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Structural transformation, competition and economic power: the need for better policies

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The economy remains highly concentrated and existing firms have substantial advantages over entrants and smaller rivals. These firms can use their power to block rivals, also by influencing regulations in their favour. Changing the structure and the ownership of the economy simultaneously requires a package of measures to tackle the abuse of market power by large firms, change regulations to open up markets, and effectively support the development of the capabilities of smaller firms.

Introduction

The structure of the economy in 2018 still is much too similar to that inherited in 1994 (Black, Craig & Dunne 2016). This has prevented the economy from growing dynamically and becoming more inclusive. Recent debates on changing this path have tended to focus on ownership and control, largely ignoring the problems of concentration and economic structure. However, changing ownership without ensuring more dynamic and inclusive markets is not an effective and sustainable strategy.

Central to structural transformation and competition is the recognition of the market power of 'incumbents' (i.e. established businesses in a market) relative to that of 'entrants', i.e. newcomers (Roberts 2017a). This reflects the broader patterns of economic power. Understanding the nature of this power and how it can be leveraged is important in order to foster dynamic competition that leads to investment, research and development (R&D), new business models and products, as well as the successful entry of black entrepreneurs.

The Competition Amendment Bill, published on 1 December 2017, proposes important changes to make the authorities more effective in dealing with anti-competitive conduct.

However, these changes need to be part of a much broader package of measures to open up the economy.

The impact of economic concentration and market power

High levels of market concentration and barriers to the entry and growth of rivals partly explain the disappointing performance of the South African economy. Rivals bring new products and business models, and spur existing businesses to invest in improving their own offerings. However, powerful incumbent businesses can block rivals through various strategies. This includes being able to lobby for policies and regulations that make it more difficult for rival firms to enter the market. Regulation is required to discipline market power and also to ensure access to essential facilities for entrants (Das Nair & Roberts 2017).

Market power means that firms, acting unilaterally or collectively in cartels, can extract high prices from buyers because the buyers do not have good alternatives to which they can turn. These prices are higher than can be explained by the costs of production or earning a reasonable reward for investment, effort or innovation. The power to levy such 'supra-competitive' prices is simply a 'return on incumbency'. Indeed, there have been a large number of competition law cases in South Africa relating to insiders' exploiting their market power through cartels, as well as cases of excessive pricing (Muzata, Roberts & Vilakazi 2017; Das Nair & Mondliwa 2017).

The exertion of substantial market power hinders exactly the structural transformation that South Africa needs. It can inhibit the successful entry and the growth of smaller businesses, thus shaping the whole development path of the economy. Downstream customers that are charged higher prices often are businesses that are more labour intensive. Where the buyers are firms in potentially more productive and dynamic activities, economic growth and employment can be undermined. For example, high prices of data in telecoms are a substantial handicap to all the entrepreneurs who are looking to develop and sell digital applications. High fertilizer and cement prices have raised the costs of construction and agricultural production (Vilakazi & Roberts 2018).

How economic power is used to block rivals

Economic power can also enable established firms to maintain their positions and to lobby government effectively to protect them from new competitors. New firms must simultaneously meet several challenges if they are to overcome entry barriers and become

effective competitors. In each of these pursuits, established firms may be able to block them, as the following examples illustrate.

First, new firms need to build brands and reach consumers. Studies of consumer behaviour have highlighted the importance of perceptions and brand awareness, as well as consumers' reluctance to switch to new suppliers. For example, in network industries (such as telecommunications and financial services) there are substantial advantages to being the first major business able to build a membership base.

Secondly, successful entry requires investment in the firm's internal capabilities and a substantial period of learning-by-doing. In addition, linkages to key input suppliers and customers in the value chain have to be built, especially where coordination is required to design new and improved products. Incumbent firms may well be vertically integrated. This could mean that new firms have to buy key inputs from the same corporates with which they are competing with their main product.

Thirdly, in certain industries new businesses require access to critical infrastructure and facilities to be able to provide services at affordable prices. Because existing firms have the critical infrastructure and facilities (combined with network effects), regulation is required to ensure that new firms also acquire access to these.

Fourthly, established firms can use strategies such as loyalty rebates, which make it difficult for smaller rivals to attract customers. The effective enforcement of laws prohibiting competition is necessary to identify where these types of arrangements undermine competition.

Given such barriers and complexities, entrant firms may need a long time to establish themselves in a new market with strong incumbent firms. For example, it took companies such as *Capitec* and *Fruit and Veg City* around a decade before they became effective rivals to the incumbent firms in those markets.

As noted above, influential large businesses are also able to lobby strongly for regulatory regimes which are in their interests – their economic power enables them to influence the 'rules of the game'. For example:

- in liquid fuel, the major oil companies have long had a regulatory regime which favoured their control over key infrastructure such as off-loading facilities at ports, storage and access to pipelines;

- in telecommunications, Telkom has persuaded policy makers to support its privileged position in the name of extending access;
- in pay TV, there has been similarly strong lobbying to obtain the promulgation of regulations which effectively hinder potential rivals; and
- in beer distribution and retail, SAB-Miller (now ABInbev) headed off changes to the Liquor Act which would have opened up distribution to rivals (although some concessions were subsequently granted as part of obtaining approval for the merger).

Agenda: what needs to be done?

Concerted policy action is needed across different fronts to alter the economic landscape. Competition policy must go beyond enforcement of the competition law to open up markets to more participants. In addition, industrial policies – including access to development finance, incentives, and procurement – all have a major influence on making markets accessible, open and fair. Finance obviously matters, but providing development finance without addressing the other barriers to effective entry is likely to be a waste of money. Similarly, support for small businesses in the absence of addressing the power of established business is setting up small firms to fail.

Getting more competitors and increasing dynamic rivalry, in the form of improved products and services, require changing the rules of the game. If government provides robust leadership of the 'regulatory state', much can be done to counter the in-built advantages of large firms. In the absence of this leadership, the economic power of incumbent firms is likely to remain unchallenged.

The Competition Amendment Bill takes steps to address these issues. However, competition policy enforcement alone cannot address the levels of economic concentration and the negative effects of market power in the economy. The track record shows that, though the competition authorities have penalised cartels and prosecuted unilateral conduct, this has not necessarily led to increased participation or more effective competition. For example, the Competition Commission uncovered a cement cartel in 2012, prosecuted the firms and ordered them to disband the cartel. However, it was the entry of Sephaku in 2013/14 that led to more vigorous competition and, as a result, prices fell by 25% (Roberts, 2017b).[1]

[1] It is important to note that Sephaku's entry was facilitated by the 'use-it-or-lose-it' provision in mining laws, whereby Sephaku was sold limestone mining rights by Anglo American. This points to the need for a policy package to open up markets.

The entry and success of new competitors are crucial. We propose a positive agenda for competition policy, regulation and related policy areas that includes the following:

First, the 'rules of the game' in many areas of economic regulation should be changed to favour entrants and ensure that incumbent firms can be effectively challenged. For example, regulatory steps already taken in fuel and gas should be boosted to allow independent suppliers access to key facilities. In telecommunications, the allocation of the frequency spectrum must foster greater rivalry, while local governments can open up access to existing infrastructure such as electricity poles to rival providers. In finance, regulations to support mobile money (the transfer of funds via a mobile phone) and branchless banking will widen opportunities. For supermarkets, measures could include soft regulation such as codes of conduct to support small suppliers who wish to sell to large supermarket chains.

Next, there should be more effective enforcement of competition laws against anticompetitive conduct that excludes smaller rivals. While the Competition Amendment Bill proposes important changes in this regard, these appear to be too limited, or narrow. We need a much broader package of competition policy measures. These measures need to shape the competition process to reward investment, innovation, creativity and effort rather than incumbency.

Finally, we propose proactive enabling measures to support newcomers, especially black entrepreneurs. This includes a development finance fund, funded from competition penalties, which can take higher risk in financing entrants and smaller rivals. Complementary measures are required at local government level to help create suitable business spaces and open up critical infrastructure to new and existing small firms.

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