfection of economic information will therefore limit the willingness of entrepreneurs to enter into contractual arrangements that could increase the supply of market information.

Entrepreneurs cannot rely on the wording of a contract, and must therefore rely on an analysis of past behavior, which involves knowledge that cannot be quantified. The conditions for supply (quality, quantity, specifications, etc.) cannot be fully specified, and therefore cannot replace goodwill and reputation. This information cannot be completely expressed though contractual arrangements.

Thus, where parties are unwilling to accept obligations with respect to their future behavior, cooperation cannot take place. In these cases market transactions replace cooperation. Here, there is no continuing association.

It may be difficult to arrange a prospective return through long-term contracts in proportion to the risks that parties are assuming if such risks, relating to class problems, are unknown.[52] For example, one party may be required to make heavy investments in exchange for a return several years ahead. In this regard, long-term contracts are only one way to ensure control of the firm responsible for complementary investment. There may be other ways of ensuring compliance and further control, such as establishing special price conditions. Another solution, when the risks are high (say, due to faulty contractual enforcement procedures), is to set up a more intimate form of cooperation than a contract. The two companies might form a subsidiary in which they both possess equity interest, or might decide to merge.[53] With regard to this, Fukuyama argues that firms may resort to alternative "unofficial" alliances, such as family bonds, to increase the level of trust that cannot be gained through official channels in "high trust" societies.[54]

For this reason, the longer the relationship is between investors, the more important the links to eliminate uncertain-

52. *See id.* at 84.

53. *See id.* Obviously, under this corporate form, parties still would be related under a contractual bond, but such a link would be more complex in nature, and regulated under more severe conditions than a simple contract.

54. F. FUKUYAMA, TRUST: THE SOCIAL VIRTUES AND THE CREATION OF PROSPERITY 23-24 (1995).

ty are because the parties will have more trouble identifying possible changes.[55]

Naturally, an effective level of trust is not determined by a single factor. Other factors come into play which influence the level of reliability that entrepreneurs can reasonably expect from each other. Amongst these factors, the number of alternative suppliers or customers is paramount, as this will give participants a measure of actual or potential contract alternatives. Entrepreneurs acquire information about other market participants from several sources. In the first place, they look at their numbers. If, for example, entrepreneurs have fewer clients, their need for evidence of commitments is likely to be stronger; therefore, they tend to integrate vertically in these cases. By contrast, with larger groups, firms tend to rely on the aggregate supply of complementary investment to influence their investment decisions. If an entrepreneur fails to make a deal with one participant, he knows he is likely to find another participant to deal with. For this reason, the extent of coordination of complementary activities depends on the degree of development of the country within which they are undertaken. In a more advanced country, with a large manufacturing sector, the output of one industry is likely to have a large and varied number of outlets so that there is no need for an acute complementarity between the investment decisions of any particular units.[56] In less developed countries, with fewer firms, any increase in output would have to be absorbed by a small number of complementary firms.[57] Integrity would be strong, and profitable investment by one producer might depend on the expansion of the others.

3. The Development of Knowledge Capabilities Inside Firms

A second factor determining an entrepreneur's choice in favor of a given organizational arrangement is the complexity of productive activities which developed through joint action.[58] Such complexity has to be undertaken by human organizations embodying appropriate experience and skill. Firms carry out

55. *See* RICHARDSON, *supra* note 10, at 81.
56. *See id.* at 85.
57. *See id.*
58. *See* Richardson, *supra* note 5, at 888.

an extremely large number of activities related to the discovery and estimation of future wants, research, development and design, marketing and transformation of physical goods. These activities require the appropriate knowledge, experience and skills: command of a particular technology, skill in marketing or reputation in a particular market. These are essential to understanding why firms sometimes co-operate and why they sometimes act as rivals. It is also important in understanding why they develop new products and make innovative improvements to existing ones.

Firms perform a myriad of productive activities, including manufacturing, sales and services, consumer support, research and development, and so forth. All these activities require "capabilities," which may be undertaken by a single firm or by several firms linked together with contractual bonds.[59] In the face of uncertainty, firms create "reserves" and develop "capabilities" of skills and knowledge, which enable them to cope under any unexpected circumstances.[60] Under this perspective, and Adam Smith's ideas on the division of labor,[61] firms tend to specialize in the activities for which their capabilities offer comparative advantage.

The nature of productive activities exploited by entrepreneurs will determine whether certain capabilities held by a single firm will suffice for this purpose. In other cases, it may be necessary to contract other firms which possess different capabilities in order to exploit the activity successfully. Thus, firms develop around closely complementary capabilities, and inter-firm outsourcing subsequently results if the activities involved are "dissimilar." Entrepreneurs enter into cooperative relations to gain access to upstream or downstream activities because the activities concerned are complementary. Indeed, in these cases it would not be convenient for a firm to undertake "dissimilar" activities because that would bring diseconomies of scope and/or increased informational costs. It is preferable to develop cooperation through inter-firm arrangements such as

59. *See id.* The capabilities theory contrasts with the contractual explanation followed by the neo-classical authors. *See generally*, N. FOS, CAPABILITIES AND THE THEORY OF THE FIRM, (Danish Research Unit for Industrial Dynamics, Working Paper No. 96-8, 1996).

60. *See id.* at 4.

61. *See* Hahn, *supra* note 6, at 8.

long-term contracts, joint ventures, licensing agreements, and so on.

Also, capabilities evolve on an ongoing basis, thus changing the landscape of cooperation agreements, firms and markets.

Initially, firms comprise undifferentiated capabilities, but entrepreneurial discovery eventually leads firms to differentiate product lines.[62] "Imagination, rather than information in any ordinary sense, is what entrepreneurs require in order to discover new ways of combining resources so as to meet consumers" desires; production functions exist unknown to entrepreneurs only in the sense that musical tunes await discovery; in either case originality, rather than the possession of "information," as considered exclusively hitherto, is what is required for successful new combinations to be produced."[63] Therefore, the variety of production lines is inextricably linked to the discovery process that shapes competition: "the scope of entrepreneurial, or competitive activity, is therefore much greater in reality than in the so-called purely competitive model."[64]

The activities of firms trading in apparently different activities may be more similar than they appear. At first sight, a firm may seem to be acquiring another which is engaged in different activities, but the activity could be interpreted as similar if the firm is bought to restore efficient management before reselling.[65] Management would be the particular capability in this case.

Therefore, firms' capabilities determine the different directions in which companies grow, depending on whether they (the capabilities) expand and alter.[66] However, random factors also have an influence: in these cases, a firm's motivation for taking up an activity is not determined by the prior possession of an appropriate capability, but by cheap acquisition.

New products frequently emerge from the combination of different capabilities and skills. Inter-firm cooperation enables

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62. C. Menger explains how firms initially undertaking activities in a given sector expand into other sectors by concentraing on what they are better able to perform. *See generally* C. Menger, *The Principles of Monopoly Trading, in* PRINCIPLES OF ECONOMICS (1981).

63. RICHARDSON, *supra* note 10, at 105.

64. *Id.*

65. Richardson, *supra* note 5, at 889.

66. *See id.* at 888-889.

these capabilities to combine and create new products and services. Hence, complementary activities become the source of cooperation among firms; the less complementary they are, the more likely firms are to compete for a bigger share of the undifferentiated "aggregate" demand.[67] In this case, price competition will often be the prime element of differentiation between them, but the scope for competition is very limited, as it will be constrained by price reductions.[68] Assuming that producers choose to make the same commodity with similar production processes, competition between them is possible only as long as costs are reduced. Such reductions will consist of minor improvements to the production process. However, if producers devise new "production functions," combining resources in different ways to make the same or different commodities, the field for active competitive warfare is greatly enlarged and there is wider scope for innovation.[69]

Conversely, the process of competition and exploiting comparative advantages may develop particular lines of products which could turn formerly similar activities into complementary ones. This process explains why former rivals may find it desirable to cooperate in developing new products, by mutually exploiting their respective complementary capabilities. It also explains why, during their initial stages, markets tend to consist of few firms, each holding a strong position. As time passes, more entrepreneurs become capable of seizing profit opportunities by imitating successful entrepreneurs. Consequently, markets become less and less concentrated as technologies spread out amongst producers. Later we examine in detail how competitive entry undermines the position of those entrepreneurs initially holding a monopoly.

To sum up, firms will tend to develop capabilities dealing with closely complementary activities themselves, and leave dissimilar activities to outsourcing. Also, they will leave those transactions in which they feel that there are sufficient alternative providers for markets, whereas they will attempt to integrate those areas in which they are required to hold higher levels of trust, due to the features of the transaction concerned.

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67. G.B. Richardson, *The Organization of Industry*, *in* FIRMS, ORGANIZATIONS AND CONTRACTS 892 (P. Buckley & J. Michie eds., Oxford University Press 1972).
68. *See id.* at 893.
69. *See id.* at 892-3.

This happens, either because of the need for endurance of the expectations of transacting parties over time, or due to the features of the activities in which they engage.

The way entrepreneurs sense their capabilities is ultimately responsible for the decision of outsourcing or developing a capability within the firm. Hence, this factor will determine the size and boundaries of the firm. Richardson distinguishes three modes of coordination of complementary activities.[70] First, entrepreneurs may seek coordination through "direction," where single control fits into a coherent plan and is undertaken by one organization.[71] Direction within a firm is possible where economies of scale exist, and where complementary activities are possible: the larger the organization, the greater the number of capabilities with which it may to be endowed, and thus the greater the number of complementary activities subject to coordination through direction it is likely to undertake.

Second, entrepreneurs may coordinate their activities through "cooperation," where independent organizations agree to match their plans in advance.[72] Cooperation arises where there is reason to believe that individual components (i.e. the interactive parties) of demand are more stable than aggregate demand considered "as a whole." In this case, the individual parties would seek to match their investment and output plans "ex-ante."[73] They have to match "closely complementary" activities, rather than undifferentiated "similar" aggregates. Coordination is undertaken either through close cooperation, by institutional arrangements, by limited shareholding, or by other forms of affiliation. Matching is not only quantitative in this case, but also qualitative. The personal element is decisive; thus, prices are to some extent irrelevant, in the sense that their stability does not tell anything in itself about the value attached by the parties to their underlying relationship.

Finally, the coordination of complementary activities can be done through market transactions.[74] Here, the benefits arise indirectly from successive interactive decisions taken in

70. *See id.* at 890-1.
71. *See id.*
72. *See id.* at 891.
73. Richardson, *supra* note 67, at 891.
74. *See id.*

response to changing profit opportunities. In this case, the estimates that firms infer from the conduct of other firms are not based on the individual conduct of particular firms, but on their actions when considered as a whole. In this case, the crucial element for reinforcing expectations is not based on the conduct of the firms concerned, but on their particular features or pattern of activities, which are diluted in the presumed aggregate output of all those firms considered to be working together. Firms will prefer to rely on these market outcomes, rather than seeking to cooperate with a particular firm. Therefore, coordination through markets occurs whenever there is reason to believe that aggregate demands are more stable than their component elements (i.e. the parties involved). Thus, parties rely on having enough customers to cover the potential canceling out of random fluctuations in their separate demands.[75]

These considerations allow a clearer understanding of the position in which the entrepreneur is placed when deciding in which arrangement he will engage. Vertically integrated firms coordinate closely complementary activities, whereas horizontal alignment should be expected amongst entrepreneurs whose activities are competitive and where the products and services offered thus require some degree of homogenization.

The neo-institutional analysis thus espoused inevitably develops an alternative explanation, which is different from the *market power* rationale.[76] Therefore, it avoids making entrepreneurs responsible for the lack of competition. One can conclude that mutual trust and productive complexity fix the limits of business conduct and organizational structure. Consequently, arguing that entrepreneurs impose these restrictions on others to achieve some monopolist purpose through market power seems out of focus. Indeed, the conventional explanation of *market power* (that is, the feasibility of imposing a monopolistic price on consumers or of engaging in exclusionary conduct against competitors)[77] becomes dubious as soon as we realize how irrelevant it is in the view of competition as a process.

75. *See id.*
76. *See id.*
77. RICHARDSON, *supra* note 10, at 127.

C. Business Competition in the Market Process Setting: Legal Barriers as the Determining Factor of Market Competitiveness

Under the neo-institutional perspective, what are the causes responsible for restricting competition?

In the market process view, the position held by a firm at any given point in time does not prevent other firms from operating freely.[78] In other words, it does not give them any "dominance" or "power" in the market. The suspected monopolist may have the intention of gouging out additional profit due to his pre-eminent position in the market, but that intention is only produced by his expectation that the profit opportunity is there for him to reap.[79] He may well be wrong. Indeed, the fact that information about these opportunities is subjective and the position of our entrepreneur is pervaded by sheer ignorance affects him too. As Kirzner states, "... no one knows, and no one can possibly know, in advance, what 'the' market price 'ought to be'... once it is recognized that no one does or can know the 'correct' price, it becomes apparent that a price discriminator is simply 'feeling' his way, by grasping (or rather, by attempting to grasp) profit opportunities he believes available to him."[80] Therefore, the firms' incentives to compete in the market are not determined by how much market power incumbent firms exercise either on those firms attempting entry or on established firms.

Size and pre-eminence in the market are not important factors as soon as we consider the availability of capital markets to alert entrepreneurs. Of course, the possession and ownership of productive resources gives economic power. But this power does not become an essential factor in forestalling the freedom of other entrepreneurs if competitive entry is ensured. To understand this issue properly, let us examine the nature and effect of freedom of entry in more detail.

The crucial factor of market competitiveness is competitive entry, namely, the awareness that institutional rules are sufficiently flexible to give anyone interested a chance to challenge established industries should the occasion arise.[81] Competitive

78. *See id.*
79. *See* KAISLA, *supra* note 32, at 19.
80. Kirzner, *The Goals of Antitrust: A Critique, in* INFORMACION COMERCIAL ESPANOLA 18 (1998).
81. F. Machlup, *Competition, Pliopoly and Profit,* 9 ECONOMICA, No. 33, at 2

entry will be a sure deterrent to any entrepreneur attempting to lower the quality or increase the prices of products or services sold.[82]

Competitive entry ensures that any firm, regardless of size, or any entrepreneur, regardless of their ownership of productive factors, will be able to enter into the market, should incumbent firms decide to raise prices beyond normal levels. It disciplines those entrepreneurs who attempt to restrict investments in order to maintain a rate of profit which is permanently excessive. In this case, alert entrepreneurs erode the position of the incumbent firm by exploiting those gaps of information discovered.

Competitive entry requires that no incumbent firm holds privileges which exploit productive activity.[83] These privileges arise mainly from government fiat, as well as from private arrangements bearing similar effects.[84] For example, laws, regulations, decrees, and other legal instruments belong to the first group, whereas arrangements adopted by trade or business associations (*e.g.*, the cartelization of an industry, which is not to be confused with collusion among competitors) belong to the second. Indeed, the virtual effect of these private arrangements is virtually to function as a statute would, since their effects extend over a whole industry.

These privileges prevent entrepreneurs from exercising their alertness in the discovery of future profit opportunities, through whatever arrangements they perceive to be necessary in order to seize these opportunities and co-ordinate the social system by eliminating gaps of (thus creating new) socially valuable information. Therefore, competitive entry has little to do with the prior ownership of resources. Inequality in resource ownership and in the power that such ownership provides is irrelevant to the ongoing process of discovering future profit opportunities. "It is superior entrepreneurial perceptiveness and prescience alone which is necessary and sufficient for the grasping of pure profit opportunities."[85] Even those firms commanding large volumes of resources must depend on their

(1942).

82. *See id.* at 3.

83. *See* Kirzner, *supra* note 80, at 18.

84. *See id.*

85. *Id.* at 10-11.

entrepreneurial foresight to find ways of deploying those resources innovatively. Otherwise these resources will simply continue to be used conventionally, until shrewder and more innovative entrepreneurs bid them away from larger but less entrepreneurial firms.

It soon becomes apparent that market power is non-existent in a changing environment as long as competitive entry remains unblocked. In this case, the relevant problem is not how many firms interact within the market, thus enabling them command of productive resources, but whether those within it will be threatened by the entry of others, and whether those outside will be allowed to erode the position of incumbents.

Thanks to the flexibility of the institutional framework market, actors possess freedom to compete.[86] Notice that "competition" in this sense has little connection with, and even contradicts, neo-classical perfect competition.[87] Indeed, the meaningful question is not whether firms want to eliminate their capacity to compete, but whether they will be able to do so indefinitely, thus imposing an absolute and unwanted restriction on freedom. Antitrust policy does not always make this distinction clear, as it confuses the number of competitors with their ability to compete.[88] It is clear that in the long run, absolute restriction on freedom in flexible institutional frameworks is impossible, due to market selection and discipline imposed over conditions of competitive entry.

In a free market, new entrants will seek to imitate formerly established firms, therefore reducing their profits. For this reason, a firm can freely expand output without the threat of excess competitive supply, but will have no protection against the ultimate encroachment of more innovative rivals and no opportunity to maintain profits at a permanently abnormal

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86. *See id.*

87. *See* Machlup, *supra* note 81, at 3.

88. *See id.* at 1-2. Machlup explains the sources of this terminological confusion, "The confusion is understandable: where there are many sellers already, why should there not easily be more sellers when profits lure? In actual practice easy entry into a trade and large numbers in the trade go well together." However, "even if a large number of sellers and an augmentable number of sellers seem to be closely correlated, logically the two things are completely divorced from each other. And, it will be seen, [they are concepts] of very different nature; indeed, they belong to different spheres of thought." *See also* G. STIGLER, MEMOIRS OF AN UNREGULATED ECONOMIST 92-93 (1988).

level. If entry is free, some barriers would persist while others would disappear as new entrants erode the position of incumbent firms, thus rendering any artificial restrictions useless. Therefore, under competitive entry, indefinite market foreclosure is impossible.

III. THE IMPLICATIONS OF NEO-INSTITUTIONAL ANALYSIS FOR ANTITRUST POLICY IN THE CASE OF EXCLUSIVE DEALINGS

The conventional literature in industrial organization has often emphasized that market vertical arrangements may lead to foreclosure and therefore, to welfare inefficiencies. These are regarded practices oriented to either monopolize the market or prevent the entry of new competitors. From the conventional antitrust perspective, vertical integration achieved through exclusive dealings prima facie appears as an anti-competitive instrument devised to foreclose market entry to potential competitors.

Salop and Scheffman[89] consider a set of exclusionary strategies that while pursuing the same objectives seek to raise rival's costs instead of cutting prices. One of these strategies is precisely vertical integration.[90] While Salop and Scheffman develop a formal analysis of these issues, here we will only extract their basic tenets and conclusions.

Let us first consider forward integration into retailing. According to Salop and Scheffman, "if there are scale economies or other entry barriers in retailing, exclusive dealing arrangements can raise small rivals' costs of distribution."[91] Firms may undertake a set of exclusionary strategies that while pursuing the same objectives seek to raise rivals' costs instead of cutting prices.[92] One of these strategies is vertical integration.[93]

This is basically the same conclusion reached by Aghion and Bolton as to the negative externalities stemming from long-term contracts in markets of several buyers. Some kind of contracts between a seller and a buyer, such as exclusive deal-

89. *See* S. Salop and D. Scheffman, *Raising Rivals' Costs*, 73 AM. ECON. REV. 267 (1983).

90. *See generally id.*

91. *Id.* at 267.

92. *See id.*

93. *See id.*

ing, deferred rebates by shipping firms, frequent flyer programs, franchise fixed fees, leasing arrangements, etc., serve the purpose of deterring entry to a market by potential competitors. All these contracts share as a common feature the presence of switching costs or "liquidated damages" that would make it costlier for a buyer to switch from the incumbent to the entrant seller.

In both the cases forward integration erects a barrier to the entry of new competitors and helps to monopolize the market.[94] On the other hand, a firm may also raise its rivals' costs through backward integration into inputs, this being especially the situation when the upstream unit is a monopolist producer.

In either case these strategies, according to Salop and Scheffman, yield the same outcome: profitability to the dominant firm, competitor injury and consumer welfare reduction. In effect, a strategy focused on raising rivals' cost differs from predatory pricing in that while the latter usually leads to price cuts, the form generally implies prices increasing with costs. This is in turn welfare reducing.

Regretfully, the focus of antitrust enforcement has been misdirected, as excessive emphasis has been placed on market power attained by incumbent firms in the market, particularly while the market is in the initial stages of its development. This is clearly evident in the special focus placed on price considerations as the expression of such "power." Schumpeter criticized this exaggerated focus of economists on prices as variables of competition:

> As a result of the alternative institutional analysis] the first thing to go is the traditional conception of the modus operandi of competition. Economists are at long last emerging from the stage in which price competition was all they saw. As soon as quality competition and sales effort are admitted into the sacred precincts of theory, the price variable is ousted from its dominant position. However, it is still competition within a rigid pattern of invariant conditions, methods of production and forms of industrial organization in particular, that practically monopolizes attention. But in capitalist reality as distinguished from its textbook picture, it is not that

94. *See* P. Aghion and P. Bolton, *Contracts as a Barrier to Entry*, 77 AM. ECON. REV. 388 (1987).

> kind of competition which counts but the competition from the new commodity, the new technology, the new source of supply, the new type of organization (the largest-scale unit of control, for instance) competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives. This kind of competition is as much more effective than the other as a bombardment is in comparison with forcing a door, and do much more important than it becomes a matter of comparative indifference whether competition in the ordinary sense functions more or less promptly; the powerful level that in the long run expands output and brings down prices is in any case made of other stuff.[95]

In sum, the neo-classical analysis condemns vertical restraints to a permanent policy disapproval by competition agencies, which can only be overturned through positive evidence of their "efficiencies." In the context of neo-institutional economics, that cannot certainly be the logical conclusion that follows.

A. The Neo-Institutional Analysis of Exclusive Dealings and Vertical Integration

In the light of neo-institutional economics, market organizations are not regarded as potential sources of undue market foreclosure. Exclusion or limitations of rivalry in a market may be necessary to ensure that a profit opportunity will be discovered and exploited at all. It may seem ironic (but no less true) that the more information there is available about these opportunities, the less likely it is that anyone will seize it.

It is necessary to examine more closely how different vertical integration levels acquire a different outlook under a market process perspective.

Klein and Leffler hold that there could be risks of nonperformance where the costs of withdrawing from a transaction are low to one party and high to the other.[96] One solution

95. SCHUMPETER, *supra* note 18, at 84-85.

96. *See* B. Klein & K. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 625 (1981).

these authors propose is to increase contractual prices.[97] A necessary and sufficient condition for performance is the existence of prices sufficiently above salvageable production costs so that the non-performing firm loses a discounted stream of rents on future sales which is greater than the wealth increase from non-performance. Another solution, when determining the risks involved in the long run proves difficult, is to merge both firms; in this way compliance is ensured through common stock and the expectations of the firms involved will not be diminished.[98]

Klein and Murphy argue that vertical restraints are means which ensure compliance from dealers when written contracts are not economically feasible because they would have to cover every possible contingency. Manufacturers use vertical restraints to reduce the short-run gain (by limiting non-performing dealers' ability to expand output) and to increase the long-run gain of performing dealers (by creating a quasi-rent stream). To induce a desired retailer behaviour when it is not feasible for a manufacturer to write explicit, court-enforceable contracts with retailers for the supply of particular services, the only mechanism is to increase the direct return which retailers receive from consumers when those services are supplied. Resale Price Maintainance increases this return by increasing the retail margin, thus creating an incentive for individual retailers to engage in non-price competition and supply the desired services. Exclusive territories increase the direct return by eliminating nearby retailers.[99]

The restraints produced by organizational structures appear on the surface to be the very antithesis of the sort of freedom that drives unsuccessful entrepreneurs out of business; yet it is undeniable that they play an important informational role.

For this reason, the agreements entered into by entrepreneurs can be regarded as efficient in the sense that they ensure them a profit which would otherwise be impossible to achieve for anyone, and would therefore be lost. Again, a profit

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97. *See id.*

98. *See generally* Klein & Leffler, *supra* note 96.

99. *See generally* B. Klein & K. Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, 31 J.L. & ECON. 265 (1988).

made available to all is lost by everyone.[100] Without them, market co-ordination would be impossible, and producers would certainly be prevented from making new discoveries, innovation, and related improvements which in the end benefit consumers. In other words, these advantages would accrue only if we allow a particular entrepreneur to restrict his freedom of action so as to enable everyone else to have some predictability about his future actions; a condition which, under a static perspective, appears to be a restriction on rivalry in the market.

In evolving environments new information constantly unfolds, thus providing entrepreneurs with new business opportunities. However, these opportunities will not be exploited unless some restrictive arrangements are devised whereby some entrepreneurs ensure their chance of seizing such opportunities before other entrepreneurs do. If these opportunities are equally accessible to all, no one will have an incentive to get there before everyone else.

From an institutional viewpoint, these arrangements coordinate the integration of scattered knowledge, which would otherwise remain scattered among many individuals, into socially useful purposes. Therefore in principle, they improve social welfare and promote competition processes.

Different levels of vertical integration reveal the extent to which the activities of the firms involved are complementary: the more complementary, the more integrated. Exclusive contracts can be similar to full vertical integration, where advantages for the coordination of complementary activities are obvious. Exclusive dealings simply require a more reliable business environment within which to distribute goods or services to certain customers. Similarly, exclusive supply contracts may require reliability in supply or resources. Whenever the risks involved in the activity require it to be so, entrepreneurs can be inclined to pursue a more stable relationship by acquiring the management of a firm in an upstream or downstream market.

In this regard, Richardson classifies organizations on different levels of vertical integration as follows: first, a trading relationship between two or more parties, which is stable

100. *See id.*

enough to make demand expectations more reliable, and thereby facilitates production planning.[101] This is the simplest form of inter-firm cooperation. In this case, the relationship may acquire its stability through goodwill or more formal arrangements such as long-term contracts or shareholding. The selection of any of these arrangements is a matter of qualitative rather than quantitative coordination. The habit of working with models that assume a fixed list of goods may be responsible for the neglect of consideration of qualitative coordination and for encouraging us to think merely in terms of the balancing of quantities of inputs-outputs.[102]

Second, one firm may subcontract another by outsourcing. This modality is becoming quite popular for co-operation between firms located in different countries. Subcontracting does not in itself imply much co-operation; and may be the result of competitive bidding. Stability arises from the fact that subcontractors assume the risks inherent to their narrow specialiation in skills and equipment; and from the fact that it permits continued co-operation between those concerned with the development of specifications, processes and designs.

Third, cooperation between firms relying on each other for manufacture or marketing. These relationships may entail complex patterns of coordinated activity, ranging from quantities demanded (promoting quantitative adjustment of supply to demand), to qualitative standards involving processes or products.

Finally, cooperative arrangements specifically contrived to pool or transfer technology. These agreements are commonly based on the licensing or pooling of patents but they provide for the provision or exchange of know-how through the transfer of know-how, personnel, drawings and tools. They are normally associated with price agreements, market sharing and the like.[103]

As long as competitive entry to third parties is not blocked, these will put pressure on integrating firms to be competitive and avoid "abusive" business behaviour against consumers.

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101. *See* Richardson, *supra* note 5, at 884.
102. *See id.* at 885.
103. *See id.* at 886.

B. The Welfare Trade-off Between Short-Term Market Restrictions and Long-Term Innovations

The central question, therefore, lies in determining whether there can be a compromise between the functioning of these restraints and the conditions of "freedom" which ensure market discipline and the selection of productively efficient firms.[104] Public policy has a trade-off to make between the restriction introduced which limits both market discipline and efficient selection in the short-term, and the information that the arrangements bring about in the long-term, which will encourage productive investments. Policy-makers are thus confronted with the question of whether the endurance of these restrictions is justified over time, given the economic landscape of the industry in which they are implemented.

The reasons summarised above justify in principle the creation of organizational structures which restrict short-term rivalry to enhance long-term discoveries. Thus, appraising the proper length of these arrangements is crucial. The question, of course, is can a third party (i.e., a policy-maker, or a competition authority) identify what short-term restrictions should be challenged and what should be tolerated in order to pursue long-term, socially-valuable discoveries?

The answer lies in the capacity to choose between the disadvantages brought about in the short run due to the restrictions imposed on freedom and the welfare brought about in the long run.

In principle, this is an Herculean task. In the real world, unless the analyst of a market transaction is simultaneously a party in it, it is not possible to determine with exactitude what business activities should be subject to rivalry and what should

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104. In the words of Richardson:

> There would seem to be a need that the markets of individual producers should be both secure, in order to give them the confidence to invest, and at the same time vulnerable, lest their policies are inefficient or restrictive. Must we admit this incompatibility to be genuine and ineluctable? Is it possible to find a compromise between the conflicting requirements, an optimum degree of inertia or restraint, which will best favor the process of resource allocation taken as a whole?

RICHARDSON, *supra* note 10, at 120.

be subject to vertical integration.[105] Only entrepreneurs can have different opinions about the degree to which an economic activity is complementary or competitive. Thus, they are able to develop subjective perspectives of market participants, at times identifying them as competitors, and at times seeing them as potential customers or suppliers. As the process of competition is aimed at increasing information and knowledge, this sometimes leads to rivalry among market participants but in other cases it leads to cooperation. There is no clear-cut distinction between competitive and complementary investments. In the end, it is the consumer's subjective perception based on their preferences, which determines what entrepreneurs will come to regard as complementary and what as competitive. Neo-classical demand theory assumes that consumers can order their preferences as different combinations from a fixed list of commodities; the logic of choice. Entrepreneurs, however, have to determine what combination of qualities goods must possess; therefore, the model of consumer behaviour does not suit.[106] Certain commodities may possess alternative uses which consumers must decide upon. Preferences between various commodities are not just "given" to a consumer; they have to decide by weighing up the contributions made by each of them with their own objectives.[107] It is not preferences between goods, but stability over time which characterises the various desires that goods meet: some desires demand changing commodities for their satisfaction (novelty);[108] desires also require social distinction because the possession of a commodity offers prestige when confined to a few people.[109] Consumers buy because of the preferences they expect to get. It is a trial-and-error process. In short, consumers are endowed with a set of desires and form their preferences for commodities on the basis of their imperfect knowledge of the power that the commodities have to satisfy these desires. Entrepreneurs are constantly trying to "guess" the opinions and tastes of consumers, in order to point their activities in a

105. *See id.*

106. *See* P. EARL, MICROECONOMICS FOR BUSINESS AND MARKETING 144-155 (1995).

107. *See* STIGLER, *supra* note 88, at 95-96 (citing CHAMBERLAIN, THE THEORY OF MONOPOLISTIC COMPETITION).

108. *See id.*

109. *See id.*

particular direction.

Therefore, a policy aimed at enhancing competition should certainly not challenge or undermine these arrangements, but should confine itself to condemn arrangements that are solely based on the intention to extract rent from consumers. However, this is not an easy task, as Wiseman observes:

> [T]he fact of uncertainty makes the association of competitive behaviour and profit maximisation, on which the market-economy model depends, less generally acceptable. The desire to reduce uncertainty by gaining control of the uncertain variables must be an important motive in attempts to eliminate competition. Uncertainty thus implies the need for positive government policy to ensure competitive behaviour in pursuit of profit maximisation, since only such behaviour conduces to an efficient distribution of resources. The difficulty in framing such a policy lies in distinguishing those factors which are the inevitable accompaniment of ignorance and uncertainty and those which arise simply out of a desire to maximise net revenue in an environment characterised by these things.[110]

This is easy to concede in theory, however, in practice, how can an external observer such as the competition agency determine whether a decision taken by another subject (i.e., entrepreneur) is the result of either reason?

Only by adopting a long run perspective can one clearly see that these organizational forms are constantly threatened by innovation from other firms providing substitute products. Innovation itself is triggered by the promise of receiving profits for creativity, which leads to output expansion in the long run. Clearly, removing all profits would be efficient from an equilibrium point of view, but would threaten innovation and so would be less efficient in the long run. Innovation has transition costs, and restrictive policies with the old product or technology may ease the transition and spread the costs (retraining, unemployment, etc.) over time. In a long term perspective innovation will render these arrangements obsolete.

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110. J. Wiseman, *Uncertainty, Costs and Collectivist Economic Planning*, *in* L.S.E. ESSAYS ON COST 198, 234 (J. Buchanan & G. Thirlby eds., New York University Press 1973).

The differences in foresight, or the capacity to increase production that enable entrepreneurs to gain an advantage over their competitors are transitory and subjective to the context within which entrepreneurs adopt their decisions. Thus, although unlikely, in a given transaction, two contracting parties may well possess different views about the efficiency they expect to get from the arrangement.

Obviously, under a perspective that visualizes markets as something static, where resources are given and no discovery arises, all these techniques appear to limit the opportunities open to entrepreneurs for taking independent paths, and indeed in this sense, they are restrictive. In the process of ensuring customer loyalty, entrepreneurs may attempt several strategies which third parties (i.e. antitrust authorities) could interpret, following a structural logic, as "market foreclosures" imposed against other competitors.[111] As Lepage contends, "a number of business conducts traditionally regarded as 'restrictive' and deemed incompatible with the needs of a healthy competition are nothing else but private contractual arrangements purporting to improve market functioning (particularly to reinforce the loyalty of the participants in the transaction) [and competition]."[112] In a dynamic setting:

> [T]he impact of new things - new technologies for instance - on the existing structure of an industry considerably reduces the long-run scope and importance of practices that aim, through restricting output, at conserving established positions and at maximizing the profits accruing from them. We must now recognize the further fact that restrictive practices of this kind, as far as they are effective, acquire a significance which they would not have in a stationary state or in a state of slow and balanced growth.[113]

Hence, it is possible to conclude that in a dynamic evolving framework, rivalry and co-operation do not really "oppose" each

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111. H. LEPAGE, LA NOUVELLE ECONOMIE INDUSTRIELLE 231 (1989) (unofficial translation). Lepage also adds, "Ce que l'Etat considere generalement comme des entraves ou des atteintes a la concurrence, n'est le plus souvent que le resultat des procedures utilisees par le marche pour resoudre precisement les problemes d'efficience et de loyaute qui servent de motif a son intervention." *Id.* at 233.

112. *Id.*

113. SCHUMPETER, *supra* note 18, at 87.

other, but form a complex game in which managers sometimes engage in rivalry and sometimes co-operate, according to the level of differentiation they observe in the activities, products and services offered by a particular cluster of firms within the market. Only in a static framework does it appear that both forms of relationship between firms and markets are contradictory and incompatible. In a dynamic framework, what appears essential is the competitive entry of any entrepreneur to be ensured, by eliminating all sources of legal privileges preventing access to the market.

In conclusion, individuals exercise their property rights and freedom of contract by arranging their affairs and entering into association with other individuals thus creating a wide array of corporate structures and business practices set up to meet their objectives and enhance their mutual business expectations. If not constrained by external interference and legal privileges, these structures represent the best possible state of affairs to their members, within the limits of their access to knowledge and available technology, and their functioning leads to the efficiency of the spontaneous market order.

It would be difficult, if not impossible, for government authorities to conclude, on the single basis of the social welfare trade off analysis between short term contrived market restrictions and long term innovations, whether certain arrangements should be approved. The analysis of competition must also consider the institutional causations creating pervasive anti-competitive culture among businessmen. It is necessary to identify first and foremost, the existence of regulations and any institutional barriers to the transmission of knowledge among entrepreneurs. Such competitive entry barriers conflict with the awareness of entrepreneurs to discover new valuable business opportunities, or somehow impede this information to circulate among other entrepreneurs.

C. Selected Examples of the Venezuelan Competition Policy Experience on the Analysis of Vertical Integration

After having discussed the contrasting neo-classical and neo-institutional approaches to vertical restrictions as either efficient and welfare enhancing or exclusionary and welfare decreasing devices, the original question of this essay remains unanswered. Throughout the reviewed literature this question remains essentially unsettled, mirroring perhaps the strong disagreement among economists about what purposes vertical integration serves. Should competition policy challenge these agreements?

In the beginning, guided by the normative precepts of conventional antitrust theory, Latin American competition authorities were inclined to see in vertical restraints an instrument of market foreclosure bearing a monopolistic spin. This is clearly revealed in the administrative decisions taken by the Argentinean Competition Commission, Brazil's Cade, the Chilean Fiscalia Economica, Venezuela's Pro-Competencia, and other agencies in the region.

In the course of time, however, they have realised the need of acknowledging a more realistic view, grounded on the institutional reality of Latin America, which is predominantly characterised by the ubiquitous lack of legal certainty and business unpredictability. It became increasingly obvious that many restrictive agreements possess beneficial effects which compensate anti-competitive restrictions, as they normally combine forms of co-operation between entrepreneurs. In this sense, they became increasingly aware that the neoclassical market concentration hypothesis could not explain why competition grew strong in sectors where few economic agents operate.

The development of an extensive rule of reason is seen in the emphasis that policy enforcement has developed towards vertical restraints, where the analysis of economic efficiencies is essential. Compared to the initial emphasis given in the first stage to horizontal restrictions, and cartel behaviour, the introduction of a more extensive rule of reason analysis highlights the sophistication gained by competition analysis.

This trend is seen most clearly in the pre-eminence that efficiency analysis has over competition authorities, persuading them of developing a more lenient attitude towards restrictions which were formerly regarded as illegal, under a conventional structured vision of markets. The new vision, instead, is increasingly emphasizing dynamic elements of market interaction, and the complexities surrounding its functioning. As a result, the legal doctrine has increasingly acknowledged the beneficial effects of agreements which, notwithstanding the market power enjoyed by the firms undertaking them, possess desirable economic effects. As put in an official report of experts: "many practices that on the surface appear to be anticompetitive (*e.g.*, vertical market restraints such as exclusive dealing requirements) can, depending on the circumstances, serve legitimate pro-competitive purposes."[114]

Examples of these undertakings are franchises, exclusive distributions, exclusive supply arrangements, and licensing. Generally, most of the jurisdictions reviewed subject these arrangements to a rule of reason analysis, in which the enforcing agency determines whether the market power of the exercising firm is justified by the economic efficiencies brought about by the relevant arrangement.

The new analysis emphasizes, besides the traditional elements of antitrust analysis, other aspects of business transactions resulting from the institutional landscape where such agreements are implemented. Closer attention is given to the merits of such conduct, as examined in the economic context where it takes place, rather than relying exclusively on the market power factor.

The new focus stresses on the need of enhancing the level of business co-ordination in complex webs of shared knowledge and industries. *Improving co-ordination in the system may eventually require that potential entrants in the system enjoy a fair chance of accessing the market*, such as a limitation of their capacity to innovate. Therefore, it is likely that competition agencies will focus on the factors that lessen or impede such market access. Of course, market access is frequently subject to numerous impediments arising from both private and government activities.

One acute problem in this regard has to do with the spontaneous arrangements arrived by competitors in a given industry to standardise their products. The standardisation of the web production may impose unexpected or unnecessary costs to potential entrants; yet it may also be necessary to enhance scope economies, develop shared capabilities, and deliver consumers the minimum quality they expect from the products they purchase from the market. However, the compulsory imposition of such standards, either under joint trade association decisions or by government fiat, may lessen the fair opportuni-

114. *Competition Policy and Economic Reform: An Interpretative Summary*, The World Bank, (OECD, CADE, IBRAC eds. 1998) pp. 18-19.

ty of potential entrants to access the market. It may be necessary to intervene through antitrust enforcement in these occasions, albeit with care, and distinguish the necessary standardisation from the unnecessary one.

In vertical relationships, the problems of accessing networks may be more crucial if the network is essential to the trade of downstream firms. Here the policy dilemma is more evident, because the gains of allowing an unlimited number of entrants may discourage incumbent firms to make further investments in the improvement of the network (to preserve monopoly gains from limiting access to everyone else) and therefore, hamper the standards of quality necessary to preserve the very existence of the web. On the other hand, the disproportionate foreclosure of the network may impair its future value, because it may limit the access of clients excessively and, as a result, of profits that could be otherwise reinvested in improving the network. Access to the network is crucial to ensure that the network itself develops and gains more value. These problems are evident in the case of infrastructure industries, such as telecommunications, water supply, electricity, and similar others. In these industries, the impediments placed on potential entrants by incumbent firms at the point of entry not only undermine the rights of the former to a fair chance of competing in the market, but also lessen the value of the infrastructure as a whole, by limiting the number of potential competitors in it, thus, reducing the exchange of ideas and innovations.

In this section we explain the implications of the new perspective in the antitrust analysis carried out by Venezuela's competition authority, the Superintendencia para la Promocion y Proteccion de la Libre Competencia (Pro-Competencia).

In the *TV Cable* case, decided by Pro-Competencia in 1999,[115] several TV cable companies sued several operating electricity companies for not allowing them to install their connecting wires at the poles belonging to the former. Allegedly, the electricity companies had the intention of imposing exploitative contractual conditions, which also excluded them from the market. The contracts did establish a rental price

115. Resolution N° SPPLC/034-99.

which was not considered to be monopolistic itself; yet, the lack of a contractual formula for the rental price increases was regarded to be against the legitimate expectations of the parties concerned, as enforcing such price increases was in some instances much higher than inflation levels. The inflation rate is the formula conventionally applied in rent contracts in the absence of an express formula determining how price increases will take place. Here, *Pro-Competencia* considered the development of a future market such as TV cable, for which network access was essential, and therefore had to be protected.

Furthering potential market network co-ordination is an activity requiring from the enforcing agency an exercise of forecast, and as such, its success is much dependent of the level of free will left to economic agents to behave in such a way that their individual actions promote the development of the network as a whole. By no means does it entail the dictation, by the competition agency, of a given or predefined course of action, as this would surely reach the opposite results: network stagnation, the reluctance of agents to invest in higher network co-ordination, and their long-term impoverishment. A practical way of ensuring the former and avoiding the latter is by concentrating the policy focus on eliminating sources of institutional uncertainty from the economic system.

Pro-Competencia is paying increasing attention to the factors that characterise the activity of firms in the market in an uncertain institutional environment. The reappraisal is focused on the arrangements entered into by firms for preventing or limiting uncertainty in their dealings with other firms. As a result, Pro-Competencia has developed the "doctrine of legitimate expectations," whereby the analysis of restrictive behaviour not only focuses on whether short term efficiency considerations offset exploitative or excluding conditions imposed in market transactions, but also on whether businesses' legitimate expectations, in the long run, are preserved. This doctrine is currently (but not exclusively, as stated in the TV cable case indicated above)[116] applied in cases involving unfair competition (*e.g.*, false advertising, simulation of products, violation of industrial secrets), where the precise definition of what constitutes *fair* and *unfair* had always been related to

116. *See id.*

the certainty in their trade activities that businesses get from moral codes of behaviour. The legitimate expectations doctrine represents a step further, as it attempts to give the competition agency an upper hand with which to appraise the potential prospective consequences of market interaction, should the expectations of individuals entering into market transactions be protected.

The new economy has also impacted the way in which competition agencies are increasingly undertaking market analysis, by introducing new analytical tools that concentrate not so much on *past* market concentration as on what the prospective development of the market might be. Therefore, introducing a measurement of market behaviour in the course of time becomes crucial in the analysis of competition and in the assessment of the anti-competitive nature of restrictions foreclosing the market. The time factor reveals an important and novel trend emerging in the analysis of market size. Businesses that appear to compete in the short run may not compete in the long run, and thus be regarded as outside the relevant market for the period reviewed. Similarly, businesses that operate in one market may foreclosure downstream developing markets, particularly if they are in control of a resource essential for ensuring such development.

Market size analysis is not limited to structural short-term considerations. Often, if not always, it depends on the subjective perceptions of those engaged in the transactions themselves. For example, income levels affect the range of preferences of consumers for a given period, and, therefore, their willingness to substitute one product for another. Assuming that substitutability will remain stable for long-term periods is an unwarranted assumption.

Today, Pro-Competencia emphasises the institutional conditions within which markets function, and is less concerned with concentration levels. Therefore, it pays more attention to incorporating dynamic elements in market analysis, and to entry barriers, particularly those of legal origin. Thus, since 1998, there has been a marked concern for incorporating a fuller consideration of the elements that characterize market size in a long run perspective. For instance, attention is paid to innovation as a factor of antitrust analysis. In the Venezuelan

AGB case,[117] several TV channels claimed that the most important rating company, AGB, had been manipulating rating levels in favour of other TV companies. In defining the potential effects of the alleged behaviour, Pro-Competencia took the view that AGB's activity, in fact, provided a useful service, by encouraging innovation, and a better use of social resources, from a long-run perspective. Conventionally, TV companies define a year in advance the spaces available for advertising. However, this mechanism may prove too rigid for smaller advertising companies, whose need for segmenting available TV spaces is not satisfied under that scheme. AGB's activity could enable more information about the exact value of TV spaces all year round, hence, encouraging smaller TV companies to offer better conditions for trading the advertising "spaces" with advertising agencies, and making a better use of TV space, as a "social resource." Thus, such information would enable the growth of new markets for placing different products, and for enabling smaller advertising agencies to negotiate TV space for their products.

Another case that reveals how economic efficiency considerations justify the vertical integration of a firm that enjoys a dominant position in the market is found in the Toyota case.[118] Here, Pro-Competencia found that the exclusion of non-authorized dealers was legitimate, because of the efficiencies expected to report to the development of markets. Toyota decided, in 1997, to change its traditional policy of selling replacement parts to independent distributors, in order to develop a policy called "just in time." According to the new policy, Toyota refrained from selling replacement parts to unauthorised sellers, thus raising the profits of Toyota's exclusive agents. In return, Toyota could get a better assessment of the timing schedules necessary for the replacement of used parts within the industry, as exclusive distributors had a closer relationship to Toyota, and the latter could have a better knowledge of their commercial needs for replacement parts, compared to isolated independent distributors. In this way Toyota could make better plans for sensibly reducing its stocks and inventories, all of which would reduce consumer prices in

117. Resolution Nº SPPLC/0004-99.
118. Resolution SPPLC No. 0015-98.

the long run. Pro-Competencia regarded this explanation as a reasonable justification based on economic efficiency considerations.

In conclusion, the Venezuelan competition analysis of vertical restraints shows a clear analytical concern for the efficiencies brought about by certain restrictive conducts. The fact that more complex and sophisticated forms of market restriction have superseded "simpler" competition infringements reveals the development of competition enforcement in the region. All this is leading the authorities to reinterpret the notion of economic efficiencies, following a broader view of the market, and of the problems affecting its transparent functioning. In part, this is a consequence of the interest of competition authorities in considering other elements different from those embodied in the conventional analysis of economic theory. In particular, the new focus is revealing a concern for linking competition policy to issues of economic development. In essence, the new approach concentrates its attention to the emergence of long-term innovations, which can arise from short-term restrictions to competition. This assessment regards the long-term benefits that certain restrictions could bring about in the efficient development of innovations. Therefore, it is a perspective that emphasises the role played by institutions spontaneously emerged in limiting the uncertainty of the business environment, which is necessary for inducing them to innovate, and indeed, to compete. The approach, which is being increasingly known as the "New Economy," is particularly relevant to assess the situation of developing countries, engaged in institutional transition.[119]

Probably, this emphasis will show the way for other Latin American agencies to follow. After all, economic development is about the long-term. Societies structure their institutions, routines, and social networking to promote economic growth. The New Economy provides a proper analytical tool to examine the emergence of routines and of institutions that shape market transactions. This analysis focuses on the emergence of standards and networks defining the ongoing process of evolution that takes place within markets, determining the emergence of firms, products, and new technologies. Therefore, it

119. K. KELLY, NEW RULES FOR THE NEW ECONOMY, (1999).

gives the focus point from which it is possible to derive a theory of market competition in the transitional and changing landscape of Latin American institutions.

Competition agencies in the region may not have articulated these principles in a systematic way, as yet, but it is undeniable that they are increasingly being influenced by this novel approach; as it is revealed in their enforcement activities. Clearly, they are steadily developing awareness of their self-identity, and of their role in the promotion of social welfare. This self-identity is reinforced by the recognition that the promotion of policy initiatives for the promotion of competition in developing countries requires due consideration of special caveats. These guidelines have been aptly summarized as follows:

> 1. Emphasis on dynamic rather than static efficiency as the main objective of competition policy in developing countries.
>
> 2. Introduction of a concept of 'optimal degree of competition' (rather than that of maximum competition) to promote long term growth of productivity;
>
> 3. Introduction of a related concept of 'optimal combination of competition and co-operation' between firms so that developing countries can achieve rapid long-term economic growth.
>
> 4. The critical need of maintaining the private sector's propensity to invest at high levels requires a steady growth of profits; for this to occur there is a need for government co-ordination of investment decisions which in turn requires close co-operation between government and business;
>
> 5. Introduction of the concept of 'simulated competition', which involves contests among those seeking state support and which can be as powerful as real market competition;
>
> 6. The recognition of the importance for developing countries of industrial policy and hence the need for coherence between industrial and competition policies.[120]

120. The South Centre, *Competition Policy, Development and Developing Countries*, at 7, Trade-Related Agenda, Development and Equity (TRADE) Working Papers, November 1999.

These principles are changing the perception of competition policy as one aimed at improving the co-ordination feasible in a given industry and not one dealing with attaining optimal social resource allocation. This is hardly surprising, given the structural nature of the problems faced by markets in the region. It is difficult to think that competition agencies can overcome the magnitude of the structural malfunctioning by appealing to antitrust remedies alone, without influencing or challenging the rules of the game where economic agents develop their relationships.

By applying these ideas in their practical policy enforcement, competition agencies in the region are paying increasing attention to new areas of policy enforcement, which had been neglected in favour of the conventional analysis of market concentration.

IV. CERTAIN GUIDELINES TO FOLLOW IN THE PROMOTION OF COMPETITION

The concepts indicated above establish an idea of the kind of government intervention compatible with the promotion of markets and of competition.

In the neo-institutional approach, public interest is not embodied in an abstract formula of social welfare devised in the mind of a superior "central planner" under an abstract welfare calculation of efficiency (as for example, the Pareto Criterion, or the Kaldor-Hicks). Instead, it integrates with a truly social sense the mutual perceptions and collective wants of many individuals through an aggregate "opinion" expressing the particular way that individuals find most acceptable for co-ordinating their activities.

Under the institutional paradigm, the social efficiency standard does not measure how resources are allocated but how much the social system co-ordinates scattered, changing information, which is subjectively perceived by different entrepreneurs according to their own learning experiences.[121]

The allocation of resources is essentially a problem involv-

121. The emphasis on the coordination of plans, rather than on the allocation of resources, as a measure of social efficiency was first made by F.A. Hayek. *See* F.A. Hayek, *Economics and Knowledge*, IV ECONOMICA 33 (1937). N. Foss, *Austrian and Post-Marshallian Economics: The Bridging Work of George Richardson*, *in* ECONOMIC ORGANIZATION, CAPABILITIES AND CO-ORDINATION 145 (1998).

ing the decision of each individual in the social system, whereas co-ordination is the key to understanding how different plans and pieces of knowledge are separately held in the mesh of a social setting. Economic theory has not as yet clearly acknowledged the full implications of this different perspective, being concerned almost exclusively with the individual level. In Hayek's words:

> The economic problem of society is thus not merely a problem of how to allocate "given" resources, if "given" is taken to mean 'given' to a single mind which deliberately solves the problem set by these data. It is rather a problem of how to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know. Or, to put it briefly, it is a problem of the utilization of knowledge which is not given to anyone in its totality.[122]

Social efficiency is only feasible if entrepreneurs can coordinate their activities to the maximum and exchange available information which enables them to meet their goals.

Markets possess an inner condition of pattern coordination or institutional efficiency which brings about a correspondence between the expectations of each participant through a learning process. This way of coordinating individual actions secures an effective utilization of the knowledge and skills of the members. Later, we will explore how market arrangements provide the necessary web of information to reach a solution to this problem of uncertainty.

In this perspective, the existence of externalities lessening "public interest" in the conventional Pigouvian sense is, by definition, denied.[123] In the context of market relationships,

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122. F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519-520 (1940).

123. De Soto, *La Methodenstreit, o el Enfoque Austriaco Frente al Enfoque Neoclasico en la Ciencia Economica*, ACTAS DEL 5. CONGRESO DE ECONOMIA REGIONAL DE CASTILLA Y LEON 58 (Nov. 28-30, 1996). This trial and error process inevitably disappoints some expectations. Responses to the differences between the expected and the actual results will lead to fewer frustrated expectations in the next round. Hence, there will be some expectations that the market order will inevitably fail to fulfil. *See* F.A. HAYEK, LAW, LEGISLATION AND LIBERTY: THE MIRAGE OF SOCIAL JUSTICE ch. 10 (1973). Nevertheless, the process has created new knowledge, although in a negative sense, but indicating what course of action

as Huerta de Soto explains, the fact that entrepreneurs fail to see or ignore the existence of profit opportunities leads them to err.[124] But with this approach, such errors do not necessarily entail a negative bias, as the notion of market failures would, because their existence provides an opportunity to profit for more alert entrepreneurs, "It is precisely the existence of [sheer entrepreneurial errors] that generates pure entrepreneurial profit."[125] Therefore, the presence of errors does not diminish the efficiency of the open-ended system, as long as individuals are left free to correct them.

Hence, public interest is not related to the protection of a value which lies "outside" the will of those actually involved in the transaction concerned. It is more related to the generation of valuable information, achieved through a learning process which demands both coordination between entrepreneurs and competition so that they may seize information gaps and reveal uncoordinated business opportunities. Its existence does not depend on the specific outcomes achieved at one given stage. In this framework, there are neither "good" nor "bad" market outcomes resulting from the interaction of entrepreneurs, simply because there is no aggregate welfare standard against which reality can be meaningfully compared and contrasted. There is no way in which governments can acquire sufficient information to decide the "right" size or composition of markets. As Foss argues, "it is not possible to discriminate among different kinds of economic organization on grounds of efficiency under full information and no uncertainty; one kind of economic organization is as good (efficient) as any other kind."[126] If so, it seems at first instance that the role of governments is significantly reduced.

Yet such a conclusion does not necessarily follow. On the contrary, governments in the neo-institutional approach have an important role to play in facilitating the discovery of institutionally-efficient arrangements that could ease the coordina-

should be avoided. In this way, markets fulfill a social role in disclosing hidden information, even if by doing so some individual expectations have to be disappointed. Market order guides individuals' actions and brings about a correspondence between the expectations of the people that actually succeed, while inducing unsuccessful ones to sharpen their forecasts in future transactions.

124. *See* Soto, *supra* note 116, at 58.

125. *Id.*

126. FOSS, *supra* note 8, at 6.

tion of investments. It may be important to recall that under the neo-institutional perspective, individuals are not regarded automatons (i.e., homo economicus) possessing full information of their choice alternatives.[127] In the real world entrepreneurs decide to invest depending on the context where they operate, as they interpret the latter. Entrepreneurs realize that certain environments are more conducive than others to enhance the likelihood of a safe return for their investments. Certain institutional environments reduce business uncertainty and enhance the predictability of the expectations of everyone in the system, compared to others. They identify such environments following a learning process, based on the analysis of past experience, which may tell them that certain institutions are preferable to others for the sake of enhancing cooperation. Also, they may realize, after comparing the experience of other societies in the implementation of social institutions, that alternative institutions may be preferable to their own.

Thus, public interest depends on the fact that present and prospective coordination is improved as much as possible, because it is then that the hidden value of social information will materialize and satisfy the needs of those who "become aware of it." Governments could play an important role in encouraging such improvements in market coordination.
Hayek gives us a hint:

> Policy need not be guided by the striving for the achievement of particular results, but may be directed towards securing an abstract overall order of such character that it will secure for the members the best chance of achieving their different and largely unknown particular ends. The aim of policy in such a society would have to be to increase equally the chances for any unknown member of society of pursuing with success his equally unknown purposes, and to restrict the use of coercion . . . to the enforcement of such rules as will, if universally applied, tend in this sense to improve everyone's opportunities.[128]

This institutional perspective defines a two tier level of rules, which emerge at different speeds: first, there is a level of

127. *See* discussion, *infra* Part IV.
128. Hayek, *supra* note 121, at 114.

social rules which provide a stable shelter of predictability within which entrepreneurs may adapt their particular businesses[129] and second, there is a level of rules that emerges from the commercial routines and practices of immediate market interaction.[130] The responsibility for keeping the first level updated and adaptable to market needs is essentially (albeit not exclusively) in the hands of governments, whereas the second is essentially defined by entrepreneurs in their dealings.[131] Changing circumstances make the second level bound to experience more frequent changes, as entrepreneurs develop and adjust the boundaries of their relations with other entrepreneurs, both at a competitive and complementary level. By contrast, the level of general rules tends to evolve at a slower pace, since its materialization depends on the cumulative social learning process brought about by failures and successes of particular experiences.

This is not to say that general rules can eventually achieve an "optimal" point of efficiency in this task. However, preserving an environment governed by "general rules" is important, since such rules embody accumulative knowledge that enables the authorities to decide, without being constrained by their own imperfect knowledge about a particular situation, simply because the specifics are circumvented in the decision making process. As Rizzo predicates:

> The need for rules is predicated on our ignorance . . . . Rules must therefore be applied in particular cases regardless of the hypothesized or "guessed-at" consequences. The very unpredictability of these consequences requires adherence to the given rule . . . If the law cannot systematically achieve specific social goals, then the best it can do is provide a stable order in which individuals are free to pursue their own goals. The unpredictability of a rule's effect in a concrete situation is the price we must pay so as to achieve the predictability of the abstract order.[132]

Preserving a set of general rules does not necessarily sub-

129. *See id.*
130. *See id.*
131. *See id.*
132. Rizzo, *Rules Versus Cost-Benefit Analysis in the Common Law*, 4 THE CATO J. 873 (1985).

ject the whole system to stagnation. The cumulative learning process embodied in emerging general rules never ends, due to the very essence of the discovery process. They provide a stable shelter of predictability within which entrepreneurs may adapt their particular businesses, but which acts as a shelter in constant flux as well.

Furthermore, identifying a set of general rules is an entirely different task compared to deciding whether market arrangements are optimal. This is a decision that only those engaged in the transaction concerned can meaningfully take. Only entrepreneurs can decide which organizational structures they should choose to meet their needs, even they do not know for sure what activities they need in order to integrate with other individuals, or for how long. Managers are neither omniscient decision-makers, nor immune to mistakes; they are subject to the natural limitations of human knowledge. However, it is still easy to see that entrepreneurs are better suited to appraise the particular circumstances involved in any given transaction. The closer individuals are connected to the situation whose uncertainty they wish to control, the more likely they are to succeed.[133]

Evidently, this is a question which depends upon the subjective perception of the individuals concerned. The closer individuals are to the situation at hand, the more they will know about it, and the less "open" the rules will therefore presumably be. On the other hand, if individuals are distant, they will obviously have to leave their commitments more "open" to incorporate any new knowledge, which is unavailable at that particular time.

Consequently, if the goal is to enhance the level of efficiency of markets, measured in terms of new discoveries of valuable information (i.e. innovation, technological progress, etc), then the legal system must be supportive of individual decisions to develop particular "rules," "patterns" or "institutions,", "corporate forms" or "levels of contractual integration," which

133. As Hayek contends, "If we can agree that the economic problem of society is mainly one of adaptation to changes in the particular circumstances of time and place, it would seem to follow that the ultimate decisions must be left to the people who are familiar with these circumstances, who know directly of the relevant changes and of the resources immediately available to meet them." *See* Hayek, *supra* note 121, at 525.

enable the process to unfold as much information as entrepreneurs are capable of discovering.[134]

Governments should therefore acknowledge their own limitations by enabling individuals to negotiate freely the institutional arrangements which they believe will reduce their uncertainty. In this way they can do a great deal for improving institutional conditions which introduce unnecessary curtailments of social knowledge, thus enabling firms to be spared from these.

What are the implications of this perspective for the design of competition policy?

Setting up the right framework to stimulate free competition requires fulfilling two essential conditions, which governments could ensure. First, policymakers should eliminate institutional obstacles impeding entrepreneurs to coordinate their scattered bits of knowledge with the rest. These obstacles could arise from regulations imposed at the request of interest groups pressing against liberalization of the economy who exercise rentseeking activities. Also, they could arise from the erosion of the legitimate expectations of those engaged in trade activities, due to the misbehavior of other firms.

Public policy, then, should define those instances where entrepreneurs are prevented from voluntarily defining the limits of market organisation. This could happen, for instance, if a gap in the legal protection of these rights or defective official enforcement encourages other entrepreneurs to misappropriate business reputation (i.e., violation of copyrights or trademarks). More significantly, government regulations could distort the growth of economic organization by dictating entrepreneurs how to behave in the market. Public policy which aims to preserve competition should focus on either challenging market restraints, which are sustained by a legal source or challenging the legal source itself.

Also, they could emerge as a result of the poor awareness of entrepreneurs concerning business opportunities, thereby being lost. Obviously, enhancing through education the likelihood of these opportunities should be a policy priority in the industrial policy of any government.

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134. *See id.*

In sum, the following guidelines are recommended:

1. In the area of vertical agreements and exclusive dealings, competition authorities should be more sensitive to the cultural setting where the allegedly anti-competitive agreements are undertaken. This setting is comprised by patterns and routines developed by businesses, which determine the size of the firm. A proper understanding of the underlying reasons supporting these patterns is beyond economic analysis. Determining whether a given business behaviour is procompetitive or anticompetitive is not only a matter that economic welfare analysis can sort out. Competition agencies above all should evaluate the importance of the conducts reviewed in the context of the cultural setting where they take place. Some conducts that appear to outsiders as restrictive may not be so if we use a different approach from the conventional neoclassical one. Under this alternative perspective, these arrangements are neither restrictive nor anticompetitive, but simply fulfil a role, which may be socially useful or harmful, depending on the goals sought by the community.

2. As a consequence of the former, the rule of reason analysis should not only ascertain the short term welfare loss of the undertakings analysed but also the long term welfare benefits that they could bring about in terms of new discoveries, innovations, the exploitation of new markets. These agreements are often nothing but institutional devices emerged over time to cope with the institutional uncertainty characterising Latin American domestic markets. Others are instruments to offset government interventionism in specific areas. Therefore, no general simplistic conclusions can be drawn in advance.

3. The former also calls for the revision of the enforcement criteria, to enable the suspected firm to challenge the presumption against her on the basis of the efficiencies that could always arise as a result of a conduct. No per se behaviour should be enforced against any conduct, as the analysis of the environment where such behaviour takes place will always be necessary.

4. In the area of dominance and unilateral behaviour, network access to small firms is also a priority. Very often this

access is limited by legal impediments making the access obtrusive or difficult. Obviously, the higher the costs of accessing to an essential network, the less likely it will be for smaller firms to compete. This is the case of sectors representing a vital network infrastructure for firms competing downstream. Public policy should guarantee access to competing or downstream firms requiring access to an essential facility, or to an array of essential business services and other inputs in the case of downstream user enterprises.

V. CONCLUSIONS.

Markets are organizations that emerge spontaneously as an integrated network of rules devised by their participants, whose existence is justified by the need to find solutions to the new and recurrent problems created by ever-changing information. Such changes in the subjective perceptions of entrepreneurs enable them to see knowledge gaps unseen by other entrepreneurs, and to therefore forecast profit opportunities, which they attempt to seize before the others. These gaps encourage them to compete as long as they feel they can outdo their rivals, provided they are sufficiently alert. Whenever an alert entrepreneur discovers an information gap, thus identifying a profit opportunity, profits may not materialise (in which case, it is as if no discovery has been made) unless our single entrepreneur seeks cooperation with others. Finally, these gaps can sometimes be seized and exploited only if firms give out alternative choices to those with whom they must trade in order to make the opportunities real.

For these reasons, condemning organizational structures embodied in business strategies because they restrict rivalry in the market could be a misjudgment of their economic rationale. This could also lead governments to impose losses on society, because it could induce them to prevent (or make costlier) the exploitation of valuable information, and distort future processes of information discovery.

As a result, one should not draw hurried conclusions from the varied arrangements which comprise markets without understanding the context of evolutionary and changing information within which they are placed. By assuming perfect information, the conventional paradigm assumes away the main problem faced by entrepreneurs, which is their decision to integrate and cooperate with many "restrictive" forms in order to insure them against the factor of sheer uncertainty. By adopting an evolutionary institutional perspective, these arrangements appear as the outcome of differing and unavoidable levels of knowledge handled by different entrepreneurs.

The need to develop regulations which fit the needs of entrepreneurial discovery is all the more important if one considers the need to ensure effective compliance with them by those who are subject to them. This is particularly relevant in the case of those countries possessing weakened official institutions that are incapable of effectively ensuring compliance with the rules laid down by the policy makers.

Forcing the entry (or endurance) of more firms into an industry than it can naturally tolerate with the aid of regulatory devices would do away with the freedom of those affected by the prohibition placed on their actions (to buy and sell, set whatever prices they regard as convenient, insure their businesses from unexpected risks, and so on) and would not compensate those firms which have suffered any loss of freedom. Indeed, these would have no more freedom to decide any given course of action. Any decision would now depend, not on their own will, but on the existence of the regulation imposed.

For this reason, Salin believes that the use of the term "restriction" for such barriers or impediments to competition is misleading, because it compares them with a nonrestrictive standard, which in this case is impossible.[135] In an imaginary world this standard would be the existence of perfect information among producers, which would allow them to avoid inconvenient restrictions on their freedom, otherwise necessary to overcome any problems in obtaining information concerning future demand.[136] Thus, when the time factor is considered, present contractual (or formal) constraints over future action cannot be seen as restrictions on competition or on freedom, but as means of ensuring expectations and ensuring access to valuable information on profit opportunities.

For this reason, these seeming "limitations on freedom" which enable some firms to seize profit opportunities, cannot

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135. P. Salin, *Cartels as Efficient Productive Structures*, REV. OF AUS. ECON. at 29, 34 (1996).

136. *See id.*

last indefinitely in a voluntarily negotiated setting. In such an evolving setting, the restrictive effects of these arrangements are irrelevant because they create the conditions favourable for their own elimination. As time passes, new circumstances render these agreements obsolete. This erodes their use as conveyors of useful information on how to meet consumer demand (and therefore, how to make some profit). Knowledge gaps resulting from the obsolescence of former conventions solutions will encourage alert entrepreneurs to make new ones, and thus seize the new profit opportunities created.

Different organizational forms enable information to reach some market participants, at the expense of restricting the freedom of the participants, but at the same time, enhancing their possibilities for them to receive such profits from others. Therefore, it will encourage them to make further investments. In the words of Richardson, "these market connections, whatever the additional objectives for which they are designed, and whatever their indirect effects, do afford entrepreneurs a more secure market for their individual products. They serve, in other words, as a means of increasing the amount of market information in a decentralised economy, or, in other words, of increasing the predictability of the entrepreneurial environment."[137] Thus, "the availability of [the] kind of such information - that related to competitive production - depends in particular on the existence of restraints which, in varying degree, reduce the freedom of action of individual entrepreneurs."[138]

Ignoring or neglecting official regulations is entrenched in the culture of Latin American effective institutions. It is therefore essential that policy-makers do not attempt to curb market functioning on the basis of aiming to achieve outcomes which, as we have seen, are not even subject to commonly agreed standards. It is not only a question that policymakers will be incapable of defining social welfare goals accepted by all, or even that they will be misled by their closedend perspective of market interaction. Optimal regulation will never be so if it cannot achieve its aims due to the resistance of those subject to it. This is, again, all the more important in Latin America, because of the cultural values impinging upon the enforce-

137. RICHARDSON, *supra* note 10, at 68-69.
138. *Id.* at 69.

ability of official rules.[139]

If competition is designing incentives to put firms under the constant threat of being driven out of the market if they fail to discover or exploit useful information, competition policy should ensure that firms are not prevented from making their own discoveries and exploiting opportunities whenever they have the possibility of doing so.

In the real world there is no such division between firms and markets. Instead, there is a continuum passing from transactions, such as those organized in the commodity market where co-operation is negligible, through intermediate areas where there are linkages based on goodwill, to complex and interlocking clusters, groups and alliances, which represent fully developed co-operation.

Individuals interact in the market through complex corporate forms, which co-ordinate their activities to achieve their production goals. Freedom of contract enables them to arrange their affairs as they see fit, giving rise to firms of varying shapes and sizes. Contractual freedom enables individuals to create whatever corporate form they consider necessary to achieve "institutional efficiency," i.e., they can reach their individual goals through a mixture of rivalry and cooperation. This provides them with the best information they can possibly have to arrange their affairs.

Conventional antitrust analysis suffers from an intrinsic inability to understand the nature of firms. Thus, it condemns several forms of market arrangements to being branded as "anti-competitive restrictions" which deserve surveillance. However, under an alternative neo-institutional approach which emphasises on how markets evolve, and how entrepreneurs seek ways to eliminate their uncertainty about the fate of their investments, certain "restrictive" contractual and corporate arrangements institutionally emerged, may prove necessary to encourage them to invest.

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139. On this question, Voigt emphasizes the significance of "preconstitutional" values in ensuring the effective credibility of constitutional rules. He claims that this is a factor absent from the Latin American reality, thus leading these countries to disregard the rule of law, which leads them into economic backwardness. *See* S. Voigt, *Making Constitutions Work: Conditions for Maintaining the Rule of Law*, 18 CATO J. 191 (1998).