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Culture and Competition

Kenneth M. Davidson
U.S. Federal Trade Commission
Resident Legal Advisor
KPPU RI
Jakarta, Indonesia

I wish to thank the organizers of this conference for giving me the opportunity to express my views on this important topic. By tradition at the Federal Trade Commission, I am required to open with a disclaimer about my speech. The views that I am about to express do not necessarily represent the view of the United States Government, USAID, the FTC, or any of its Commissioners. In other words what I am about to say reflects my own personal views and experience, having spent about thirty years working for the government of the United States and another ten years teaching, writing and researching on topics of law and business.

The topic of this session is a fundamental building block of this conference. How competition is understood determines the goals, aspirations and uses that a country will have for competition and a competition law. Is competition good, and for what is it good? How does it work? Is it compatible with ASEAN cultures? What risks does a competitive economy pose to ASEAN cultures, if any? These are just a few of the topics that need to be considered.

I would like to start my consideration of these topics with my first impressions of the Indonesia and the ASEAN cultures last June when I was chosen as Resident Legal Advisor to the KPPU, the Indonesian Competition Commission. Most of what I read before arriving suggested two primary characteristics of the economy: first, the culture was based on consensus rather than competition; and, second that the economy of Indonesia and other ASEAN countries reflected something called “crony capitalism.” I had heard of “crony capitalism” and it sounded like something that was very bad, but I had no clear idea of what it meant.

When I arrived last August, I was immediately persuaded that competition is not inconsistent with Indonesian culture. As a stranger in a foreign city, I first noticed the competition in transportation. Jakarta has taxis, buses, motorcycles, and strange to me three wheeled motorized bajajs all competing for my business in traveling to work. Even among taxis, there was a wide variety of quality, price and service. Some taxis are luxurious and expensive, other are small, smelly and cheap.

Shopping also demonstrated a degree of competition that sometimes surprised me. I went to a large department store by the name of Pasaraya to buy some Batik cloth to send to my wife. As I walked around the store with an Indonesian friend, I noticed signs on all of the floors about a 30% off sale. I went from display to display and finally found a tablecloth that I thought my wife would like. My friend asked the price and I said that the price was not too high because of the sale. We were then told that these tablecloths were sold by a business that was not part of the Pasaraya sale. Their tablecloths would be on sale, but not until the next day. So I found competition inside what I had thought was a single store and returned the next day to make my purchase.

Throughout my stay in Indonesia and during visits to Malaysia and Singapore, I consistently found that consumers appreciated differences in quality and service and were willing to pay more for better products and more pleasant or quicker service. So although I had many occasions on which to observe differences in culture from that of the United States, I never saw anything that suggested that these cultures were inconsistent with the features that make a competitive market work. Consumers here, as well as in the United States, care about price, quality and service. They will pay more for a new product, the latest cd or dvd. They will shop at an open air market on Block M to get a cheaper version of the same product sold in department stores. So I was convinced that, despite many differences between our cultures, the basic attitudes that make a market work exist here much as they do in the United States.

Crony capitalism posed a different set of questions for me. First, I was not sure what the term meant; second, I did not know whether it had benefits for the ASEAN countries, and third, I did not know how much of the economy of any nation was affected by crony capitalism. Just the term "crony" made me feel uneasy, because in English the word has negative connotations. "Cronyism"means giving special favors to your friends that are not open to people who are not your friends. It has a flavor of corruption, of unfairness and perhaps even illegality.

Yet the term, crony capitalism, was widely used in Asian books, newspapers, and television to describe business organization of many ASEAN economies. To be sure, it is generally used to talk about bad economic practices, but it is often used to refer to the basic organization of an economy. So it seems important to understand whether this crony capitalism is consistent with competition and a market economy.

I am certainly not an expert on ASEAN economies or an expert on economics for that matter. Nevertheless, I have developed some understanding of what is meant by crony capitalism and some of the reasons that it has had an appeal to some governments. Crony capitalism describes economies where a relatively small group of individuals get special economic privileges. They get an exclusive license to import a product, or they get an exclusive right to produce and sell a product that also excludes all foreign competition. They might get large subsidies that prevent anyone else from competing for sales of the same product. If they are the only domestic producers, they might agree among themselves to divide markets into exclusive geographic territories. They might agree to fix prices and thereby determine who will win an auction or contract bid.

In many instances, the individual – the crony – gets his or her rights from the government, but it can also result from agreements between competitors or persons who would be competitors. In either case, the result is less competition or no competition.

Crony capitalism is inconsistent with competition. It is in fact the opposite of competition.

It is not difficult to understand why businesses would try to eliminate competition. Adam Smith observed all the way back in 1776 that, "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices." But is there any explanation for why a government would encourage crony capitalism other than corruption, that is, other than getting bribery payments from the person who government grants the right to a monopoly?

I think there is another explanation for government support of crony capitalism. In a country that believes that it has limited resources, a government may want to guarantee that certain products or services will be available to its people. If there are only a small number of people in the country who have the capital to produce those products or services, it may seek to persuade members of that small group to produce the product or service. A person who agrees to invest his or her money may insist that the government reduce the risk by forbidding foreign or domestic competition.

The government may decide that it is worth giving special protection to the investor if it does not want to be dependent on foreign suppliers of critical basic products. Many countries have argued that this is a legitimate justification for protectionist agricultural policies. Or for reasons of national prestige, national defense, or international competitiveness, a country may decide to protect and favor the growth of a national automobile company, a national airplane manufacturer, an aerospace program, or a national nuclear program. In any of these circumstances, it may seem that the most economic way to achieve the national goal is to grant exclusive favors to the individuals who are willing to invest in achieving the national objective.

The favoritism may appear to grant other benefits to the country. By protecting an industry, it reduces the investment risk for the investor and it may reduce the risks for the employees of the company. In fact, for employees of some companies, the employees may enjoy not only greater job security but also higher wages if the company shares some of its monopoly profits with all or part of its labor force.

Every country engages, to some degree, in this kind of favoritism to achieve national objectives. For most countries, the special privileges do not lead to problems associated with crony capitalism. However, the anticompetitive favors become a fundamental national economic problem when the favoritism to the few investors begins to feed upon itself and the power of the few becomes greater and greater in relation to the rest of the economy. At first, the favored few have only a little more capital than others, but as a result of government favors they increase their capital, so that they can offer the government more capital for the next national project, which generates more monopoly profits and the projects of few make them increasingly richer compared to the rest of the population.

At some point, the favored few have so much of the nation's capital, the government must seek their support for any new investment. This becomes especially true if the national project is expensive and not likely to be profitable under any circumstances. When the size of the businesses owned by the favored few become large enough, the government cannot afford to let the businesses of the favored few fail because the effects on employment and production would endanger the national economy. As a result, the government becomes more and more dependent on the continued success of the businesses of the cronies to pursue national priorities, and it becomes less and less likely to allow such businesses to fail, so it is more and more likely to provide additional favors to the few.

This kind of crony capitalism creates many bad consequences for a nation. The most obvious result is that it creates a class of super rich people who are almost always resented by the vast majority of the nation. Whether this results in physical confrontations against the rich, the disparity of income and opportunity contributes to domestic disharmony.

More important to the topic of this conference, crony capitalism weakens the economies of nations because it tends to inhibit or eliminate competition. Competition is the engine of a market economy. It provides the energy or incentive for businesses to improve products, their quality and variety, and to lower prices to consumers.

In the absence of competition, firms are likely to become less efficient. In a competitive market, if costs rise because workers do not try hard, the firm will lose business to its rivals who are more efficient and have lower costs and lower prices. And the nation loses because the inefficient monopoly uses more resources to produce a smaller amount of products. Whereas crony capitalism tends to benefit only a few favored large producers, competition provides benefits to individual consumers and all buyers, large and small, of industrial products.

For the same reason, lack of competition also reduces the incentives to increase service, quality, and innovation. Customers therefore pay more than they need to and get less for what they pay. But it is not just the customers that get less, it is the nation as a whole that loses from the inefficiency of monopoly.

Innovation is probably the key result of a well functioning competitive market. In the middle of the twentieth century two American economists, Robert Solow and Edward Dennison surprised their colleagues by calculating how much the American standard of living had improved as a result of innovation as compared with increased capital investment. Solow stunned his contemporaries by demonstrating that less than 20 percent of economic growth could be attributed to increased capital investment. Eighty percent came from innovation. Denision made similar estimates that attributed 22 percent of economic growth to improved education and training of the work force, 48 percent came from scientific and technical innovation and only 12 percent came from increased investment in capital equipment.

If those results seem improbable, consider the computer industry in the mid-twentieth century. In the 1950s, it looked as if the industry would be dominated by GE and RCA who manufactured the vacuum tubes on which the computers relied. They had more money and more experience with computers and larger research budgets. Nevertheless, within a decade, both firms were out of the computer business because they had failed to understand the potential of transistors and other solid state technology.

One of my favorite examples is the development of the hand held calculator. Before the 1950s, you had a choice in the United States between big heavy mechanical calculators or even bigger vacuum tube computers to calculate numbers. Then along came Texas Instruments with its transistor calculator that was battery operated and could be carried around. It was a revolution. This new calculator was relatively inexpensive and easy to use. But that is just the beginning of the competitive story, not the end. The success of Texas Instruments brought in more competitors. Someone discovered printed circuits could do the job of transistors so calculators could be even thinner. Someone discovered how to hook up a photovoltaic plate so the calculator would work on a little light and you never needed to replace batteries. Someone else discovered liquid crystal displays that again made the calculator thinner. As this calculator became better and better as a result of competition, another amazing thing happened. The hand held calculator became cheaper and cheaper. In fact, it became so inexpensive that practically anyone with a job could afford one. Ultimately, it has become so inexpensive that the hand held calculator that is about the size of a credit card is now commonly given away as an advertising promotion. Companies give away these small calculators with the name of the company or the product printed on the calculator to remind customers of their products every time it is used.

Of course the result of these developments had devastating effects on jobs of employees of many companies. As this technology was being developed it moved into the manufacture of computers and all those people making complicated delicate vacuum tubes lost their jobs as did the people making the steel and metal parts for mechanical calculators. Many of these were highly paid skilled jobs that became unnecessary.

But for every job that was lost, there developed entire industries that used the same technology that became popular with the hand held calculator. The liquid crystal display is used for everything from digital watches and alarm clocks to laptop computers and flat screen TV sets. The silicon chips in the solid state technology made possible the personal computer but is used in everything from watches to automobiles to refrigerators to greeting cards that sing to the person who opens it.

In a competitive economy, innovation is not a choice. It is a product of what American economist Burton Klein has called the “hidden foot” of capitalism. Since the time of Adam Smith, economists have talked about the “invisible hand” of capitalism to emphasize that economic growth in capitalism happens without any central planning. But Klein’s hidden foot emphasizes that capitalism kicks out those competitors who fail to innovate or keep up with the innovations of their competitors.

Innovation and the hidden foot of capitalism are considerations that should be kept in mind when we think about economies moving from crony capitalism to competitive markets. In the competitive economy, there may be no one with whom a government can make a deal to create or maintain existing businesses. There is no doubt that the free market, competition, the invisible hand all will cause changes in the economic structure of nations that move from controlled economies, whether they are the product of crony capitalism or centrally planned economies.

But the choice to retain a controlled economy is not a viable solution for a nation that wants to engage in international trade. The protected industry, the national champion even subsidized by the government is not likely to succeed against a competitive world economy. Unless the nation is extremely lucky, it is likely to invest in the wrong technology and commit resources to produce products for which there is no international market. The failed efforts of GE and RCA in the 1950s were repeated by other giant corporations throughout the twentieth century. Exxon invested over a billion dollars to create an office automation business that never sold a single unit. AT&T also tried to enter the personal computer business and failed. Nations which try to outguess and out-perform the market are likely to have similar fates.

If planning innovation does not work, what does? I would suggest that the person who has thought best about the issue of what works is Michael Porter of the Harvard Business School. His book, *The Competitive Advantage of Nations*, is the most direct and comprehensive discussion of what does and does not work in international competition. The answer he gives is much the same answer that competition agencies would recommend as domestic policy: Competition. The nations that are the leaders in international competition are the nations that face the most competition for sales of a particular product in their own domestic market.

His book discusses successful international companies in many industries. My favorite example is the ceramic tile industry in Italy. Italian tile companies are not large businesses; nevertheless Italy became by far the largest exporter of ceramic tiles in the world. In 1987, it exported $1.4 billion worth of tiles. Italian companies produced only 30 percent of the tiles made in the world, but Italian exports accounted for 60 percent of the tiles that were sold internationally. Its closest rival for international sales was Spain which sold a total of 11 percent of exported tiles. What makes this example so important is that even though Italy is the export leader, it has no large tile manufacturers. The largest Italian tile firm manufactured 5.3 percent of the total tiles made in Italy. The twenty largest tile firms together made less than 40 percent of the tiles made in Italy. Italy had a total of 356 tile making companies and another 200 companies which made tile making equipment.

How did these small Italian companies become the world leader in tile exports? Porter has an extended explanation that starts with the fact that tile making had long been an industry in Italy. It was traditionally used in Italy for flooring instead of wood or rugs. Italians cared about the quality and design of their tiles. As a result of consumer sensitivity to quality there was strong rivalry among the many small firms that made tiles.

Most of these firms were located near each other in Sassuolo. So that when one firm came out with an innovation, the other firms quickly learned about the innovation and worked hard to find a competitive advantage by introducing new techniques and designs of their own. The rivalry became so intense that the tile manufacturers ceased to rely on foreign equipment manufacturers. Instead, they encouraged tile equipment manufacturers to locate their plants close to Sassuolo so they could work together to develop new and improved technologies more quickly. With so many different firms trying to find a competitive advantage, Italy became the world center for tile development.

I like this story because it emphasizes the role of competition without the distraction of high technology or huge capital investments. Most of us in America are familiar with similar stories about Silicon Valley and the California computer industry, but Silicon Valley is a typical story of industrial development not an exceptional one. The American automobile industry developed in Detroit, the steel industry in Pittsburgh, the movies in Hollywood. The industries developed because of competition not despite competition. Only when pushed by the hidden foot of domestic competition did the American firms become world leaders. And when the United States automobile and consumer electronics industries were challenged in their domestic markets by Japan, Japan had more domestic car manufacturers and more manufacturers of consumer electronics than did the United States.

So what can we learn from these examples. First, competition, especially domestic competition matters. Competition is the way businesses learn how to become good and how to become better at doing what they do. Second, not every nation is going to be as good as every other nation in making every product. Some will have natural advantages because they have more demanding local customers. Others will have advantages because of traditions or resources. Still others will have advantages because that country was the first to see the possibility of a new product or new kind of product. But to keep an international advantage, the country will have to be will to continue to compete with all producers and potential producers of the product.

The United States still makes and sells automobiles around the world, but American firms face constant competition. America now makes few of the many consumer electronic products that we buy.

The businesses of every nation must make choices about what they can successfully sell domestically and internationally. They will be aided in international competition if their nation adopts a strong domestic competition policy, including a strong competition law and an effective competition agency. If national monopolies are privatized they should either be broken up into competitive companies to train for international competition or if breaking up a company would make it too small to be efficient, it needs to compete domestically with foreign producers before it is likely to be able to compete internationally. But a firm standing alone will not benefit from having neighbors that compete intensely in the same or related markets.

How then do I answer the questions that I posed at the beginning of this speech? I do think that domestic competition is compatible with the cultures of the ASEAN nations. I also think domestic competition is essential if ASEAN nations are to realize their international economic aspirations. There are economic risks from opening domestic markets to competition. Some firms will fail, but others should prosper. Henry Ford failed twice with car manufacturing companies before he founded the Ford Motor Company that exists today. We learn from what we attempt. If we take no risks, we are bound to fail in international competition because there are firms out there that will take the risks and some of them will succeed. I applaud ASEAN for its willingness to risk competition to reap the rewards of the free market.