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Freeing the Global Market

How to Boost the Economy by Curbing Regulatory Distortions

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Introduction

The U.S. economy faces major challenges competing internationally. One of the most worrisome is the growing use in China and other advanced developing countries of anticompetitive market distortions (ACMDs)—including regulatory protection that privileges specific companies—which put foreign competitors at a disadvantage.[1] ACMDs are government actions that give certain business interests artificial competitive advantages over their rivals, be they foreign or domestic, to the detriment of consumer welfare. These market distortions are especially damaging to the industries in which the United States enjoys the greatest comparative advantages, but they are also harmful to the long-term prosperity of developing economies and cost the global economy trillions of dollars.

To combat ACMDs, the conventional trade policy approach of focusing on the removal of narrow market access barriers is inadequate. Trade negotiations traditionally involve countries removing domestic barriers protecting import-sensitive industries in exchange for greater access abroad for successful export industries. Opposing trade ministries are the only parties at the negotiating table. Yet this approach does not build competitive markets and drive through regulatory reform. Instead, the United States and other countries should initiate new international negotiations that bring to the table those who advocate for exporters (typically trade ministries) and those who advocate for domestic consumers and competing firms (typically competition agencies). Such negotiations would have the goal of maximizing consumer welfare, using competition to deliver more and better goods and services at lower prices.

The United States should lead in this effort because these market barriers pose a considerable threat to the U.S. industries that today constitute the country's comparative advantage. To carry out this approach to international negotiations, the U.S. federal government needs to restructure its economic agencies around the goal of strengthening competitive markets at home and abroad. It will also need to develop new tools to reduce market distortions that have flourished largely outside the scope of the World Trade Organization (WTO) and other trade agreements.

Threats to U.S. Comparative Advantage: Why Current Trade and Competition Negotiations Are Inadequate

U.S. innovation has thrived in large part due to an effective regulatory environment. The United States has emerged as a global leader in software, biotechnology, advance manufacturing and services, and other sectors that depend on proprietary intellectual property (IP). Today, IP-intensive companies increasingly depend on overseas markets for growth. Yet the ability of these companies to realize their full market potential is being compromised by other countries' market-distorting regulatory measures. Such distortions are increasing in number and significance in many of the world's fastest-growing consumer markets, such as China, Brazil, India, and Russia.

IP-intensive industries are high-value ones that many countries seek to nurture, which is why they tend to be protected by foreign governments that want to see domestic firms move up the value chain. But the forms of protectionism are rarely traditional tariff barriers or quotas, most of which have been eliminated through successive rounds of international trade negotiations. Governments instead set product standards, limit entry by competitors, restrict advertising, and otherwise distort market competition in ways that benefit favored domestic firms. The competitive success of these U.S. industries is therefore contingent on reducing market barriers, such as discriminatory standards and regulatory policies that secure advantages for domestic competitor firms in overseas markets.

The outcome matters greatly for the economic future of the United States. Take one example: the International Trade Commission (ITC) recently estimated that U.S. firms with collective global sales of $5.9 trillion were harmed by China's "indigenous innovation" policy, a basket of regulatory measures designed to benefit domestic companies at the expense of their foreign competitors.[2]

The best-paying U.S. jobs are at stake. Export jobs generally pay higher wages than domestic industry jobs. Wages in research-based industries that rely on proprietary intellectual property are higher still. The U.S. industries with the highest annual average wages are all IP-intensive, while the industries with the lowest wages are not (see Table 1).[3]

Table 1. Annual Average Wages, by Industry (2011)

Industries	Annual Average Wages
Highest wages	
Information software	$110,052
Petroleum, coal products	$70,855
Communications equipment	$70,036
Pharmaceuticals, medicines	$69,689
Navigational, electro medical	$63,667

Lowest wages	
Plastics, rubber products	$35,602
Food, beverage, tobacco	$33,444
Wood products	$30,816
Furniture	$30,625
Textiles, apparel, leather	$26,667

Source: Bureau of Labor Statistics.

High-wage, IP-intensive industries are the backbone of the U.S. economy. They accounted for 61 percent of total U.S. exports in 2010.[4] Two IP-intensive industries—the health-care sector (including medical devices) and the biopharmaceutical sector—currently account for roughly half, or $24 billion, of the United States' $56 billion in private sector research.[5] Exports from IP-intensive industries have the potential for rapid growth as millions of people in developing countries enter the middle class, consuming more advanced manufacturing and high-tech products.

The United States has established a dominant global position in many high-tech sectors largely as a result of robust intellectual property protection, federal research and development (R&D) support, and a generally supportive regulatory environment. The computer software industry in the United States took off in the 1970s in large part because software producers could protect their ideas through copyright. For centuries Europe was the unquestioned center of pharmaceutical R&D, challenged only by Japan in the postwar period. But in the 1990s, the United States began increasing its share of global pharmaceutical R&D thanks to regulatory changes, patent legislation, and court decisions.[6] A Milken Institute study found that in 1990 the global research-based pharmaceutical industry invested 50 percent more in Europe than in the United States, but by 2006 investment in the United States was 40 percent higher than in Europe.[7] A similar trend can be found in the global share of new chemical entities (NCEs), a proxy for gauging innovative capacity (see Table 2).[8] The United States' global share of NCEs leapt from one-third in the 1980s to nearly two-thirds in the 2000s.

Table 2. New Chemical Entities, by Headquarter Country of Inventing Firm (1971–2010)

	1971–1980		1981–1990		1991–2000		2001–2010	
	NCEs	% of total	NCEs	% of total	NCEs	% of total	NCEs	% of total
United States	157	31%	145	32%	75	42%	111	57%
France	98	19%	37	8%	10	6%	11	6%
Germany	96	20%	67	15%	24	13%	12	6%
Japan	75	15%	130	29%	16	9%	18	9%
Switzerland	53	10%	48	11%	26	14%	26	13%
UK	29	6%	29	6%	29	16%	16	8%
Total NCEs	508		456		180		194	

Source: The Milken Institute, *The Global Biomedical Industry*.

Access to venture and risk capital has also contributed to the U.S. edge in R&D. The United States captured 68 percent of the $8 billion total global venture capital in life sciences in 2007.[9] Regulatory structures have encouraged capital to flow into start-up companies, and the rewards derived from a

strong patent environment stimulate investment and capital flows. When South Korea improved its patent environment, for example, venture capital inflows increased dramatically.[10]

Sound regulatory systems are essential for ensuring vibrant domestic innovation in high-value, IP-based industries. Conversely, distorted regulatory environments abroad can harm the export competitiveness of these industries.

Another leading high-value U.S. export—advanced service industries—is similarly affected by ACMDs. Telecom companies can be frozen out of big foreign markets if governments adopt specific national product standards that differ from prevailing global standards. Financial services firms can be restricted from using domestic electronic payment systems to process credit and debit card transactions.

Regulatory measures abroad are often designed to favor national champions or to carry out national industrial strategies that free-ride off the innovation of others. The lower costs for favored firms are not secured through business competition, greater efficiency, or a labor cost advantage, but rather through a deliberate skewing of the market by the government to reduce their operating costs in comparison to their rivals.

SHORTCOMINGS OF TRADE AND COMPETITION RULES

Regulatory market distortions, unlike more conventional trade barriers such as tariffs or import quotas, are hard to identify and lurk in the shadows of domestic regulation. They are designed to evade detection and are difficult to quantify.

Traditional trade negotiations have done little to remedy ACMDs. Since they are not necessarily discriminatory in the trade sense of establishing different rules for domestic and foreign companies, attempts to bring them under the jurisdiction of the WTO have not been met with great success.[11] Take, for example, U.S. efforts to alter the Canada Wheat Board's (CWB) anticompetitive activities. The CWB is a state trading enterprise that acts as a single seller for Canadian grain on the world market and for certain domestic markets, practices the United States says give Canada greater flexibility than any commercial seller to price below its competitors in certain markets. The United States brought a case before the WTO, but both the WTO Dispute Settlement Panel and the Appellate Body resisted attempts by the United States to read competition principles into Article XVII of the WTO Agreement, which covers state trading enterprises. The United States argued that state trading enterprises like the CWB should be required to act according to "commercial considerations," which should preclude price cutting in certain markets to expand market share. The WTO panels did not agree with that argument.[12] Efforts by the U.S. Congress to use existing U.S. anti-subsidy laws against some of the more systematic ACMDs in the Chinese market have not been effective either. WTO rules are written in such a way that broad regulatory measures are generally allowed, even if their effect is to block new competitors.

Domestic competition laws within advanced developing countries have been no more successful. They do not generally deal in a concrete way with government anticompetitive practices and focus much more on private practices, such as cartels and single-firm conduct. Government anticompetitive practices consist of laws or regulations that distort what would be otherwise competitive markets, and because they are government actions, most countries' competition laws either expressly exclude them from the law's disciplines or at best apply only hortatory nonbinding mechanisms to rein them in. The success of domestic competition laws depends on the credibility of the competition

agency with the government's other branches. In many advanced developing countries where ACMDs exist, competition agencies are relatively new and powerless.

ACMDs tend to fall between traditional trade disciplines and internal regulatory disciplines. Undisciplined by existing statutes, ACMDs have been allowed to proliferate. Resources are not being allocated most efficiently, but rather in favor of a particular firm or firms because of an artificial cost advantage created by government regulations.

ACMDs artificially reduce costs for certain companies while raising costs for others who are often in direct competition and raising prices for consumers. Although the costs of such distortions are difficult to measure precisely, they are far greater than remaining traditional trade barriers, such as tariffs and quotas. One widely cited assessment of the additional gains to the world economy from conventional trade liberalization measures puts the figure at $500 billion annually.[13] The gains from eliminating ACMDs are likely to be many multiples higher, in the trillions of dollars. The combined static and dynamic losses caused by ACMDs have effects in downstream markets and cause significant efficiency losses. In many emerging markets, these ACMDs influence almost every aspect of the economy.

When the topic of ACMDs is brought up in international regulatory dialogues, proposed solutions are inadequate. Too often discussions focus on divergences among countries' regulatory systems, devolving into negotiations between specific regulators from each country. A good example is the Transatlantic Economic Council negotiations, which seek to ensure greater trade flows between the United States and the European Union by curbing the negative impact of regulatory barriers and differences. Negotiations tend to result in a mutual recognition agreement (MRA), in which countries agree to recognize each other's regulations as equivalent. Such agreements can be valuable, but they fail to address the more pressing problem—the high cost imposed by the distortion itself. There have been some recent attempts to address ACMDs in the context of state-owned enterprises, most recently in the Trans-Pacific Partnership negotiations. But attempts by trade negotiators to confront these challenges are in their infancy and have yet to make significant progress.[14]

The Challenge of Anticompetitive Market Distortions

Over the past two decades, many countries—such as China, India, Russia, and Brazil—that have followed some type of command and control or import-substitution economic model have become part of the global economy. Laws and regulations designed to exclude or discourage foreign competitors in domestic markets are in many cases still in place. While these nations have been forced to eliminate traditional border trade barriers in order to join or meet commitments under the WTO, previously protected industries have sought, and continue to receive, protection in other forms. For example, a domestic banking industry that is now forced to compete with foreign banks may seek to require a complex licensing system, putting its new foreign competitors at a disadvantage. Mexico began to open its national telecommunications market to foreign firms in the 1990s, but rigid barriers were put in place with respect to interconnection policy and settlement rates that made it impossible for those new entrants to succeed.

ACMDs, however, benefit narrow domestic interests, and come at a steep cost to the rest of the domestic economy, both to consumers and domestic competitors. They distort the overall market from a welfare-enhancing equilibrium, reducing their economies' potential wealth creation. Consumer or small-business advocacy groups in these countries are often too politically weak to force their governments to dismantle these ACMDs.

LIMITING THE NUMBER AND RANGE OF COMPETITORS

The most pernicious regulations effectively exclude new competitors. Historically, established companies have sought to restrict entry in order to maintain or charge higher prices for their products. In advanced economies, competition laws prevent such practices by private firms. But if a private firm achieves through government regulation what would be illegal if done privately, there is little or no remedy. In large emerging markets, governments are increasingly enacting regulations that are designed to favor certain national companies over both foreign and smaller domestic competitors. These regulations include the grant of exclusive rights for a company to supply a service or product; license requirements; limitations on public procurement opportunities; and geographic limitations on the ability of firms to supply goods or services, invest capital, or supply labor.

Entry regulations are the most common source of complaints from both foreign and domestic firms, often taking the form of direct prohibitions, such as retail store bans or airline agreements that limit foreign competitors. India, for example, restricts establishments by foreign retail operations, and the Indian government has faced significant difficulties in pushing through a plan to try to ease those restrictions after complaints from small Indian retailers. As a result, Indian consumers will continue to pay higher prices. Restrictions are especially pernicious in services, where markets are generally far more closed than in the goods trade. Services have only recently been subject to liberalization after the Uruguay Round agreement in 1994. Goods trade, in comparison, has been subject to gradu-

al tariff reductions since the General Agreement on Tariffs and Trade (GATT) going back to 1947. Moreover, the way services are liberalized generally leads to lower levels of liberalization. In the WTO negotiations, countries only agree to liberalize specific, listed services, which generally results in much lower levels of liberalization. Many sectors are excluded at least in part, and emerging services related to high-technology industries are not covered because they did not exist at the time of the last WTO service negotiations, which occurred in the 1990s. This contrasts with the negotiations on goods trade, in which all tariff lines are systematically ratcheted down. Since many technology companies such as IBM are essentially service providers, these types of barriers are serious impediments to U.S. high-tech firms.

There are also many indirect restrictions, including quality standards, certification rules, overreaching capital adequacy requirements for banking services, and administrative or bureaucratic barriers.[15] In some cases, governments grant exclusive rights to certain domestic suppliers. Jamaica's telecoms privatization, for example, granted exclusive rights to cable and wireless service for a twenty-five-year period over the local wired telephone network.[16] Mexico's telecoms privatization offers a similar example. The Mexican government granted a monopoly for Telmex in the local telephony market, which the company used to establish a dominant position in the supposedly competitive long-distance and international markets. Coupled with an interconnection policy that favored Telmex, the result was prices and telephone service that were higher and poorer, respectively, than for consumers in any other country in the Organization for Economic Development and Cooperation (OECD), and few opportunities for foreign competitors.[17]

State- or province-level regulations can also limit entry, and these limitations affect both foreign and domestic firms.[18]

RESTRICTING THE ABILITY OF COMPANIES TO COMPETE

Even when foreign companies are permitted to set up businesses, many countries maintain regulations that limit the intensity with which those firms can compete with established domestic companies. Some countries have restrictions on direct-to-consumer advertising, entrenching market leaders. Such restrictions are especially pernicious for foreign companies that are unfamiliar to consumers or for high-tech and IP-based firms that develop entirely new classes of products. Many countries strictly limit advertising for pharmaceutical products. Though ostensibly done for public health reasons, these restrictions deprive consumers of important information about new products that could improve their health. This tends to entrench the market leader and constrains the price-reducing effect of newer, more competitive products.

Some regulations set product standards that benefit a national champion or other favored domestic firm. China's state-owned telecom companies are prime examples. In China, the government has used "standards setting" with increasing frequency to favor domestic champions over foreign competitors. It introduced technical standards that differ from generally accepted global standards for similar products. In 2009, China launched the TD-SCDMA 3G wireless standard, and assigned it to China Mobile, which controls two-thirds of the Chinese wireless market. U.S. companies seeking to tap the Chinese market have to invest resources developing new versions of existing products. Apple, after over two years of delays, has only recently been able to introduce its iPhone to customers of China Unicom, which operates the more broadly used WCDMA standard. But it will still have to develop TD-SCDMA–compatible phones in order to access the larger China Mobile market. In the

meantime, a market for sophisticated counterfeits—fueled by the unavailability of the iPhone—has already emerged. Additionally, the Chinese government has supported Chinese companies adopting the TD-SCDMA 3G standard with billions of dollars in subsidies. These companies have not only displaced foreign companies in China, but are aggressively competing abroad. ZTE, for instance, was ranked one of the top five global handset producers in 2010.

China's standard-setting policies may compel U.S. firms, which already produce many of their phones in China, to shift even more production and R&D to China, resulting in further job losses in the United States. Most recently, China has drafted new technical standards and licensing requirements for foreign software producers seeking to sell their products in China. The recently revised China Compulsory Certification (CCC) rules require producers of certain types of software (including antispam and operating systems) to submit their products for certification by the Chinese government. U.S. firms have expressed concerns that submission will result in IP theft and increase the cost and time needed to bring new products to market. In 2007, the Chinese government also introduced MSPS, a set of rules governing security technology that categorizes software systems into five tiers. Only domestic producers will be allowed to supply Chinese companies with products categorized in the top three tiers.

FAVORING STATE-OWNED ENTERPRISES

One of the most significant problems in global economic policy is competition between private and state-owned enterprises (SOEs). In the past, SOEs tended to be the large agro-industrial conglomerates, such as wheat boards or steel companies. As countries are seeking to advance up the global supply chain, however, many are turning to SOEs in more technically advanced areas. Telecoms are a leading example, but China's SOEs are moving up the value chain in other areas, too. China Union Pay, for instance, is a credit card company that competes head-on with Visa and MasterCard.

The problem is not necessarily state ownership, but rather that governments frequently skew their domestic regulatory environments to give their SOEs an unfair advantage in the global market. As a result, foreign firms and domestic nonstate-owned firms are at a disadvantage. Many of these regulations give privileged licensing terms to SOEs, grant them access to preferential loans and financing opportunities, and provide free or low-cost inputs such as water, energy, and raw materials.

Governments also exempt SOEs from national competition laws.[19] SOEs can then engage in anticompetitive practices and distort global markets without fearing any domestic penalty, while at the same time benefiting from variants of the foreign sovereign immunity defense in foreign markets.[20] China's Anti-Monopoly Law provides a broad exemption for SOEs that are important to national security or to the economy. In practice, the loophole has been applied to allow China's largest potassium fertilizer importers to engage in price-fixing, and has permitted Chinese telecom companies to agree not to compete in their respective territories.[21]

Policy Prescriptions

The U.S. government has increasingly tried to address ACMDs in a variety of ways, including the bilateral Strategic and Economic Dialogue (S&ED) with China and the ongoing Trans-Pacific Partnership (TPP) trade negotiations in Asia. In the S&ED negotiations with China, there has been some focus on the role that the new Chinese competition agency might play as China moves toward a more competitive market, as well as discussion of the indigenous innovation policy. In the TPP, there are specific negotiations related to the most pernicious aspects of state-owned enterprises and anticompetitive regulations.

These efforts to discipline ACMDs, however, have not targeted the major problem, which is their negative impact on competition. Instead, U.S. negotiators have sought to find a discriminatory aspect to particular measures showing that the measures violate international trade rules by favoring domestic companies over foreign competitors. A good example is the protective distribution laws, which can be found in many countries in Latin America. These laws protect local distributors by forcing foreign suppliers to pay extraordinarily high termination indemnities (often multiples of gross profit over the lifetime of the agreement) if they wish to end the contract and change distributors. As a result, the distribution market becomes badly distorted and product prices increase, sometimes by over 100 percent. These laws, however, would not violate trade rules if they were applied equally to both foreign suppliers and local suppliers, even though the result is much higher prices for consumers. But searching for a discrimination hook on which to hang a trade case is to miss the wider point—the market distortion does enormous damage to the domestic market, consumers, and companies exporting into those markets.

Addressing ACMDs will require a comprehensive approach that brings together both trade and competition tools. There are four broad approaches that the United States should pursue that would build on existing U.S. policy initiatives in some cases and take U.S. policymaking in a new direction in others:

- Negotiate a multilateral agreement, such as a WTO plurilateral agreement, with like-minded countries that accept free competition as an organizing economic principle. Along with imposing disciplines among members with respect to ACMDs, an agreement would offer economic benefits and allow member countries to use "self-help" remedies in response to violations.[22] This would give countries that are distorting their markets an incentive to eliminate those distortions.
- Launch additional dialogues between trade ministries and competition agencies. These dialogues would bring export interests for adversely affected markets into alignment with consumer welfare interests in the distorting country and domestic companies that are harmed by ACMDs. Building such alliances is more likely to lead to a solution.
- Restructure some U.S. government agencies around competition as an organizing economic principle. The two core principles would be free trade unencumbered by governmental restrictions and competitive markets as measured by the maximization of consumer welfare.

- Develop a market-based metric to measure the costs imposed by ACMDs. The metric would be essential for reaching agreement on how to offset ACMDs' negative effects.

A MULTILATERAL AGREEMENT DISCIPLINING ACMDS

The United States should lead efforts to negotiate a multilateral agreement that disciplines ACMDs. Such an agreement could have proactive measures that curb ACMDs, as well as defensive measures that enable members to take action against countries that refuse to remove them. The remedy process could be triggered by complaints from specific companies, as is currently done under U.S. antidumping and countervailing duty laws, or it could be initiated directly by governments. It is important to note that such an agreement would not be intended to supplant the existing WTO framework but rather to supplement it.

A multilateral agreement on ACMDs should deal with at least three specific cases for goods trade:

- Goods exported by foreign companies that benefit from ACMDs, and therefore receive an unfair competitive edge by lowering the costs of exports into the United States or other countries that are party to the agreement. In this case the agreement would encourage negotiations to end the market distortions, under the threat that the United States (or other countries similarly affected) could otherwise impose tariffs on those goods that have benefited from these market distortions. The size of the tariff would be determined by the impact of the distortion.[23]
- Goods exported to third country markets by foreign companies that benefit from ACMDs, and therefore have a preferential position in competition in those markets. In this case the agreement provides for a "positive comity" tool that would enable the United States (or other countries similarly affected) to petition the third country to activate its self-help remedy and impose import tariffs on goods from the offending country.
- Goods exported from the United States or other countries that are made uncompetitive in the distorting country's market as a result of ACMDs. The agreement would then provide for a consultation plus dispute settlement that ultimately allows for retaliatory tariffs on imports (as would be the case with any WTO violation).

In the case of services, similar disciplinary provisions could be applied, including a combination of fines or limitations on licenses to operate.

These unilateral actions, in the form of a protective tariff or other restrictive measures, would be applied only in cases where a country could demonstrate that there was a market distortion that damaged its companies or harmed its economy, according to an agreed metric. Such mechanisms would have to adhere to the rules of the new global agreement, and there would be full dispute resolution if a party violated the rules.

Similar self-help remedies could also be used in the case of ACMDs in countries that are not yet members of the agreement. The remedies would have to comply with existing WTO rules. Some of the potential measures could build on current U.S. laws and be crafted in ways that do not violate U.S. trade obligations. This poses real challenges under existing WTO rules, which prohibit any sort of self-help measures except in the case of action that clearly violate the rules of WTO agreements. But the interests at stake for the United States are such that it should be prepared to defend such actions before the WTO and make a strong case that they are consistent with WTO rules.[24]

There are a number of models that could be helpful in crafting the agreement. In maritime and air transportation there are separate agreements outside the WTO, which provide for arbitration in the case of unfair competitive practices by foreign governments. They also permit unilateral actions by governments that essentially equalize the effect of the distortion. The Convention on International Civil Aviation establishes rules of airspace, aircraft registration, and safety, and details the rights of the signatories in relation to air travel. Under the bilateral agreements negotiated by the United States and other countries, the United States can use unilateral measures, including fines, to respond to anticompetitive practices by foreign countries, and vice versa. These measures have been used successfully to force changes in behavior by foreign governments.[25] When governments act in anticompetitive ways that harm U.S. shipping or commerce, the Federal Maritime Commission (FMC) can take unilateral action, such as limiting sailings, suspending tariffs and service contracts for carriage, suspending an ocean carrier's right to operate, imposing fees, and generally taking "any other action the Commission finds necessary and appropriate to adjust or meet any condition unfavorable to shipping in the foreign trade of the United States."[26]

In order to persuade countries to join, the agreement would need to include carrots as well as sticks. These benefits for member countries could include:

- advantageous access terms for government procurement
- open immigration accords, particularly with regard to high-skilled workers
- more trade-friendly export control measures
- streamlined approval for foreign investments through such bodies as the U.S. Committee on Foreign Investment in the United States (CFIUS)

Initially, an ACMD agreement would involve more like-minded countries, such as those that signed the Anti-Counterfeiting Trade Agreement (ACTA).[27] Some of the most likely countries to participate initially could include Australia, New Zealand, Hong Kong, Korea, and perhaps the European Union or certain member states. A core agreement among these countries would raise the pressure on other countries to join. First, such an agreement would lead to an increase in the efficiency of the supply chain within those countries and create a more dynamic region with ever-increasing benefits for its members. Those countries on the outside would become less attractive to foreign investors as companies seek a more favorable regulatory environment. Second, economic carrots such as favorable procurement, immigration, investment, and export control arrangements would offer significant additional benefits to encourage new countries to join. Finally, nonmembers could still face sanctions as a result of their ACMDs, imposing additional costs for remaining outside the agreement. Over time, the disadvantages for countries that are not members are likely to outweigh the advantages of staying outside the agreement in order to avoid restrictions on regulatory measures.

The art would be in crafting a bargain that contained a combination of carrots and sticks that encouraged nonmembers to sign on. By presenting certain countries with a choice between a future solely of containment with the ongoing threat of trade retaliation over ACMDs or elimination of ACMDs plus membership in a much more dynamic economic area, there is a greater likelihood that pivot countries such as Brazil in Latin America or Korea and Japan in Asia would move more toward the pro-competitive, undistorted market system and away from distortive state-led economic development. Their membership could tip other important countries, the most strategic and challenging

of which include China, Russia, and India, toward embracing the ACMD agreement, leading to a virtuous circle of systematic reduction of ACMDs.

LAUNCH TRADE MINISTRY–COMPETITION AGENCY DIALOGUES

The pernicious effects of ACMDs should also be addressed through domestic competition policies.[28] Although ACMDs may not readily be reached by direct antitrust enforcement law or formal WTO trade enforcement mechanisms, they could be targeted by "competition advocacy" initiatives carried out by competition agencies. Such initiatives ensure that competition considerations are weighed in the formulation of laws, regulations, and public policies. Often competition advocacy involves critiques of draft rules or laws on the grounds that they would block or distort consumption, thereby reducing consumer welfare.

Historically, competition advocacy has been directed at sister agencies at the national level or at subordinate levels of government. In recent years, in discussions with emerging competition regimes, major competition agencies, such as the U.S. Federal Trade Commission (FTC), the U.S. Department of Justice, and the European Commission's Directorate General for Competition, have promoted competition advocacy as a valuable method for consumer welfare enhancement.[29]

Competition agencies should also be integrated into all trade and regulatory dialogues. By aligning Country A trade ministries with Country B competition agencies, the export interests of Country A can be more closely aligned with the consumer interests of Country B.

It has proven difficult to bring the U.S. trade and antitrust agencies together on this point. The reasons are many, but the agencies fundamentally have different goals. Trade agencies are concerned about barriers in foreign markets and their effect on U.S. exporters. Competition agencies are concerned about distortions in their own markets and their impact on consumers. Two agencies in the same country thus have different concerns and constituencies that do not intersect. However, a trade agency in Country A and a competition agency in Country B do have aligned interests. Both want to see ACMDs removed—the trade agency because of the damage to export interests, and the competition agency because of the damage to domestic consumer interests. When it comes to ACMDs, their objectives should be aligned.

The difficulty is that in many of the countries where ACMDs are most pervasive and destructive, competition agencies either do not exist or are so politically weak that they cannot be expected to battle against powerful political forces that benefit from ACMDs. While this is true, competition agencies are the best option available to combat ACMDs on the domestic front. The challenges are significant, but the type of dialogues proposed would at least help give these competition agencies the external credibility they need in order to be more effective in their advocacy. This holds out some prospects for tipping the balance of power in developing markets away from powerful, export-oriented business interests and toward domestic consumer interests.

One other development working in favor of this agenda is that many developing countries, China most prominently, are discovering the limitations of export-led growth strategies. For China to maintain its rapid growth of the past two decades, it will have to boost domestic consumption. Eliminating market distortions that raise prices to consumers would contribute significantly to that effort.

In the United States, there is an additional problem: there is no real history of significant government interference and state control of industries. In many developing countries, legacy import-substitution economics or central planning has led to a range of ACMDs, along with the widespread

understanding of their role and damage to society. Ironically, this has meant a greater appreciation in newly opened economies of the role of government to remove market distortions than in the United States.

COMPETITION AS AN ORGANIZING PRINCIPLE

The United States should reorient its trade policy by adopting competition as an organizing economic principle, with the goal of reducing both domestic and foreign market distortions that are harmful to consumer welfare.

Cost-benefit analysis on domestic regulation in the United States is conducted by the Office of Information and Regulatory Analysis (OIRA). This office, sitting within the Office of Management and Budget (OMB), evaluates the costs and benefits of new regulations. Over the past two decades, various executive orders from both Republican and Democratic administrations have moved cost-benefit analysis from a rudimentary evaluation to a more focused test that tries to evaluate the regulation's impact on the market itself (in addition to business compliance costs). The former OIRA head, Cass Sunstein, has spoken about using economic welfare effects in determining the costs of new regulation.[30] The "Buy America" regulations of the 2009 stimulus, for example, imposed local content requirements for projects that were to be funded by stimulus money. At a time when there was not a great deal of private commercial activity, these provisions led to a substantial lessening of competition in the public sector. Unwittingly, Buy America regulation and the paucity of available waivers meant that monopolies were created all over the supply chain, leading to price increases and less choice for consumers. In at least one case, the FTC pointed out the potential anticompetitive effect of Buy America regulations and a restrictive waiver policy, arguing for waivers to be more available in order to promote a more competitive market.

If countries are moving in this direction, then competition agencies—whose core function is measuring welfare effects—should be brought more centrally into the process. Competition agencies should have a seat at the table in arguing for pro-competition regulatory reform. This is in line with the OECD's Regulatory Toolkit and Competition Assessment, and it is also the practice in certain OECD members, such as the United Kingdom, the Netherlands, and Australia.[31]

The U.S. government should also reorganize its economic agencies around the idea of competition policy as an organizing principle. U.S. government agencies are generally structured along mercantilist lines. There are entities that promote exports and the interests of exporters, such as the U.S. Trade Representative (USTR) and Commerce Department. Then there are different entities that deal with domestic regulations and imports, such as the Justice Department, the FTC, parts of the Commerce Department, and the International Trade Commission. There is little if any interaction between these two groups, and this has the unhappy effect of ensuring that where the United States' offensive interests (in reducing barriers in foreign markets) are pitted against its defensive interests (in maintaining barriers to imports), its defensive interests usually prevail. It also ensures that while impediments to the global supply chain in foreign markets are treated with seriousness, impediments to the same supply chain located inside the United States are basically ignored (or in bad cases increased, such as the Buy America legislation).

The Obama administration has proposed consolidating the various trade-related agencies, though for different reasons, and the plan is now waiting for congressional action. The ideal reorganization would begin by merging the many departments that currently are concerned with both internal and

foreign trade into a single Department of Economic Competitiveness (DEC), whose function would be to maximize the nation's economic competitiveness by targeting market distortions in both U.S. and foreign markets.[32] The DEC would include personnel currently located within the International Trade Administration of the Department of Commerce, the USTR, and the Bureau of Economic, Energy, and Business Affairs at the Department of State; relevant trade officials in the Department of Treasury and OIRA within the OMB; and personnel from the FTC and the antitrust division of the Department of Justice.

To better protect property rights and reduce economic distortions, a Bureau of Domestic Regulation (BDR) within the new department would perform a cost-benefit analysis of all domestic regulation to be promulgated. The establishment of the BDR would represent a new approach to regulation; by making the true market impact costs of new regulation more explicit, the BDR would enable legislators to decide whether those costs are worth paying.

Finally, the United States should establish a Bureau of Market Access and Contestability (BMAC) to ensure that the regulatory framework of foreign markets is as pro-competitive as possible, and to enact measures to counteract ACMDs abroad. While the BMAC would have the lead on negotiating to eliminate ACMDs, the USTR would continue to be the lead trade negotiator for the U.S. government.

Government reorganizations of this scale are difficult at any time, because there are too many vested interests that benefit from the established structure. The Obama administration's reorganization proposal, for instance, faced immediate opposition in Congress, and not just from Republicans. There are certainly other, bureaucratically simpler ways to reorganize, such as a revamped interagency process that puts ACMDs more fully into the center of policymaking. But a more thorough reorganization would be a better fit for the international trade realities of the twenty-first-century world. Even if a less ambitious reorganization is considered in the short term, the type of structure proposed here should remain the goal.

In order for this reorganization to work policymakers need to embrace competition as an organizing principle and apply it to both domestic and foreign regulations. This requires a change in approach from a purely mercantilist mindset to one that is focused on competition and consumer welfare, which is a significant change, but one required by the large changes that have occurred in the global economy. The goal would be to address market-distorting foreign regulations with the same focus that is applied to domestic regulation. This reorganization would acknowledge the new reality that all countries benefit from global GDP growth—growth that would be strengthened if the distortions that plague the global supply chain are eliminated. The goal of these reformed agencies would be to ensure that competition is based on business merit rather than by how well competitors wield government power. Just as the Department of Homeland Security was set up to deal with a new threat to U.S. national security, so the DEC would deal with this new threat to American economic security.

DEVELOP A COST METRIC

One of the biggest challenges in removing market distortions is to develop some agreed measure of the costs imposed by ACMDs. An agreed measure of the harm caused by ACMDs is necessary not only for better understanding of the problem, but to enable the self-help and dispute settlement remedies that should be part of any new international agreement.

The question is what that metric should be. It should measure the impact on consumer welfare as well as on trade, and include direct and indirect costs.[33] Regulatory distortions can lead to significant price increases for consumers. But there are also larger dynamic losses caused by firms deciding not to invest in new products or new technologies because they are unable to compete in distorted markets. A good example would be where a pharmaceutical company is faced with market distortions that reduce profits, and can therefore no longer afford to invest in research that could lead to better or lower-cost products. Any high-tech company suffers an immediate loss when it is unable to fund research because the regulatory costs have been raised to unacceptably high levels. And since the global supply chain's efficiency is also damaged by ACMDs, other companies feel the impact. The static losses caused by ACMDs spawn a vicious cycle of losses that travel through the downstream firms and can have wide-ranging ripple effects across the whole economy.

Designing a metric for measuring the welfare effects of ACMDs is a complex endeavor given the variety of factors that need be considered. In order to create a realistic metric, it is important to account for not only the direct costs or consequences of ACMDs, but also the indirect or hidden ones. There are many ways of calculating the welfare effects of ACMDs. One option is to assume a market equilibrium and then impose the distortion on this equilibrium through a partial equilibrium analysis.[34]

The OECD has already carried out substantial work on regulatory reform and would certainly be a logical entity to help develop a new metric. It is likely that as the negotiations are initiated for the multilateral agreement on ACMDs proposed in this paper those negotiations would quickly turn to the question of how to establish an appropriate, agreed metric. This is one of the reasons that it is so important that these negotiations are initiated by countries that share an agreed normative framework—fair competition as an organizing economic principle.

The metric should also be driving in the same direction as the rest of domestic regulatory policy. It should reinforce what external and credible actors, such as the OECD, are telling countries they should follow in their domestic regulatory policy to promote competitive markets and all their benefits.

Conclusion

ACMDs represent a serious problem in the global economy. Although it is difficult to assess the exact scale of the problem, a conservative estimate suggests costs to consumers worldwide in the order of trillions of dollars. Fixing the ACMD problem will require understanding the nature and scale of the challenge to further economic growth, and reorienting global policymakers to the consumer rather than producer side of the economic ledger. This will lead to policies across both international and domestic fronts that reduce ACMDs and expand wealth creation globally. This is vital to ensuring that the first fifty years of the twenty-first century boast the kind of enormous economic gains that were seen in the last fifty years of the twentieth. This outcome will only be achieved if those who believe in competition as an organizing economic principle offer other countries a clear choice between an economic zone governed by these principles and the distortive system that still prevails in much of the world today.

Endnotes

1. *Mapping the Global Future: Report of the National Intelligence Council's 2020 Project*, National Intelligence Council, December 2004, pp. 27–35 and 47–55, http://www.foia.cia.gov/2020/2020.pdf.
2. See United States International Trade Commission, "China: Effects of Intellectual Property Infringement and Indigenous Innovation Policies on the U.S. Economy," Investigation No. 332-519, USITC Publication 4226, May 2011, pp. 5–9 (Figure 5.3 sets forth a list of programs or policies that collectively form China's indigenous innovation program encountered by U.S. IP firms doing business in China. Those programs and policies include: tax incentives; subsidies; preferential lending; Chinese-specific technical standards; government procurement policy; unequal treatment; unequal enforcement of China's Anti-Monopoly Law; incentives to register patents or other IP; compulsory licensing; closure of sector to foreign participation; technology transfer requirements; R&D requirements; and other *Id.*)
3. See Nam D. Pham, *The Impact of Innovation and the Role of Intellectual Property Rights on U.S. Productivity, Competitiveness, Jobs, Wages, and Exports*, NDP Consulting, April 2010, p. 41, table 14, http://www.theglobalipcenter.com/sites/default/files/reports/documents/NDP_IP_Jobs_Study_Hi_Res.pdf.
4. See *Intellectual Property and the US Economy*, Department of Commerce, March 2012.
5. *Occupational Employment and Wages Release,* Bureau of Labor Statistics, May 2011.
6. These new measures included the Stevenson-Wydler Technology Innovation Act, which facilitated the transfer of technology from the federal government to private institutions, and the Bayh-Dole Act, which allowed universities and businesses operating under federal research contracts to have exclusive rights to their intellectual property.
7. Brian Ager, "The Research Based Pharmaceutical Industry: A Key Actor for a Healthy Europe," European Federation of Pharmaceutical Industries and Associations, Hospital Healthcare Europe, no. 7, 2006, http://62.102.106.100/Objects/2/Files/BA0706.pdf.
8. Ross C. DeVol et al., *The Global Biomedical Industry: Preserving U.S. Leadership*, Milken Institute, September 2011, http://www.lifechanginginnovation.org/sites/default/files/files/Global%20Bio_Full%20Report_WEB.pdf.
9. Ibid.
10. See "The Triple Interface Between Intellectual Property, Competition and Trade," chapter 9, pp. 323 and 327; and Shanker Singham, *A General Theory of Trade and Competition: Trade Liberalization and Competitive Markets* (London: CMP Publishing, 2007).
11. Under WTO rules, only government subsidies that benefit specific industries can be subject to offsetting tariffs, whereas ACMDs generally benefit many domestic industries.
12. See Bernard Hoekman and Joel P. Trachtman, "Canada—Wheat: Discrimination, Non-Commercial Considerations, and the Right to Regulate Through State Trading Enterprises," World Bank Development Group, Policy Research Working Paper 4337, August 2007, http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2007/08/29/000158349_20070829095818/Rendered/PDF/wps4337.pdf.
13. See Gary Clyde Hufbauer and Matthew Adler, "Why Large American Gains from Globalization Are Possible," Vox, July 24, 2008, http://www.voxeu.org/index.php?q=node/1445.
14. See Thomas J. Bollyky, "Better Regulation for Freer Trade," Policy Innovation Memorandum No. 22, Council on Foreign Relations Press, June 2012, http://www.cfr.org/trade/better-regulation-freer-trade/p28508.
15. For banking requirements: While we concede that capital adequacy rules for banks are needed, but some may be imposed in ways that are distortive and damage consumer welfare in unjustifiable ways. The OECD Competition Assessment Toolkit contains helpful examples of what constitutes these types of barriers to entry in Volume 2: Competition Assessment Guidance.
16. See Ricardo de Paredes, "Jamaica: Privatization and Regulation, Challenges in Jamaica," IDB Economic and Sector Study Series, July 2003, http://natlaw.com/interam/jm/tr/sp/spjmeg00002.pdf.
17. For a comprehensive treatment, see Singham, *A General Theory of Trade and Competition,* chapter 12.
18. See Alwyn Young, "The Razor's Edge: Distortions and Incremental Reform in the People's Republic of China," NBER Working Paper no. 7828, August 2000, http://www.nber.org/papers/w7828.pdf.
19. See Antonio Capobianco and Hans Christiansen, "Competitive Neutrality and State-Owned Enterprises: Challenges and Policy Options," OECD Corporate Governance Working Paper, no. 1, 2011, http://www.oecd.org/dataoecd/29/43/46452890.pdf.
20. In a recent case before the Eastern District of New York, the defendants—state-owned Chinese vitamin producers—argued that they had been compelled by the Chinese government to fix their prices. The district judge refused to dismiss the case under the foreign sovereign compulsion doctrine, and recently certified the class of plaintiff-consumers. See Memorandum Decision and Order, *In Re Vitamin C Antitrust Litigation*, No. 06-MD-1738 (S.D.N.Y. Sept. 6, 2011); Nate Raymond, "Plaintiffs Win Class Cert in Price-Fixing Suit Against Chinese Vitamin Makers," *Asian Lawyer*, January 30, 2012, http://www.law.com/jsp/tal/PubArticleAL.jsp?id=1202540453307&Plaintiffs_Win_Class_Cert_in_PriceFixing_Suit_Against_Chinese_Vitamin_Makers.

21. Darcy Davison-Roberts, “Competition laws in China and Hong Kong: different tracks, same direction,” October. 3, 2008, http://law.lexisnexis.com/webcenters/hk/Blogs--Analysis/Competition-laws-in-China-and-Hong-Kong-different-tracks-same-direction; Wentong Zheng, “China’s Antimonopoly Law—One Year Down Part 5. A De Facto ‘Dual-Track’ Competition Regime?” Antitrust and Competition Policy Blog, December 30, 2009, http://lawprofessors.typepad.com/antitrustprof_blog/2009/12/chinas-antimonopoly-lawone-year-down-part-5-a-de-facto-dualtrack-competition-regime-.html; and Elizabeth E. Drake, “Chinese State-Owned and State-Controlled Enterprises: Policy Options for Addressing Chinese State-Owned Enterprises,” Testimony before the U.S.–China Economic and Security Review Commission, February 15, 2007, http://www.uscc.gov/hearings/2012hearings/written_testimonies/12_02_15/12_2_15_drake_testimony.pdf. The OECD corporate governance papers contain a useful catalogue of anticompetitive practices that benefit SOEs: 1) predatory activity by SOEs. The underlying economics of SOEs means that they are generally more focused on increasing revenue and market share than profits, as a private firm would be; 2) raising rivals’ costs and raising barriers to entry. Examples included withholding essential inputs or infrastructure from competitors, or obtaining selective grandfather clauses for SOEs with regard to new regulations; 3) cross-subsidization. This is where the SOE uses its monopoly position in a particular market to cross-subsidize into a related competitive market to knock out rivals; and 4) imposing an inefficient technology on a given sector, because the use of such technology harms the SOE less than its use harms its private rivals.

22. In the Canada Wheat Board case, the Panel and AB reported that competition rules should not be used to define what constitutes commercial considerations. The problem with this approach is that the issue faced by U.S. firms is that they are profit maximizing entities competing with SOEs which tend to be revenue maximizers at best. These firms can outcompete profit maximizers because of their government subventions, and their ability to sustain losses. Only a competition test would level that playing field.

23. Note that tying the tariff to the size of the distortion is significantly different, and arguably much less trade-diverting than the current analysis used in anti-dumping and countervailing duty cases.

24. The United States could defend any WTO case brought against it for imposing these measures by counterclaiming that the ACMD in the other market nullified or impaired that country’s trade obligations under Article XXIII of the GATT 1994. Article XX furthermore provides a defense in cases of measures taken to protect intellectual property or to avoid unfair competition, and so countries could couch their self-help remedies under Article XX.

25. One recent example: American Airlines, United Airlines, Federal Express, and United Parcel Service filed a joint complaint (Joint Complaint of American Airlines, Inc., Federal Express Corporation, United Airlines, Inc., and United Parcel Service Co., filed May 1, 2003, in Docket OST-2003-15092) under the International Air Transportation Fair Competitive Practices Act alleging they were being required by Argentina to pay for airport and air traffic control services at discriminatory currency exchange rates approximately three times greater than the rates applied to Argentinean carriers, in violation of the bilateral Air Transport Services Agreement between the United States and Argentina (Air Transport Agreement between the Government of the United States of America and the Government of the Argentine Republic, Art. 11, para. 1, December 6, 1999). In this case, the department found the complaint justified, and in November 2003 inserted a condition in Aerolineas Argentinas’ foreign air carrier permit requiring it to remit into escrow the difference between the amount it was paying, and the amount it would have been paying if the same discriminatory rates applied to it (Order 2003-11-26, November 26, 2003). Aerolineas Argentinas complied with this condition and as of March 2011 nearly $10.5 million was in escrow.

26. See Section 19 of the Merchant Marine Act, 1920 (46 USC 876), subsection (i), http://www.fmc.gov/assets/1/Page/Section%2019%20of%20the%20Merchant%20Marine%20Act,%201920.pdf.

27. The Anti-Counterfeiting Trade Agreement (ACTA) is a plurilateral agreement signed by a number of like-minded countries. The agreement seeks to enforce intellectual property rights internationally by creating a legal framework combating widespread, commercial-scale theft of IP, http://www.ustr.gov/acta.

28. This discussion draws on Shanker A. Singham and Alden F. Abbott, “Enhancing Welfare by Attacking Anticompetitive Market Distortion,” Concurrences, no. 4, 2011.

29. For a good overview of the importance of competition advocacy as a tool to combat government-sponsored restraints on competition, see James C. Cooper and William E. Kovacic, “U.S. Convergence with International Competition Norms: Antitrust Law and Public Restraints on Competition,” *Boston University Law Review*, vol. 90, no. 4, August 2010.

30. See E.O. 12291 (1981), 12866 (September 30, 1993), 13422 (January 18, 2007). According to Sunstein, the “benefits [of regulations] must justify the costs.” See Cass Sunstein, “Smarter Regulation,” White House Blog, February 7, 2011, http://www.whitehouse.gov/blog/2011/02/07/smarter-regulation.

31. The OECD Competition Assessment Toolkit seeks to promote competition “by providing a method for identifying unnecessary restraints on market activities and developing alternative, less restrictive measures that still achieve government policy objectives.” The toolkit is available at http://www.oecd.org/document/48/0,3746,en_2649_37463_42454576_1_1_1_37463,00.html; see OECD Regulatory Toolkit; see also OECD Recommendation on Competition Assessment, October 22, 2009, http://acts.oecd.org/Instruments/ShowInstrumentView.aspx?InstrumentID=219&InstrumentPID=215&Lang=en&Book=False.

32. There are “over four dozen agencies in the Executive Branch with jurisdiction touching on international economic matters and over a dozen independent agencies or authorities with such concerns.” John H. Jackson et al., *Legal Problems of International Economic Relations: Cases, Materials and Texts*, 5th ed. (Minnesota: West Group, 2008).

33. Singham and Abbott have analyzed how the metric to measure distortion might work, and note:

> The question is what is the best metric for measuring ACMDs? Historically, analysis of behind the border trade barriers, or regulatory protection, has focused on the impact of these barriers on trade flows. However, we suggest that this metric does not properly evaluate the true impact of ACMDs. While it clearly measures the impact of the barrier on external trade, it does not properly measure the true impact of the ACMD under scrutiny on

the domestic economy in the country where the ACMD exists. A better measure of this is a welfare-based metric based on the implications of the measure for consumer welfare (as previously defined). The type of analysis would be a standard partial equilibrium analysis where the ACMD itself would act as an external shock and the reduction in consumer welfare occasioned by this shock would be measured. The estimate would not need to be exact—it could be stated as a rough estimate, plus or minus a certain percentage (error tolerance). Such an approach could add credibility by recognizing imperfections in estimation and limitations on knowledge, while at the same time highlighting the real harm to domestic interests flowing from the ACMD. More generally, by highlighting the aggregate deleterious effects of ACMDs on the domestic public at large, broad adoption of this metric might marginally weaken *ex ante* private and public incentives to adopt new ACMDs in the first place.

34. This type of analysis is conducted by competition agencies on a routine basis, and could be conducted to deal with government restraints as well as private ones. One can use either the Herfindahl Hirschmann Index (HHI = Sum of the squares of the market shares of all the firms in the market) as a starting point for evaluating how market structure will respond to a distortion, or one can use the Lerner index, which is a better measure of price/cost (L, Lerner Index = (p - MC)/p). Whatever measurement is used, a manageable metric to measure distortion and welfare effect can be developed. But some form of partial equilibrium analysis is what should be used. A U.S. government, properly organized around this issue, could conduct this analysis in real time and produce information that would be important in evaluating the welfare impact of ACMDs here and abroad.

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