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COMPETITION POLICY AND ITS EFFECTS ON GROWTH IN SOUTH AFRICA

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K. Mohamed
9470072

Competition Policy and its Effects on Growth in South Africa

by

KHALID MOHAMED

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DECLARATION

I, ... declare that this dissertation entitled "Competition Policy and its Effects on Growth in South Africa" is my own work and that all sources I have quoted have been indicated and acknowledged by means of references.

Signed: .....

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DEDICATION

This dissertation is dedicated to my parents, whose sacrifices and love have made my education possible, and to my wife for her support and encouragement.

ABSTRACT

This paper aims to critically evaluate the New Competition Act of South Africa and further suggests that this form of government policy tends to harm the economy more than the benefits it reciprocates.

The first chapter provides a critical overview of the New Competition Act, Competition Act No.89 of 1998 which was signed into law on the 20 October 1998, but would only come into force on the 1 September 1999.

The second chapter looks at competition policy and its impacts on Foreign Direct Investment (FDI). It does so by using occurrences in the US and Japanese markets as a case study.

The final chapter evaluates the recent bid by Nedcor to merge with Stanbic. It provides a background to the merger proposal and then offers some reasons as to why the merger should take place. Lastly before concluding this chapter, a summary of all the findings together with some suggestions as to whether the merger should take place or not, is provided.

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CHAPTER 1

THE NEW COMPETITION ACT OF SOUTH AFRICA

1. INTRODUCTION

South African business, labour and government saw the need for new competition legislation, but expressed severe differences on how competition should be promoted. Agreement was eventually reached on a number of key issues, in particular on the need for an effective new competition law regime for South Africa.

A concern that was strongly emphasized by Trade Unions was the potential loss of jobs through mergers between large enterprises. Thus all aspects of the country's industrial policy should be sensitive to the generating of job opportunities and competition policy should therefore be no exception.

When one looks at history, it is clear that apartheid and other racist laws and practices under the NP government led to the ownership and control of the majority of the economy by a small white minority. For this reason the ANC government is looking to put credible competition laws in place with effective structures to administer these laws. The Competition Bill proposed by the current government promises to create an environment which balances the interest of workers, owners and consumers.

In that regard the Competition Act No.89 of 1998 was signed into law on the 20 October 1998, but would only come into force on the 1 September 1999. The principal reasons for the delay is: firstly, to allow for the establishment of the institutions created by the Act which are vital to the enforcement of its provisions. Secondly, the delay provides for the additional time needed to formulate rules and procedures which are necessary for dealing with the numerous exemption applications, complaints and disputes which are expected to arise from the Act's provisions.

The scope of the Act as pointed out by Gareth Driver and Morne van der Merwe (1999) states that subject to a few exceptions, the Act applies to all economic activity within the boundaries of South Africa. In addition the Act also applies to any economic activity outside the boundaries of South Africa that has an effect within South Africa. The Act therefore extends to cover even international business practices.

2. *OBJECTIVES AND OUTLINE OF THE ACT*

Before proceeding with the outline of the Act, it seems to be an appropriate time to refresh the readers as to the objectives of the Act.

The objectives of the Act are to:

- provide all South Africans with equal opportunities to participate fairly in the country's economy.
- achieve a more effective and efficient economy in South Africa including promoting employment.
- provide for markets in which the people have access to the quality and variety of goods they want.
- restrain trade practices which undermine a competitive economy (with regard to SMME's).
- create a better capability and an environment for South African businesses to compete effectively in international markets.
- control the transfer of economic ownership particularly promoting black empowerment and establish independent bodies to monitor competition.

[Reekie, 1999]

With regard to the outline of the Act, its major components are:

- its various prohibitions on anti–competitive conduct. Note that the prohibitions may be subdivided into generally applicable prohibitions and prohibitions applicable to dominant firms.
- a new procedure for the control of mergers and acquisitions.
- the provisions of the Act which create institutions and procedures for the enforcement of its provisions.

3. *THE COMPETITION AMENDMENT ACT NO.35 OF 1999*

The Competition Act 89 of 1998 paved the way to fundamentally reforming the law regulating mergers and acquisitions. It states that mergers and acquisitions exceeding a certain threshold (barrier) of combined annual turnover or assets in South Africa, must notify and await the approval of such an action by the new competition authorities established by

the new Act. Such notification and approval was not required by the now repealed Maintenance and Promotion of Competition Act of 1979 ("old Act").

Pieter Steyn (1999) describes a "merger" as defined in the Competition Act as the "direct or indirect acquisition or establishment of control over all 'significant interest' in the whole or part of the business of any person".

The Competition Act had two potential problems in relation to its merger control provisions. Firstly, it required the Minister to determine the initial merger thresholds — which would only come into force six months after such determination — "as soon as practicable" after the Competition Act is enforced. Secondly, the Competition Act does not allow the Competition Commission the power to investigate any mergers that took place during the 1979 Act. By repealing the 1979 Act and adopting a new Act, all mergers that took place prior to the commencement of the Competition Act (new Act 89 of 1988) escaped the scrutiny of the competition authorities.

The government has subsequently closed these loopholes for "opportunistic mergers" by passing the Competition Amendment Act 35 of 1999.

This Amendment Act amends the new Competition Act and provides that:

- any merger occurring between 30 October 1998 and the 1 September 1999, and which exceeds the relevant threshold, will be regarded as a merger in contravention of the new Act for a period of twelve months after 1 September 1999. A merger then will only be allowed if approved by the existing Competition Board or if the parties involved has notified the competition authorities within three months after the new Act comes into operation that they seek approval of the merger under the new Act.

- the first thresholds — which will determine whether a merger is affected by the new Act — must be determined by the Minister before the new Act comes into operation (1 September 1999 in this case). These initial determinations will apply with immediate effect from the date on which the new Act comes into operation.

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The implications for already implemented mergers and acquisitions now require careful consideration. In particular regarding the Competition Act's requirements that notice of the merger be given to employees and that mergers exceeding the thresholds be evaluated on "substantial public interest grounds" with special reference to the effect of the merger on employment and the ability of SMME's and historically disadvantaged persons to become competitive.

With this bit of background to the Act, this paper will next deal with the challenges and criticisms the new Competition Act is faced with. It will discuss these challenges and criticisms under the following headings:

- Prohibition of Restrictive Practices
- Dominant Positions
- Exemption from the Restrictive Practice and Dominance Prohibitions
- Merger Control

3.1 PROHIBITION OF RESTRICTIVE PRACTICES

For the purposes of the generally applicable prohibitions, the Act distinguishes between horizontal and vertical economic relationships. A horizontal relationship is defined as a relationship between competitors and a vertical relationship is defined as a relationship between a firm, its suppliers and/or its customers. In addition the Act also uses two different kinds of prohibitions in regulating these relationships. Firstly, reasonable prohibitions (or "rules of reason") outlaw any conduct which is or has an anti–competitive element in it. Such conduct will only be condoned if justified on certain specified grounds. This immediately prompts a debate as to the applicability of the prohibition. Secondly, outright prohibitions (or "per se" prohibitions) outlaw specifically described conduct without providing any opportunity to justify it.

3.1.1 Restrictive Horizontal Practices

In section 4 of the Act, in the horizontal context, the Act contains a reasoned prohibition which falls away if "a party to the agreement can demonstrate that there are net gains resulting from the agreement due to the presence of 'technological, efficiency or other pro–competitive' effects". [Reekie, 1999:260].

In addition, section 4 outright prohibits any agreement or decision if:

- it inhibits or lessens competition in a market;
- it involves "directly or indirectly fixing a purchase or selling price or any other trading condition;
- dividing markets by allocating customers, suppliers, territories or specific types of goods or services; or
- collusive tendering". [Reekie, 1999:260].

Furthermore, in an effort to discourage cross–shareholdings and directorships, section 4(2) of the Act provides that firms having a director or substantial shareholders in common which engage in any restrictive horizontal practice "are presumed to have agreed to engage therein". The presumption also applies where one of the firms engaging in the restrictive horizontal practice has a substantial shareholding in another of them.

The onus is upon the firms or directors to prove that their practices are not anti–competitive and are in fact in line with the market in question before the above presumption is lifted or rebuked.

However, many economists dispute the validity or relevance of section 4 in the Act. Stigler (1966:230) persuasively states that "they are gentlemen's agreements, where the participants seldom are, or long do". In other words Stigler argues that such agreements are nothing else but cartels. In his view, since cartels are either tacit or explicit agreements, rivalry is due to occur and thus such agreements seldom last.

Horizontal restrictive practices will not persist because firms will always have the incentive to cheat on any explicit or tacit price agreement. Such cheating results in competitors lowering their prices. Ultimately lower non–collusive prices providing normal returns results.

Secondly, to protect themselves against cheating or chiselling, firms set up monitoring mechanisms of each other or they allocate shares of market revenues or territories for exclusive use. Apart from being very costly to initiate, it is difficult to enforce or agree upon or both. Efficient firms are less likely to 'carry' inefficient firms (since each likes a fair share

of the profits — and fairness is difficult to define) and therefore an agreement is less likely to occur. In short the less likely is an agreement the more likely is a cartel breakdown.

Thirdly, a cartel breakdown is more likely the higher the ratio of fixed to total costs in an industry. High fixed costs may create financial difficulties if high uniform prices [thus lower sales (perhaps)] and the absence of chiselling exists. This is particularly true during times of market recessions or depressions when demand is extremely low. In addition if cartels receive quotas based on their productive capacity, cartel members may build bigger plants in order to receive a bigger portion of the quota, and as a result they dissipating cartel profits. This according to Stigler is called "investment rivalry". Also, if existing firms do not cheat then in any contestable market, new entrants into the industry (or even the threat of new entrants) will achieve the same result as existing firms.

Finally, restrictive horizontal agreements are "unnecessary where the parties to the agreement constitute in aggregate only a small share of the relevant market". [Reekie, 1999:264]. This is true since they would not be able to manipulate price and output so as to make abnormal profits. However, if a cartel agreement comprises most of the firms in a market place, then certain efficiency benefits (such as lower transaction costs) would allow for the persistence of the agreement because of demand side "ups and downs", collusion may be necessary to ensure stable industry equilibrium.

3.1.2 Restrictive Vertical Practices

Section 5(1) contains a reasoned prohibition on agreements between parties in a vertical relationship which have the effect of substantially preventing or lessening competition. Franchise and distribution agreements which provide for territorial or other kinds of exclusivity is governed by this section because franchisers and franchisees as well as suppliers and distributors have a vertical relationship with each other. These agreements would then have to be justified by reference to their pro–competitive effects.

However, this section is questioned when one considers the fact that the effect of franchise or distribution agreements providing for exclusivity, is in essence to restrict competition amongst the competing franchisees or distributors. It is questioned because section 4's prohibitions (especially the outright prohibition on market sharing) on restrictive horizontal practices is enforceable. Even though this restriction might not be in terms of a contractual

relationship between those distributors, section 4 may still be applicable since it applies to non–binding arrangements as well as to legally binding contracts.

Furthermore, most relationships within firms and many between firms are vertical in nature, thus rendering the overall prohibition redundant. Reekie (1999) further argues that it is almost impossible to define and isolate a single stage in the in the production process. The concern that one firm may subsidise associated companies for monopolistic gains is self deception, involving sacrifice of returns and merely enticing associate firms to behave uneconomically. Cross–subsidisation cannot increase existing returns, nor can it enhance any above–normal or monopolistic returns. According to Bork, argues Reekie (1999), above normal profits if they do exist, can be extracted only once from the value chain.

To demonstrate the above point, consider the following scenario looking at an integrated manufacturer and retailer. Consider a monopoly manufacturer selling to competitive retailers. The manufacturer will set output and price so that consumers will be charged the monopoly price after retailers have added their costs, including a normal return. The manufacturer will not want retailers to earn more (since that would be foregone profit), nor will he want them to earn less (since that would ultimately mean less sales for the manufacturer). Similarly, if retailers earned more and so expanded, the manufacturer would be paying for unwanted retail services. If the manufacturer takes over the retail sector, the costs and market demand he faces will be unchanged. There can only be one monopoly profit.

A final reason for fear of vertical agreement abuse is predation. This is when firms engage in price wars to drive out their competitors or potential entrants. But if price wars occur, firms cannot be behaving non–competitively. Only after a successful price war can prices be raised to monopolistic levels. It is at this point when a vertical relationship can be examined for abuse and after it is too late to be useful. Lastly for predation to be successful, both the victim and the predator must suffer losses today so that the predator can manipulate and sustain higher prices tomorrow, thus earning above–normal profits for a period long enough to recover the losses sustained by both parties. However, at that instance entry by new rivals or chiselling by existing firms would be even more attractive. Thus the entire cartel project becomes futile.

3.2 DOMINANT POSITIONS

Dominant firms are subject to an additional set of prohibitions because they have market power, which is defined as the power of a firm to control prices, to exclude competition or to behave to an a appreciable extent independently of its competitors, customers or suppliers. Dominance is thus a concept that relates to a particular market and is usually derived from a firm's share of that market. Firms having 45% and more of a market are automatically dominant while firms having between 35% and 45% of a market are presumed to be dominant unless they can show that they do not have market power. Firms having less than 35% of a market are only dominant if they are proved to have market power. The onus is upon the firm accused of being dominant through having 35% or more of a market, to prove that it does not hold any market power. Section 6 explains that the critical percentages can refer either to the sales or assets of the firm and market in question. In addition the authorities must make it clear to the industries how these percentages will affect them.

From the above, two definitional problems are evident. First, it is not clearly defined or explained what is meant by an industry (or relevant market) and what significance these percentages have. This default will undoubtedly affect the conclusions reached by the authorities. Industries can be defined from a technological stance or a consumption stance. As a technological stance a group of products are seen to have a high cross–elasticity of supply. Two firms are considered to be in the same industry if firm A's resources can be readily transferred to producing the products of firm B. For example two leather producing footwear firms would be competitors but if one firm is changed to a canvas producer then uncertainty arises as to whether the cross–elasticity of supply still falls under the competition proxy. Alternatively is to use cross–elasticity of demand. The more acceptable are substitutes to consumers in the market the higher is the index.

Reekie (1999) states that consumer substitutability is an extremely important link in defining the market as it currently stands. Moreover potential entry and producer substitutability are important components in this regard as well. Finally he argues that if markets are too broadly defined, then the measures of concentration may be misleadingly understated. Conversely if they are too narrowly defined concentration may appear to be overwhelming.

3.2.1 *Price Discrimination by A Dominant Firm Prohibited (Section 9)*

This prohibition was drawn largely from the redundant and unused American Robinson–Patman Act of 1936. It is professed that this surprising prohibition was included for two reasons. First, as in America, powerful supermarkets and multiple chain pharmacies (which grew in importance) approached the old Competition Board to protest against discriminatory pricing. Secondly, price discrimination is a technical term and to the lay person it is value laden (e.g. perfect competition, inferior goods and discriminatory pricing). In section 9(1b) of the Act price discrimination is defined as different prices to different customers for the same transactions. A technical definition would define the price differences relative to costs.

Not surprisingly a number of weaknesses have been pointed out with this view. Economist from the Chicago School argue that consumer welfare does not depend on price alone. Product variety, quality and innovation impacts on consumer welfare as well. Further, there is little empirical evidence that less concentrated markets necessarily foster better performance on all these counts. [Creamer, 1999]. Second, in terms of contestable market theory, contestability (usually dependent on the extent to which entry requires 'sunk costs') is a more important aspect of market structure than concentration. For this reason then, even highly concentrated industries will be forced to be competitively priced because of the threat of 'hit and run' entry. Finally, this view ignores the important feedback mechanism in that market structure/concentration is itself a result of competition. Thus, firms in concentrated industries earn profits not because they set higher prices, but rather because they are more efficient [Creamer, 1999].

To round off this section, one may clearly conclude that without empirical data as to whether price discrimination harms the interest of the consumer or not, will remain to be one of the more surprising prohibitions in the entire Act.

3.3 EXEMPTIONS FROM THE RESTRICTIVE PRACTICE AND DOMINANCE PROHIBITIONS

Section 10 empowers the Commission to grant exemptions from the prohibitions of horizontal and vertical restrictive practices as well as the abuse of dominance. Such exemptions are only granted if the agreement "contributes to any of the following objectives":

i) the maintenance or promotion of exports;

ii) the promotion of the ability of small businesses, or firms controlled or owned by historically disadvantaged persons to become competitive;

iii) change in productive capacity necessary to stop decline in an industry; or

iv) the economic stability of any industry designated by the Minister of Trade and Industry.

[The Competition Act No.89 of 1998: Section 10]

The problems with these exemptions particularly points (iii) and (iv) is that they are irrelevant to competition policy designed to promote the efficiency, adoptability and development of the economy.

Alleviating the impact of structural industrial decline or economic instability, are social objectives of Government and not the concern of the Competition Commission. Furthermore the price discrimination exemptions as pointed out in section 9(2) of the Act are laden with shortcomings. First, because price discrimination has both a legal definition and a technical definition, how it is interpreted may lead to contradicting conclusions. Second, the Act follows the US legislation on price discrimination very closely. This is regrettable since very few American economic figures are satisfied with their own law. Since the South African Act copied the US law, it is inevitable that the conflicting objectives of Robinson–Patman will cause a misunderstanding of the objectives of the South African Act.

On the one hand the Robinson–Patman Act attempts to protect small business against price disadvantages; while on the other hand it simultaneously attempts to render price discrimination as anti–competitive. "Essentially the Robinson–Patman Act and the South African Act both protect particular competitors, rather than competition." [Reekie, 1999: 281].

3.4 MERGER CONTROL

In order to restrict the concentration of economic power, section 12 of the Act creates a merger control mechanism, which prohibits the implementation of any mergers until it has been approved.

The Act defines a merger as "the direct or indirect acquisition or direct or indirect establishment of control by one or more persons over all significant interests in the whole or

part of the business of a competitor, supplier, customer or other person..." [The Competition Act No.89 of 1998: Section 12].

The Act goes further and defines "control" to include the ability to influence the policy of the firm as if majority control was held. It also includes ownership of, "or the ability to vote a majority of the relevant shares." [Reekie, 1999:281].

Notification of mergers (proposed or accomplished) must be made to the Competition Authorities as well as to the relevant employees or Trade Unions. The Act will apply to all mergers exceeding a specified threshold of turnover or asset size. For this purpose two thresholds have to be determined by the Minister of Trade and Industry as soon as possible after the commencement of the Act (in this case, after 1 September 1999).

When assessing a merger the authorities must determine whether the merger is likely to prevent or lessen competition. In addition they must judge if there will be any technological efficiency or pro–competitive gain. Lastly, the authorities must ascertain whether the merger is in the interest of the public. Section 16 of the Act sets out the considerations to be taken into account as to whether a merger can be justified on public interest grounds or not. The authorities must consider the effect the merger will have on:

i) a particular industrial sector or region.
ii) employment.
iii) the ability of small business, or firms controlled or owned by historically disadvantaged persons to become competitive.
iv) the ability of national industries to compete in international markets.

The shortcomings of this is firstly, it is difficult if not impossible to predict what the competitive situation of a merger will be in the future. With regard to public interest grounds, there are huge inadequacies in the flexible interpretation and subjectivity of points (i) to (iv) mentioned above. Both local and/or foreign investors will be deterred from takeover activity due to the unpredictable reactions that could be taken by the authorities. This could adversely affect employment, exports, corporate tax revenue, and demand from small and medium enterprises.

Finally, the definition of public interest incorporates socio–economic objectives (i.e. redistribution, labour interest and black economic empowerment) which are inappropriate to depend on competition policy to achieve. There are other, more effective and appropriate policies, which can be used to achieve these objectives. The aim of competition policy should be to allocate resources in society such that consumer wants can be satisfied as far as technological and physical constraints permit.

4. *THE NEW COMPETITION ACT AND ITS REGULATORY PROBLEMS*

From what has been discussed thus far, it is clear that the new Competition Act is not free of any shortcomings. Apart from the shortcomings already mentioned, there exist additional problems with regard to the act's regulations. Many businesses and investors perceive the act and its regulations as inappropriate for South Africa. For small and medium size firms to understand the act and the regulations, they have to turn to lawyers who specialize in this field. It goes without saying that this is often an expensive procedure.

In addition, as hinted earlier in this paper, the competition policy has negatively impacted on investment (domestic and foreign) and consequently growth and job creation in South Africa. Evidence quoted by BSA (1999) confirms that foreign direct investment (FDI) in South Africa for 1998 was substantially lower than it has been in 1999. This is despite an increase in FDI flows throughout the world.

"World–wide the level of foreign direct investment powered ahead almost 40% to more than $640 billion, driven by mergers and acquisitions... . South Africa now even falls behind countries such as Nigeria, Egypt, Tunisia, Algeria, Zimbabwe and Angola — the top African recipients of foreign direct investment." [BSA, 1999:1]. To quantify the impact of mergers and acquisitions on the global economy, reports show that it "hit a record of $2.2 trillion" between January and September of 1999. This was largely due to greater merger activity in Europe.

4.1 THE ACT AND ITS REGULATIONS

It is very evident that the act has major problems with regards to thresholds for mergers, notification fees, the definition of a "merger", the time constraints with respect to mergers, the socio–political considerations in the evaluation of mergers, inflexibility of exemption grounds and a letter of comfort in respect of possible prohibition practices.

4.1.1 Thresholds for Mergers

Paragraph (2) of Notice 1943 of 1999 states that the turnover and assets of the acquiring and target firm must be carefully perused in determining whether the Act applies to the merger or not [BSA, 1999]. This section states that if the combined figure of the acquiring and target firm is greater or equal to R50 million then the Act applies if the annual turnover or asset value of the target firm is greater than R5 million.

Clearly these thresholds are a problem. Firstly, the R50 million is much too low, especially when compared to other countries. In Canada, for example, the threshold is R1.66 billion. This low threshold only aggravates compliance costs and delays for firms, and unnecessarily increases the work–load of the Commission. For this reason it is recommended that the threshold be increased to at least R200 million [BSA, 1999]. Secondly, the R5 million of the target firm implies that in the event of a big firm acquiring a small firm, there is a notification fee of R500,000. This causes a problem as it may deter mergers (because of its costs to smaller firms) even if it has positive competitive outcomes. Thus, the R5 million should be increased to at least R20 million.

4.1.2 Notification Fees

South Africans are faced with one of the most burdensome tax system in the world. In order to understand the forthcoming argument, we distinguish between two types of levies. The first type is user charges and the second, earmarked taxes. In the former (e.g. toll roads, licenses, etc.) there is a definite connection between making the payment and enjoying the benefit. In the latter (e.g. social security taxes and fuel levies) this quid pro quo relationship is not clear.

Reports from the Katz Commission (in BSA, 1999) state that earmarked taxes equals 6% of total tax revenue (1.5% of GDP) while similar results are true for user charges. These charges only add to the already high tax burden of South African taxpayers.

The problem then is whether notification fees "can be regarded as user charges" or not. This is because of the uncertainty surrounding the quid pro quo connection between the Competition Commission and the applicants (firms paying the notification fee). For this reason a user charge cannot be used in this case.

Furthermore, as mentioned in section 4.1.1 of this paper, the filing fees of merger notices that range from R5000 to R500,000 have discouraged mergers. These exorbitant fees discourage big businesses from acquiring smaller firms, which can be saved and turned into prosperous ventures. Also, the amount of unnecessary administration work this fee poses, reinforces company's negative perceptions about this fee. Thus, bigger companies are "discouraged by this Act and the regulations to be buyers." [BSA, 1999:3]. This is particularly bad, because it restricts the entrepreneur's market to smaller buyers, which is certainly not good for promoting entrepreneurship in this country.

To highlight the exorbitant maximum fee of R500,000 in South Africa, one only has to compare it to other countries like Australia and the USA where the maximum fee is R60,000 and R276,000 respectively. Ideally no fee should be charged, but for now the Commission should concentrate on reducing the fee substantially.

4.1.3 Definition of "Mergers"

In the section of the Act dealing with mergers (S12), it is not clear what is meant by "joint control" and as a result huge uncertainties result as to how "joint control" ventures should be dealt with. This is a grave problem and cannot be solved by merely relooking the policy guidelines. Instead, an amendment is needed to Section 12 so that concentrative joint ventures are dealt with under the merger provisions of Chapter 3 in the Act. If this is not done, then the incorrect sections of the Act would apply and thus incorrect outcomes would result.

4.1.4 Time Constraints of Mergers

If a merger is investigated by the Competition Commission then that merger cannot take place until an outcome is given by the Commission. As a result many potential profitable businesses cannot be saved due to this time inadequacy.

4.1.5 Socio–Political Considerations and Mergers

The Act extends its boundaries to socio–political consideration (S16) when investigating mergers. It takes into account the impact a merger will have on employment, on a region, small businesses and historically disadvantaged persons.

'Of course' this section of the Competition Act has severe consequences. Not only is such a system unique when compared to the rest of the world, but it also has negative impacts on foreign investors contemplating an acquisition in this country. Finally, "the outcome of a merger investigation in South Africa is made uniquely uncertain. Politisation in some cases seems inevitable." [BSA, 1999:5].

There is, therefore, every reason for this section to be revised by omitting the socio–political issues.

4.1.6 Inflexibility of Exception Grounds

On the one hand Chapter 2 of the Act states that the Competition Commission may grant an exemption for any agreement or practice or any category of agreements or practices. On the other hand Section 10 of the Act restricts the Commission's power to exempt. Clearly this is contradictory. The inflexible grounds for exemption leads to great uncertainties in serious areas of business. A good example of this uncertainty on business is franchise agreements. This paper will not explore the intricacies of this issue, but it is important to note that what applies to franchising, applies to other business as well.

4.1.7 Letter of Comfort In Respect of a Possible Prohibited Practice

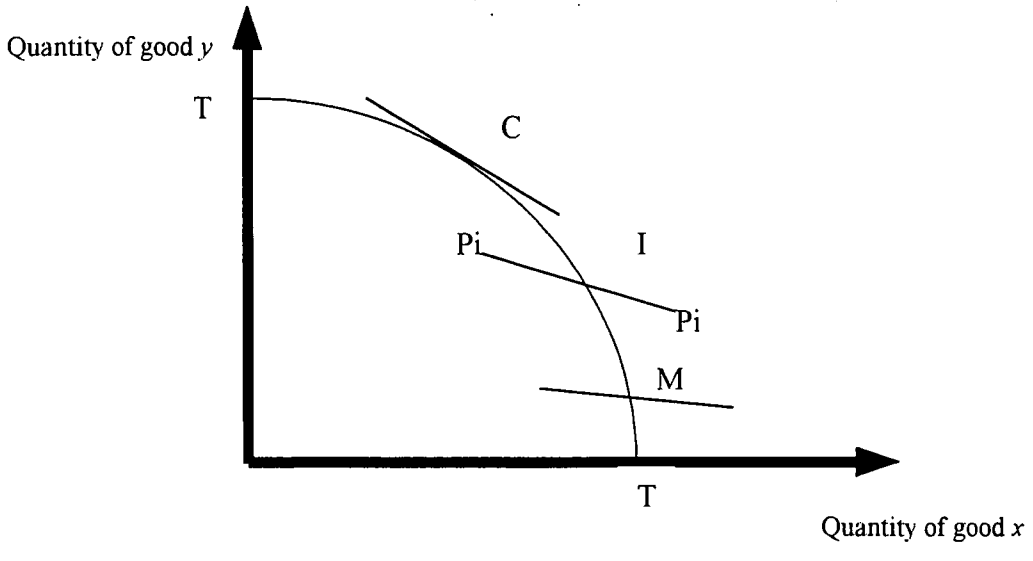
Often, reduced competition is outweighed by technological efficiency or other pro–competitive gains or benefit. But firms, especially foreign firms, are reluctant to undertake much action for fear that the Act may prohibit them to do so. Thus, what is required is a "letter of comfort" signaling that they will not be penalised if they undertake huge investment and other business commitments. Unfortunately, neither the Act nor the Regulations contain any ruling in the form of a "letter of comfort" to confirm, that the Commission will grant its approval or will not object to ventures firms wish to undertake. This is provided that reduced competition levels are outweighed by technological and efficiency gains. Clearly, this is a big problem as it deters investors.

5. *MARKET POWER AND COMPETITION POLICY*

This section attempts to highlight the connection between market power and competition policy. To help illustrate this point we refer to monopolistic competition and oligopoly. To refresh, monopolistic competition is characterized where many firms produce close substitutes with each firm having some control over price. An oligopoly is a situation where only a few firms produce a homogenous product and each firm has considerable control over price.

Both monopolistically competitive markets and oligopolies produce at a point where their equilibrium quantities and prices are greater and lower respectively than that produced by a pure monopoly (i.e. Q imperfect competition [ic] > Q pure monopoly [m] and Pic < Pm). In addition, when compared to a perfectly competitive market, they produce quantities that are lower and prices that are higher (i.e. Q perfectly competitive market [pc] > Qic and Ppc < Pic). *Note that Q and P represent the equilibrium quantities and prices respectively.*

Now suppose the following: $(^{Px}/_{Py})pc > (^{Px}/_{Py})ic > (^{Px}/_{Py})m$ [equation 1] where sector *x* is perfectly competitive and sector *y* is either perfectly competitive, imperfectly competitive or a monopoly.



Source: "Public Goods and Externalities" Chapter 3, pg.41, Oxford University Press.

In the above diagram we can show what is meant by equation 1. Point C represents the top level equilibrium when both sector x and sector y are perfectly competitive. On the other hand, when one assumes sector y to be a monopoly, we achieve point M on the diagram. Thus, when sector y is either monopolistically competitive or oligopolistic, then one can expect the equilibrium to lie somewhere between points C and M, like point I for example.

The slopes of the price lines tell the reader that imperfectly competitive markets have a smaller negative effect on allocative efficiency than a pure monopoly. However, when one compares imperfectly competitive markets to perfect competition, the degree of allocative inefficiency is rather obvious.

Of course this is a very theoretical argument and in practice policy makers are more concerned with the structure of an industry and how it determines the conduct of firms in that industry, and further how that conduct determines their performance. This argument is referred to as the "structure–conduct–performance" (SCP) paradigm. Adherents to the SCP paradigm believe that highly concentrated industries lead to collusive behavior on the part of the large firms comprising the industry which in turn gives rise to monopoly pricing. It is for this reason that the SCP hypothesis advocates that the power of highly concentrated firms should be curtailed in order to prevent monopoly pricing.

This is where the competition policy fits in. It is the aim of competition policy to prevent this type of behavior from occurring. Section 2 of this chapter highlights the objectives of the South African Competition Act which is the tool used to protect consumers, provided of course that the competition policy is properly applied. This opens up the door to another, somewhat sensitive debate — Is competition policy necessary?

6. *COMPETITION POLICY OR "NOT"*

Why should market concentration and dominance lead to abusive behavior?

Adherents to the SCP paradigm certainly believe this but not Demsetz. Harold Demsetz argues that the high degree of market power and concentration is a result of efficiency. This efficiency hypothesis of Demsetz states that it is because of greater efficiencies of certain firms that allow them to outperform their competitors and ultimately achieve market power.

He further argues that the prices these firms charge are the lowest possible and any attempt to break these firms down would only be to the detriment of consumers.

In addition, Demsetz and others argued that the profits derived by dominant firms are used to improve the quality of their products or to cut production costs, and thus prices. The reason for dominant firms investing their profits as such, is to keep potential entrants and competitors out of the industry. Thus, to do this they have to produce a better product at a better price all the time.

It is therefore, very important not to adopt the populist view that "Big is Bad". By intervening in the market to prevent dominance and concentration policy makers can infact undermine efficiency, dampen investor confidence and of course harm the interest of consumers.

7. CONCLUSION

The new Competition Act was designed to cover up certain loopholes that were evident in the old Act, but it appears that new loopholes and greater uncertainties flourished.

On the one hand the Act contains aspects that are totally irrelevant to competition policy and on the other hand it sets the scene for politically correct or "journalistically" attractive targets such as international competitiveness. This merely creates a platform for uncertainty in future interpretations to occur.

According to Reekie (1999:284) "when the Act moves from ill–defined, non–pertinent objectives towards promoting competition ..., it displays inappropriate understanding of how competition should be assessed."

Moreover the Act does not provide clear definitions of broad economic terms. This only leads to greater interpretation and hence concluding uncertainties. Finally, and in my opinion, probably the greatest disappointment of the Act, is the message it gives to investors. It discourages investment and this damages competition in the short run and reduces national wealth in the long run. Ultimately the country suffers. The following two chapters provide further evidence that competition policy may not always achieve its objectives; unfortunately this is so at the expense of growth in an economy.

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9. *QUESTIONS FOR DEBATE*

1. The Act stands to cover international business practices. Is this a good thing?

2. Why should a merger be prohibited if it exceeds the determined threshold, when the merger may create or lead to the creation of employment?

3. Why should merger be allowed for black empowerment? Who are we helping? The masses or the already rich and powerful?

4. Do horizontal prohibition practices restraint of trade agreements lead to the division of a market?

5. Is unbundling a form of reducing market power/dominance (e.g. Murray and Roberts)?

CHAPTER 2

COMPETITION POLICY AND ITS IMPACT ON FOREIGN DIRECT INVESTMENT

CHAPTER 2

COMPETITION POLICY AND ITS IMPACT ON FDI

The previous chapter was an attempt to outline and give an overview of the New Competition Act. In that section it was hinted that government policy — such as competition policy — has a huge impact on making sure that the practices of private firms do not discourage foreign direct investment (FDI). However, there are often times where such government policy may in fact deter FDI.

This section will use as a case study, the occurrences in the United States and Japan to evaluate this problem. Sectoral data on inward FDI from the USA and Japan are then analysed econometrically.

1. INTRODUCTION

One of the more difficult tasks that face economist today is to try and find a country that does not restrict FDI in some way or the other. Among the more common ways are through official prohibitions, restrictions or official approval processes where the government intervenes directly to affect the level, composition or form of foreign investment. However, the behaviour of certain firms and practices may also affect the level, composition and form of FDI. Ironically, the behaviour of such private parties are often facilitated by government policies which is not directly aimed at foreign investment, but (indirectly) eventually impacts on FDI. According to Marcus Noland (1999), at the Institute for International Economies, this takes the form of privately supported, but publicly sanctioned barriers to entry. It is not quite sure who is affected more by this, potential domestic entrants or potential foreign entrants, but there have been cases where domestic and foreign potential entrants have been affected equally, and those where foreign firms face greater barriers. The point here is that often government policies and private behaviour affect foreign firms' decisions to trade with or produce in the domestic country and thus local production is adversely affected. Ultimately the level, composition and form of FDI are affected.

In addition many other factors such as large production sunk costs or brand loyalty (to name a few) may also play a role in discouraging entrants, both domestic or foreign. Furthermore, a survey done by the Japanese government on foreign firms operating in Japan, found that private impediments do not play a significantly big role in discouraging FDI. These findings reinforce the findings of an earlier survey of American firms conducted for the American Chamber of Commerce in Japan [Noland, 1999].

Moreover in product markets, restrictive business practices can impede FDI associated with the distribution, serving, development and production of goods. In service markets barriers to entry can discourage investment which is essential to service local markets. Firms who engage in horizontal activity may deter potential investors or their decisions. Horizontal agreements that could affect FDI include price fixing, cartels or market allocation schemes, bid rigging, and refusals to deal. On the other hand, vertical restraints on trade among buyers and sellers as well as the distribution of final products can also affect FDI. Such restraints, to mention a few, include practices of refusing to deal and boycotts, retail price maintenance, exclusive–dealing arrangements, tie–ins, and so on.

It should be clearly noted that these practices do not exclusively affect foreign firms only. In fact many domestic new entrants and their investment decisions, and its impact on FDI may also be affected.

Factor markets is another mechanism through which existing firms may deter entry. Capital market imperfections provide a second channel through which private arrangements among host nations can affect FDI. More specifically, the behaviour of existing firms allows them to sometimes exploit capital market imperfections and in so doing prevents the development of a market for corporate control. This kind of behaviour dampens merger and acquisition activity that plays an important role in attracting FDI in developing countries. Thus FDI throughout the economy is affected. In addition, lifetime employment practices in many labour markets (in developing countries) can discourage FDI by preventing firms from acquiring potential staff.

Clearly then, government policy (apart from competition policy per se) can affect the ability of private firms to engage in anticompetitive private behaviour and impede FDI. Secondly, if existing firms can use the regulatory environment to deter entry, their ability to exploit their

positions may be constrained by domestic competition policies. A huge 'problem' here is, that there is no single international standard and thus what is regarded as unacceptable or illegal practices in one country may be different to the laws of another country. On the complete extreme, there are certain countries that have no competition policy rules or laws at all. For example, according to the WTO (1998), Uganda has no competition law or other legislative banning or sanctioning of collusive or restrictive business practices. Such practices include price cartels, price maintenance, bid rigging and boycotts [Noland, 1999]. Furthermore, private monopolies are not subject to restrictions or controls. However, even where laws do exist, there are huge differences in terms of content, sectoral scope, entities covered and the implementation procedure of these laws.

2. *HORIZONTAL AGREEMENTS*

Horizontal agreements among competitors which include activities such as price fixing, cartels and bid rigging are all mechanisms for exploiting market power [Nicholson, 1990]. The impact of horizontal agreements on FDI is less obvious. If prices are artificially raised, then new entrants, attracted by the supernormal profits, will now enter the market in an attempt to share in the supernormal profits, and thus the arrangement is undermined. On the other hand, prices may be lowered to drive out potential entrants, but when existing firms start to raise prices, new entrants will re–enter the market. Similarly for bid rigging to be successful some mechanisms for restraining entry into the market must be put in place in order for cartel arrangements to be sustainable, whether legal or not.

It is not surprising then that successful horizontal arrangements with significant implications for FDI are not that common. The best documented example of bid rigging is that of the construction industry in Japan. Restrictions on entry in the construction business (especially for foreign firms) have contributed to the formation of cartel agreements and the associated rents are allocated through a process know as **dango** ("a form of bid–rigging in which firms negotiate with each other as to which firms will participate in bidding on a given project and at what prices" [Noland, 1999:5]). McMillan (1991) estimates that excess profits from collusion in public works projects amount from 16% to 33% of the price of the project. These figures are supported by cases that have been prosecuted in this regard. The most famous of cases, argues McMillan (1991), was the 1989 episode where the US Justice Department reached an out of court settlement with 99 Japanese construction firms for bid–rigging at the

Yokosuka Naval Base. Fines levied in this case amounted to $32.4 million, or 24% of the costs of the project.

Another type of market access barrier arises if industry associations are given regulatory power or status, in the establishment of product standards or testing and certification procedures. Thus existing firms can use the 'quasi–regulatory' power to impede potential entrants. In the case of Korea, Korean authorities investigated 68 industry associations in 1994, and later in that year found that 48 of these associations were abusing the regulatory authority to impede new entrants [Noland, 1999]. It is such behaviour that has led the Korean government (in 1996) to proclaim that it would begin regulating collusion among rival firms and trade associations, since such anticompetitive behaviour negatively impacted investment and/or trade in the economy.

Lastly, in the US airline travel industry, American airline companies control the electronic reservations systems. This allows these companies to give preference to same line connections over interline connections thus discriminating against foreign carriers who do not have extensive US domestic networks.

A possible solution to this would be for foreign carriers to purchase a US airline for its domestic routes; but US law has prohibitions on foreign ownership of airlines. Another possibility would be "code sharing". However, this arrangement may put foreign carriers at a commercial disadvantage over US domestic carriers. This is so because foreign carriers will now be forced to enter into agreements with US carriers and in so doing disallows foreign carriers from entering their preferred (and often more efficient and profitable) strategies [Noland, 1999]. Clearly, in this case, government intervention acts as a facilitating device to impede foreign entry into local markets.

3. *VERTICAL RESTRAINTS*

Typical vertical restraints include resale price maintenance, exclusive dealing or distribution, tied sales, reciprocity agreements, territorial restrictions on dealers or distributors, refusals to deal, or vertical mergers [Noland, 1999]. Bork (1978, 1966) argues that the traditional competition policy approach discouraged the efficiency enhancing aspect of these vertical agreements. He holds that these agreements reduced transaction and search costs, removed retail price distortions and encouraged an optimal level of investment in production and

distribution. However, subsequent evidence suggest that these practices were more beneficial to private welfare than social welfare. Nevertheless, research done by Salop (1983) and Scheffman (1987) show that dominant firms may deter entry, force rival firms to leave the market or merely put rivals at a disadvantage through vertical arrangements. From this it is clear that these opposing effects present a conundrum. It is for this reason, therefore, that many regulatory authorities have taken a less decisive stance with regard to vertical agreements in comparison to the horizontal agreements.

A typical example of (alleged) vertical restraints affecting international commerce are the affiliated firm groups in Japan (or kieretsu). A kieretsu consists of a group of large core firms (including financial firms) which are linked across markets together with their vertically linked input suppliers (and possibly a captive distribution network) [Noland, 1999]. In addition, this form of industrial organization can be distinguished into vertical kieretsu involving vertical supply relationships in product markets, and distribution kieretsu involving distribution networks in intermediate or final products [WTO, 1995].

According to WTO (1995), vertical supplier kieretsu "may induce apparent anti–competitive practices such as vertical boycotting and exclusive dealing...long term relationships cultivated through a kieretsu push up 'switching costs' and make it more costly for kieretsu participants to change their business partners." [WTO, 1995:92]. Practices such as kieretsu make it particularly disadvantageous for new entrants (domestic and foreign) especially in LDC's where the investment of new entrants is most needed.

A second potential impediment to inward FDI is vertical restraints within the distribution system. This occurs in both consumer and capital goods. Distribution firms that are vertically integrated refuse to carry or transport the products of competitors. Furthermore, product return and rebate system incentives are used to persuade (or 'coerce') retailers toward using domestically produced goods rather than foreign goods. WTO argue that vertical distribution affiliation kieretsu "usually set up by manufacturers, tie wholesalers and retailer together through various links including special agent contracts, extension of technical and financial assistance, exchange of personnel and cross shareholding." [WTO, 1995:93]. 'Cleverly' enough, distribution kieretsu are concentrated in sectors which are characterized by product differentiation; e.g. cosmetics, electrical appliances and automobiles. Outside the automobile

sector distribution kieretsu cover approximately 50% of the cosmetic sector and 40% of the electrical appliance sector [WTO, 1995].

Clearly such restrictive practices have an impact on both trade and investment as well as both potential foreign and domestic entrants. Ultimately production in a country may be lower which means economic growth will consequently be dampened.

4. *CAPITAL MARKET IMPERFECTIONS*

Capital market imperfections is yet another (potential) impediment of a good functioning market for corporate control. It therefore goes without saying that these capital market imperfections may act as a tool for private agreements to affect the level of inward FDI. More specifically, informal obstacles to merger and acquisition activity including cross–holding and tactical impediments "to acquisition may impede the primary channel of FDI in developed country markets." [Noland, 1999:6].

To begin with, stock markets across countries differ in size, depth and portfolio size. [*Note that stock markets can be used as a form of authority to gain corporate control and hence influences FDI through merger and acquisition activity.*] **Table 1** shows data on stock market capitalization as a percentage of GDP as well as the number of listed shares for selected countries. Among the developed countries as reported in Table 1, two groups emerge.

Table 1: ***Stock Market Indicators***

Countries	*Stock Market Capitalization CAP/GDP (1994)*	*Listed Companies (1995)*
US	0.76	7.671
Japan	0.81	2.263
Germany	0.26	678
France	0.33	450
Italy	0.16	250
UK	1.19	2.078
Canada	0.58	1.196
South Africa	1.85	640
Malaysia	2.80	529
Korea	0.51	721
Brazil	0.34	543

Table 2: *Regression Results* (*Note*: Numbers in parenthesis are t-statistics. Supercripts a, b and c indicate 1, 5 and 10 percent significance levels, respectively.)

Indep. Var.	Dep. Var. FDI (2.1)	Dep. Var. FDI (2.2)	Dep. Var. FDI (2.3)	Dep. Var. FDI (2.4)	Dep. Var. FDI (2.5)	Dep. Var. FDI (2.6)	Dep. Var. FDI (2.7)	Dep. Var. FDI (2.8)	Dep. Var. FDI (2.9)	Dep. Var. FDI (2.10)	Dep. Var. FDI (2.11)	Dep. Var. FDI (2.12)	Dep. Var. FDI (2.13)
CONST	42.11	-0.56	-5.64	28.73	3.54	4.02	38.12	3.21	4.13	5.92	4.62	-5.37	-3.08
	(4.16)[a]	(-0.11)	(-0.64)	(3.74)[a]	(0.61)	(0.36)	(4.62)[a]	(0.52)	(0.52)	(0.61)	(0.33)	(-0.43)	(-0.23)
HERF	-6.82	0.22	0.96	-4.47	0.02	0.24	-4.77	0.19	0.76	0.40	0.18	0.84	0.67
	(-4.61)[a]	(0.29)	(0.70)	(-3.85)[a]	(0.02)	(0.15)	(-3.83)[a]	(0.19)	(0.68)	(0.27)	(0.15)	(0.81)	(0.46)
HKEI1		-3.08			-2.86			-2.36			-2.06		
		(-6.07)[a]			(-5.52)[a]			(-1.92)[c]			(-0.43)		
VKEI1		-0.49			0.57			-0.58			-0.46		
		(-0.82)			(-0.98)			(-0.97)			(-0.56)		
HKEI2			3.28			1.30			-0.81			0.23	
			(2.26)[b]			(0.80)			(-0.62)			(0.17)	
VKEI2			-8.51			-5.82			0.67			1.00	
			(-4.70)[a]			(-2.80)[b]			(0.28)			(0.40)	
HKEI3				7.48			6.78			1.02			1.31
				(2.23)[b]			(1.72)[c]			(0.35)			(0.42)
VKEI3				-9.99			-9.38			-1.52			-0.85
				(-3.19)[a]			(-2.48)[b]			(-0.49)			(-0.26)
RD					0.83	1.52	2.03	0.81	0.96	0.95	0.87	0.97	1.00
					(2.63)[b]	(2.39)[b]	(3.26)[a]	(2.45)[b]	(1.98)[c]	(1.95)[c]	(1.54)	(2.17)[b]	(2.19)[b]
SALES								-0.17	-1.10	-0.98	-0.05	0.08	0.12
								(-0.45)	(3.43)[a]	(-4.03)[a]	(-0.08)	(0.12)	(0.21)
LAB											0.21	2.79	0.12
											(0.05)	(1.88)[c]	(0.21)
CAP											0.92	2.22	2.21
											(0.39)	(0.91)	(0.84)
HCAP											0.59	-1.05	-0.66
											(0.13)	(-0.31)	(-0.19)
R^2	0.47	0.94	0.83	0.76	0.96	0.87	0.84	0.96	0.97	0.93	0.94	0.94	0.94

Legend:

FDI	= Log Foreign Direct Investment as Share of Industry Sales
HERF	= Log Herfindahl Index
HKEI1	= Log Horizontal Keiretsu Share of Industry Sales according to Dodwell Marketing Consultants
VKEI1	= Log Vertical Keiretsu Share of Industry Sales according to Dodwell Marketing Consultants
HKEI2	= Log Horizontal Keiretsu Share of Industry Sales according to Toyo Keizai
VKEI2	= Log Vertical Keiretsu Share of Industry Sales according to Toyo Keizai
HKEI3	= Log Horizontal Keiretsu Share of Industry Sales according to Keizai- Chousa-Kyoukai
VKEI3	= Log Vertical Keiretsu Share of Industry Sales according to Keizai- Chousa-Kyoukai
RD	= Log Research and Development Expenditures as Share of Industry Sales
SALES	= Log Value of Industry Shipments
LAB	= Log Labour Share
CAP	= Log Capital Stock Share
HCAP	= Log Human Capital Share

Source: International Finance Corporation, Emerging Market Handbook (1996)

First we have the continental European countries where stock markets are relatively small, and then we find the other developed countries where stock markets are much larger. Among the developing country emerging markets, stock market capitalizations in Taiwan, South Africa, Malaysia, Korea and Brazil exceed that of Italy in both relative and absolute size, and have more listed firms than both France and Italy. However, looking at market capitalization alone to make decisions on its impact on FDI can be misleading. This is because of cross–holdings that exist in the markets. In Japan for example, due to cross–holdings, only 30% to 40% of shares are actually traded, effectively making it impossible for corporate control. In Europe a similar stance exists [Noland, 1999:17]. According to Rao and Ahmed (1996), German banks and insurance companies own a sizable share of non–financial firms. Moreover market concentration is made worse by laws which state that a 75% share of voting stock is required to assure control [Noland, 1999]. Thus a major obstacle for corporate take–overs is created and therefore such access barriers could impede FDI. However, there are those who argue that intensive cross–shareholdings lead to superior economic performance. These arguments are 'misleading' according to others and may in the short run contribute to economic performance but in the medium to long term only dampens FDI and hence economic growth.

5. *QUANTITATIVE ANALYSIS*

Thus far the discussion of this chapter has centered around how private practices may affect foreign direct investment (FDI). This section continues from the previous section by analysing some simple statistical evidence on industrial structure and inward foreign direct investment.

Data on inward FDI (as a share of industry sales) was gathered for USA and Japan. Herfindahl's indexes of concentration were then regressed against the FDI data. The regression results are reported in **Table 2**. In Table 2 regression (2.1) shows that the degree of industry concentration is negatively correlated with inward FDI. This means that large firms may indeed exhibit FDI through the mechanisms described in the previous section. Since kieretsu is a vague concept, different definitions from three alternative sources were used to check on robustness, as can be seen in regressions (2.2), (2.3) and (2.4) where kieretsu

variables were added to the regression. The regression results are not completely consistent. Regression (2.2) shows that horizontal kieretsu (kieretsu affiliations across industries) are negatively associated with inward FDI, while the result of vertical kieretsu (kieretsu affiliations vertically within industries) is statistically insignificant. The data for these regressions were obtained from Dodwell Marketing Consultants. The results were very different when data from Toyo Keizai and Keizai– Chousa–Kyoukai are used. Here, horizontal kieretsu are positively associated with inward FDI, while vertical kieretsu variables indicate a negative relationship. In regression results (2.5), (2.6) and (2.7) research and development expenditures are added to the specifications. In all three regressions, the co–efficient on the research and development variable is positive and statistically significant, while at the same time, the positive co–efficient on the horizontal keiretsu variables in (2.6) and (2.7) become insignificant.

In specifications (2.8) to (2.13), additional variables are added to the regression, beginning with industry shipments. The figures in Table 2 show that FDI is negatively correlated with industry size (though this result is not robust). Similarly when the labour, capital and human capital shares in value–added are included they are almost always insignificant. The addition of these variables also tends to reduce the statistical significance of the co–efficients on the other variables due to multicollinearity, with the exception of those research and development co–efficients which are relatively robust to specification.

Taken together, it appears that research and development expenditures are positively associated with inward FDI in the US and Japan. Industry concentration is negatively associated with FDI. Furthermore, evidence in specifications (2.5) to (2.7) suggest that both horizontal and vertical kieretsu may be negatively associated with inward FDI.

The regression results therefore show Japan has lower levels of inward FDI than the US, but industrial organisation variables have almost no explanatory power in this regard. Thus the evidence shows that industrial organisation or private practices do not appear to be a major impediment to FDI.

6. *CONCLUSION*

As government policy often provides the facilitating devices that sustain anticompetitive behaviour, government competition policies and their enforcement can in fact constrain

existing firms abilities to implement anticompetitive strategies. These practices can affect both goods trade and, particularly FDI in three ways. First, product market impediments may deter complementary investment in distribution, service, product development and production. Second, service industries intrinsically require a local presence, and barriers in service markets dampen this type of associated investment. Finally, impediments to merger and acquisition activity in capital markets can discourage FDI in all sectors.

To round off then, informal barriers do not appear to restrict FDI, although as formal restrictions move toward stricter competition policy/rules and more vigorous enforcement thereof (as is the trend in both developed and developing countries), existing firms then, may use these laws to prevent potential entrants from entering the market. Thus investment is restricted and incumbent firms use competition laws to enforce their anticompetitive practices.

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CHAPTER 3

SOUTH AFRICAN CASE STUDY OF THE STANBIC/NEDCOR MERGER

CHAPTER 3

SOUTH AFRICAN CASE STUDY OF THE STANBIC NEDCOR MERGER

1. INTRODUCTION

South Africa is rapidly following the international trend of mega mergers, particularly in the financial services, telecommunications and media sectors. Internationally mergers are being driven by the need for increased efficiencies, delivery capacity and reduced operating costs. In South Africa these factors too play a major role in prompting mergers, but a factor often overlooked is the fact that local companies in South Africa are looking for increased focus, a kind of spill–over from the hothouse effect of an isolated country with limited investment opportunities that produced diversified conglomerates such as South African Breweries (SAB) and Barlows.

According to the head of corporate finance at African Merchant Bank (AMB), Loutjie Geldenhuys, companies divest from non–core assets and in so doing refocus and streamline their businesses or operations. This is mainly due to the fact that management teams are looking for opportunities that make commercial sense and those which enhance core operations. Furthermore, Geldenhuys believes that "we will see more hostile takeover bids in South Africa, with the momentum increasing." [The Business Report, 2000:11]. Recent practices such as the 1998 bid by African Life for Norwich, the Harmony/Randfontein issue and the ongoing Nedbank/Stanbic saga reinforces Geldenhuys's predictions.

The rest of this paper will focus on the Nedcor/Stanbic 'potential' merger and the role of the competition commission in this regard. It will then conclude by providing some policy suggestions as to the effects competition policy has in South Africa.

2. BACKGROUND TO THE PARTIAL OFFER

On the 29th September, 6th October and 27th October 1999, Nedcor made a cautionary announcement. In addition to this announcement, the direction of Nedcor announced their intention to a 'Partial Offer' to the shareholders of Stanbic with a view to combining the two

businesses. However, Nedcor's formal offer to Stanbic cannot proceed without the approval of the registrar of banks and the finance minister.

Having received substantial negative or disappointing commitments from the Stanbic shareholders, Nedcor approached Stanbic on the 11th November 1999 with an intention of reopening discussions [High Court of South Africa, 1999]. Nedcor subsequently met with Stanbic on the 12th November 1999 and indicated that it was making an offer for Stanbic at an exchange ratio of 1 Nedcor share for every 5.50 Stanbic shares, but was willing to improve the terms to 1 Nedcor share for every 5.25 Stanbic shares. Stanbic did not accept the offer and refused to re–open any discussions. Nedcor then, on the belief that there are significant merger benefits available to the shareholders of both groups as well as other shareholders, decided to seek the support of Stanbic shareholders through the proposed Partial Offer in order to achieve the full merger.

Although the Partial Offer is being made on an unsolicited basis, Nedcor did not consider it to be hostile to the Board, management and staff or Stanbic in any way and, therefore, continued to persevere in their 'negotiations' for a full merger.

3. *TERMS OF THE PARTIAL OFFER*

"The Partial Offer will be for 50.1% of each shareholder's holding of Stanbic shares at the record date of the offer, to be notified in the offer document." [High Court of South Africa, 1999]. Furthermore, the Partial Offer was conditional on a **minimum level of acceptances** of 50.1% of the issued share capital of Stanbic. The Partial Offer would also be regarded at a lower percentage than the specified 50.1%, but any such decision must be done with the approval of Old Mutual, Nedcor's parent company.

The Partial Offer Ratio was 1 Nedcor share for every 5.50 Stanbic shares. In addition, based on the closing share price of 11700c per Nedcor share on 12th November 1999 (which was the last trading day before the announcement of the Partial Offer by Nedcor), the Partial Offer Ratio valued each Stanbic share at approximately 2127c, and the current issued ordinary share capital of Stanbic at R29.2 billion [Business Report, 1999].

However, Nedcor has shown a willingness to improve the Partial Offer Ratio (Recommended Offer Ratio) to 1 Nedcor share for every 5.25 Stanbic shares, provided that the Stanbic Board and shareholders agree to a full merger. The Recommended Offer Ratio values each Stanbic share at 2228c and the current issued ordinary share capital of Stanbic at approximately R30.6 billion [Business Report, 1999].

The Partial Offer Ratio and the Recommended Offer Ratio represent premiums of 11% and 16.3% respectively, to the 30–day weighted moving average ratio of 6.105 to 28th September 1999, being the day before the first cautionary announcement by Stanbic.

4. *STANBIC SHAREHOLDER SUPPORT FOR MERGER*

With the approval of the Securities Regulation Panel (SRP), Nedcor held confidential discussions with a limited number of the largest shareholders in Stanbic. The outcome from these discussions were in favour of the proposed merger.

Shareholders currently holding 488.0 million shares representing approximately 35.5% of Stanbic's share capital, have given their "irrevocable" support to Nedcor on this issue and for Nedcor to accept the Partial Offer either at the Partial Offer Ratio (30.7%) or at the Recommended Offer Ratio (4.8%) in respect of the shares they continue to hold. In addition, shareholders currently holding a further 12.4% have given Nedcor either written or verbal indications of their support for the proposed merger.

Table 3 below sets out the details of the irrevocable commitments as discussed above.

Shareholder	Number of Shares	% Holding in Stanbic
Old Mutual	293.8	21.4
RMB Asset Management	74.2	5.4
Gencor Group	28.6	2.1
BOE Asset Management	27.4	2.0
NIB Asset Management	19.0	1.4
Coronation Fund Managers	18.0	1.3
Investec Guinness Flight	13.2	0.9
Mines Pension Funds	7.2	0.5
Mutual and Federal Insurance Group	6.6	0.5
	488.0	35.5

Source: Cape High Court of South Africa (1999–2000), Transvaal Provincial Division, Case No. 99/35807; page 42.

Clearly, Nedcor's ultimate aim is to acquire 100% of Stanbic and achieve the recommended full merger. However, given the substantial number of shares in Stanbic held within the Stanbic group, Nedcor may not be able, in the absence of a recommendation from the Stanbic Board, to achieve its stated objective by attaining a 90% acceptance level necessary for compulsory acquisition of the minority shareholders. Consequently, Nedcor intends to acquire a majority shareholding through the Partial Offer, thus meaning that the shares currently held within the Stanbic Group be relooked. In the event that the Partial Offer becomes unconditional, it is intended for an arrangement to be made where Nedcor would offer to acquire all of the shares in Stanbic other than those already held by Stanbic.

This then means that Stanbic and Nedcor Shareholders will each hold approximately 50% of the merged group in the event that the full merger is actually accomplished at the Partial Offer Ratio. Thus any future synergies, earnings and profits (or losses) will be shared equally between the two groups.

5. *WHY THE MERGER SHOULD TAKE PLACE*

Of late many changes have taken place in the global financial service industry. The clear trend in the banking sector has been a significant increase in the speed and scale of consolidation, as banks seek to merge to achieve critical mass, realise cost synergies and increase their profitability. More recently as regional and international expansion by banks has increased, South African banks have been more motivated to increase their base and efficiencies to the extent where they will be recognised as major competitors of international banks, in both their domestic and foreign markets. In addition because the banking sector faces an increasing pace of technological change and fierce competition from other (existing) banks as well as potential and new entrants into the financial services sector, there is a greater motivation for banks to merge and thus achieve lower cost structures which enhances their chances of successfully targeting niche areas.

Nedcor firmly believes that the South African financial services sector must face and meet these challenges. In addition, the consequent low cost base of banks (given South Africa's history) will help service the needs of the previously and currently disadvantages members of society.

6. *NEDCOR'S REASONS FOR THE MERGER*

Nedcor is one of South Africa's leading banks, and over the past five years has more than tripled its earnings through pursuing a strategy of cost containment, efficiency, risk avoidance and credit quality. The directors of Nedcor believe that the proposed merger will create a market leader capable of bettering the above mentioned challenges. They believe that the merger will give rise to the following benefits:

- The creation of a bank with the scale and efficiency to compete with international banks.
- The ability to eliminate duplicated costs and thereby achieve globally competitive levels of efficiency and profitability.
- The ability accelerate the development and share the significant investment costs of future state–of–the–art technology.
- The creation of a bank with improved returns and greater free cash flow.
- The application of the merged group's low cost base to extend banking services to the under–banked sector of the community.
- A range of opportunities for Black Economic Empowerment.

[Finance Week, 2000]

Currently, Nedcor's infrastructure is well placed to achieve this and more. Therefore its shareholders, Stanbic shareholders and the country as a whole stands to benefit from the merger. Furthermore, levels of foreign and domestic investment is most likely to increase because of the existence of a highly efficient, well capitalized bank of international scale which will be capable of meeting the requirements of these investors. Ultimately growth in the economy is enhanced.

7. *PROPOSED ACTIONS FOLLOWING COMPLETION OF THE MERGER*

Following the merger, Nedcor intends, in conjunction with Stanbic management, to take immediate steps to realise the benefits outlined in the previous section. Amongst other actions there would be plans to:

- take immediate actions to retain key staff and clients in both banks and ensure that staff of both banks are given the opportunity to participate and co–operate in the new venture.

- combine the operations of the two banks in order to maximise the potential cost synergies.

- build on the brand equity of the merged group.

- undertake an immediate review of the risk exposures in the domestic and international markets in order to assess and, if appropriate, reduce the risk profile of the merged group.

- review the relative strengths of Standard Corporate and Merchant Bank and Nedcor Investment Bank Limited with a view to optimising the market position of the merged group's investment banking operations.

- work with the board of Liberty Life Association of Africa Limited to maximise Liberty's value through either a sale or unbundling of the Liberty business.

[The High Court of South Africa (1999–2000),
Transvaal Provincial Division, Case No. 99/35807; page 46]

8. *BENEFITS OF THE MERGER*

8.1 BENEFITS TO SHAREHOLDERS

Stanbic shareholders will benefit from:

- an immediate premium to the Nedcor/Stanbic ratio of weighted average share prices to 28th September 1999 as follows:

Period (days)	30	60	90	180	360
At Potential Offer Ratio	11.0%	12.5%	14.1%	20.1%	21.8%
At Recommended Offer Ration	16.3%	17.8%	19.5%	25.9%	27.5%

- an aggregate lower risk profile.
- an improved capital adequacy ratio.

Assuming a full merger at the Partial Offer Ratio, both groups of shareholders will benefit equally from:

- the anticipated annual merger synergies of 1.9 billion post–tax per annum by the end of 2002.
- an improved platform for future growth.
- value uplift greater than either company is likely to be able to achieve as a stand–alone entity.
- a management team with a record of long–term value creation, re–inforced by drawing from the best resources of both groups.

8.2 BENEFITS TO OTHER SHAREHOLDERS

- The majority of staff from both banks will benefit from a better, more efficient working environment.

- Retrenchments at Nedcor have been minimal, and the majority of the expected staff reductions arising from the merger will be achieved through natural attrition.

- South Africa benefits from the establishment of a well capitalised regional and international player with the economic scale and cost efficiency to further extend banking products and services especially to previously disadvantaged clients.

- The merger will also create a range of significant Black Economic Empowerment opportunities, including the creation of a well–capitalised, competitive force in the retail banking/home loan sector.

- Clients will benefit from the expansion of ATM's, product offerings and the use of leading edge technology.

9. *FINDINGS AND SUGGESTIONS*

This section of the paper aims to evaluate the evidence of the arguments presented thus far with regard to the Nedcor/Stanbic proposed merger, and then provide some suggestions as to why this is such a complicated merger.

Banking in South Africa (if not the whole financial services industry), is dominated and controlled by four financial institutions. These institutions, considering their asset values and the towns, villages and cities they operate in, are the economy of South Africa. The banking groups in question are Stanbic, which owns Standard Bank, ABSA, First Rand and Nedcor. The largest of these banks, whether measured by banking assets, shareholders funds or profits is Stanbic and its subsidiaries. Nedcor is the fourth largest banking group, as measured by banking assets and shareholders funds.

Stanbic employs approximately 31000 people in South Africa, has shareholders funds totalling R13.3 billion, and total banking assets of over R174 billion [Standard Bank Handbook, 2000]. It not only operates in South Africa, but also from London and the continent of Africa. It is thus an important mechanism in channelling and encouraging inward foreign direct investment. In addition it holds a controlling interest in its subsidiary, Liberty Life, which is one of the countries largest life assurance companies. Both Stanbic and Liberty are listed on the Johannesburg Stock Exchange and are important attractions to foreign investors.

Nedcor, on the other hand, employs 18000 people and has shareholders funds of R9.8 billion, and total banking assets of R126.8 billion. It too is a listed company [Nedcor Handbook, 2000]. Although Nedcor is listed, 54% of its share capital is owned by Old Mutual pk. Old Mutual constitutes South Africa's largest life assurance group. Apart from controlling the majority of the shares in Nedcor, it also holds and controls approximately 24% of Stanbic's share capital [JSE Handbook, 1999].

For the past year and a half, Old Mutual and Nedcor have aspired to the acquisition by Nedcor of all of the issued share capital of Stanbic, meaning if successful, Stanbic would become a wholly–owned subsidiary of Nedcor. If this merger takes place, the new combined bank (NEDSTAN, perhaps?) would be approximately 95% bigger than its nearest competitor, ABSA, based on shareholder funds and 79% bigger based on banking assets. It would have

well in excess of half of the total market share in credit card business and in cash, cheque and transmission deposits. Furthermore, a successful merger would mean that Old Mutual would indirectly control the business of Liberty, which alone makes up 18% of Stanbic's earnings.

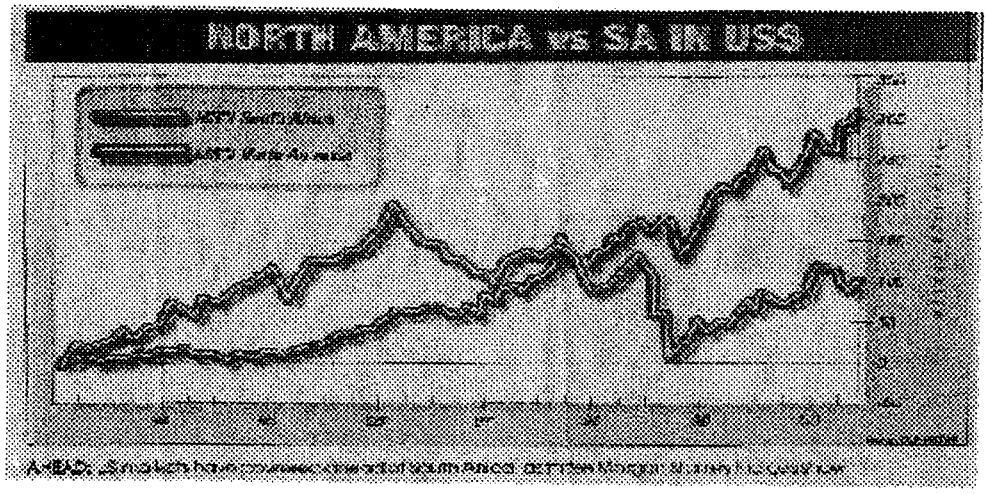
Clearly Old Mutual's influence in every sphere if it acquires Liberty's business through the merger, should be questioned. This proposed merger is certainly then a matter that may have significant consequences for the entire country. The elimination of Standard Bank as a competitor in the financial services industry, and the subsequent creation of such an economic unit with the power and strength the new proposed bank will have, will definitely affect all South African economic life. The entire country will be run by Old Mutual and its subsidiaries.

According to the Competition Commission, the above notion is bad for an efficient, competitive environment, balancing the interests of workers, owners and consumers. Is this necessarily so? The ultimate aim of Old Mutual and its subsidiary companies is to make a profit. At present these companies are already running on a skeleton staff which eradicates fears of any retrenchments should the merger be successful. Furthermore, Nedcor has categorically stated that it does not intend undergoing major retrenchments. Any retrenchments that will take place would be done under close supervision of trade unions. This creates a favourable environment with regard to any retrenchments that will take place. In addition, if Old Mutual gains control of Liberty it intends unbundling the company which too has its benefits to society at large.

In short then, even if Old Mutual and its subsidiary companies should control most of the economic life in South Africa, it does not mean that this is bad for growth in the economy, but instead could enhance growth in the economy. By maintaining high levels of growth in the economy these companies ensure a better performance within their industries, thus every body benefits.

10. CONCLUSION

Figure 1:



Source: Old Mutual in Weekend Argus, Personal Finance, 03/06/00, pg.3

The previous section highlighted the fact that perhaps the merger should take place, as it would benefit the entire country. To conclude this paper, this section suggest that, why have competition policy at all. Competition Policy and the new Competition Act per se, is there to enable the transparent, unrestricted and independent consideration and control of all economic activity within South Africa and outside, if any such activity has an adverse effect within South Africa. The roots of the Act lie in the intention of the people of South Africa, as expressed through legislature, that there be profound changes in the economic and social order.

However, recent developments surrounding the Nedcor/Stanbic merger has led the Supreme Court to decide that the proposed merger would be regulated by the Banks Act, the Registrar of Banks and Finance Minister, Trevor Manuel. This leads us to the question of why have a competition act/policy at all. Furthermore, competition policy in South Africa scares away foreign investors. Thus government policy, by far and large competition policy (as it may inhibit certain companies from operating at their peak and thus even further maximize their profits), has played a significant role in recent drops in foreign direct investment (FDI) in South Africa for the first quarter of 2000 as reported in the Business Report on the 11th May 2000. Figures that have recently been released shows that investment in January–March was R1.9 billion, well down on the R3.2 billion for the first quarter of last year. (Incidentally, during the first quarter last year the new Act was not yet implemented.)

Moreover, according to Graham Kane of Old Mutual Asset Managers in London, foreign fund managers are reluctant to invest in South African companies because of certain "inhibitory" competition laws. According to Kane, "would you invest in South Africa if you were a foreign investor, especially with current competition laws?" [Personal Finance, 2000:3].

Foreign Fund Managers are interested only in returns and on past performance. Unfortunately, certain government policies and regulations, inhibited South Africa from being major competitors in markets of the United States and Europe. Since 1993, Wall Street has shown returns (in US dollar terms) of more than 300%, while South African shares, as measured by the Morgan Stanley South African Index, have managed only 95%. Against other emerging markets, South Africa does not look any better, only just beating the general emerging market index performance of 75%.

Figure 1 shows how US markets have powered ahead of South Africa, especially from the third quarter of 1997.

In retrospect then one wonders why government implements certain policies in an attempt to help its community, when in actual fact an absence of these policies is all the help the people of this country needs. Who says big is necessarily bad?

Personally, I believe a successful merger will do wonders for this country and any retrenchments will, in the long run, be absorbed by progressive economic growth rates.

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   The Minister of Finance (*third defendant*)
   The Registrar of Banks (*fourth defendant*)
   and 6 others, case number 99/35807.

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